[COMMITTEE PRINT]

THE PENN CENTRAL FAILURE AND THE ROLE OF FINANCIAL INSTITUTIONS

PART I

EFFECTS OF PENN CENTRAL'S DIVERSIFICATION PROGRAM ON THE RAILROAD'S CASH POSITION

STAFF REPORT OF THE
COMMITTEE ON BANKING AND CURRENCY
HOUSE OF REPRESENTATIVES
91st Congress, Second Session

NOVEMBER 2, 1970

Printed for the use of the Committee on Banking and Currency

U.S. GOVERNMENT PRINTING OFFICE
51-903 WASHINGTON : 1970

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price 10 cents

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LETTER OF TRANSMITTAL

November 2, 1970.

To Members of the Committee on Banking and Currency:

Transmitted herewith for use by the Banking and Currency Committee and the Congress is Part I of the staff report on *The Penn Central Failure and the Role of Financial Institutions*. Part I deals with a fundamental issue involved in the recent history of the Penn Central and one of its principal predecessors, the Pennsylvania Railroad: *The Effects of the Penn Central's Diversification Program on the Railroad's Cash Position*.

Former top officials of the Penn Central have consistently claimed to the Congress and the public that the diversification program begun in 1963 was a tremendous success. A careful examination of the diversification program reveals, however, that this program, rather than financially supporting the railroad's operations, proved to be a very serious drain on the railroad's financial resources amounting to at least $175 million and contributed significantly to the Penn Central's ultimate financial collapse. It is of more than passing interest to place this $175 million up against the $200 million loan guarantee requested by the railroad from the government in June, 1970.

In addition, the use of credit lines by the Penn Central to finance this diversification program, principally in real estate development, proved a serious problem in attempting to secure additional bank financing when the liquidity crisis hit the railroad in the spring of 1970. This diversification program was largely supported by bank loans from major Eastern banking institutions that were also the principal sources of the railroad's financing.

As mentioned above, as well as discussed with the Committee at the executive session of September 15, 1970, the material transmitted herewith is but one of several aspects of the collapse of the Penn Central Transportation Company that is being investigated by the staff. Other parts of the investigation will deal in detail with such matters as specific aspects of diversification; possible conflict of interest situations involving officers and directors of Penn Central in their personal financial transactions; and the relationship between commercial banks and other financial institutions, and Penn Central and its subsidiaries prior to the collapse of the Penn Central. These additional parts of the staff report will be forthcoming in the next several weeks.

The views and conclusions found in this report do not necessarily express the views of the Committee or any of its individual Members.

Wright Patman, *Chairman.*

THE PENN CENTRAL FAILURE AND THE ROLE OF FINANCIAL INSTITUTIONS

PART I

Effects of Penn Central's Diversification Program on the Railroad's Cash Position

HISTORICAL ASPECTS OF PENN CENTRAL'S DIVERSIFICATION PROGRAM

For many years, the Penn Central corporate complex has consisted of many companies either owned or controlled by the Pennsylvania Railroad Company (subsequently renamed the Penn Central Transportation Company following the merger with the New York Central Railroad in February 1968). These companies, prior to 1963, consisted entirely of other railroads or companies engaged in railroad-related activities. Up to that point in time, ownership of non-railroad-related companies by the Pennsylvania Railroad was nonexistent.

This program of ownership or control of other railroads and railroad-related companies has proven to be very successful over the years. These companies, primarily through the payment of dividends, have provided and continue to provide significant sums of cash to the parent Railroad.

Beginning in 1963, the Railroad embarked on a diversification program completely different from its previous acquisition program. For the first time, the Railroad began to acquire control of non-railroad companies. Within the next few years, the Railroad made four major acquisitions under its new diversification program: (1) Buckeye Pipe Line Company; (2) Great Southwest Corporation; (3) Arvida Corporation; and (4) Macco Corporation. The latter three companies are all real estate investment and development companies.

The companies were all acquired through the Pennsylvania Company, the Railroad's 100-percent-owned subsidiary holding company. In the case of each acquisition, large sums of cash were needed to acquire sufficient stock to gain control of the companies.[1]

By the end of calendar year 1965, the acquisition of the four companies was substantially completed. In total, the Pennsylvania Railroad, primarily through the Pennsylvania Company, invested a total of about $144 million of cash in these four companies. Much of the cash used in the diversification program was obtained through bank loans.

