1st MONDAY
3rd MONDAY

Prepared for employees by the
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April 21, 1980

Managers and Supervisors:

As of today, we are three weeks into the operation of what amounts to "Milwaukee II." It's far too early to be making conclusive statements, of course, but what we've observed so far tells us that we can be optimistic about what we'll be seeing, operationally, in the months ahead.

With no difficulty at all, we've slipped into the predesigned "Milwaukee II" operating and service pattern, and it's working very well. As an example, we've retained via Kansas City virtually all the traffic with the Union Pacific which we were interchanging at Council Bluffs. The increased volumes flowing to and from such points as stations in Wisconsin has permitted us to restructure our service to and from Kansas City and to reduce total elapsed time materially. We now operate run-through service to the Union Pacific at its own yard in Kansas City, Kansas, and to the Missouri Pacific at Osawatomie, Kansas, the MoP's first terminal southwest of Kansas City. Additional run-through service is in prospect.

Concurrently, we've assumed, with considerable success, the Rock Island's operations at Muscatine and the DRI&NW, of which we own half, has done likewise in the Quad Cities area. We are supplying customers with our cars -- coming up short only a few gondolas, which are chronically short in the industry -- and taking the revenues. Rock Island employees have joined our ranks and those of the "Dri Line" to do much of the former Rock Island work as required by the so-called "Miami Accord."

Plainly, the added traffic on the Kansas City line -- nearly double the train service -- is straining the physical condition of the track. We expect to spend at least $3.5 million of our own internally generated funds on the line this summer and are attempting to find a way to do some badly needed work on portions of the Rock Island as well.

Recently I visited both the Quad Cities and Muscatine and came away with the view that this territory is not only extremely valuable to us and that we'll fight to retain it, but that we've already resolved what were critical shipping problems for the area's former Rock Island customers. We see in the Mississippi River Valley from Clinton down to Muscatine one of the strongest business areas which "Milwaukee II" could naturally serve. We have friends in this area among our customers, and we should do whatever is appropriate to keep them.

Soon we'll be opening discussions with the Trustee of the Rock Island over the ultimate purchase of those portions of the Rock which we are currently operating under a directed-service order. While we don't expect prolonged negotiations, we do have to consider the fact that the ultimate transaction will require the approval of the Rock Island's reorganization court, our own reorganization court, and the ICC.

For the time being, the item of top priority is the statement which Trustee Ogilvie will be making to Judge McMillen on or about May 9. We want to have the statement completed by that date because Judge McMillen will be gone for a period thereafter. The judge expects to conduct hearings on the statement in early June. I would expect that during those hearings the FRA would indicate what its future policy will be with respect to funding the Milwaukee's reorganization. I spelled out its current policy, as best it could be interpreted, in FM/TM for April 7.

The FRA's current lending policy was the subject of a letter which Judge McMillen wrote to Chairman Harley Staggers of the House Commerce Committee on April 11. Judge McMillen called to Chairman Staggers' attention the fact that the DOT's present policy certainly provides appropriate protection to the United States for any loans, but that it doesn't accomplish the objective of doing so without unnecessarily burdening the owners of the railroad and its creditors.

"If the railroad is to continue as an operating entity and to make a contribution to the public interest, then the financial burden now being imposed upon it by the terms of the Secretary (of Transportation's) loans must be substantially moderated so that the operations are in part subsidized until they can become self-sustaining," Judge McMillen wrote.

"The delays in effectuating a reorganization plan are becoming increasingly burdensome in view of business conditions in the areas served by the railroad and, more particularly, in view of the high cost of financing current operations," he told the chairman. As you know, the only source of deficit operating funds which are available to the Trustee come from the Department of Transportation, and that department, pursuant to pressure from the Office of Management and Budget, has changed its lending policy toward the Milwaukee Railroad. It requires not only priority over all prereorganization creditors but also an interest rate very close to prime, although a few months ago it was willing to lend on a general creditor basis.

"This new governmental policy, although perhaps temporarily helpful in economizing and reducing federal disbursements, is entirely unrealistic as an effort to implement the reorganization of this crippled railroad. The Milwaukee cannot be expected to sustain this type of economic burden very long and still show the operating profit required by the Interstate Commerce Commission decision, Judge McMillen said.

"We are therefore going to be confronted relatively soon with making the decision of whether the interests of the secured and general creditors can continue to be superseded by government loans for working capital. Obviously this cannot be required indefinitely, and we expect to have a report from the Trustee by May 15, 1980, indicating whether it can be justified any longer.

