U. S. Department of Transportation

LINES WEST STUDIES

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Contents

THE SECRETARY OF TRANSPORTATION
WASHINGTON, D.C. 20590

JUL 31 1979

Honorable Harley O. Staggers
Chairman, Committee on Interstate and
Foreign Commerce
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to transmit the enclosed studies and analyses concerning the "Western Lines" of the Milwaukee Railroad. This letter also discusses the conclusions we draw from them and outlines for you the course of action which we propose to follow concerning the Milwaukee Railroad, and particularly the "Western Lines."

First, let me summarize the contents of the enclosed documents.

The document titled "A Review of Booz-Allen & Hamilton's Milwaukee Road Strategic Planning Studies" (the BAH Review) discusses a report prepared for the Trustee (BAH Study) to assist him in determining whether any part of the Milwaukee system is reorganizable. The BAH Review was prepared by FRA staff and addresses the fundamental integrity of the BAH Study assumptions and procedures concerning the viability of the various segments of the Milwaukee Railroad. Specifically, regarding the Western Lines, the report to the Trustee finds that the Western Lines configuration would provide significantly less traffic potential than other options for the Milwaukee Road while requiring a substantially higher level of rehabilitation investment. The report concludes that the 1977 contribution of the Western Lines was negative and held out little hope that a system configuration built around the transcontinental extension would generate sufficient cash flow over the long-term to justify the investment in rehabilitation required to become competitive with other railroads in the market. In fact, according to the consultant, rehabilitation alone would not permit the Western Lines to generate a positive net operating income, leaving aside any coverage of fixed charges. Under a speculative scenario of rehabilitation plus long-term growth, the consultant calculated that a small operating profit could be achieved in 1986. However, the amount would not be sufficient to make up for operating losses incurred in the meantime or to service rehabilitation-related debt issued, even assuming that it were issued on very favorable terms. After summarizing and analyzing the BAH Study, the FRA-prepared BAH Review finds its underlying assumptions and methodology to be reasonable and consistent.

The consultant study titled "Traffic Effects Study: The Viability of the Western Lines of the Milwaukee Railroad" (Lines West Study) was commissioned by FRA in satisfaction of Section 303 of the Local Rail Services Assistance Act of 1978. The Lines West Study: 1) attributes a substantial operating loss to the Western Lines for 1977 and estimates that the lines generated revenue per route mile well below the Milwaukee system average; 2) identifies traffic flows on a commodity basis within the region served by the Milwaukee's Western Lines; and 3) examines the ability of the Western Lines to attract traffic through 1985. The study concludes that a significant portion of the 1977 traffic base is potentially susceptible to capture by other modes (trucks and barges) on the basis of comparative costs, and that the traffic could be retained only through uneconomic ratemaking.

The study titled "Assessment of the Financial Self-Sustainability of the SORE Lines West Proposal" (the SORE Study) was commissioned by the Office of the Secretary of Transportation in response to a request from several Members of Congress. The study assesses a proposal by a number of Milwaukee Railroad employees and former employees to acquire and operate the Milwaukee's transcontinental line and associated facilities west of St. Paul, Minnesota. The study analyzes the SORE proposal over a broad range of issues, technical subjects and assumptions.

The consultant generally accepts SORE's traffic and revenue projections with slight adjustments, but judges SORE's projected expenses as being overly optimistic (i.e., too low) in relation to the traffic to be recaptured. In addition, SORE's proposed method for acquiring the assets (i.e., by the assumption of $152 million of existing Milwaukee debt) is considered infeasible. Finally, the study argues that SORE would not be able to acquire the assets of the Milwaukee Land Company to help finance its proposal. In total, the study concludes that the SORE proposal, as presently constituted, cannot achieve self-sustainability and that pursuit of the proposal would require $1.092 billion in external financial support, including $370 million for rehabilitation, operating losses and establishment of an Employee Stock Ownership Plan, $84 million for branch line rehabilitation and $638 million for purchase of the Western Lines and associated facilities. It should be noted that the latter amount is premised upon financing of the purchase of the assets through Government guarantees of securities redeemable in 10 years, with the amount adjusted for the time value of money. The report attributes a present value of $246 million to those assets. Thus, if the assets could be purchased outright by SORE, the total amount of external financial support needed would be $700 million instead of $1.092 billion. The study goes on to state that 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 titled "Financial Analyses of the Impact on Labor and Labor Protection of the SORE Lines West Proposal" (Labor Impact Study) was commissioned by the Office of the Secretary of Transportation to examine the impact on labor of various approaches to dealing with the Milwaukee Western Lines and to explore the relevance of the Employee Stock Ownership Plan (ESOP) concept to these approaches. The consultant examined four potential scenarios for the disposition of the Western Lines and the effect each would have on the affected Milwaukee employees. These were: 1) An embargo on all Western Lines traffic; 2) the Western Lines to be abandoned under existing ICC procedures; 3) the Western Lines to be reorganized in accordance with the SORE proposal; and 4) the SORE proposal to be implemented in the form of a traditional leveraged Employee Stock Ownership Plan. Recognizing the difficulties inherent in estimating the actual job loss impact on the Milwaukee work force and the possible resultant cost to the estate, the consultant established a gross range of labor protection costs. In an embargo situation judged not to be subject to ICC authority, the consultant assumed that few employees would have separation payment rights. The range of labor protection costs was thus only \$31-\$167 million. The range grew to \$83-\$521 million in the situation where all employees would be eligible for separation payments or guaranteed wages under ICC abandonment regulations. (The low end of the range assumes that all employees agree to a one time, front end settlement, versus a six-year earnings guarantee.) The study also contains a discussion of Employee Stock Ownership Plans and evaluates the concept in relation to the SORE proposal and the SORE Study. The consultant's general conclusion is that any Western Lines reorganization must first demonstrate economic feasibility before an ESOP is considered.

From these studies and analyses we reach three major conclusions. First, the Western Lines of the Milwaukee are not likely to become self-sustaining, either independently or as part of a reorganized Milwaukee system. Whether one takes the optimistic traffic outlook of the SORE Study, the more moderate assumptions of the BAH Study, or the more pessimistic views of the Lines West Study, the conclusions in this regard are similar. Even under optimistic assumptions, only minimal operating income can be generated by the Western Lines, and then not until the fifth year. Moreover, the analyses make no provision for paying interest or principal on the initial capital investments, costs which would be included in any normal business or public investment analysis. Even if the capital investments are assumed to be covered by external sources, total operating losses through 1985 far exceed total profits in all studies. Thus, we conclude that the Western Lines have little if any likelihood of ever becoming self-sustaining and would not be able to generate sufficient income to repay, or even to pay the interest on, the large amounts of financing that would be necessary for rehabilitation and operating expenses and, in the case of the SORE proposal, for purchase of the involved properties.

Second, the concept of an Employee Stock Ownership Plan for the Western Lines of the Milwaukee does not appear to be practical. As is well demonstrated in the Labor Impact Study, for the sake of the employees and the public, operations of the Western Lines must be shown to be economically feasible before an ESOP can be deemed appropriate for consideration. Based upon these studies, we cannot say that Milwaukee employees should invest their personal assets or rights to labor protection in an ESOP for the Western Lines. We make that statement in full recognition of the general effectiveness of employee ownership in improving operating efficiencies. However the Western Lines lack the profitability potential to take advantage of an ESOP. On the other hand, it may well be that an ESOP will assist in the reorganization of a Milwaukee "core" railroad. In that case, the feasibility and benefits of an Employee Stock Ownership Plan should be determined in the reorganization process itself.

