



# U.S. Senate Committee on Appropriations

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## **U.S. Senate Appropriations Transportation and Housing and Urban Development Subcommittee Testimony of David Tornquist, USDOT Office of the Inspector General**

WASHINGTON, D.C. . The U.S. Senate Appropriations Transportation and Housing and Urban Development Subcommittee on Wednesday held a hearing to examine the proposed Fiscal 2008 budget for Amtrak. The subcommittee heard from Mr. David Tornquist, Assistant Inspector General, Competition and Economic Analysis, Office of the Inspector General, U.S. Department of Transportation. Mr. Tornquist's prepared testimony is below.

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I appreciate the opportunity to present the views of the Office of Inspector General on Amtrak's Fiscal Year (FY) 2008 financial needs, its recent efforts to improve its financial condition, and alternatives for financing intercity passenger rail. My statement today will draw upon the Quarterly Reports on Amtrak's Savings from Operational Reforms your committee and your House counterparts have requested of our office, as well as other work we have undertaken on Amtrak's financial and operating performance.

**Amtrak's Condition Remains Precarious.** Amtrak set records in both ridership and ticket revenue in FY 2006, ended the year with over \$200 million in the bank, and achieved \$61 million in savings from operational reforms. Does this mean Amtrak has turned the corner operationally and financially? No, unfortunately, it doesn't. While improvements have been made, we believe Amtrak's condition remains precarious.

Amtrak deserves credit for the recent progress it has made in providing improved service and achieving cost savings. The result of this progress is evident in Amtrak's improved ridership and revenue. Nevertheless, Amtrak has a long way to go before it can reach, let alone turn, the proverbial corner. Systemwide, on-time performance declined for the fifth consecutive year, operating losses remain unsustainably high, the infrastructure still shows the toll of years of underinvestment, and debt service continues to significantly cut into available funds. Much has been done to improve Amtrak, but much more work remains.

**Amtrak Requires More in Capital and Less in Operating Subsidy in FY 2008.** Based on the information available today, Amtrak would need \$465 million available to it in FY 2008 for cash operating losses, \$600 million for capital spending, and \$285 million for debt service to operate a nationwide system while maintaining modest progress towards achieving a state of good repair. As Amtrak revises its revenue and expense estimates during the year, our estimate also may change. Not all these funds need come from direct appropriations, some could come from Amtrak's cash balances, depending on its projected yearend cash position later in the year.

A \$465 million operating subsidy in FY 2008 would enable Amtrak to provide nationwide passenger rail service, while focusing its attention on needed reform and operational improvements. As Congress did in FY 2006, appropriating the operating subsidy separately from the capital and debt service would prevent the deferral of capital projects in order to avoid the more difficult work of improving Amtrak's operating efficiency. The capital amount will allow modest progress toward a state-of-good repair and the debt service amount is Amtrak's estimate of its fixed cost for principal and interest.

We have testified previously that we support a state capital matching grant program as a means to stimulate corridor development. With caveats, we support the \$100 million capital matching grant program included in the President's FY 2008 Budget and in S. 294, the Passenger Rail Investment and Improvement Act. We believe this program must be designed to ensure the Federal investment leverages new state investments and does not simply supplant investments that states otherwise would have made. Further, Amtrak must finalize and gain acceptance for its route restructuring, cost recovery for state services, and labor reforms to improve the efficiency of its core operations before turning its attention to expanding those operations. Finally, we would support an 80/20 match rate, similar to that for highways, rather than the 50/50 match rate proposed by the Administration, to put state investment in rail on an equal footing as other transportation modes.

Increased Investment in Intercity Passenger Rail Must Go Hand in Hand With Improved Operating Efficiencies. Amtrak's new CEO and his senior management came aboard at a critical time in the ongoing efforts to instill fiscal discipline at the corporation through operational reforms. Since the development of the current Strategic Reform Initiatives, Amtrak is on its second CEO and its Board has three new members. The Board and current management seem committed to reform. However, the real test of that commitment will come shortly as Amtrak moves from implementing relatively easy reforms to more challenging ones.

In FY 2006 Amtrak realized \$61.3 million in savings from operating reforms by reducing the cost of its food and beverage service, improving the productivity of its train operations, reducing corporate overhead, and increasing revenues through variable fares on the Northeast Corridor (NEC) and enhanced service on the Empire Builder. Amtrak has committed to saving an additional \$61 million in FY 2007 and \$82 million in FY 2008 from reforms.

