1st MONDAY
3rd MONDAY
SPECIAL

Prepared for employees by the
Milwaukee Road's Corporate Communications Department
516 West Jackson Boulevard Chicago, Illinois 60606
Telephone 312 648-3324

August 23, 1979

Managers and Supervisors:

On August 27, the reorganization court will begin hearings on the request of the Trustee to be ordered by the court to embargo some 6,400 of the Milwaukee's 9,800 route-miles.

You'll recognize that we tried something similar before. Last April 23, Trustee Hillman sought an embargo of a sizable portion of the Milwaukee's mileage. Hearings were held during May. Judge McMillen denied the request for the embargo on June 1. As Mr. Smith indicated in his FM/TM letter of June 4, the judge agreed generally with the need for the embargo but said that he didn't have the authority to impose it as long as the Milwaukee was not "cashless." He pointed out that funds were available through ERSA as well as internally. He ordered the Trustee to borrow those funds and continue to operate the entire railroad, recognizing that the funds wouldn't maintain operations indefinitely.

Now, we believe that conditions are sufficiently different that a second try for an embargo is appropriate. And the embargo is still necessary. The cash available to us won't support the entire railroad for very much longer. By current forecasts, "cashlessness" will come in late September or early October. We are seeking the embargo effective September 17.

The U. S. Department of Transportation, policymaker for the only source of outside cash available to us under present law, has now said that it will not provide funds to operate the entire Milwaukee and it will oppose legislation which would do so. However, the DOT will consider assistance for that portion of the Milwaukee which is reorganizable.

Assisting us in our position with respect to the embargo is the fact that we now have before the court our preliminary plan of reorganization. This document is our financial and physical "game plan" for attaining economic self-sufficiency as the smaller railroad we've named "Milwaukee II."

The principal purpose of this special letter is to describe for you some of the elements of the reorganization plan. But first, one more point about the embargo -- a definition of "embargo."

As our operating and marketing supervisors know, an embargo is a temporary cessation of service because of an emergency. Embargoes are relatively commonplace in railroading, when too many cars accumulate at a receiver's unloading point, when floods damage track and bridges, when snowfall closes a line, for example. Embargoes are imposed -- and lifted -- by the railroads themselves. The size of the embargo which we now propose, and its relationship to the reorganization, make the court's approval necessary.

An embargo -- this one or a smaller, more localized, one -- isn't the same as an abandonment. Only with the authority of the ICC and only then after lengthy procedures could we abandon a line -- that is, give up all future rights to operate it and sell or dismantle it. We have begun those procedures for the entire railroad at the court's direction. The all-red Title VIII map of

June 30 was the first step. We didn't at that time entertain the notion that a complete abandonment would be necessary, and we don't now. We did then, and we do now, believe that promptly slimming the Milwaukee down to "Milwaukee II" is essential. The preliminary plan of reorganization shows why -- and it indicates that if we do, five years or so from now "Milwaukee II" could be well on the way to recovering from the economic illness which has weakened the company for many years.

If the entire Milwaukee Road is operated for the balance of 1979, the railroad will lose approximately $138 million in the full year, the plan forecasts. Its books will show a cash shortfall at year's end of about $23 million. If the entire Milwaukee is operated throughout 1980, the loss next year will be $185 million if we do no rehabilitation financed under 4R Act programs, $255 million if we do. Under ICC accounting rules, on which these figures are based, we must regard as operating expenses much of what are actually capital expenditures to improve the value of the property; hence the larger loss when rehabilitation costs are figured in. The drain on cash during 1980 would be between $150 million and $175 million. Clearly, inputs of cash necessary to meet these shortfalls aren't likely, from any source.

Yet there is a potential for reorganization within the Milwaukee. If, quickly in order to forestall further massive cash drain and remain eligible for federal help, the Milwaukee can be reduced to some 3,400 route miles, and can concentrate on that mileage the locomotives, cars, available dollars and managerial attention that are now spread across 9,800 route-miles, the point may be within sight at which the Milwaukee could pay its own way.

The reorganization plan forecasts that "Milwaukee II" would run up sizable deficits in net railway operating income in the first four years of the five-year reorganization process -- a total of some $211.7 million, nearly half of which would be in year one. But in the fifth year, because of traffic growth from improved track, equipment supply and service, "Milwaukee II" would produce positive net railway operating income -- not profit, because NROI doesn't include deductions from profit of interest payments on loans and other debt -- of $18.6 million.

