THE WHITE HOUSE

WASHINGTON

July 25, 1972

MEMORANDUM FOR

BUD KROGH

Attached is Secretary Volpe's memorandum to Ehrlichman with regard to the Penn Central. I think that the union problems described therein have been overtaken by events; however, the other problems would seem to remain.

Since you have been working on this, could you please review Volpe's memorandum and let us know what should be done as far as a response is concerned.

Thank you.

KEN COLE

Attachment

THE SECRETARY OF TRANSPORTATION
WASHINGTON, D.C. 20590

July 19, 1972

MEMORANDUM FOR: John D. Ehrlichman
Assistant to the President for Domestic Affairs

SUBJECT: Penn Central

Situation: We are faced with the possibility that the Penn Central will cease operation sometime within the next four months. The most imminent dangers are a strike over the crew consist rules and a cash drain as a result of Agnes. The situation is aggravated by the railroad's inability quickly to abandon uneconomic lines or to predict profitable operations. Several substantial creditors have already taken the position that the railroad should be liquidated, and if the unions support that position the Congress may not be willing to legislate the status quo and the Secretary of Transportation may have to exercise his option under the Emergency Rail Services Act of 1970 to operate the railroad to provide essential services.

Looking beyond the immediate, the Penn Central is only one of several railroads in bankruptcy whose operations may cease due to an unexpected worsening of their financial prospect. And there remains the distinct possibility that additional railroads will be pushed into reorganization. Thus, in dealing with the immediate Penn Central crisis, care should be taken to advance those long-term reforms which have been proposed to enhance the viability of our privately-owned surface transportation industry - particularly the railroads.

Issues: The immediate and near-term problems of Penn Central require resolution of four specific issues, as follows:

1. How can the UTU be prevented from closing down the Penn Central while at the same time permitting Penn Central management to achieve further economies in the work force by attrition?

2. How can the flood damage and resulting aggravated cash crisis be cured with the least objectionable form of Government assistance?

3. How can Penn Central most quickly abandon its uneconomic mileage, without instigating an uproar from towns and shippers that will lose service?

4. What else can be done to assist Penn Central (and other railroads) to achieve profitable operations as private enterprises?

Background:

A. Plan for Reorganization. On April 3, 1972, the Trustees appointed by Judge Fullam* filed a Plan for Reorganization in which they stated that the railroad could be reorganized by 1976 on four conditions:

1. Reduction in surplus employees (approximately 9,800);

2. Elimination of uneconomic freight lines (approximately 9,000 out of 20,000 miles);

3. Full compensation for passenger services ($97.2 million additional compensation--$32.5 million from Amtrak and $54.7 million from commuter operations); and

4. Substantial increase in freight traffic and revenues.

The Trustees envision being able to implement a restructuring of debt and equity as soon as they get $275 million in hand and can predict being able to generate at least that much net railway operating income annually.

B. Possible UTU Strike. Before filing the Plan for Reorganization the Trustees had already taken steps to reduce their payroll. In June 1971 they sought the right to determine crew consists. The UTU resisted, negotiations followed, and finally the President appointed an Emergency Board. The Board Report, issued May 15, 1972 invited the parties to negotiate crew sizes locally and offered to render a binding decision in January 1973 if the parties could not settle all their differences in the meantime. The UTU accepted the Board's Report, but refused to agree that the Report meant the railroad did not have to hire new trainmen to meet current consist rules. The Trustees thereupon sought Judge Fullam's approval to post new work rules and the UTU sued Penn Central in the district court here.

On July 12 Judge Fullam instructed the Trustees to post notice of crew consist changes effective 14 days later provided the parties could not reach agreement in the meantime. The

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* George P. Baker, Richard C. Bond, Jervis Langdon, Jr. and Willard Wirtz.

railroad posted the notices on July 12 with implementation set for July 26.

Both parties began a series of negotiating sessions on July 17 under the auspices of the Department of Labor, which is directing their efforts to reach an agreement by proposing alternatives which incorporate the attributes of both the Report of the Emergency Board and Judge Fullam's decision. Those negotiations are currently in progress.

In the event new crew consist rules are placed into effect without an agreement with the UTU, the President of the UTU has authorized local officers to strike the railroad.

We anticipate that the Trustees will stick to their position even if it means a strike. Otherwise they will have undercut one of the premises of reorganization.

C. Penn Central Operations and Economic Outlook. One of the key assumptions made by the Trustees is that by 1976 traffic will increase by 17.6%. This increase, coupled with freight rate increases and a more favorable commodity mix, is forecast to result in a 41% increase in revenues, from $1.5 billion to $2.2 billion.

This is an ambitious revenue goal because it assumes significant traffic growth. The trends, however, have been unfavorable. In a period of economic recovery and expanding production, ton-miles for the first five months of 1972 are off 2% from the Trustees' forecasts.