Regarding Amtrak's continuing efforts to improve its financial condition, we are concerned that Amtrak (1) may miss its reform savings target in FY 2007 because some planned reforms are on hold while their potential to generate actual savings is being reevaluated; (2) has limited detail on its planned FY 2008 reforms; (3) has only high-level long-term implementation plans for its planned reforms, where it has any long-term plans at all; and (4) may be overemphasizing revenue enhancements instead of cost reductions. Management's goal of "instilling a culture of continuous improvement throughout the organization" is the right one. Achieving it should be a necessary precondition for significant new state or Federal investment in intercity passenger rail service.

More work needs to be done to eliminate the losses on food and beverage and, in particular, first class sleeper service. Any subsidy of first-class passengers remains unacceptable. In July 2005, we reported that Amtrak could save between \$75 million and \$158 million in annual operating costs by eliminating sleeper car service, outsourcing

food and beverage service, and eliminating other amenities on long distance trains. In FY 2006, the operating loss on long-distance trains was almost \$600 million with a per passenger operating subsidy of over \$200 on three of the routes. A significant amount of work needs to be done to finalize and implement Amtrak's proposed route restructuring, state services, and labor reform initiatives, all three of which are critical components of Amtrak's long-term financial plan.

Reauthorization Holds the Key to Amtrak's Long-Term Outlook. As we testified previously, our proposal for financing intercity passenger rail service would focus on three key goals: (1) continuous improvements in the cost-effectiveness of services provided, (2) devolution of the power to determine those services to the states, and (3) adequate and stable sources of Federal and state funding. Our proposal requires a reauthorization for Amtrak.

These goals can be achieved through six programmatic changes: formula grants to states for capital and operating costs of intercity passenger services, restoration of the forward-going system to a state-of-good repair, capital matching grants to states for corridor development, establishment of adequate Federal and state funding, resolution of the legacy debt issues, and resolution of NEC ownership and control.

Other alternatives for financing intercity passenger rail service include (1) permitting states to issue tax exempt bonds for rail infrastructure development and (2) turning the NEC over to private investors with the support of a Federal loan. Permitting states to issue tax exempt bonds for rail infrastructure would address a goal we support of providing states with greater access to capital funds. Regarding whether tax exempt bonds is the preferred way to make these capital funds available, I would note that the Congressional Budget Office has concluded that when tax credit bonds are used in lieu of Federal appropriations, the cost to the Federal government is greater than it would be through conventional financing through the Department of the Treasury. However, carefully designed tax credit bonds could cost the Federal Government less per dollar of assistance provided to state and local governments than the Federal tax exemption accorded to municipal bonds issued by those governments.

Turning the NEC over to private investors has some attractive features, particularly adding private investment through rail-dependent development and proposed service improvements. However, we raised in the past concerns regarding proposals to separate the NEC infrastructure management and operations into two independent companies. In addition, we would have to see a more detailed financing proposal to determine its soundness.

Absent a fundamental restructuring of the company through reauthorization, it will again fall to the Appropriations Committees to maintain fiscal discipline at Amtrak, specifically by limiting the funds made available to subsidize operating losses and by making Federal support conditional upon further operational restructuring.

I will now discuss these issues in greater detail.

#### Despite Improvements, Amtrak's Financial Condition Remains Precarious

The current model for providing intercity passenger service continues to produce financial instability and poor service quality. We have seen some improvement in

Amtrak's financial and operating performance recently, but there are limits as to how much can be done within the current framework.

**Operating Losses.** Amtrak continues to incur substantial operating losses. It ended FY 2006 with a net operating loss of \$1.1 billion. On the positive side, Amtrak's net operating loss was \$65 million less than last year and its cash operating loss, excluding interest and depreciation, was \$17 million less than the same period last year. Operating losses on long-distance trains, excluding interest and depreciation, were \$440 million in FY 2006. Over the last 5 years, annual cash losses, excluding interest and depreciation, have fallen only modestly . a little more than 3 percent a year.

**Debt Burden.** Amtrak continues to carry a large debt burden. Its total debt peaked at \$4.8 billion in FY 2002 and has declined to \$4.2 billion in FY 2006. For the foreseeable future, Amtrak's annual debt service will approach \$300 million, eating into the amount of funds potentially available for critical capital investments.