Third and given all of the above, the most responsible course of action appears to be to preserve selected Milwaukee Western Line services through the transfer of those services and necessary facilities to other railroads to the maximum extent possible. To attempt to maintain the Western Lines operations, either as part of the reorganized Milwaukee Railroad or as an independent rail enterprise which would be dependent on large Federal financial contributions, would be inconsistent with the weight of sound economic analysis and would be an unjustifiable burden on the nation's taxpayers.

Before outlining the course of action which we propose to follow to achieve maximum preservation of economic rail services, let me review the recent activities of the various parties.

First, the Milwaukee Reorganization Court, as you know, denied a request from the Trustee to embargo the Western Lines on June 1, 1979. In denying that request, the Court ordered the Trustee to take immediate steps before the Interstate Commerce Commission to abandon the entire Milwaukee system, and to file a preliminary plan of reorganization with the Court before August 6. Previously the Court had permitted the Trustee to apply for $20 million in assistance under the Emergency Rail Services Act of 1970 (ERSA). The Trustee has appealed the Court's denial of the embargo and the Indenture Trustees, representing major creditors, have appealed the Court's decision regarding ERSA borrowing. Decisions by the Court of Appeals are not expected until this fall.

The Trustee has taken the abandonment steps and is expected to file a preliminary reorganization plan with the Court by August 6. The plan will be based upon continued operation of a "core" railroad, along the lines outlined in his previous submissions to the Court. The Trustee also applied to us for the $20 million in ERSA assistance and we approved such assistance in an agreement dated July 12, 1979.

The Department has taken several steps to maintain the Milwaukee's services while appropriate arrangements are being worked out, and to assist in implementation of those arrangements. First, the $20 million in ERSA assistance which we approved will be used to operate the system while the Trustee prepares his reorganization plan and presents it to the Court. We expect those funds to be sufficient to maintain the railroad's operations through the month of August and possibly through September. Second, we and the Milwaukee have been looking for willing buyers for the Railroad's lines in Iowa, under the authority of Section 401 of the Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act). That process has involved the State of Iowa, four major railroads and two short lines. We have made progress and are optimistic that we can bring this restructuring in Iowa to a successful conclusion. Third, and in connection with the Section 401 process, we have indicated to the parties our willingness to make funds available under Title V of the 4R Act to assist in the transfers of those properties. This assistance would include, where applicable and justifiable on economic grounds, the funding of acquisition costs through loan guarantees under Section 511 and the funding of rehabilitation and labor protection costs incurred as part of an otherwise fundable project through the purchase of preference shares under Section 505, subject to legislation extending the preference share program. Enclosed for your information is a letter to the Milwaukee Trustee, dated June 18, 1979, that spells out our commitment to make the Section 401 process work.

That brings you up to date on the recent activities of the various parties. Let me now outline for you the general course of action which we intend to follow over the next several months.

Until now, we have felt it inappropriate to proceed with the Section 401 process on the Milwaukee's Western Lines, since the studies enclosed with this letter were not completed. However, based upon those studies, it is now appropriate to expand the Section 401 process to expedite the transfer of Milwaukee's services on the Western Lines to other railroads. In fact, we understand that the Milwaukee has been actively negotiating sales of portions of the Western Lines with other railroads for some time, and several of those sales may be consummated shortly.

In addition to using the Section 401 process, we intend to work with the states served by the Milwaukee's Western Lines to mitigate any negative effects of the cessation of Milwaukee service through the use of the Local Rail Service Assistance Program. In that regard, the Federal Railroad Administrator, who oversees that program, will work with affected states in their rail planning process and will be prepared to expedite applications for funds, whether they be for rail planning purposes or for project related purposes. As a specific example of what can be done under that program, we have been working closely with the State of South Dakota to ensure that a major coal movement from Gascoyne, North Dakota to an electric utility plant in Big Stone City, South Dakota will continue uninterrupted. We have advised South Dakota that it may incur up to $2.3 million in costs for rehabilitation of the Milwaukee line over which the coal moves and we are hopeful that we will shortly be able to obligate those funds.

One other feature of the Local Rail Services Assistance Program which can be considered by the states in dealing with the cessation of Milwaukee service is the provision which allows states to "rail bank" lines which are abandoned but which may have future potential. That feature may be particularly relevant to states wanting to keep in place rail lines which serve potential future traffic growth areas.

Finally, we will continue to work closely with you and other members of Congress to determine what legislative action may be necessary to facilitate all of the steps that I have outlined above. For the moment, we endorse two provisions contained in legislation currently before the Congress. First, it is important that the Administration's proposals for rail deregulation and restructuring assistance be enacted as quickly as possible. To the extent that enactment is delayed, however, the extension of the 4R Act Title V preference share program beyond September 30, 1979 is acceptable as an interim measure. That extension is provided for in both versions of the pending Amtrak Authorization Bill. We favor the House version of the extension which expands the program to include all railroads. Second, we favor amending the Bankruptcy Act for railroads now in reorganization to provide their reorganization courts with the ability to order necessary abandonments without first obtaining the ICC's approval. This would bring existing bankruptcy procedures regarding abandonments into line with the new Bankruptcy Act, which becomes effective for bankruptcies occurring after September 30, 1979.

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 that 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.

Thank you for this opportunity to present you with our views.

Sincerely,

W. Graham Claytor, Jr.

W. Graham Claytor, Jr.
Acting Secretary

Enclosures

JUN 1 6 1979

Mr. Stanley E. G. Hillman
Trustee
Chicago, Milwaukee, St. Paul
and Pacific Railroad
516 West Jackson Boulevard
Chicago, Illinois 60606

Dear Mr. Hillman:

This is to advise that we are processing your application dated May 22, 1979, for $20 million in guarantee assistance under the provisions of the Emergency Rail Services Act of 1970, and will inform you by separate letter of the additional information required to complete our evaluation.

It is my strong belief that you have been pursuing a very clear and responsible approach to the reorganization of the Milwaukee Road. In keeping with your overall plan, I wish to propose to you a concentrated effort to undertake controlled transfer of Milwaukee properties to other railroads and operators.

While I recognize that the court's inability to grant an embargo of those lines not included in your proposed core alters the course you have set toward reorganization, I believe it affords an excellent opportunity to begin the restructuring of the Milwaukee system we all know should occur. Therefore, I recommend that we join in a coordinated plan to initiate transfer negotiations, under the protection and in accordance with section 5(a)-(d) of the Department of Transportation Act, and initially involve all eligible railroads and parties.

We suggest that our first effort be on Milwaukee facilities in the State of Iowa, that we meet with all interested parties on June 28 in your offices in Chicago and that we hold private meetings on June 29 with selected prospective purchasers. Representatives of the State of Iowa and ICC's Rail Service Planning Office would be asked to attend the June 28 meeting. FRA would be prepared to mediate or participate fully in all Iowa negotiations. While we anticipate that section 5 negotiations for transfer of portions or all of the Lines West will ultimately be necessary, decisions as to the participants in and timing of such negotiations should await completion of the studies described below.

In the financing area, we would make available loan guarantees to finance acquisition costs, and subject to legislation extending the program, we would make available low-cost section 505 funds for purposes of rehabilitation and labor protection. There are limitations as to the availability of resources, but the combination of resources of the Trustee and acquiring railroads, together with FRA assistance, should meet the financial requirements necessary to make the process work. We believe the participating railroads will be responsive to our plan for a private sector solution.

We are completing work on two studies of specific interest to the Milwaukee's reorganization planning. These are: 1) an objective analysis of the proposal made by representatives of SORE, and 2) an earlier study of the potential viability of the Lines West in response to a Congressional request. We are hopeful that both studies will be useful to all parties interested in Milwaukee's transcontinental rail services. We expect to have the studies completed by July 5 and will make them available to you as soon as possible.

