

1st MONDAY 3rd MONDAY SPECIAL

Prepared for employees by the
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Managers and Supervisors:

Just about a year ago, Trustee Hillman indicated publicly that the likelihood was strong that the Milwaukee's Pacific Coast Extension could not survive as part of the reorganized company. Lines West would have to be sold, either as operating railroad in whole or in part, or as salvage. There were two reasons: The lines couldn't be operated so as to contribute to profitability. The funds generated from their sale were necessary to finance the reorganization of those parts of the Milwaukee's system which possibly could be made self-sustainable.

Almost from the day of that announcement, the Milwaukee's employees and customers, political figures in and from some of the states which the Milwaukee serves, the public generally, and even the reorganization court have heard continual claims that the Trustee was in error and that Lines West could be self-supporting. Notwithstanding studies by the Milwaukee's own people, the independent findings of Booz, Allen & Hamilton, and the fact that few shippers contended that they would be affected adversely if Lines West were removed from the Milwaukee's system, a campaign was undertaken by a small group of employees and former employees to seek funds from employees, the government and others to oppose the Trustee's efforts or perhaps even acquire Lines West from him.

The campaign attracted quite a bit of political attention, particularly in Montana. Senator Melcher of Montana succeeded in writing into U. S. law a requirement that the Federal Railroad Administration review the condition of the Milwaukee and consider assisting it with loans for roadbed and track improvement -- which had been a topic of intense activity both within the Milwaukee and at the FRA since the enactment of the enabling 4R Act legislation in 1976 anyway.

On July 31, Acting Secretary of Transportation W. Graham Claytor, Jr., transmitted to Congressional committees involved with transportation four separate analyses, all bearing on the Milwaukee's circumstances west of the Twin Cities, accompanied by a letter which stated the position of the Department of Transportation with regard to further funding for the Milwaukee and the physical shape of the Milwaukee in the future. In a news release and "To All Concerned" wire dated August 2, we covered the principal points of these highly significant documents.

My purpose now is to provide you with further detail of what these studies contain. This information is essential to your understanding of a very important issue. You should use it freely to assure that all Milwaukee Road employees see the significance of the federal government's position. As stated in Secretary Claytor's letter to Congress, the DOT's position is this:

"We are opposed to any legislation that would freeze the entire Milwaukee system and provide further federal funds to support systemwide operations. ERSA funds for continuation of the existing system have so far been provided

because of the desirability of completing our studies, of providing the Trustee and the court the time to develop a reorganization plan, and of providing a period of notice and adjustment for affected shippers. Those purposes will largely have been accomplished by the time the \$20 million in current ERSA assistance has been fully utilized. We envision, therefore, that we will require any future assistance to the Milwaukee to be used only for those portions of the system which are reorganizable."

There were four studies: an analysis of the economic potential of Lines West; an assessment of SORE's plan for an independent, employee-owned railroad west of the Twin Cities; a study of the impact upon the Milwaukee's employees of the discontinuance of Lines West and of the Employee Stock Ownership Plan idea; and an analysis of the Booz, Allen & Hamilton study which was done for the Trustee. I shall deal with the economic analysis of Lines West and the Booz, Allen review in this letter and cover the SORE and ESOP studies in a separate letter within a few days.

Keep in mind what, in total, these four studies say about Lines West:— The western lines of the Milwaukee are not likely to become self-sustaining, either independently or as part of a reorganized Milwaukee Road system. The concept of an ESOP for the western lines doesn't appear to be practical. The best solution for the western lines is to transfer their necessary services to other railroads. These were the conclusions of Secretary Claytor. They bear more than a little resemblance to the conclusions of Trustee Hillman.

The economic analysis of Lines West was done for the FRA by Reebie Associates of Greenwich, Connecticut. Its objective was to examine the financial viability of the western lines, assuming that they had been rehabilitated at a cost of \$115 million so that operations were improved. The analysis was also to assume that Lines West would be part of a reorganized Milwaukee Road and not be operated as a separate system.

Reebie's conclusion: "The study results indicate that the infusion of funds would not transform the western lines into a viable segment of the Milwaukee Road. Over the last 10 years, the Milwaukee's freight volume has been stagnant, while the region's economy and competing carrier's traffic have grown. Obviously, much of the Milwaukee Road's traffic is carried at a loss. Even after the proposed rehabilitation of the western lines, the analysis indicates that the carrier would not be able to compete effectively for much of the existing traffic."