"Milwaukee II" would be, in Booz, Allen & Hamilton terminology, the "Miles City Subcore plus Kansas City." It would be that segment of the present Milwaukee which we have sometimes called "Segment 8." To this segment would be added the line south from the Twin Cities to Austin and Jackson, Minnesota, and the trackage rights which we have but don't operate between Miles City and Billings, Montana. "Milwaukee II's" mileage would total 3,400. It would operate about 355 locomotives and 23,000 freight cars. It would have a basic work force of 5,800 to 6,000 persons, to which would be added 300 to 500 persons for extensive rehabilitation programs in the first three years.

The timing and success of the entire reorganization process, and the future earning power and financial condition of "Milwaukee II," would be heavily dependent on future borrowings particularly from the U. S. Government. We would need help under both the 4R Act and the Emergency Rail Services Act. We would also need continuing help: from shippers -- for continued business and rehabilitation assistance; from employees -- for continued support through days that are likely to be difficult for a long time, and for understanding and appreciation at the bargaining table. Furthermore, the proceeds from sales to others of operable lines which can't be included in "Milwaukee II," and of the salvage and property sales associated with the abandonment of lines which no one needs, are essential to our success.

"Milwaukee II" would require an infusion of $202 million to $252 million in cash from the federal government from now through the early years of the reorganization process. None of this is grant money. Tax dollars would be paid back, with interest. Included in this amount would be about $152 million to help finance track and equipment rehabilitation programs; $20 million to cover various shortfalls of cash in year one; $50 million to fund a program of labor-protection payments if the program is implemented; and $30 million to help keep the full railroad going for the balance of the year -- if such should be necessary -- and to help cover the start-up costs of "Milwaukee II." We would also need an additional $15 million from the proceeds of sales of railroad land later this year. These funds are escrowed with a Chicago bank under the terms of the railroad's mortgages. We've already begun the court proceedings necessary to obtain these funds as well as much of the necessary federal assistance for the first year or so of "Milwaukee II."

Between now and 1982, according to the plan, the Trustee should be able to sell some 1,660 route-miles of the existing Milwaukee in several states. Union Pacific has offered approximately $29 million for about 140 route-miles and certain real estate. Burlington Northern is considering a significant purchase. There are several other potential buyers of portions of the Milwaukee which would become parts of other railroads or be continued in operation independently. No offer has been received from SORE. Between "Milwaukee II" and what's being discussed with other railroads, more than 94% of the Milwaukee's current business would continue to have rail service.

Jobs will go along with sold mileage. At present, it's anticipated that some 770 Milwaukee Road employees would be hired by others in the process of selling operable railroad. The Trustee is attempting to transfer as many jobs as possible.

The Trustee will need a staff of persons to "wind down" the activities of the railroad outside the "Milwaukee II" core, to safeguard and sell surplus properties, and to continue the work on the reorganization process. It's expected, currently, that this force of persons drawn from the existing railroad force will number perhaps 200 at the outset.

Setting aside for the moment the question of how many Milwaukee Road employees might be hired temporarily by other railroads to perform directed service in the event the embargo is granted -- a number which would be sizable -- the current thinking is that, over time, some 3,100 to 3,500 existing positions would be eliminated in the formation of "Milwaukee II."

Labor protection claims arising out of the reorganization could be so huge that they might consume so much of the assets of the estate that reorganization would be impossible, an outcome which could be disastrous for all employees. There is also the possibility that the need to pay labor protection may be taken to court by the railroad's secured creditors, delaying any settlement of the protection issue. The Trustee believes that a compromise in the best interests of all concerned parties is possible.

Accordingly, the reorganization plan proposes that a $50 million labor-protection settlement fund be established. Nine million dollars of the fund would be used to pay presently deferred back pay and vacation pay to terminated employees as an expense of administering the estate -- which means a cash payment early in the implementation of the reorganization plan. Some $36 million would be offered as severance pay. All severed employees with more than one year's service would receive $1,000 for each year of completed service at the time of termination. Terminated employees with less than one year's service would receive $500. The $4 million balance would go for relocation payments.