"In my opinion, the United States Government will have to decide whether it is willing to grant some kind of financial support other than arm's length priority loans in order to preserve this portion of our railroad transportation system and help meet the energy crisis."

On the subject of federal financial assistance, here's where we are at the moment: We've drawn down all the so-called subordinated ERSA available to us under the Milwaukee Railroad Restructuring Act to which we were entitled for operations between November 1 and February 29. In total, the amount was some $50 million out of the $75 million authorized by the Restructuring Act. We may receive a bit more on final review of the figures. We are in the process of receiving the $3.1 million in subordinated ERSA which was provided by the FRA for the continued operation of the 1,500 miles of "blue" lines during

March. As needed, we'll be receiving the federally guaranteed loans to pay the costs of labor protection provided by the Restructuring Act. By the end of April, we'll have paid out some $6.6 million in separation awards.

The FRA has yet to approve our applications for the ERSA loan for which Judge McMillen authorized top priority on March 27, or for the 4R Act Section 511 loan guarantees with which we had expected to be doing car and locomotive rehabilitation work at Milwaukee beginning in March. We currently are moving ahead on the 511 program with our own funds, but there's a question as to how much further we can go.

Let me turn now to another subject altogether.

Last week, the principal officers of the Milwaukee met with representatives of Peat, Marwick, Mitchell & Company to learn about an exercise in internal review and evaluation which PMM&Co. is beginning at the request of Trustee Ogilvie and myself. PMM&Co. is the Milwaukee's independent accounting firm. The project which it is undertaking has two objectives: to evaluate the system of management controls used throughout the railroad; and to review the railroad's computer resources and its management of data processing and associated support functions.

This project will extend over the next five or six months. It will involve a comprehensive review of activities and systems in nearly every basic functional area of management: operations and maintenance; marketing and planning; finance and accounting; systems and data processing; administration; and legal. In each functional area -- which isn't necessarily defined by the elements of our present management structure -- PMM&Co.'s experts will bring to us its professional expertise in a way that, we expect, will result in better, more timely information with which to manage and control our corporate activities, at less cost.

Already, interviewers from PMM&Co. have talked with some key management personnel. While their study is far from exhaustive, they've been able to make some preliminary determinations as to how the Milwaukee's management perceives the railroad's strengths and weaknesses -- and management's own strengths and weaknesses.

For example, managers as a group, as determined by the PMM&Co. analysis, seem to believe that "Milwaukee II" has good routes and good markets with a strong geographic diversification. Managers were impressed with the loyalty of Milwaukee Road employees. They recognize that we now have a good car supply, a good locomotive fleet, and a good level of service. They perceive a new sense of direction for the railroad.

On the other hand, the Milwaukee's managers perceive that we are somewhat hamstrung by federal regulations, by union agreements, by the fact that the reorganization process diverts top management from the job of running the railroad. We seem to have neither a long-range sense of direction nor adequate statements of goals, although this is somewhat understandable given our present circumstances. Management doesn't appear to support the restructuring or development of systems and lets requests for such things as new accounting systems get lost in the chain of command. Management may be less than properly progressive, resistant to change, and disposed to leap from crisis to crisis, delegating responsibility but not the associated authority. There are problems, PMM&Co. found, in how management measures its performance; in how decisions are made; and in upward communication. We don't seem to be able to attract or keep good people; understandably, there's uncertainty about the future.

As to information systems, PMM&Co.'s inquiry established the view of management that much information isn't clear, timely or relevant. There is disagreement over whether management should be more or less centralized. Controls, procedures and documentation appear to be absent in areas where they are needed. The perception is that some areas are not working as hard as they should be to cut costs and help preserve the estate's assets.

However this initial list of perceived problems might be modified as the project really gets under way, it's already clear that the functions of data processing and accounting control offer a fruitful area for study and future change. A more thorough study by PMM&Co. is beginning. By September, we should see some interesting recommendations. In the meantime, if PMM&Co. comes across anything which can be coopered up immediately to the benefit of the management process and the reorganization, its instructed to let us know promptly.

PMM&Co. will be bringing to bear its expertise not only in the management processes of other railroads but of well-managed non-railroad companies. Needless to say, this sort of dispassionate analysis is clearly appropriate as we restructure ourselves into a smaller, better-equipped system for which our present management structure may not be altogether suited. I know that you'll cooperate with our consultants to the fullest extent required. Thank you.

W. L. Smith
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