EFFECT OF DIVERSIFICATION PROGRAM

With the ultimate collapse and placement in reorganization of the Penn Central Transportation Company, many aspects of the Railroad's activities have been subjected to close scrutiny by various

[1] To acquire 100 percent ownership of Buckeye, a combination of stock purchases and issuance of Pennsylvania Company preferred stock in exchange for Buckeye common stock was used. The preferred stock issued by the Pennsylvania Company to the stockholders of Buckeye requires annual cash dividend payments by the Pennsylvania Company.

sources. Much of this attention has been focused on the Railroad's diversification program and the effect of the subject program on Railroad operations.

Many questions have been raised concerning the diversification program. Some of the more significant questions include:

1. Should the Railroad have embarked upon this diversification program?
2. Was this the best possible use of the $144 million in cash?
3. Could this $144 million have been used more productively by investment in the Railroad in order to enhance the profitability of the Railroad, in such projects as (1) upgrading of railroad beds, (2) overhauling and refurbishing of railroad equipment, (3) purchase of new, modern equipment, etc.?
4. Did use of the $144 million in cash on diversification represent a serious cash drain from the Railroad that significantly contributed to its ultimate collapse, since the Pennsylvania Company could have given the cash directly to the Railroad through dividend payments and loans?
5. Did the use of bank loans to finance part of the cost of the diversification program dry up lines of bank credit that could have been used to assist the Railroad during its period of tight cash needs prior to its collapse?
6. Could the Railroad have avoided or at least delayed financial collapse, if the cash and bank loans used for diversification had been applied, instead, to meeting the cash needs of the Railroad?

POSITION OF PENN CENTRAL OFFICIALS

Penn Central officials, in public statements and in appearances before Congressional Committees, have emphatically maintained that cash generated by the four companies acquired during the diversification program helped to provide the money necessary to keep the Railroad running in the face of significant operating deficits. The position of these officials is probably best typified by statements made by David C. Bevan in his appearance before the Senate Commerce Committee on August 6, 1970. Mr. Bevan, the former Chief Financial Officer for the Railroad and one of the architects of the diversification program, stated:

> In summary I believe our financial management over the years has been good. Even with all the adverse circumstances I have outlined, we were able to *produce the money* necessary for the operating people to keep the railroad running in the face of deficits and that was no small job.
>
> I might add that it would not have been possible without *the income made available* through our new diversification program.
>
> Our first acquisition was Buckeye Pipe Line in 1964, followed by Great Southwest, also in 1964, and Arvida and Macco in 1965. . . . All in all, from the Pennsylvania Railroad side, we invested a total of approximately $144 million of cash in this diversification program, of which only about three-quarters of a million dollars came from the Transportation Company. The system realized a return of $146 million from these investments from the date of acquisition through 1969, approximately five years in all. Those dividends and income from other non-railroad properties, have served to blunt the losses from passenger service and have provided the margin necessary for continued operation of the Railroad. In other words, our investment in non-railroad companies yielded a much better return than the railroad itself, which would have been in much more serious trouble without the benefits of diversification." [Emphasis supplied.]

ANALYSIS OF MR. BEVAN'S STATEMENTS

A reading of the above-quoted excerpts from Mr. Bevan's statements before the Senate Commerce Committee leaves two initial impressions.

(1) That the diversification program begun in 1963 was a resounding success, with the Penn Central corporate complex realizing a return of more than 100 percent on its investment in a little over five years; and

(2) That significant amounts of cash flowed up from these four subsidiaries to the Railroad to help keep the Railroad afloat during the period of time it was encountering enormous operating deficits.

A detailed analysis of Mr. Bevan's cited figure of $146 million return on investments from the diversification program points out some very interesting facts. Mr. Bevan's "return of $146 million" is comprised of the following:

Type of return:	*Millions*
Dividends	$37.8
Tax allocation	8.0
Interest	2.9
Undistributed earnings	115.2
Total	163.9
Less: Dividends paid by Pennsylvania Co. on preferred stock issued in exchange for Buckeye common stock	17.9
Net return on investment	146.0

The most important factor concerning Mr. Bevan's figures is that only the dividends of $37.8 million paid by the subsidiaries represent actual cash flowing up from the subsidiaries towards the Railroad. Part of the "tax allocation" and all of the "interest" was paid through the issuance of stock to the Pennsylvania Company by the subsidiary involved, not with cash. The remainder of the tax allocation is still unpaid and outstanding.