**Revenue and Ridership.** Passenger revenues increased to a peak level of \$1.426 billion in FY 2006, primarily as a result of Amtrak's systemwide general fare increases and revenue management of the NEC Regional and Acela Express services (Amtrak's premier service). Despite the fare increases, ridership increased to 24.3 million in FY 2006. For the first 3 months of FY 2007, passenger revenues were \$36 million higher than the same period in FY 2006, mainly due to fare increases. Ridership growth during this period rose 3.9 percent.

**On-Time Performance.** Systemwide, on-time performance has been declining steadily since FY 2002, from 77 percent to 68 percent in FY 2006. While Amtrak's Acela Express service achieved on-time performance of nearly 85 percent, long-distance trains averaged 30 percent last year. The poorest performing train, the Coast Starlight had an on-time performance of only 3.9 percent. Systemwide, on-time performance in the first quarter of FY 2007 increased to 69.1 percent, compared to 65.3 percent for the first quarter of FY 2006.

#### The Appropriations Process Can Provide Needed Fiscal Discipline Over Amtrak's Operating Losses While Amtrak Continues to Address Critical Capital Needs

The delivery of intercity passenger rail service needs to be fundamentally restructured through a reauthorization. However, as we have seen in the past year, meaningful, but incremental, operational reforms are still possible in the absence of a reauthorization. The process established by the Appropriations Committee in FY 2006, which specifically directed Amtrak to achieve savings through operating efficiencies, achieved \$61 million in savings in the first year. This process is not a substitute for reauthorization, but it is of considerable value nonetheless,, and we strongly encourage Congress to continue it in FY 2008. As we stated in our March 16, 2006 testimony, a critical component is funding Amtrak at a level that maintains the impetus for reform. This would require that the operating subsidy be appropriated separately from the capital and debt service appropriations.

Our recommendation of an operating grant of \$465 million in FY 2008 reflects the need to keep the process of continual improvement at Amtrak moving forward. It also takes into consideration Amtrak's better-than-expected FY 2006 headcount, lower FY 2006 expenses, and our concerns regarding the methodology Amtrak uses in developing its budget estimates, which we previously reported on. These factors led us to conclude in

our January 2007 Quarterly Report on Amtrak's Savings from Operational Reforms that Amtrak needed a FY 2007 operating subsidy of \$470 million. (This recommended FY 2007 operating subsidy was an increase of \$37 million above Amtrak's actual cash operating loss in FY 2006 of \$433 million.) Our lower starting point for FY 2007, recent increases in revenue, and lower personnel costs lead us to our recommendation of a \$465 million FY 2008 operating subsidy.

A significant unknown at this point is whether there will be labor settlements this year and, if they occur, what the associated costs and possible work rule changes may be. Agreement labor costs, including benefits, account for more than half of Amtrak's current cost structure. The net effect of a final settlement would need to be reflected in our recommended FY 2008 operating subsidy recommendation.

Amtrak estimates a backlog of approximately \$5 billion in capital projects. Our recommendation to provide an increase in FY 2008 for capital to \$600 million reflects a need to address this backlog to continue progress towards achieving a state-of-good repair balanced with practical considerations regarding how many additional capital projects Amtrak can take on in one year

#### Increased Investment in Intercity Passenger Rail Must Go Hand-in-Hand With Improved Operating Efficiencies

Amtrak achieved \$61.3 million in savings from operational reforms in FY 2006, exceeding its original savings estimate by \$37.7 million or more than 60 percent. Well over half these savings came from reforms that increased revenues, not reduced costs. Amtrak saved \$14 million from food and beverage service reforms, \$7.6 million from improved train operations, \$5.6 million from reduced corporate overhead, \$5.2 million from enhanced revenue generated on long-distance trains, and \$28.9 million from revenue enhancements and operating efficiencies on the NEC. This is a good start, but, in part, reflects reforms that were easier to implement.

Amtrak has also taken steps to improve its oversight and management of reform initiatives. This includes developing a standardized project management approach in an effort to provide a more reliable measurement of cost savings, better internal oversight, and enhanced tracking and reporting capabilities. In addition, Amtrak is working to develop the appropriate links between its planning and financial systems for more reliable estimating and reporting of cost savings and better integration of these savings into the budget process.

