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Managers and Supervisors:

This is the second of three special letters concerning the four studies which were made public by the U. S. Department of Transportation on July 31. This letter discusses the DOT's study of SORE's proposal to create an independent, self-supporting railroad out of the Milwaukee's Lines West.

A third FM/TM special in this series will report to you on the analysis made for the DOT of the impact on labor of various scenarios concerning Lines West and the applicability of an Employee Stock Ownership Plan.

You'll recall that, in a letter dated August 8, I discussed the other two studies: the DOT's analysis of the basic economic potential of Lines West, and its review of the Booz, Allen & Hamilton study which was done for the Milwaukee's Trustee. In essence, the Lines West study found that, even after massive rehabilitation, Lines West couldn't be made either competitive or economically viable. The study of Booz, Allen's methodology showed that Booz, Allen's work was valid, consistent and reasonable, and that it could properly serve as a preliminary guide for the Trustee.

The four studies together led Acting Secretary of Transportation W. Graham Claytor, Jr., to the following conclusions, which he expressed to Congressmen and Senators who are involved with transportation: 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.

Secretary Claytor indicated that it was unlikely that the DOT would approve further federal financial assistance for the Milwaukee except for those lines which could be part of the reorganized railroad. He opposed legislation which would freeze the Milwaukee at its present mileage. He opposed legislation which would provide further federal funds to support systemwide operations.

Later, Secretary Claytor conveyed his conclusions to Judge McMillen of the U. S. District Court which is overseeing the reorganization. On the basis of the four studies, the White House supported Trustee Ogilvie's proposal for a partial embargo.

The assessment of the financial self-sustainability of SORE's Lines West proposal was done for the DOT by The Consulting Center, Inc., USA. It was completed early in July. There is reason to believe that it was suppressed for several weeks for political reasons.

The Consulting Center's report summarized SORE's proposal as it was presented late in April. Since an embargo of much of the Milwaukee's mileage "remains a real possibility," the report said, and "because federal financial assistance is inherent to the SORE proposal, Congress and the DOT were interested in obtaining an independent assessment of the SORE proposal." The study's stated

objective was "to assess the financial self-sustainability and need for external financial assistance if the SORE Lines West Proposal were to be implemented."

SORE had proposed to establish a new company to acquire and operate the assets of the Milwaukee west of the Twin Cities. It had proposed to acquire the assets by assuming a percentage of the Milwaukee's existing debt. The common stock of the new company would be purchased by employees and possibly by some shippers, according to the proposal. The proposal took the position that, by operating more trains, providing more cars to shippers, and rehabilitating the track of Lines West, a remarkably rapid financial turnaround would occur. SORE's published projections were that while the SORE-operated Lines West would lose more than $17 million in the first year of operation, figuring in all costs including interest on its debt, it would clear about $18.5 million before taxes in year 5 and $42.8 million before taxes in year 10.

SORE's proposal had called for federal financial involvement in Lines West through approximately $118 million in 4R Act funds for rehabilitation programs, a guarantee of $32.1 million in loans to the employees of Lines West to establish the employee-owned trust necessary to acquire ownership of the stock of the new railroad, and possibly a loan of some $20.2 million under ERSA or some other statute to cover SORE's estimated cash shortfall in the first two years of operation. Total proposed federal involvement: $170.2 million.

One of the key assumptions of the SORE proposal was that SORE would acquire Milwaukee Land Company, a wholly owned subsidiary of the Milwaukee Road and a key source of income which the railroad has been using to offset some of its own losses for years. Under its proposal, SORE would acquire the Milwaukee's interest in other subsidiaries, as well as much of the Milwaukee's rolling equipment.

The consultants began their assessment of SORE's proposal with this: "The Milwaukee's problems are similar to those of other marginal and bankrupt railroads operating in the midwestern region of the country: average density levels are much lower than the industry as a whole and traffic carried by these weaker roads appears insufficient to justify the level of investment needed to rehabilitate and maintain their plants on an individual basis." For this reason, the study said, Trustee Hillman had determined that the Milwaukee must concentrate its resources on the lines which have higher average revenue densities -- at least $38,000 per mile. The lines embraced by SORE's proposal have an average revenue density of only $32,000 per mile, according to the study.