Finally, as we have said before, we are prepared to provide the $20 million in ERSA working capital assistance for which you have applied, as long as the required ERSA findings can be made, so that you may promptly prepare and submit a preliminary plan of reorganization.

Sincerely,

s/ John M. Sullivan

JOHN M. SULLIVAN
Administrator

Form FRA F 8 (10-73)

UNITED STATES GOVERNMENT

Memorandum

DEPARTMENT OF TRANSPORTATION

FEDERAL RAILROAD ADMINISTRATION

DATE: July 23, 1979

In reply refer to:

SUBJECT: Reebie Associates Report

FROM: Charles Swinburn Charles Swinburn
Associate Administrator for Federal Assistance

TO: Recipients of the Milwaukee "Western Lines" Studies

Attached is the Executive Summary to the Reebie Associates report "Traffic Effects Study: The Viability of the Western Lines of the Milwaukee Road." The body of the report is in the final stages of editing and production and will be forwarded to you immediately upon receipt by the Federal Railroad Administration. We are informed by Reebie Associates that the contents of the Executive Summary accurately reflect the substance of the body of the report.

Attachment

REPORT No. DOT-FR-8072

TRAFFIC EFFECTS STUDY
THE VIABILITY OF THE WESTERN LINES
OF THE MILWAUKEE ROAD

EXECUTIVE SUMMARY

JULY 1979

PREPARED FOR

DEPARTMENT OF TRANSPORTATION
FEDERAL RAILROAD ADMINISTRATION
WASHINGTON, D.C.

REEBIE ASSOCIATES
CONSULTANTS TO MANAGEMENT

200 RAILROAD AVENUE
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EXECUTIVE SUMMARY

THE VIABILITY OF THE WESTERN LINES OF THE MILWAUKEE ROAD

The Chicago, Milwaukee, St. Paul and Pacific Railroad (the Milwaukee Road) has not had a prosperous existence. Assembled from a miscellany of short line operations in the years between 1875 and 1915, the Milwaukee went through bankruptcy and reorganization in 1928 and again in 1945. From 1975 through 1977 over $50 million in operating losses were incurred. The Milwaukee Road declared bankruptcy for a third time in December of 1977, and has yet to be reorganized. The trustee has petitioned to abandon fully 75 percent of the railroad.

The Milwaukee Road's basic service area extends from Chicago across the Northern Plains States to the Seattle/Portland area. Several major railroads serving this region have also exhibited financial weakness, and one other carrier is currently in bankruptcy. Concern for this general deterioration in the region led the Federal Railroad Administration (FRA) to initiate in mid-1978 a study to develop a methodology for evaluating proposed railroad consolidation projects in the Midwest. In October of 1978, under Section 303 of the Local Rail Assistance Act of 1978, Congress mandated that "The Federal Railroad Administration shall promptly review the condition of the Chicago, Milwaukee, St. Paul and Pacific Railroad and consider assisting such railroad with loans for roadbed and track improvement." The FRA and the consultant adopted the previously developed study methodology to conduct this investigation.

Reebie Associates' efforts have been addressed to that portion of the Milwaukee Road known as the Western Lines. These lines are comprised of the main line and branch lines extending west of Minneapolis to the Pacific Coast. The Milwaukee's trustee, Stanley E.G. Hillman, has said of the Western Lines: "Seldom since the Pacific Coast Extension was completed in 1909 has the Milwaukee been able to attract sufficient business to the route to justify hundreds of miles of totally unproductive line that are included in it, and never in recent years has it been able to do so". Given Mr. Hillman's observation, it is hardly surprising that in recent years the physical condition of the Western Lines has been allowed to deteriorate to a point where train speeds are largely restricted to 10 to 25 mph. In contrast, on competing main lines to the Pacific Northwest, train speeds of 60 to 80 mph are common.

Objective

The objective of this FRA financed study was to examine the financial viability of the Milwaukee's Western Lines, assuming that those lines were to be rehabilitated to permit improved operations. The analysis was also to assume that the Western Lines would be rehabilitated and maintained as an integral part of a surviving Milwaukee System, not as a separate entity. The consultant was to:

- Develop forecasts of traffic levels between the Twin Cities and Pacific Northwest and the flow of revenues generated by that traffic.

- Develop an operating cost scenario of moving the traffic.

Conclusions

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 ten years, the Milwaukee's freight volume has been stagnant, while the region's economy and competing carriers' 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. The study arrived at this conclusion by comparing the full economic costs of alternative modes for each of the Milwaukee's traffic segments. (In a competitive environment carriers may elect not to price on the basis of their full costs, but their prolonged failure to do so on an aggregate basis inevitably leads to financial failure). Given this competitive cost scenario, the Western Lines would suffer major traffic diversion, with 1985 ton mile volume amounting to only 39 percent of 1977 levels. Moreover, other rail carriers in the region would face similar prospects.

The Western Lines' rehabilitation project would require a $115 million effort. It would result in improvements 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 or 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.

Methodology

An existing generalized study approach, designed to provide a rapid response analysis of a wide variety of railroad consolidation or coordination proposals was employed. The methodology was designed to focus on the implications of proposed changes as they relate to a carrier's route structure, traffic volumes, freight revenue and, ultimately, profitability.

The approach began by segregating the carrier's total existing freight traffic into individual traffic flows. These flows were identified by origin and destination (cities and states), individual railroads participating in the move, and type of commodity being transported. These traffic flows, some 35,000 in the case of the Western Lines of the Milwaukee Road, were then projected to a 1985 traffic level using economic forecast information from the Department of Commerce.

Truck and barge carriers offer significant competition for freight movements in the region served by the Western Lines. For this reason, the analytical routine subjected each individual traffic flow to a preliminary assessment of the likelihood of its future diversion to an alternative form of transportation. For each such alternative, estimates of comparative service characteristics and average unit cost profiles were developed, with the latter portrayed at a level sufficient to provide full long term support for private sector operations. In each case where the comparison indicated that railroad costs (including not only the transportation component but handling and inventory differentials as well) were within ten percent of those of the alternative means of transportation, the traffic was considered likely to be retained by the railroad. The resultant traffic base was then reaggregated to a total railroad operating system and analyzed in terms of the resulting revenues, expenses and profits.

Premises

The study design and methodology incorporate several basic assumptions which must be recognized and understood to properly evaluate the findings which result.

The diversion analysis and projected financial results were based on the existing railroad industry operating practices and institutional environment. Major changes in technology, labor agreements, marketing programs or the regulatory process were not incorporated in the study. Such issues would be more properly treated in a sensitivity analysis than in the base case which was developed here.

As a corollary assumption, no significant new sources of rail traffic were allocated to the Western Lines. 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 development 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 Union Pacific (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. Consequently, the overall traffic increases that have been projected for all areas were apportioned among the various carriers in terms of the distribution of freight volume found in the 1977 flow data.

A major assumption employed in both the traffic and financial analyses was that the projected rehabilitation effort would be completed by 1985. Moreover, the Western Lines were credited with achieving all of the projected operating improvements and economic benefits of the rehabilitation by that time.

The financial results were evaluated without consideration of the repayment of the rehabilitation funds, or related financing charges. In addition, operating deficits during the intermediate period prior to the completion of the rehabilitation were excluded from the analysis. The financial results portrayed for 1985, thus, should properly be viewed as relevant to that year only, since they exclude the assessment of any charges related to the rehabilitation program and the operating losses for the intervening years.

Also incorporated in the analysis was the assumption that no major investment would be made in the Western Lines, unless these lines would ultimately be able to operate profitably and not require indefinite subsidization. To satisfy this requirement, the competitive modal analysis was framed in terms of full economic costs. This approach recognized the need for revenues to cover all elements of long run costs, including normalized maintenance and replacement of equipment. A similar approach was adopted for all modes.