In FY 2007 and beyond, Amtrak plans to implement operational reforms in eight areas:

- (1) improving service quality on long-distance trains and reducing the cost of providing food and beverage service;
- (2) improving the efficiency of Amtrak's major ticket sales, distribution channels, and related pricing enhancements;
- (3) improving the reliability and efficiency of Amtrak's Mechanical Department and materials management;
- (4) increasing business efficiencies through the development of improved Management Information Systems and the reduction of overhead costs;
- (5) improving the cost-effectiveness of train operations;
- (6) network restructuring, corridor development, and improved fleet and infrastructure utilization;
- (7) improved cost recovery from states for corridor services and from commuters on the NEC; and
- (8) reducing unit costs and

increasing job flexibility by negotiating new labor agreements that will eliminate certain work rule and outsourcing restrictions.

Amtrak estimates that these initiatives will save at least \$320 million in FY 2012. Almost three-quarters of these savings are expected to come from three initiatives: food and beverage reform and service quality improvements, mechanical service efficiencies, and network restructuring and asset utilization improvement.

There is considerable uncertainty as to whether these savings will be achieved. First, the savings estimates that do exist are preliminary and the proposals lack detailed annual program plans. Projected FY 2012 savings have not yet been developed for the state payments and labor reform initiatives.

Second, the lack of detail makes it impossible for us to assess the accuracy of these cost estimates. As we have seen recently with the sleeper car initiative, once substance is added to the proposal, the savings can evaporate. This proposal was originally targeted to save almost \$20 million in FY 2007. However, it is currently on hold as Amtrak reevaluates whether the costs saved by removing some sleeper cars outweighs the associated foregone revenue. It is unlikely that any savings will be derived from this reform in FY 2007, if any savings are derived from it at all.

Third, reliance on revenue enhancements to achieve savings raises concerns regarding their reliability over the long run. Several initiatives are aimed to increase ridership and ticket revenues, including service quality improvement, on-time performance, enhanced long-distance service, and market-based pricing initiatives. While we believe Amtrak should pursue initiatives to increase revenues, the long-term sustainability is subject to factors beyond their control, such as changing market demand, the relative cost of different travel modes, and competition from new air service. As such, it is more difficult for Amtrak to count on these savings in the long run.

Amtrak needs to define the reform initiatives it plans to implement in FY 2008 to achieve its stated goal of \$82 million in savings. In addition, it needs to settle on which initiatives it is willing to commit to over the long run, develop detailed implementation plans for those initiatives, and incorporate them into its upcoming multi-year strategic plan.

#### Critical Decisions are Needed Before Implementing a State Capital Grant Program

Amtrak's vision for the future is based on passenger rail growth through state-led corridor service development, supported by a Federal program of state capital matching grants. We have long believed that corridor service, that is, routes of between 100 and 500 miles, represent the greatest potential for ridership growth. An obstacle to realizing this potential has been the significant capital investment needed to improve the freight-owned infrastructure to accommodate this expanded service. The Administration's proposed \$100 million state capital matching grant program would be an important start to new corridor development. A robust program that would support a reasonable level of new service in the long run could ultimately require this program to be funded at annual levels of from \$1.3 billion to \$1.6 billion.

Several critical issues need to be addressed before this program is implemented. First, the purpose of this new Federal investment must be to leverage an increase in total investment in rail service and infrastructure. There is little point to this new program if it simply results in supplanting existing state investments.

Second, this program is premised on states assuming funding responsibility for any new service that does not cover its costs. If a significant Federal capital investment is going to be made to initiate a new service, consideration must be given to a state's commitment and capacity to support the operation of this service over the long run.

Third, we believe an 80/20 matching rate, instead of the Administration's proposed 50/50 matching rate, would provide an incentive for a state to take an ownership role in developing rail corridors on a more comparable basis with other transportation modes (historically, highways have used an 80/20 match). A higher match rate for rail infrastructure would require a state to invest more of its own money to obtain the same amount of Federal funds in return. As such, this may cause states to favor highways over rail to maximize the return on their state investments.

### Reauthorization Is a Better Course for Reforming Intercity Passenger Rail Service

Incremental operating savings over the next 5 or 6 years will not be sufficient to fund the significant increases in capital investment required to return the system to a state-of-good-repair and promote corridor development. This mismatch of funding sources and needs requires a long-term solution that can be achieved only by changing the model for intercity passenger rail.