"Undistributed earnings", while ostensibly impressive for accounting purposes, do not represent any cash flow unless they are eventually paid out in the form of cash dividends. To date, none of the $115.2 million in undistributed earnings has been paid out in dividends to the Railroad and, based on the cash position of the subsidiaries, there is no indication that this will occur anytime in the immediate future.

Therefore, if one limits the use of Mr. Bevan's figures to those representing actual cash flow, we find that only $19.9 million in cash flowed up towards the Railroad during the subject five years on a cash investment of $144 million, hardly an impressive return. This is computed as follows:

	Millions
Cash dividends paid by subsidiaries	$37.8
Less: Dividends paid by Pennsylvania Company on preferred stock issued in exchange for Buckeye common stock	17.9
Net cash flow up towards Railroad	19.9

Further analysis of the cash dividends paid by the four subsidiaries points out the following interesting facts. Of the $37.8 million in cash dividends paid by the four subsidiaries, about $33.5 million came from the Buckeye Pipe Line Company. Buckeye was the first acquisition under the diversification program, and the only one of the four companies acquired that does not engage in real estate investment and development. In fact, Buckeye's activities are so closely related to the transportation business in which the Railroad is engaged that Buckeye operates as a common carrier under the jurisdiction of the Interstate Commerce Commission.

Elimination of Buckeye's cash dividend payments from the above calculation leaves the total cash flow up to the Railroad from the three real estate subsidiaries at about $4.3 million over a five-year period. When compared to the Railroad's total cash investment in these three companies—about $114 million—the return cash flow from the three real estate subsidiaries is very unimpressive. In fact it would appear that the Railroad might have realized a greater rate of return by simply investing this money in improving the Railroad, rather than venturing into real estate development.

In sum, based on the cash flow figures, the diversification program was anything but the resounding success various Penn Central officials have described it to be. For the five-year period referred to by Mr. Bevan, the total cash flow up towards the Railroad from the four subsidiaries averaged less than $4 million a year. It is apparent, using Mr. Bevan's own figures, that the diversification program did not provide large sums of cash for the Railroad during its tight cash position in the years immediately preceding its collapse, despite his claims to the contrary.

Another interesting point is Mr. Bevan's statement that, of the $144 million invested in the diversification program, only "three-quarters of a million dollars came from the Transportation Company." While this statement may be technically accurate, it does not take into account the nature of the relationship between the Railroad and the Pennsylvania Company. Since the Pennsylvania Company is 100 percent owned by the Railroad, it can make its cash resources directly available to the Railroad through dividend payments and loans. Thus, the cash resources of the Pennsylvania Company are, in fact, potentially the cash resources of the Railroad.

The $144 million expended by the Pennsylvania Company on diversification involved the use of funds that ultimately could have been made available to the Railroad. Accordingly, it is clear that the diversification program, in effect, represented a very substantial cash drain on the Railroad.

INVESTIGATION BY STAFF OF HOUSE COMMITTEE ON BANKING AND CURRENCY

As part of its investigation into the collapse of the Penn Central Transportation Company, the staff of the House Committee on Banking and Currency has examined the diversification program and its effect on the cash position and cash needs of the Railroad. The Committee staff limited this part of its investigation to the cash flow aspects of diversification—a comparison of the cash flow down from the Railroad and Pennsylvania Company into the four subsidiaries with the cash flow up from the four subsidiaries towards the Railroad.[2]

[2] The investigation did not concern itself with profit and loss statements, undistributed earnings, or accounting techniques for calculating rates of return on investments. Rather, it concerned itself with the fundamental question: What effect did the diversification program have on the cash position of the Railroad?

The examination discloses that the diversification program had serious negative effects, both direct and indirect, on the cash positions of the Railroad. As discussed below in more detail, it has been found that (1) the total cash investment in the diversification program was a serious cash drain on the Railroad and far exceeded the $144 million direct cost of acquiring the four subsidiaries, and (2) the diversification program may have seriously affected the lines of bank credit available to the Railroad.

TOTAL COST OF DIVERSIFICATION PROGRAM

Analysis of figures supplied to the Committee by the Railroad show that the total direct cash investment in the four subsidiaries was approximately $144 million, as follows:

DIRECT CASH INVESTMENT IN COMPANY

Company acquired	Parent Railroad	Pennsylvania Co.	Total
Buckeye Pipe Line Co	0	$30,042,869	$30,042,869
Great Southwest Corp	$738,150	51,225,637	51,963,787
Macco Corp	0	39,450,702	39,450,702
Arvida Corp	0	22,046,893	22,046,893
Total			143,504,251

However, the figures supplied by the Railroad do not give consideration to the costs of financing the diversification program. At the time the Railroad embarked upon the diversification program, it had outstanding debt of several hundred million dollars. For example, had the $144 million used for diversification been applied to reducing this outstanding debt, the Railroad's interest costs for financing its outstanding debt would have been reduced proportionately.