Finally, the study was developed in terms of constant (1977) dollars. Thus, it was assumed that price increases would affect all cost components in a nearly equal fashion.

Findings

The analysis estimated that the Western Lines' share of total Milwaukee System freight losses in 1977 was $27.9 million (almost 60% of the total). With rehabilitation, significant cost savings could be realized on the Western Lines. Even so, large amounts of current rail traffic would likely be diverted to more economic alternative transportation modes over the next 5 years. The expected net result is that 1985 operations would still show a loss of $26.5 million, exclusive of rehabilitation expense or the associated financing costs. As a result, funding requirements would be far greater than those needed for rehabilitation alone.

In addition, the $115 million proposed rehabilitation would not bring the Western Lines' trackage up to the standards of other railroad carriers in the region. The track structure would be rehabilitated to a level sufficient to permit freight traffic speeds of up to 40 mph west of Miles City, Montana, up to 60 mph east of Miles City, and 10 to 25 mph on the branch lines. By contrast, BN trackage on main lines is maintained at 60 mph standards and that of the UP at 80 mph levels.

No zone within the Western Lines, when analyzed individually, would break even in 1985, much less show a profit. Approximately 60 percent of the current operating revenues on the Western Lines is generated in the western-most 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 percent 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 percent 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 percent 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.

In its western-most region, the Milwaukee makes extensive use of trackage rights agreements. Even if the Western Lines ceased operating, many shippers could still obtain service from the other railroads who own the tracks over which the Milwaukee is now operating. Indeed, 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.

The Reebie Associates analysis has determined that 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.

FRA Staff Paper
July 23, 1979

A Review of Booz-Allen & Hamilton's "Milwaukee Road Strategic Planning Studies"

General Observations

Booz-Allen & Hamilton was asked by the Trustee of the Milwaukee Road to assist him in carrying out strategic planning studies evaluating the potential long-term viability of various configurations of the railroad's system. The planning studies were to be used by the Trustee to determine whether all or parts of the Milwaukee Road might prove economically viable and to assess the accompanying requirements for rehabilitation and investment.

The results of the studies were also to aid the Trustee in developing a reorganization plan, in determining the impact on the remaining system if parts of the system were sold off or liquidated and in analyzing the probabilities of success and the risk/reward characteristics of undertaking investment in various configurations. Specifically, Booz-Allen was asked to determine:

* The availability of traffic for various networks and configurations;
* Operational requirements for each configuration;
* Facilities and equipment required to support operations;
* Pro forma financial results for each configuration;
* Capital investments required to rehabilitate plant and equipment;
* The employment impact of each system.

FRA staff has reviewed the Booz-Allen studies to determine if the methodology and results appeared reasonable and consistent and to determine how the information that was developed could be useful to the Department's in its deliberations over the Milwaukee Road.

As a result of that review, FRA Staff has 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.

While the studies present a range of useful options, as well as criteria for evaluating further options, several caveats as to the scope of the work undertaken by the consultant should be listed.

First, the studies do not encompass all of the financial analysis that will be necessary to develop a plan of reorganization. Pro forma results were measured in terms of net rail operating income, a criteria that ignores, for instance, the amortization costs of financing the rehabilitation associated with each configuration. Second, the studies did not examine how the Trustee might obtain the funds necessary to support each projected configuration. Generally, the funds were assumed to be available, with the exception of one configuration for which the size of the potential investment was considered to be beyond the reach of the railroad. Third, the overall impacts of transitioning to various configurations including labor protection settlements and other ancillary costs were not examined. Finally, the studies did not evaluate the desirability or usefulness of various lines to rail carriers other than the Milwaukee, but simply assumed for each line that it was in or out of the Milwaukee network depending on the configuration being evaluated.

Booz-Allen & Hamilton Methodology

Booz-Allen used a "top-down" approach in developing traffic forecasts, relying on econometric assumptions but also incorporating growth from specific market opportunities that were identified by the study team through shipper surveys and by Milwaukee Road personnel. 1977 was used as a base year and traffic was added to the base to reflect three scenarios: market opportunities identified via a market survey; short term economic growth through 1981; and long term economic growth through 1986. An internal diversion analysis was used to forecast shifts in traffic both from and to the Milwaukee under various network configurations. In the 1981 and 1986 scenarios it was assumed that the rehabilitation necessary to make the Milwaukee competitive with other transcontinental railroads had been undertaken.

Operating expense projections were driven by the traffic projections and were based on two major sources of financial data: the Milwaukee's 1977 annual report to the Interstate Commerce Commission, and the Milwaukee's responsibility accounting system. Through the use of an operating simulation model and a financial model, pro forma cash operating income statements were developed for the configuration being analyzed. Rehabilitation expense was excluded from the pro forma operating income statements, but normalized maintenance after rehabilitation was included as an expense.

Finally, the study outlined the tradeoffs between the various configurations as to the costs to rehabilitate and maintain each, the number of employees for each, the revenue generated by each, and the risks associated with achieving various revenue and operating income levels for each. An additional consideration was the adequacy of the existing pool of locomotives and freight cars to the requirements of each configuration.

Much of the public debate regarding the Milwaukee centers on what to do about those lines not included in the configuration which the Trustee has identified as being potentially reorganizable. It should be pointed out, therefore, that the Booz-Allen methodology is not directly applicable to determining the economic merit of particular lines not included in the Trustee's "Core" configuration. First, it is likely that rehabilitation costs on those lines are understated. This is primarily because Booz-Allen's assessment of the condition of the Milwaukee's physical plant and the consequential rehabilitation costs were based upon 1977 information and those lines not included in the Trustee's preferred configuration have clearly deteriorated further since then as a result of the Milwaukee's cash situation. Deterioration in the Trustee's configuration has been somewhat less because of the influx of Federal "4R Act" funds into some of its main lines. Further, the studies do not allow pinpoint evalation of track condition and rehabilitation expense by line, and many operating expense items, such as equipment repair, were based on system averages and do not reflect the traffic and densities of a particular line segment. Finally, the impact of inflation was not included in the rehabilitation estimates.

It is also likely that traffic assumptions have been somewhat overstated, as was acknowledged by Booz-Allen in the report. The overstatement was due to the continued deterioration of the Milwaukee traffic base during 1978 and early 1979 as the railroad's service capabilities worsened. Recovery of the traffic lost since 1977 would be necessary before the Milwaukee could reach the base year levels used in the studies. Additionally, since the studies assumed that during the period of the forecasts rehabilitation would be in place and that adequate equipment would be available, they did not factor in time delays for rehabilitation, service recovery and traffic recovery.

Although the studies do not focus on the amount of cash required to support operating losses during the rehabilitation and projected recovery period, they do exhibit a clear bias toward risk avoidance. The consultant's calculations favored smaller over larger networks throughout, largely because the differences in returns on an operating basis did not rise proportionally with higher levels of investment. The studies did take into account the availability of resources, especially the concentration of existing equipment and manpower levels, to determine the most favored options. This approach optimized the Milwaukee's use of resources already in place and minimized the need for new investment.