"These figures suggest, and are confirmed by the SORE analysis itself, that the western lines cannot be operated profitably unless traffic densities are substantially increased," the DOT study says. "SORE's hopes of increasing traffic levels do not revolve around efforts to consolidate traffic by dropping redundant lines; they depend instead upon the conviction that traffic on these lines could be vastly increased by offering faster, more frequent and more reliable service and by attracting a reasonable share of projected growth for the area."

The basis for SORE's plan accordingly led the Consulting Center to research the validity of SORE's assumptions on revenues, equipment acquisition, rehabilitation, timing, and expenses, and the relationship between these assumptions and forecasts for the railroad industry both nationally and in the west. The Consulting Center also evaluated SORE's assumptions on how it would acquire the Milwaukee's assets, its ability to finance interim losses, the adequacy of

its income to cover the interest on its debt, the adequacy of its proposed capital structure, the adequacy of its projected start-up costs and normalized maintenance program, and the effect on its figures of future inflation.

The Consulting Center found that the numbers contained in the SORE proposal would have to be adjusted in several respects. Most significantly, the report to the DOT said, "SORE's expenses are judged too optimistic; SORE's initial method of acquiring assets was judged infeasible; and SORE's ability to acquire the Milwaukee Land Company was determined to be highly unlikely." The Consulting Center accepted SORE's revenue expectations, although it called them ambitious.

After making these adjustments in SORE's figures, the Consulting Center said, "it is the opinion of the Consulting Center that the SORE proposal, as presently constituted, cannot initially and never will achieve self-sustainability. To pursue the SORE proposal as constituted will likely require a minimum of $1,092,000,000 in federal support consisting of $370 million in federal loans or loan guarantees, $638 million in federally guaranteed securities that are redeemable 10 years from issuance and assuming no prior interim payments of either interest or principal, and $84 million in branch-line rehabilitation grants."

The Consulting Center told the DOT: "In order to achieve self-sustainability, SORE would have to significantly reduce operating expenses, essentially through innovative work rule changes; avoid paying for the initial assets assumed from the Milwaukee, perhaps by foregoing all labor claims to the Milwaukee estate in exchange for the assets; and receive federal financial support of about $286 million for the required main- and branch-line rehabilitation programs as well as an initial loan to finance the Employee Stock Ownership Plan."

The study for the DOT found several problems with the list of assets of the Milwaukee which SORE indicated it would acquire, and with the values SORE assigned to these assets.

For one, SORE's plan is based on SORE operating its railroad to the Twin Cities, but the Trustee's definition of the viable portion of the Milwaukee extends as far west as Miles City. The Consulting Center had to assume that no jurisdictional overlap existed but, because the State of South Dakota is negotiating with the FRA for rehabilitation funds for the line between Miles City and Minneapolis, "the new Trustee and the South Dakota government will probably wish to have a say in the ultimate designation of this line segment."

SORE's proposal revolves around the number 44. SORE would acquire 44% of the Milwaukee's mileage and 44% of the Milwaukee's rolling equipment in return for assuming 44% of the Milwaukee's debt. But 44% of the Milwaukee's cars would provide SORE with some 10,000 of the existing 24,000 cars, leaving the Trustee 3,000 cars fewer than the 17,000 he had said he would need. "The Consulting Center has assumed the Trustee would have first rights to this equipment and has therefore adjusted SORE's equipment expenses to reflect SORE's need to acquire additional equipment," the study says.

The study found SORE's proposed acquisition of Milwaukee Land Company unacceptable: "In the opinion of the Consulting Center, neither the Milwaukee Trustee nor the reorganization court will permit the SORE group to acquire the Milwaukee Land Company, particularly for an amount considerably less than its full net liquidation value. The firm of Ford, Bacon & Davis estimated that the net liquidation value of the Land Company is $110 million. Yet SORE

proposes to acquire this company plus an additional $260 million worth of assets by assuming only $152 million worth of debt.