"The Trustee expects to conduct further negotiations with the representatives of the employees with respect to the details of such a settlement program and at an appropriate time will seek the authority of the court to commence such a program," the plan says.

The cooperation of employees and their unions is a critical element in making the reorganization work. (Others: streamlining management, obtaining government assistance, and avoiding a complete shutdown of the Milwaukee this fall or winter.) With this in mind, the reorganization plan outlines areas of relief from existing work rules affecting the train- and engine-service crafts which would help the reorganized railroad by more than $11 million per year.

The reorganization plan goes into considerable detail in suggesting an initial and tentative classification of the claims against the Milwaukee's estate and a method of treating them in the reorganization process. It is in this respect that the plan document brings home the real meaning of the reorganization process: an effort to recover from serious financial difficulty, which includes satisfying the monetary claims against the railroad of many parties.

As of June 30, 1979, the claims against the Milwaukee's estate which have been deferred totaled some $371 million. In addition, the railroad has some $125 million in nondeferred current liabilities and $123 million in nondeferred long-term liabilities. Except for those deferred by court order, the Milwaukee generally has been meeting its post-bankruptcy obligations as they come due.

If you are interested in the details of the proposal concerning the claims against the estate, please look up a copy of the news release of August 10. The proposal is spelled out there at some length. Here, permit me simply to point out that, generally, the Trustee proposes that claims be given this order of priority: first, administrative expenses of keeping the railroad running, paying back pay, and developing the reorganization plan; second, ERSA borrowings which by law have priority ahead of all other claims; third; state and local tax claims, personal injury claims and certain expenses of administration not settled at reduced amounts; fourth, and with a specific ranking among them, the claims of the holders of the mortgages on the railroad's property; fifth, the U. S. Government for its post-bankruptcy assistance under the 4R Act; sixth, claims of holders of $56 million in unsecured income debentures; seventh, amounts owed to prebankruptcy "trade creditors" -- suppliers of materials and services; eighth, claims for employee labor protection; ninth, prebankruptcy 4R Act obligations to the U. S. Government; tenth and eleventh, respectively, claims of preferred and common stockholders.

These claims would be settled by various combinations of cash, five-year notes, an exchange of existing mortgages for new mortgages on the Milwaukee Land Company, new obligations to the U. S. Government, nonvoting preferred stock in the reorganized railroad, a form of security called "certificates of contingent value," and new common stock. I refer you again to the news release or to the plan document itself for the details. But in view of the misunderstanding which at times has appeared widespread with respect to how the "stockholders and bondholders" of the present Milwaukee might come out of the reorganization process, let me point out here that, in general, the proposal calls for bondholders to receive -- not cash -- but new bonds with reduced face values and interest rates in line with interest rates generally, and for existing preferred stockholders to receive -- not cash -- but new common stock. The Trustee anticipates that the Milwaukee's existing common stock will have no value.