Study Results

Initially Booz-Allen subjected 33 different configurations of the Milwaukee Road to preliminary analysis. These 33 configurations were constructed by dividing the Milwaukee Road into traffic providing segments and arranging them in various combinations. In the preliminary studies, market analysis was not performed and estimates were not made of future growth. The 33 preliminary scenarios were then reduced to eight:

A System Without Light Density Lines -- This system excluded all light density lines that were identified on the Milwaukee Road system diagram map dated March 31, 1978, as pending abandonment, or likely to be abandoned within three years. (7,965 route miles--10,700 employees in 1977)

The "Core" -- This system included main lines between Louisville and Duluth, Chicago and Omaha, and Milwaukee and Kansas City as well as secondary lines to Green Bay, Wausau, Sioux City, Sioux Falls, Des Moines and Madison and a number of feeder lines. (3,894 route miles--6,600 employees in 1977)

A Miles City Core -- This system included all lines in the Core system plus the Renville, Minnesota--Miles City, Montana, line, the New England branch in North Dakota, and the Sisseton branch in South Dakota. (4,661 route miles--7,100 employees in 1977)

A Subcore -- This system was a reduced Core system designed to minimize rehabilitation requirements and consisted of main lines between Louisville and Duluth, and Green Bay and Madison as well as certain feeder lines. (1,722 route miles-4,400 employees in 1977)

A Miles City Subcore -- This system included all lines in the Subcore, plus the Renville-Miles City line, the New England branch and the Sisseton branch. (2,488 route miles--4,900 employees in 1977)

A Kansas City Subcore -- This system included all lines in the Subcore, with the addition of the River Junction-Kansas City line, the Davis Junction-Sabula line, the Burlington-Beloit Junction segment and the East Moline-Albany and Eldridge branches. (2,393 route miles--5,100 employees in 1977)

A Louisville-Transcontinental System -- This system included all lines in the Subcore, plus the transcontinental main line from Renville to Portland, as well as the New England, Sisseton, Bonner, Spokane, Coeur D'Alene Senoqualmie Falls and Everett branches. (3,861 route miles--7,000 employees in 1977)

A Twin City Transcontinental System -- This system included the main line from St. Paul to Portland, as well as branches in the Sioux City-Mitchell area and most branches along the transcontinental main line. (4,467 route miles--4,300 employees in 1977)

Booz-Allen's studies conclude that the Miles City Subcore is the preferred configuration. The investment commitment would be nearly double that for the Subcore but the downside risk would be the lowest of the options considered across the range of potential traffic recovery. Booz-Allen's assessment of the other options follows:

The System without Light Density Lines produced not only the largest managerial requirement and investment commitment, but also the largest potential operating losses on the downside (lowest potential traffic levels). On the upside, potential operating income would be modest compared to the other options. In addition, this option would be the most difficult and time consuming to implement.

The Core and the Miles City Core would require substantial investments, would produce high downside risks if long-term traffic opportunities did not develop and would offer barely marginal operating expense coverage on the upside.

The Subcore principal advantage was that it would require the lowest investment. It would have somewhat less profit potential and downside risk than the Miles City Subcore. It would permit the Milwaukee the greatest concentration of equipment and management attention.

Extending the Subcore to Kansas City would require three times the investment commitment of the Subcore, and would provide only the same upside potential and somewhat greater downside risk. Booz-Allen found that because of the added investment the Kansas City Subcore was less attractive than either the Miles City Subcore or the Subcore.

The Louisville--Transcontinental system would have the highest potential if long term market opportunities and operating improvements were to be achieved. On the downside, at 1977 traffic levels the potential losses would be greater than the Subcore or the Miles City Subcore options. Further, the Louisville option would require the second highest plant rehabilitation commitment and the third highest total investment commitment. Additionally, the investment commitment would have to be largely completed before any meaningful penetration of this highly competitive market could be anticipated. Booz-Allen noted the initial risk of the Louisville Transcontinental option, with the Milwaukee Road competing from a position of weakness and facing substantial cash losses during the rehabilitation period.

The Twin City Transcontinental option, which equates to the "Western Lines" considered in other studies, also would require a substantial rehabilitation commitment with little incremental gain on the high side and increased risk on the low side. Booz-Allen foresaw a particular risk in the Milwaukee having to face direct competition with the Burlington Northern and Union Pacific while having to depend on other granger railroads to feed business at St. Paul. Further, local traffic would be minimal.

Booz-Allen concluded that: "... this option would have disastrous consequences since the Milwaukee would walk away from its direct eastern and southern connections as well as the markets in which it has a strong position in Wisconsin." Under the most optimistic scenario, the long term traffic growth of 17.9 percent by 1985 (from the base year of 1977) was the lowest of the various configurations.

Booz-Allen concluded that this segment would produce a negative contribution at 1977 traffic levels, and would require more capital for rehabilitation than would be available from Milwaukee sources. However, in an attempt to be responsive to the concerns of those states, communities and shippers served by the Pacific Coast Extension and Milwaukee employees, the Trustee requested Booz-Allen to subject this major portion of the railroad to the same level of analysis as the seven other potential configurations.

The configuration, Booz-Allen concluded, has significantly less traffic potential than any of the other options, while requiring approximately 2.5 times the rehabilitation investment as the Subcore. The rehabilitation would also have to be essentially completed before additional service-sensitive transcontinental traffic could be attracted, thus adding further to the investment risk.

The Twin Cities Transcontinental option would generate 1.9 times the revenue per carload and 18 percent more revenue per employee than the Subcore. However, the Subcore would generate 2.2 times the revenue per route mile, which Booz-Allen believed to be a more appropriate measure of the probability of success. That belief is consistent with FRA's basic views on the economies of density as developed and explained in several studies over the last several years (primarily the 4R Act Section 503 and 504/901 reports).

Conclusion

The Booz-Allen studies establish priorities for various system configurations on the basis of investment requirements and avoidance of risk, after projecting ranges of operating income based on varying levels of traffic growth. Increases in net railway operating income were not in proportion to increases in investment levels. The investment requirements ranged from \$837 million for the System without Light Density Lines down to \$51 million for the Subcore. The Twin City Transcontinental option produced a 1986 net railroad operating income of \$5 million under the most optimistic traffic scenario and a 1986 loss of \$21 million with traffic at 1977 levels. Even with the positive figure the system would fall well short of viability, considering, at a minimum, the debt service required for the $136 million rehabilitation investment plus funding of expected interim operating losses. On a conservative basis, using Booz-Allen assumptions as to improvement and growth, cash operating losses would amount to $73 million through 1985 for the transcontinental option. Financing of rehabilitation (repayment over 25 years at the government's cost of money) would require annual payments of an estimated $14.4 million per year. If the interim cash operating losses were also capitalized and financed, the combined charges would exceed $24 million per year, well in excess of the $5 million operating income generated in 1986 under optimistic traffic assumptions. Moreover, FRA's staff accords a low probability to achievement of those assumptions.

ASSESSMENT OF THE FINANCIAL SELFSUSTAINABILITY OF THE SORE LINES WEST PROPOSAL

The Consulting Center, Inc., USA
July 2, 1979

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EXECUTIVE SUMMARY

The Consulting Center's assessment of the financial selfsustainability and need for external financial assistance of a proposal to acquire, rehabilitate and operate the Chicago, Milwaukee, St. Paul and Pacific Railroad Company's lines from Minneapolis, Minn. to the Pacific Northwest, is contained in this report. This subject proposal is titled, S.O.R.E., Lines West Proposal, 1979.

SORE proposes to establish a new company to acquire and operate the assets of the Milwaukee Railroad west of St. Paul, including the necessary cars, locomotives and supplies. The lines to be acquired include 1784.7 route miles of main line, 595 miles of secondary lines and 2038 miles of branch lines. These assets are to be acquired by assuming a percentage of the Milwaukee's existing debt. The common stock of the new company would be purchased by employees of the railroad and possibly some shippers. SORE's turnaround strategy is to immediately offer more trains per day than are currently operating on the western lines, augment its equipment fleet to win back traffic lost as a result of equipment shortages, and rehabilitate the line to reduce transit time and win back time-sensitive traffic lost to competitors.