The decision to diversify meant that the Railroad was deprived of the potential use of $144 million in cash at a time when it was heavily in debt. To compensate for this loss, it must be assumed that the Railroad borrowed sufficient funds to replace the funds lost through diversification. While no detailed effort has been made to calculate the exact interest costs incurred by the Railroad as a result of having to finance the replacement of funds lost to it through diversification, preliminary calculations indicate the cost exceeds $51 million.[3]

Based on these calculations, it is estimated that the total cash cost of the diversification program is at least $195 million—direct cash investment of $144 million, plus interest costs of at least $51 million incurred in financing the diversification program.

Using this conservative figure—$195 million—as the cash cost of the diversification program, it appears that the diversification program resulted in a net cash drain from the Railroad of approximately $175 million, calculated as follows:

[3] Interest cost calculations were based on the net cash outlays for each year. Interest rates used were the average rates charged the Railroad in each year for equipment financing. Interest was computed on a simple interest basis. Computing the interest on a compound basis would have significantly increased the interest costs incurred in financing the diversification program.

Cash Flow Down From Railroad:	*Millions*
Direct cash investment in companies	$144.0
Dividends paid by Pennsylvania Co. on preferred stock issued in exchange for Buckeye common stock	18.0
Interest costs of financing diversification program	51.0
Total	213.0
Less: Cash flow up to railroad: Cash dividends paid by subsidiaries	38.0
Net cash drain to Railroad	175.0

Based on the above figures, it is quite evident, on a cash flow basis, that the diversification program was extremely detrimental to the cash position of the Railroad. The Committee staff believes that the net cash drain from the Railroad of at least $175 million at a time when the Railroad was faced with a critical cash shortage, significantly contributed to the ultimate collapse of the Railroad. The significance of this sum is even more evident when compared with the abortive proposal in June of this year to have the Government guarantee a $200 million loan to the Railroad to meet critical cash needs.

OTHER NEGATIVE EFFECTS OF THE DIVERSIFICATION PROGRAM

Examination also discloses that the diversification program had other negative effects on the cash position of the Railroad, particularly as relates to the drying-up of bank lines of credit potentially available to the Railroad.

As stated previously, much of the cash used in the diversification program was obtained through bank loans. In addition, the Railroad had to finance sufficient sums of cash to compensate for the cash drain resulting from the diversification program. In these instances, the diversification program was drying up lines of credit that potentially could have been available to the Railroad during its period of tight cash needs prior to its collapse.

The committee staff also found that the diversification program indirectly affected the Railroad's potential lines of credit. Subsequent to their acquisition by the Railroad, the real estate subsidiaries embarked on major expansion programs. In financing these expansion programs, the subsidiaries drew upon the same sources of credit, including bank loans, that the Railroad used to finance its cash needs.

For example, several large eastern banks, which previously had supplied the Railroad with credit for many years, became heavily involved in financing the activities of the real estate subsidiaries acquired by the Railroad. Thus, the subsidiaries were competing with the railroad for the same limited sources of credit at a time when the Railroad was having trouble obtaining needed financing. (See table, page 7.)

A subsequent part of this report, to be issued at a later date, will deal in more detail with the banks' involvement in the Railroad's diversification program.

EXAMPLES OF LOANS BY EASTERN BANKS TO REAL ESTATE SUBSIDIARIES OF PENN CENTRAL

Company Receiving Loan	Date of Loan	Bank Making Loan	Amount of Loan
Great Southwest Corporation	Dec. 1, 1969	Provident National Bank	$3,000,000
Arvida Corporation	June 13, 1969	First National City Bank	5,400,000
Great Southwest Corporation	Dec. 18, 1969	Provident National Bank	5,000,000
Arvida Corporation	Dec. 11, 1968	Chase Manhattan Bank	4,350,000
Arvida Corporation	Apr. 11, 1969	Chemical Bank of New York	2,500,000
Great Southwest Corporation	June 30, 1969	Provident National Bank	1,000,000