Morgan Stanley has basically promised to solve all the complex problems connected with this transaction with incredible ease. The Government will avoid all the risks of the sale, the Conrail workforce will be immune from many job losses, the Treasury will reap enormous benefits because no one connected with the proposal will even consider taking any form of tax deduction, and the intractable dilemmas of the Northeast rail industry over the past 20 years simply vanish, like the morning mist.

What can be made of these claims by Morgan Stanley concerning its proposal? The most appropriate response todate was probably made by Senate Commerce Committee Chairman John C. Danforth, who remarked after hearing the rosy claims of the Morgan Stanley witness, "I used to believe that when you are told something was too good to be true, it is." Upon close scrutiny, many of the claims made by Morgan Stanley seem more like Morgan's myths.

Morgan Myth #1: Norfolk Southern has allegedly not offered to pay a full and fair price for Conrail. After months of trumpeting this allegation, the Morgan proposal came in at exactly the same amount - $1.2 billion - as that offered by Norfolk Southern. As the Pittsburgh Post Gazette said in its editorial of May 21, 1985,

> "One might expect many of the most vocal supporters of Morgan Stanley's new offering to be very red-faced. For several months, they've been complaining loudly that Norfolk Southern is proposing to steal Conrail from the taxpayers. Now they turn around and offer to buy it for the same amount."

<u>Morgan Myth #2</u>: Conrail management has led the railroad to an incredible turnaround, with an impressive profit record over the past four years. This record is clear evidence of Conrail's ability to prosper in the private sector.

As explained in the Senate Commerce Committee Report, Conrail's recorded profits <u>overstate</u> its actual position to a significant degree. The Senate Report points out that "a major share of the profits recorded by Conrail over the past 4 years resulted solely from government ownership.

This occurred for three reasons. One, the Federal Government paid Conrail's labor protection in the amount of $20-120 million per year. Two, Conrail has been free from payment of State taxes, saving $25-30 million per year. Three, Conrail has paid below standard wages under the 1981 agreement with rail labor, worth about $120-130 million per year.

Without these significant advantages, Conrail would not have earned a profit in 1981 and 1982 -- it would have experienced serious losses. Further, it would have experienced these losses in 1981 despite borrowing $135 million from the Federal Government. In 1983, Conrail would have recorded a profit of only $90 million, instead of $313 million. Even this $90 million is a great overstatement of income from rail operations, since Conrail earned almost that amount in 1983 through selling tax benefits to other corporations (which, of course, is a direct and significant revenues loss to the Federal Government). In 1984, Conrail's profits would not have been $500 million, but a more modest $288 million. The total value of these advantages over the period 1981-1984 is more than enough to reduce Conrail's much touted 1984 year-end cash balance of $845 million to zero.

<u>Morgan Myth #3:</u> The impressive list of sophisticated investors in the Morgan Stanley Proposal is proof of these investors' belief in Conrail's long-term viability.

To put it simply, these investors won't be around long enough to know or care about Conrail's long-term viability. The participation of these investors is proof only that they believe they will be able to resell their stock to the public, at a profit, in fairly short order, based on a projected dividend set at twice the industry norm. There is nothing novel about stock speculators being interested in making a quick profit, but it is clearly misleading to suggest that that interest is somehow related to a deep faith in the long term health of the railroad. In fact, taking cash out of Conrail to allow these quick profits to investors will inevitably lead to long-term financial weakness, not health and viability.

<u>Morgan Myth #4:</u> A stand alone Conrail after the Morgan Stanley public offering will be a financially strong, viable railroad for the long term.

Morgan Stanley presents an extremely upbeat picture of Conrail's future, which of course is to be anticipated. This is the biggest myth of all, and also the most dangerous.

First, it is clear that the Northeast regional economy has undergone a dramatic and irreverisble change. The annual tonnage in 1984 was just <u>one half</u> of the tonnage in 1964.

Second, the viability of Conrail is greatly affected by only slight decreases in revenues. Operating leverage, this is called, and railroads all have it. Conrail is more vulnerable than NS because it leases all its equipment and because it doesn't pay any income taxes. In the first quarter of 1985, for example, Conrail's revenues were only 6% below last year, but its net income was down 40%. Under the best of all possible worlds there may not be a recession in the next 5 years, but if there is, it will have a dramatic, negative impact on Conrail's profits. The result will inevitably be deferred maintenance and postponed capital investment, starting down the all too familiar path of railroads in the northeast. This problem became worse without a "loss of business clause." Such a clause would allow Conrail to cut back its forces when a severe business decline occurs.

Third, the rail industry in general is faced with increasingly intense competition from trucks. Nowhere is the problem of truck diversion more acute than in the northeast region served by Conrail. Not only does this make Conrail vulnerable to further traffic loss, but also clearly limits Conrail's ability to increase revenues through rate increases - anything beyond very minimal increases will simply drive more traffic to trucks.

If Conrail cannot realistically expect major revenue gains, then in order to remain financially stable it must take significant steps to control costs. The problem here is that the basic efficiencies available to Conrail have in fact already been achieved - Conrail cut off 17,000 freight employees from 1981 to 1984, and abandoned thousands of miles of track. The fat has been taken out of the system. While further job loss would inevitably occur with a stand alone Conrail, it probably won't be at nearly the levels of past years, and further abandonments will start to cut into the heart of the system. More importantly, the fact that the only road to Conrail's long-term viability as a stand alone carrier would involve downsizing of its system, with the resulting pain to shippers, labor, and affected communities, is a matter of grave concern.

An analysis based on these hard facts, accordingly, led the Senate Committee on Science, Transportation and Commerce to conclude, in its report:

> "Thus, the nature of the Northeast economy and Conrail's traffic base are such that questions must be raised about Conrail's future and its ability to remain viable as more than a marginal carrier. The concern raised about the strength of Conrail's current financial picture, together with the doubts raised about the traffic base . . . raises a question about Conrail's viability without curtailing service and employment or without additional resources and funds."

Interestingly enough, probably the most eloquent statement of dilemma facing a stand alone Conral comes from none other than the CSX Corporation, one of the leading forces in the effort to block the sale to Norfolk Southern. In a letter to DOT Secretary Dole, Chairman & CEO Hays T. Watkins, said:

> ". . . the Northeast area will not long support three major duplicative rail systems in good financial health . . . Conrail remains untested over a full turn of the business cycle, let alone several such turns. Its recent earnings must be seen as a short-term aberration that will most surely disappear once Conrail loses the benefits of government financing and the special advantages it has enjoyed under government ownership.
>
> "In summary, rail traffic in the Conrail service area will not grow, and is likely to continue its decline over any foreseeable period. 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, causing turmoil in its region . . .""