"Creditors, possibly including the U. S. Government which has issued loans to the Milwaukee for rehabilitation projects, will seek to block any such transfer because the Milwaukee Land Company is one of the Milwaukee Road's most valuable and most liquid of assets. The only way SORE could acquire the Milwaukee Land Company would be to provide the estate with cash or equivalent securities equal to the value of the company. Since the Land Company is presently being operated as a profitable going concern, the value of the company should be based on going-concern value, not liquidation value.

Similar problems exist with the manner in which SORE proposed to acquire The Milwaukee Motor Transportation Company, the study says. And: "Additional problems may exist with SORE's intention to acquire percentages of the Milwaukee's investments in various switching and terminal companies. Since the Milwaukee does not have a controlling interest in any of these companies, it is unclear to what extent SORE would benefit from acquiring minority shares in these companies."

The Consulting Center disputed on an even broader basis SORE's ability to acquire the necessary Milwaukee assets, in fact. "In the opinion of the Consulting Center, SORE's proposal to acquire $370 million worth of assets by assuming $152 million worth of debt will not be accepted by the Milwaukee Trustee, the Milwaukee's reorganization court, or the Milwaukee's creditors.

"Although a similar technique was followed in the case of employees' acquisition of the Chicago and North Western Railroad, the circumstances of that acquisition were entirely different. First, the debt assumed by the employees of the C&NW amounted to approximately $405 million and the book value of the assets assumed amounted to approximately $440 million. Second, the C&NW transaction involved a going-concern railroad and was based on an arm's length negotiation between the acquirers and the railroad's holding company. Creditors presumably approved the transaction because their status with respect to existing lines and future repayment remained unchanged. The SORE proposal does not offer so close an exchange of debt for assets, nor involve transferring a going concern from one owner to another at an arm's length agreement.

"Regardless of the outcome of the Trustee's plan, creditors will most certainly argue that any assets not needed by the Trustee should be liquidated. This liquidation in no way precludes selling these remaining assets to other railroads or to a group such as SORE, but in our opinion it means that buyers will have to pay at least net liquidation value for the assets. Furthermore, the means of payment will have to be cash or some form of security which promises repayment of net liquidation value, adjusted for the time value of money at some future date. More than likely, these securities would have to be guaranteed by the federal government.

Critical to SORE's proposal was an intensive maintenance-of-way program which would return Lines West to a normalized state in about five years. SORE had figured the cost of this program to be $118 million. Additionally, SORE would increase maintenance expenditures to keep Lines West in the normalized state. For branch lines as opposed to the main line, SORE counted on state and shipper assistance. It therefore included no branch-line maintenance costs in its estimates. Nor did its maintenance budget include the cost of maintaining side and yard tracks.

After intensive review, the Consulting Center concluded that SORE's rehabilitation program for its system main lines was "adequate to accomplish the intended improvements." But on the other hand, it said, "SORE's intention to undertake this program within five years may be somewhat ambitious, but we have assumed the work can be accomplished within that timeframe." However, the consultants noted that by the time SORE's program would be completed its cost, given inflation, would be $166 million. On the same basis, an additional $84 million would be necessary to rehabilitate SORE's branch lines -- an amount which, based on existing federal branch-line subsidy programs, would have to come entirely from shippers or state and local governments in the form of grants rather than loans.

The Consulting Center disputed SORE's manner of concluding that, in effect, maintenance-cost estimates could be manipulated to include the cost of maintaining passing tracks and yards. "As a consequence, and because comparisons indicate that SORE's maintenance-of-way budget may be somewhat on the low side to start with, the Consulting Center added an annual $4 million to SORE's maintenance-of-way budget."