The Consulting Center's analysis consisted of examining a broad range of issues and technical subjects. These included the revenue projections, equipment acquisition plans, the rehabilitation plan, the assumed state of the economy, the bases for expenses, expectation for productivity improvements, the method for acquiring initial assets, adequacy of financing interim losses and the effect future inflation might have on SORE's projections.

As a result of its analysis the Consulting Center has concluded that SORE's projections must be adjusted in a number of respects. The more significant adjustments which need to be made are because 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. Only modest adjustments were made to revenues since SORE's revenue expectations, while ambitious, were accepted.

As a result, it is the opinion of the Consulting Center that the SORE proposal, as presently constituted, cannot initially and never will achieve selfsustainability. To pursue the SORE proposal as constituted will likely require a minimum of $1.092 billion in federal support consisting of $370 million in federal loans or loan guarantees, $638 million in federally guaranteed securities that are redeemable ten years from issuance and assuming no prior interim payments of either interest or principal, and $84 million in branch line rehabilitation grants.

In order to achieve selfsustainability 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.

REASON FOR THE STUDY

The Chicago, Milwaukee St. Paul and Pacific Railroad Company filed a voluntary petition for reorganization, under Section 77 of the Federal Bankruptcy Act, in December 1977. The order was approved and in February 1978 Mr. Stanley E.G. Hillman began serving as Trustee of the railroad.

Since that time, the Trustee and others have been trying to determine whether or not the railroad could be reorganized *in toto* or as a smaller system. In an April 23 submission to the reorganization court Mr. Hillman reported his conclusion that the railroad could not be reorganized in its present configuration and asked the court for permission to embargo freight services over 7400 route miles so that the railroad could concentrate its resources on a 2400 mile subcore[1] that stands "some chance of becoming a self-supporting system."[2] Under the Trustee's plan, the 7400 miles not included in the system would be sold to other railroads or otherwise liquidated to help meet claims against the estate.

The prospect that service will be abandoned and the rail infrastructure possibly dismantled on lines outside the subcore

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(1) The 2400 mile subcore which the Trustee hopes to reorgnize consists primarily of the Milwaukee's main lines between Louisville, Chicago, Duluth, Green Bay and Madison, certain feeder lines and a portion of the transcontinental line from Minneapolis, St. Paul to Miles City, Montana. This system was designated as the "Miles City Subcore" in an analysis by Booz Allen & Hamilton for the Trustee.

(2) *Traffic World*, April 30, 1979, p. 15

is a grim one to employees associated with these lines and to shippers for whom alternative service is not readily available. Facing termination of their jobs and feeling that "the importance of preserving service on the Milwaukee's western lines" in particular has "not received a fair hearing from either management or the Trustee,"[1] a number of Milwaukee employees grouped together in September of 1978 to analyze the potential viability of the Western Lines and to determine whether there was any alternative to the Trustee's intended abandonment of transcontinental service. Named SORE (Save Our Railroad Employment) the group is an unincorporated association whose members are all either present, retired, or recently furloughed employees of the Milwaukee Railroad.

Based upon a viability study undertaken for SORE, SORE believes that the "Milwaukee's Western Lines can be operated profitably by a properly-managed private company."[2] The manner by which the Milwaukee's transcontinental line and associated operations west of St. Paul, Minnesota, would be acquired and operated is presented by SORE in an April 28, 1979, Lines West Proposal.

As mentioned earlier, the bulk of the lines included in the SORE proposal would have been under a traffic embargo if the court had agreed to the Milwaukee Trustee's request.

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(1) Supplemental Affidavit of J. Fred Simpson in Support of (1) SORE's Motion For Leave To Intervene, and (2) SORE's Motion for an Order for Special Notice on Certain Matters; In the Matter of Chicago, Milwaukee, St. Paul & Pacific Railroad Co., Reorganization Proceedings, in the U.S. District Court for the Northern District of Illinois Eastern Div., p.10

(2) SORE Lines West Proposal, p.1

By various joint resolutions, the U.S. Congress sought to postpone the embargo for 45 to 60 days so that the SORE proposal, as well as other alternative actions to an embargo, could be studied. Although the court denied the Trustee's request on June 1, 1979, embargo at a later date remains a real possibility. For this reason and because Federal financial assistance is inherent to the SORE proposal, Congress and the Department of Transportation were interested in obtaining an independent assessment of the SORE proposal.

Toward this end the Department of Transportation retained the Consulting Center, Inc. to undertake an assessment of the financial selfsustainability of the SORE lines West Proposal. The report which follows contains the results of this assessment.

OBJECTIVES OF THE STUDY

The overall objective of the study was "to assess the financial selfsustainability and need for external financial assistance if the SORE Lines West Proposal were to be implemented." In particular, the Consulting Center was asked to:

- Analyze the SORE assumptions and projections to assess their reasonableness.
- Make independent assumptions and projections of the SORE system.
- Compare the independent assumptions and projections to those made by SORE.
- Assess SORE's ability to achieve financial self-sustainability.
- Make an independent assessment of the requirements for SORE to become financially self-sustaining.

PROJECT STAFF

The Alexandria, Virginia, branch of the Consulting Center, Inc. performed all of the work on this project with members of its own staff. The Alexandria Office is comprised of senior staff with significant railroad experience - both within the industry and within governmental agencies dealing with railroads. Collectively, we have conducted analyses of railroad operations, evaluated alternative rail investments, designed a financial forecasting model for the rail industry, evaluated loan applications, and been instrumental in developing regulatory reform proposals and other government policies affecting the rail industry. Appendix B of this report highlights qualifications of those individuals who worked on this assignment.

DATA RESOURCES

In the course of our study we utilized data regarding rail performance readily available to the firm; reviewed various documents supplied to us by DOT and SORE staff; discussed aspects of the proposal with the staff of SORE for purposes of clarification; consulted with DOT officials regarding the degree to which and under what circumstances SORE could receive federal financial assistance under existing programs; consulted with T.K. Dyer to clarify points pertaining to rehabilitation estimates for the Milwaukee railroad; and discussed the prospects of additional traffic for SORE's proposed system with several shipping executives. A list of the documents supplied to us by SORE and DOT as well as other publicly available reports used during the course of our analysis is contained in Appendix A.

SUMMARY OF THE SORE PROPOSAL

SORE proposes to establish a new company to acquire and operate the assets of the Milwaukee west of St. Paul, including necessary cars, locomotives and supplies. The lines to be acquired include 1784.7 route miles of main line trackage, 595 miles of secondary main line, and 2038 miles of branch line. No mention is made of miles of rail yards, sidings and passing track. Exhibit I portrays a map of the system. SORE also proposes to acquire the Milwaukee Land Co., "a wholly-owned subsidiary of the railroad with extensive timber and approximately 150,000 acres of land in Washington, Idaho and Montana."

Acquisition of Assets

SORE proposes to acquire these assets by assuming a percentage of the Milwaukee's existing debt. The net liquidation value of the assets SORE wishes to acquire is $370.5 million and represents 44% of the net liquidation value of the Milwaukee's total assets.[(1)] SORE thus proposes to assume $152 million or 44% of the Milwaukee's existing debt.