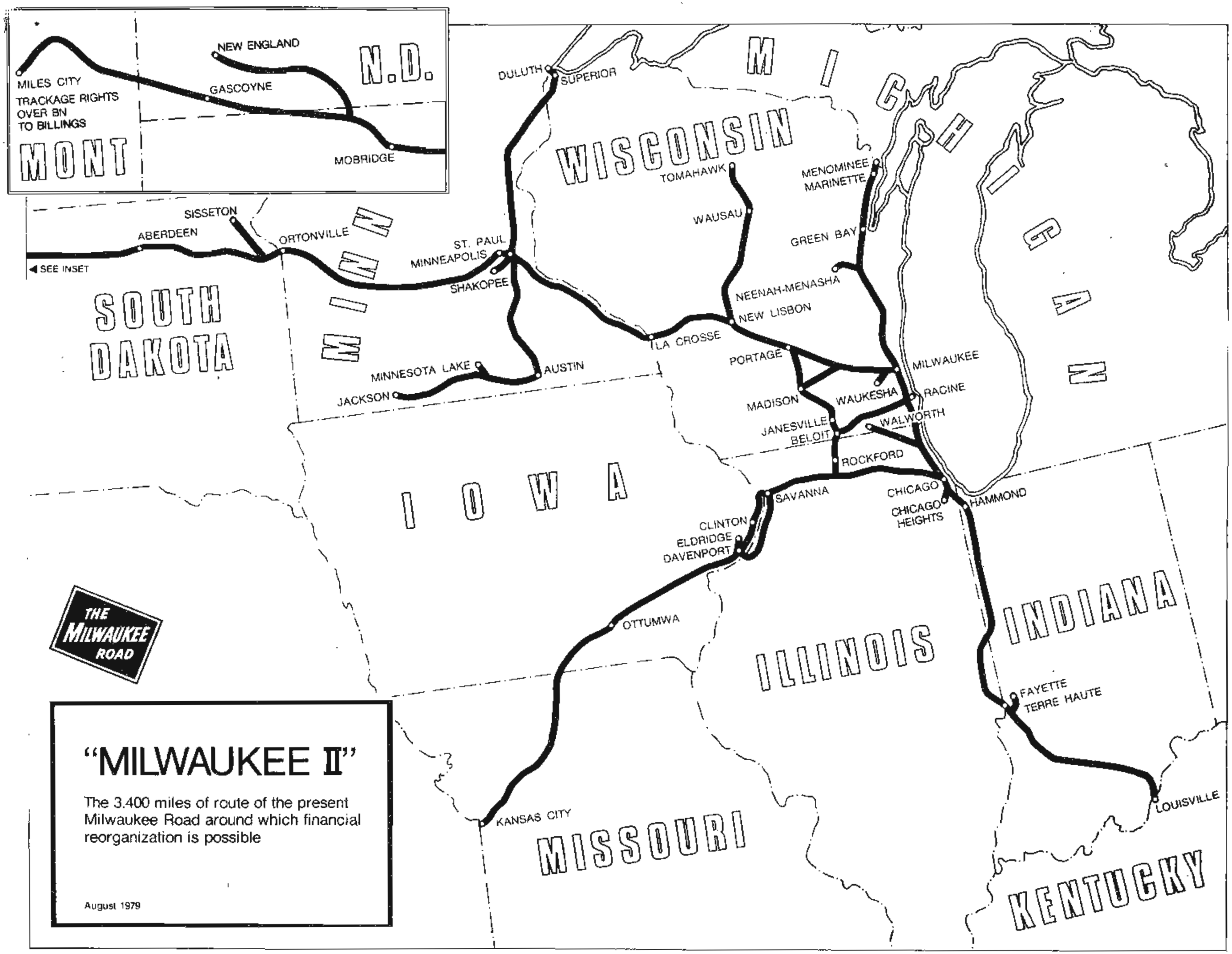
There is, at best, a year or two of work to be done on the preliminary plan of reorganization before it becomes a final plan ready for implementation -- and, as laid out in the preliminary plan, a five-year period of implementation. This, generally, will be the procedure:

First, the court will allow a period for competing plans of reorganization to be filed with it by interested parties. Then, following procedures laid down by the Bankruptcy Act, the ICC will hold public hearings on the feasibility of the preliminary plan. If the ICC approves the plan for the hearings, with or without changes which it is empowered to make, and the court accepts the ICC's judgment, the plan then is subjected to the votes of the various classes of creditors and claimants. If they approve the plan, it may then be ratified by the court. When the plan has been implemented, the surviving railroad -- "Milwaukee II" -- would be released from the guardianship of the court and the Trustee and be turned over to the emerging equityholders. Once again, then, the Milwaukee would be a stockholder-owned enterprise.

Much remains to be done before that time comes, and not all of the questions which shall require answers can be anticipated now. Success is by no means assured. We've built three checkpoints into the preliminary plan as a guide to our progress toward reorganization. Within a year of start-up of "Milwaukee II," we need to be taking in 90% of the plan's projected 1980-level operating revenues. Within three years of start-up, we must be approaching the level of traffic which Booz, Allen & Hamilton determined to represent a slimmed-down railroad's ability to utilize new market opportunities. And in the fourth year of "Milwaukee II," we must be generating a positive cash flow from operations, excluding rehabilitation costs.

Is success possible? Certainly. Do we have the capacity to succeed? Of course. Permit me to suggest that any railroad of our size with our complex problems which can come up with a reorganization plan in less than 20 months, while plowing through all the difficulties we've experienced, has a lot going for it. Nothing like that has ever been done before.

Richard B. Ogilvie



"MILWAUKEE II"

The 3.400 miles of route of the present Milwaukee Road around which financial reorganization is possible

August 1979