Generally, the DOT's consultants accepted SORE's revenue projections as not being greatly inconsistent with either Booz, Allen's or those contained in Reebie Associates' study, which I discussed in an earlier special letter. However, they indicated their concern that because of the deterioriation of traffic since 1977, the base year for the SORE study, "the SORE system may have difficulty reaching its own estimate of 1977 traffic levels in year 1, much less higher ones."

The Consulting Center wasn't optimistic about SORE's ability to reverse current trends by providing more equipment. It termed too optimistic SORE's 3% annual traffic growth rate: "It ignores cyclical downturns in the economy; it assumes all commodites carried by the new company will grow at the same rate; and it is higher than justified based on current forecasts of the economy's long-term macro outlook." Take coal out of the Milwaukee's historic growth patterns, the study pointed out, and the Milwaukee's growth rate hasn't equaled that of the railroad industry as a whole -- which itself hasn't equaled that of the growth rate of the economy.

The DOT study wasn't as optimistic as was SORE in assuming that time-sensitive traffic would flow back quickly to the rehabilitated railroad. It added a year to SORE's scheduled recovery of this traffic.

As with SORE's revenue figures, the Consulting Center made several adjustments to SORE's expense forecasts. Some came by reason of the aforementioned adjustments in revenues. Others: higher and more realistic equipment-lease costs in view of SORE's planned equipment acquisitions; higher maintenance-of-equipment expenses because SORE probably would inherit from the Trustee cars with higher-than-average bad-order ratios; an increase on SORE's track-maintenance budget of $4,500 per mile to cover normalized maintenance to yard tracks and sidings which SORE had left out.

As the result of these adjustments, the study showed that SORE couldn't turn itself around until the sixth year of operations. SORE had forecast losses in net railway operating income of $28.2 million over two years. The Consulting Center determined that its losses would be $95.4 million over five years. By the end of year 6, the study found, SORE would have a cumulative cash shortfall of $167.7 million even before considering the financing of SORE's rehabilitation program or the initial financing of the acquisition of the assets from the Trustee.

What about longer-term growth? SORE had indicated that net railway operating income would grow by 11% to 14% per year. "The Consulting Center believes sustained improvement of this magnitude is unrealistic. Although revenues may continue to grow as SORE is able to take advantage of the growing import-export market in the Pacific Northwest and other marketing opportunities, we do not believe net income levels can grow at even higher rates."

Sufficient cash simply wouldn't be available to SORE to meet all the demands, the study said. "Even with sustained improvement of net income levels over the long term, the Consulting Center has concluded that SORE's cash flow would never be great enough to repay the $168 million needed to finance cash shortfalls over the first six years, the $118 million rehabilitation loan ($166 million inflated), much less to finance the acquisition of assets. If long-term securities are used to acquire these initial assets, the Consulting Center calculates that SORE will need to pay $638 million for redemption of these securities in year 10."

Calling SORE's proposal "too risky and too unprofitable to enable it to obtain private capital to finance any of its needs for funds," the Consulting Center added up the financial assistance which would be required from the federal government: $370 million in loans or loan guarantees for main-line rehabilitation and cash shortfalls; $638 million in guarantees for loans to cover the initial purchase of assets, including interest; $84 million in grants for branch-line rehabilitation. Total: $1,092,000,000

SORE might be able to reduce its interim losses some if employees and labor unions were willing to agree to a number of changes, the study said. It suggested several areas involving existing work rules. Or, the study said, SORE might be able to find another way to finance the cost of acquiring the Lines West properties initially.

"Since SORE is to be employee-owned, one possible approach would be for SORE employees to consider giving up their employee protection claims against the Milwaukee estate in exchange for the assets attributable to the western lines. The Consulting Center cautions, however, that this trade may not be easy to arrange because the actual liability of the Milwaukee estate to pay these labor-protection claims in the event of liquidation is not clear.

"SORE's employees would also have to consider what they would be giving up if SORE's new company did not achieve self-sustainability."

SORE's Lines West proposal of last April became SORE's proposed plan of reorganization as filed with the reorganization court in September.

W. L. Smith
President