As a result of the labor agreement made to facilitate the merger, Penn Central has the highest average train crew complement in the railroad industry. Three-man crews, the goal of the Trustees, are presently in service on several other carriers (e.g., the Chicago Northwestern).

The floods triggered by Agnes not only have increased Penn Central's immediate costs of operation, but also will cause additional loss of traffic, both short and long run. In the short run traffic has declined due to the shutdown of industries served by Penn Central and the railroad's inability to provide service in many areas.

In the long run, Agnes will continue to hamper Penn Central's ability to improve its traffic base. First, all of the eastern rail carriers were hard hit. Traffic diversion was not from Penn Central to other rail carriers but to other modes, making recapture difficult. Secondly, some of the industrial plants in the East damaged by the flood will not be replaced, affecting Penn Central's overall traffic base.

The effect of a strike on traffic will be much the same as that of the floods. In the short run, traffic will be diverted to other railroads and other modes. In the long run, the strike will cause traffic managers to look for permanent alternatives for at least that traffic which they feel must move regardless of Penn Central difficulties. Shippers will turn to distribution systems upon which they can rely, as any short term disruption in distribution patterns can quickly outweigh the lower shipping costs offered by rail. These developments cast considerable doubt on Penn Central's ability to achieve the traffic levels that they state are necessary for survival, assuming their competitive stance remains unchanged. Such a change in competitive stance, however, could flow from the reduced crew sizes, to the extent the cost savings are reflected in more competitive rates or service. In addition, the rail abandonments proposed by the Trustees, and the other regulatory reforms and financial assistance which the Administration has proposed to the Congress, offer an even greater hope of improvement in the competitive stance of Penn Central and other railroads.

D. Agnes and Cash. The Penn Central cash position has been precarious ever since it filed for reorganization. Toward the end of 1971 it looked as if Penn Central might run out of cash, even if it drew down the last $25 million against the trustees certificates guaranteed by the Government under the Emergency Rail Services Act of 1970. (It had long since drawn down $75 million. The other $25 million authorized under the Act has either been used or will be needed by other railroads in reorganization.)

Agnes has jeopardized the short term cash position. The railroad now says it needs $21.6 million to restore essential facilities. With the extra operating expenses and losses of income described above, the last $25 million of trustees certificates probably will not be enough to keep the estate solvent. Restoration of essential services for all the railroads in the Northeast affected by Agnes will probably require approximately $40 million for facilities and equipment, and we have proposed to OMB that the Department of Transportation be authorized to make direct loans to railroads in reorganization or operating unprofitably. In order to make such a loan acceptable to Penn Central and Judge Fullam, and to overcome objections from other creditors, interest on such loans would have to be deferred for five or ten years and the Government would have to accept a low priority creditor status, without any security for the loan.

Recommendations:

A. The Administration should transmit to Congress a resolution imposing upon the parties legislatively the recommendations contained in the Emergency Board Report. Two recommendations should be modified to advance the reporting date and the date for the Board's final report (if such report is necessary). Such a resolution would require the parties:

1. to refrain from self help measures (strikes or the unilateral promulgating by the railroad of a new crew consist rule);

2. to continue bargaining at the local level while permitting crew size reduction by attrition;

3. to report on bargaining progress to the Board on September 15 and October 15, 1972; and

4. to abide by the final recommendations of the Board issued within ten days after the reconvening of the Board for the purpose of making such recommendations, if necessary, on November 15, 1972.

The Administration should also press for enactment of the Crippling Strikes Act (or Senator Packwood's substitute), but it would have to be amended to be clearly applicable to this strike.

The alternatives are to reconvene the Board, but that would undermine its authority and delay resolution of the issue (which Penn Central cannot afford); or explicitly to legislate arbitration for this case, but that would fail to take advantage of the binding arbitration implicit in the Board's Report and would provoke labor opposition generally.

B. The Administration should request Congress to authorize and appropriate $40 million for loans to railroads in reorganization and unprofitable railroads to restore essential facilities, equipment and services destroyed by Agnes and the South Dakota flood in June. The rate of interest should be the same as that available to other industry under the SBA authority, and the Secretary of Transportation should be authorized to defer the payment of principal and interest for ten years, to waive security, and to accept the position of a subordinated creditor. This is the only kind of loan which Penn Central would accept or could get from the court, and for policy reasons it is preferable to an outright grant, the only other way of avoiding a cash crisis for Penn Central that would lead to early liquidation.

C. Section 77 of the Bankruptcy Act, the railroad reorganization statute, has some very serious defects. These problems have, under the current crisis situation among the northeastern railroads, become intolerable if a system of privately owned railroads is to be preserved in this part of the country. Therefore we propose a revision of Section 77 which accomplishes the following things:

1. It requires the trustees of the debtor to abandon lines which do not yield enough revenues to cover their cost or show cause to the court why they should not be required to do so.