To create a new model for intercity passenger rail, a comprehensive reauthorization that provides new direction and adequate funding is needed. The problem with the current model extends beyond funding: there are inadequate incentives for Amtrak to provide cost-effective service; state-of-good-repair needs are not being adequately addressed; and states have insufficient leverage in determining service delivery options, in part because Amtrak receives Federal rail funds, not the states.

Reauthorization should establish meaningful reforms that ensure greater cost-effectiveness, responsiveness, and reliability in the delivery of passenger rail transportation. Three central themes will drive successful reform.:

" Improvements in Cost-Effectiveness. Amtrak, as the sole provider of intercity passenger rail service has few incentives, other than the threat of budget cuts or elimination, for cost control or delivery of services in a cost-effective way. Amtrak has not achieved significant costs savings since its last reauthorization.

" States Need a Larger Voice in Determining Service Requirements. The current model for providing intercity passenger service does not put states in a position to decide upon the best mix of service for their needs: what cities are served, schedules and frequency of service, and what amenities should be provided. Those decisions are made by Amtrak, and the choices Amtrak makes are not always in the same as the ones the states would make. Intercity passenger rail would be better served with state-led initiatives as to where and how intercity passenger rail service is developed. States are best able to determine the level of passenger rail service required to meet their strategic transportation needs and state sponsorship will become increasingly important as they will be asked to provide increased operating and investment support. Capital funding decisions, as with mass transit, should ultimately reside with the Department of Transportation, based on congressional direction and in partnership with the states.

“ Adequate and Stable Federal Funding is Essential. None of the corridors around the country, including the NEC, can provide the type of mobility needed without significant capital investment. In the NEC, this means bringing the existing facilities to a state-of-good-repair with no match requirement. In other corridors around the country, it means creating the infrastructure for high-frequency services in partnership with freight railroads and commuter authorities. A robust Federal program of capital matching grants will be essential if these corridors are to be developed. In addition, long-distance services that provide connections between corridors require recapitalization if they are to be run efficiently and are to provide the high quality services their passengers deserve. None of this, however, implies giving more money directly to Amtrak, especially under the current model.

In our view, a framework for reauthorization requires the incorporation of six core elements.

1. Capital Matching Grants to States for Development of Corridor Services. This program would give states the ability to improve and expand routes and service on their supported corridor routes through a Federal capital funding program with a reasonable state match requirement.
2. Formula Grants to States for Capital and Operating Costs. This program would address the needs of areas served by long-distance routes that have little corridor development potential, while simultaneously creating incentives for states to encourage operating efficiencies from the service operator. Formula funds can be used for operating expenses, capital maintenance, and/or capital improvements at the discretion of the states and have no match requirement.
3. Restoration of the Forward-Going System to a State-of-Good-Repair. This program would provide Federal funds, with no match required, to address the accumulated backlog of deferred investment and maintenance on the NEC and in fleet and facilities outside the NEC. After a state-of-good-repair has been achieved, capital funds with a reasonable state match would be available for capital maintenance.
4. Setting Federal and State Funding of These Programs at Adequate Levels. Federal funding levels, along with state contributions have not been sufficient to subsidize operations, address deferred capital needs, and significantly improve service along the existing rail network
5. Resolution of the Legacy Debt Issue. This element would give the Secretary the authority to evaluate Amtrak's debt and to take action in the best interest of intercity passenger rail that is economically advantageous to the United States Government.
6. Resolution of Northeast Corridor Ownership. The NEC is of considerable interest in reauthorization. Unlike the rest of the passenger rail system, Amtrak owns the infrastructure between Boston and Washington, D.C. The Federal Government may decide to take on the responsibility of restoring the NEC to a state-of-good-repair, and its debt, if it is determined to be in the public's interest to do so. Once the NEC is returned to a state-of-good-repair, the states can take a larger responsibility in directing and managing ongoing operations and maintenance. In return for fully funding the corridor, the Federal Government may decide to take title to Amtrak's assets. Although Amtrak may very likely remain the operator for the NEC, we will be in a better position to

decide what is the best use and ownership structure of the NEC assets by the end of the reauthorization period.

This framework would require cost efficiencies as Federal funds available to cover operating losses would decline over the 5-year reauthorization period. Specifically, it would give states greater responsibility for passenger rail investments with oversight of capital investment vested in the Department. Additionally, it would focus Federal funding on stable and robust capital investment programs that would bring the system to a state-of-good-repair, maintain it in that condition, and provide for the development of corridors throughout the country.

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