Because of competition, "the western lines would suffer major traffic diversion, 1985 ton-mile volume amounting to only 39% of the 1977 levels. Moreover, other rail carriers in the region would face similar prospects," the study said.

The rehabilitation effort "would result in improvement in operating efficiency which could be translated into reduced operating costs and improved service levels. However, even after crediting the western lines with these improvements (but handling only the traffic for which it can economically compete), operating deficits would decrease in the 1985 scenario to \$26.5 million from the estimated \$27.9 million loss in 1977. Moreover, the 1985 deficit does not include the repayment of financing of the rehabilitation program or operating deficits in the intervening years.

"Considering these factors, the infusion of capital necessary to undertake the rehabilitation of the western lines and to support continuing operating deficits would appear unwarranted."

The Reebie study saw no significant new sources of rail traffic for Lines West. "Coal has been, and will continue to be, the most significant area of new opportunity. However, no new mining operations are now being developed on the western lines, and the exact location and timing of future developments are unsure. Little, if any, new coal could be mined along the western lines before 1985, and any future production in the area could most likely be served equally well by the BN or UP.

"Similarly, lumber from the Pacific Northwest cannot be viewed as a potential new source of traffic for the western lines. It does not now constitute a significant traffic segment, and its future growth is distinctly limited by the growing role of southern and Canadian lumber in major eastern markets.

"The other large potential traffic source frequently cited for the Pacific Northwest is export grain. However, realization of these volumes would require major structural changes in the grain marketing system which are unlikely to occur by 1985. Additionally, movements of this type could be handled by competing railroads as well as the western lines."

Nearly 60% of the Milwaukee's 1977 system operating losses were incurred on the western lines, the Reebie study told the FRA. No zone within the western lines, when analyzed individually, would break even in 1985, much less show a profit, it said.

"Approximately 60% of the current operating revenues on the western lines is generated in the westernmost region which incorporates all lines in the western part of the state of Washington. The ratio of revenue to route-miles in this zone far exceeds that found in any other zone of the western lines. However, almost 50% of the traffic moving in this zone is short-haul traffic. This local traffic is particularly susceptible to diversion to truck, the low-cost mode for short-haul moves.

"The remainder of the western lines, from eastern Washington through Montana and the Dakotas to Minneapolis, produces only 40% of western lines revenues. The volume of traffic moving through these states on the Milwaukee Road is insufficient to support the cost of rehabilitation and improved maintenance. Furthermore, more than 70% of this traffic is overhead traffic, with both origin and destination outside of the area. As such, this traffic merely passes through the region and could be absorbed by competing railroads whose route networks parallel that of the Milwaukee Road."

Reebie saw little impact on shippers from the discontinuance of Lines West as a segment of the Milwaukee: "Throughout the western lines system, continuance of rail service to most shippers is a strong likelihood, since a significant portion of the traffic on the western lines originates from and/or is destined for local areas which are jointly served by other railroads."

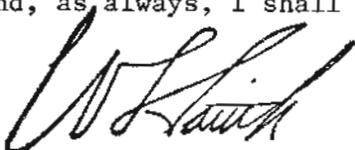
In summary: "The western lines' market share will continue to be challenged by increasingly competitive activity on the part of the railroads which parallel its route structure, and by other modes. The instability of the market share held by the western lines, coupled with their inability to generate sufficient operating revenue on large portions of the route network, strongly argues against investment in rehabilitation of the western lines."

The analysis of Eooz, Allen & Hamilton's Milwaukee Road Strategic Planning Studies was conducted by the FRA staff personnel. Indicating that the Board,

Allen analysis can't be applied to all possible analyses of the Milwaukee system because of its methodology, the FRA concluded that "the studies were carried out in a professional manner and will prove useful to the Trustee in fulfilling his responsibility for balancing public need against the protection of the corporation's assets.

"The approach used by the consultants and the criteria employed are, in the FRA staff's judgment, valid, consistent and reasonable, and the results will properly serve as a preliminary guide to the Trustee in developing an operating and management plan for a self-sustaining reconfigured Milwaukee Road, assuming that a decision to reorganize is taken," the study said.

The two studies discussed here, plus the other two which I shall discuss in a later letter, run to more than 200 pages total. We therefore shall not be distributing full-text copies except to principal department heads. If you would like to see the complete studies, please ask your superior for them. And, as always, I shall try to answer any questions you may have. Thank you.



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