2. It imposes new criteria for the abandonment of railroad lines of the debtor which, in essence, require the Interstate Commerce Commission (1) to immediately authorize the abandonment of low-density lines whose users have an effective alternative mode of transportation and (2) to authorize the abandonment of low-density lines where no effective alternative mode of transportation exists for its users if a way has not been found to make such a line cover its cost.

3. It requires the trustees of the debtor promptly to raise those of the debtor's charges which are below the average variable costs related to shipments under similar circumstances of railroads not undergoing reorganization which operate in the same region or territory of the debtor and it makes unlawful any such rates which are not raised to that level within a year from the enactment of the bill.

4. It permits the trustees of the debtor to propose a merger or consolidation of the debtor with another railroad as part of its plan of reorganization without approval of the debtor's board of directors.

5. It permits a merger or consolidation of the debtor with another railroad to be approved as part of its plan of reorganization without prior approval by the Interstate Commerce Commission and with only such employee protective arrangements as the court finds would be fair and equitable and would not endanger the viability of the reorganized or merged railroad.

6. It removes the requirement that the Interstate Commerce Commission hold hearings on and approve a plan of reorganization before the court may do so. It leaves approval of the plan completely up to the court, with the Commission relegated to the role of a party in the proceedings before the court.

The first three paragraphs above were proposed by us to OMB late last year as part of the draft Railroads in Reorganization Assistance Act of 1972. Assuming resolution of the labor and emergency flood problems, this change in Section 771 would make the reorganization of Penn Central feasible. It is also responsive to the current problems facing other bankrupt railroads. They could resolve those problems where there is a real need for their services and they could do so before the enormity of their losses and the Constitutional rights of their creditors compel their liquidation.

D. Last November we sent to the Congress a package of two bills: the Transportation Regulatory Modernization Act and the Transportation Assistance Act. These bills were interrelated, the latter offering significant financial assistance to the railroad industry (insurance of equipment obligations up to $3 billion; research and development for a national rolling stock scheduling and control system; and related demonstration projects), and the former bill proposing regulatory reforms applicable to railroads and regulated truck and water carriers, intended to improve the long-term financial viability of surface transportation under private ownership (streamlining railroad abandonment procedures; encouragement of rate competition among and between railroads, trucks and barge lines by creating a zone within which rates would be determined by carriers and not subject to regulation on grounds of reasonableness; reduction of the ability of all carrier modes to agree on the levels of rates in rate bureaus; and liberalization of the entry of new carriers and large-scale abolition of existing restrictions in carrier certificates governing routes served, commodities carried, equipment used, etc.).

The assistance proposals appear to be moving forward, but not all of our regulatory proposals have fared well in the Congress, due principally to strong opposition from the regulated carriers, particularly the truckers. Those regulatory proposals that offer immediate benefit to Penn Central (expedited abandonments and a floor under rates) appear to have solid Congressional support. Notwithstanding strong endorsement in the State of the Union Message, strong support and testimony before both Houses, and intense personal lobbying by ourselves and others in the Administration, the Committees have thus far omitted meaningful regulatory reforms as it would apply to modes other than railroads and have not indicated acceptance of the other parts of our regulatory package as it would apply to railroads. Moreover, the Committees appear bent on adding to our financial assistance proposals a separate $2 billion authority to guarantee loans for infrastructure improvements, principally roadbed repairs.

Unless some major new impetus can be brought to bear, it seems clear that the Congress is likely to pass a major money bill promoting aid to the railroads, with only some parts of our regulatory reform.

The current Penn Central crisis may offer an opportunity to make more legislative progress with regulatory reform than has thus far appeared possible. The regulated truckers have expressed sincere concern at the prospect of Federal ownership of our railroads, and accordingly they have supported legislation which gives major financial assistance to the railroads. The immediate Penn Central crisis can only have heightened the trucking industry's concern about possible Federal intervention in the railroad business, and therefore Administration support for immediate financial assistance to the Penn Central (including the Agnes bill) could be used to assuage trucker opposition to our regulatory reform. The regulatory reforms we have proposed are badly needed in the long run, and we should use every opportunity to secure them.

A less ambitious objective would have us seek railroad acquiescence in and trucker toleration of full-scale railroad regulatory reform--our regulatory bill limited to railroads. Congressman Brock Adams' current working draft could serve as a basis for such a bill and a model for regulatory reform for the other modes.

E. The immediate Penn Central crisis is part of a much larger, fast changing railroad problem. We are reconvening the Interagency Committee on Railroad Reorganization to monitor the situation as it develops with Penn Central and other financially vulnerable and bankrupt railroads and to prepare contingency plans accordingly.

John A Volpe