Ownership of Company

As presently constituted, SORE envisions that the new company's common stock would be purchased by employees of the railroad although SORE staff indicated verbally that

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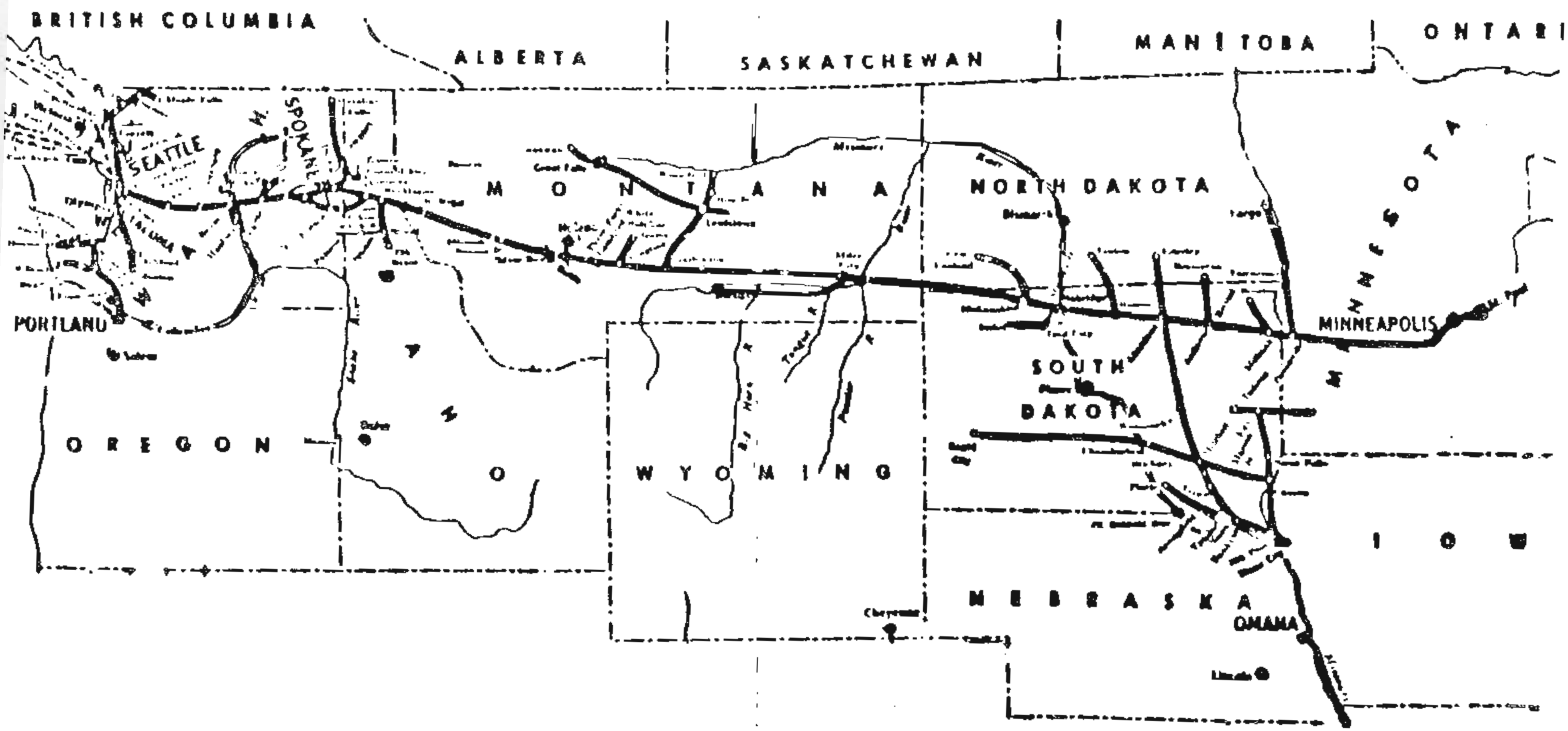
(1) Based upon a valuation study prepared for the Milwaukee Trustee by the firm of Ford, Bacon and Davis.

EXHIBIT 1



S.O.R.E.

Lines West Proposal

they hope key shippers will also contribute start up money and share in the ownership of the company. The initial equity contribution would be approximately $32 million[1] an amount based on SORE's estimate of the new company's start up expenses and need for working capital.

As described in the SORE proposal, employee acquisition of stock would be accomplished in the following manner:

> "The federal government, through the Economic Development Administration or a similar agency, would guarantee a loan of $32 million to an ESOP[2] Trust which would, in turn, use the money to purchase all of the common stock of the new company. The new company would make annual tax deductible payments to the trust with which the trust would repay the loan. As the loan is repaid, the shares of stock would be credited to the accounts of individual employees. The ESOP loan would be repaid by company contributions over 15 years."

Turnaround Strategy

At the present time, traffic carried by the lines included in the Lines West Proposal is not sufficient to enable the new company to be profitable. Present traffic levels are lower than they might be, however, for two reasons. First, shippers who are time sensitive or whose commodities could be

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(1) The Consulting Center changed the ESOP loan figure to $36 million in its analysis of fixed charges to correct an error made by SORE in preparing the first year's Sources and Applications of Funds statement.

(2) Employee Stock Ownership Plan.

easily damaged, have stopped using the Milwaukee's western lines because service on the line has been cut by the Trustee and the effects of past deferred maintenance have substantially lengthened the time needed for a train to traverse the line[1] and have precipitated an increasing number of derailments and claims due to loss and damage. Second, many shippers have been forced to use other railroads or other modes of transportation because the Milwaukee's equipment fleet is insufficient to handle all the traffic offered it.

SORE's turnaround strategy, therefore, is to immediately offer more trains per day than are currently operating on the western lines, augment its equipment fleet to gradually win back traffic lost as a result of equipment shortages, and rehabilitate the line to reduce transit time and win back time-sensitive traffic lost to competitors. These measures would also enable the western lines to obtain its share of growth forecast for the area. The economy in the area of the country served by the western lines is growing more rapidly than the U.S. economy as a whole and traffic forecasts for railroads serving this region show greater growth than the railroad industry as a whole.

SORE intends to tackle the equipment availability problem by assuming as much equipment from the Milwaukee as possible, by improving the utilization of equipment (by running more

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(1) According to testimony given by Paul F. Cruikshank, Jr., Milwaukee's V.P. of Operations, 10 mph is the maximum possible speed on 162 miles of track between Chicago & Tacoma and transit time between Tacoma & St. Paul is 137 hours. Subtracting yard and stoppage time, actual transit time was estimated by SORE at 110 hours.

frequent train service and by running trains more quickly as the track is rehabilitated) and by acquiring additional equipment as volume grows. SORE's rehabilitation program is thus as critical to this equipment plan as it is to improving service and transit times so that traffic levels can be increased. With this turnaround strategy, SORE believes the new company can begin turning a profit by the third year of operations and make increasing profits thereafter. SORE's projected income statements are reproduced in Exhibits 2, 3 and 4.

Rehabilitation Program

To correct the effects of past deferred maintenance SORE intends to increase maintenance of way expenses on all lines to "normalized" levels and to undertake a five year rehabilitation program of its main and secondary main line tracks. The program concentrates primarily on replacing ties and ballast (new and heavier rail is to be installed on only 140 miles of track although an additional 121 miles are to be improved by cascading used rail.) This program is expected to cost $118 million (1977 dollars) and SORE contemplates obtaining the necessary funds for rehabilitation from the federal government under Title V of the Rail Revitalization and Regulatory Reform Act of 1976 (the 4R Act.)

Interim Losses

As mentioned earlier, SORE's analysis indicates that the new company could begin turning a profit in its fourth year of operations. In the interim, the SORE proposal

Exhibit 2

SORE Exhibit

PRO FORMA STATEMENT OF INCOME
YEARS 1 - 5 & 10

(Amounts Stated in Thousands)

	Years 1	2	3	4	5	10
Net Revenue from Railway Operations	(19600)	(8600)	2450	13475	24500	45219
Fixed Charges	(1595)	(6608)	(7955)	(10417)	(9912)	(8397)
Income Before Taxes	(21295)	(15208)	(5515)	3058	14588	36822
Subsidiary Earnings	4000	4000	4000	4000	4000	6000
Net Income (Loss) Before Taxes	(17295)	(11208)	(1515)	7058	18588	42822

Source: SORE Lines West Proposal, p.8

Exhibit 3

SORE Exhibit

FORECAST OF NET REVENUE FROM RAILWAY OPERATIONS
(Amounts Stated in Thousands)

YEAR 1

OPERATING REVENUES

Gross Freight Revenue	$143,000
Less Adjustments and Absoptions	6,900
Net Freight Revenue	136,100
Switching	1,900
All Other	3,000
TOTAL OPERATING REVENUES	$141,000

OPERATING EXPENSES, TAXES AND RENTS

Executive Departmental Budgets	$ 600
Law Including Claims	7,200
Administration	3,300
Marketing	2,900
Finance	10,500
Operations	600
General Manager	81,000
System Engineering	3,600
Mechanical	9,300
Transportation	38,500
Taxes Other Than Payroll	2,400
Retirement Charges	200
Depreciation Charges	1,500
TOTAL EXPENSES, TAXES AND RENTS	$160,600
NET REVENUE (LOSS) FROM RAILWAY OPERATIONS	$(19,600)

Source: SORE Lines West Proposal, Appendix A - Page 11

FORECAST OF NET REVENUE FROM RAILWAY OPERATIONS
(Amounts Stated in Thousands)

YEAR 5

OPERATING REVENUES

Gross Freight Revenue	$244,900
Less Adjustments and Absorptions	11,800
Net Freight Revenue	233,100
Switching	2,200
All Other	4,500
TOTAL OPERATING REVENUES	$239,800

OPERATING EXPENSES, TAXES AND RENTS

Executive Departmental Budgets	$ 800
Law Including Claims	6,200
Administration	4,000
Marketing	3,100
Finance	10,500
Operations	600
General Manager	105,400
Engineering	7,400
Mechanical	25,800
Transportation	47,100
Taxes Other Than Payroll	2,200
Retirement Charges	200
Depreciation Charges	2,000
TOTAL EXPENSES, TAXES AND RENTS	$215,300
NET REVENUE RAILWAY OPERATIONS	$ 24,500

Source: SORE Lines West Proposal Appendix A - Page 12 indicates that it will finance its initial losses and debt servicing requirements with an Emergency Rail Services Act (ERSA) loan of $20.2 million and with earnings from the Milwaukee Land Company. Annual financial contributions from the land company are estimated to be $4 million for the first five years of operation and $6 million thereafter. In oral conversations, however, SORE representatives indicated they understood the new company would not be eligible for funding under the Emergency Rail Services Act because only railroads in bankruptcy are eligible for financial assistance under that Act. As a substitute, SORE is hopeful that support for initial losses can be obtained from shippers, in exchange for partial ownership of the company, and perhaps from several state governments as well. For purposes of this report, however, the Consulting Center assumed interim losses would be financed by debt. The potential sources of that debt and the ability of SORE to obtain it will be discussed later in this report.

Summary of Federal Participation under the SORE Proposal

The SORE proposal readily admits that it can succeed only with federal financial assistance. To recapitulate, SORE hopes the government will make available:

(1) Approximately $118 million in Title V funds for its rehabilitation program....SORE hopes to obtain these funds at available low interest

rates and under available deferred payment schedules.[1]

(2) A loan guarantee of $32.1 million to the employees of the railroad in order to establish the necessary employee owned trust to acquire the stock ownership of the new railroad.

(3) Possibly a loan (Emergency Rail Services Act or federally guaranteed loan of some sort) to cover SORE's estimated first two year operating cash shortfall of $20.2 million.

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(1) Under existing regulations, Title V funds for rehabilitation of deteriorated facilities can be obtained which carry 2-3% rates of interest with delayed payment and which defer principal repayments until the eleventh year after borrowing.

ASSESSMENT OF SORE PROPOSAL

The western lines SORE proposes to acquire and operate as an independent entity are currently part of the Milwaukee Railroad which has been operating under Section 77 bankruptcy proceedings since January, 1978. As in the case of the Northeastern railroads which went bankrupt in the early seventies, the cause of the Milwaukee's failure was not related to its debt structure but to more fundamental problems: the Milwaukee's revenues were insufficient to cover its operating expenses. 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 the 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.

It is for this reason that the Milwaukee Trustee has determined that the Railroad's resources must be concentrated upon a smaller, less redundant system if the railroad is to be reorganized. The Trustee's strategy is to select a contiguous core of lines whose average revenue densities are higher than $38,000/mile[1]. As stated in a May 1979 Booz Allen report to the Trustee, the rationale for this

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(1) Represents 1977 System Freight Revenues, less overhead traffic divided by miles of road operated.

cutoff figure was as follows:

> "Since the system as a whole had not been profitable with an _average_ revenue density of $38,000/mile, the initial definition of the CORE used that figure as a _minimum_ revenue density and as the starting point to define the CORE."(1)

According to SORE, the 1977 gross freight revenue attributable to the lines comprising the SORE proposal amounted to $143 million (after subtracting $35 million for lines East division.) Without adjusting for overhead traffic, these revenues equate to an average revenue per mile of roughly $32,000 based on a total route mileage of 4417.

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. As previously described, 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.

Thrust of Consulting Center's Analysis

In assessing SORE's proposal, therefore, the Consulting

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(1) _The Milwaukee Road Strategic Planning Studies_, May 1979 Prepared by Booz Allen & Hamilton Transportation Consulting Division, p.III-2.

Center was particularly interested in answering the following sorts of questions:

On what assumptions were SORE's projected revenues based? How much and in what years did SORE expect to win back revenues lost due to equipment shortages? Is SORE's equipment acquisition plan adequate to meet these goals? How much and in what years did SORE expect to win back time-sensitive traffic? Is SORE's rehabilitation plan adequate to meet these goals? What rates did SORE assume in projecting future growth? How do these compare with forecasts for the industry as a whole and for the western region in particular? On what assumptions were SORE's expenses based? Did expenses adequately reflect more frequent train service? What improvements in expenses, if any, were assumed over time?

In addition to questions pertaining to operating projections, the Consulting Center also evaluated SORE's assumptions with regard to the initial acquisition of assets from the Milwaukee, the adequacy of start up costs, the adequacy and availability of funds to finance interim losses, the adequacy of net income to cover fixed charges, the adequacy of SORE's projected capital structure, the adequacy of the normalized maintenance program and the effect future inflation might have on SORE's projections.

To analyze SORE's assumptions and to answer these questions, the Consulting Center relied primarily on SORE's April 28, 1979 proposal, on work papers underlying the proposal provided to us by SORE, and on conversations with SORE staff, although a number of other sources listed in Appendix A were used for comparison purposes or to provide points of reference.

Because of the short time span within which the SORE proposal was put together, SORE was able to provide annual pro forma projections to revenues and expenses only for year 1 and year 5 of its operations. Also, due to lack of data, SORE was unable to present projected expenses in a format that lends comparison to other railroads. SORE expenses are listed by categories related to the Milwaukee Railroad's system of responsibility accounting rather than by general ICC accounts. To adequately assess SORE's proposal, therefore, the Consulting Center regrouped and re-stated SORE's expenses in an ICC account format and in making its independent forecast, developed annual estimates of revenues and expenses for years 1-6. These adjustments of necessity required some degree of interpolation which may have resulted in small swings in individual accounts or in the intervening years between the first and fifth year, but the interpolation in no way affects our overall conclusion.

The Consulting Center would like to acknowledge the cooperation and helpfulness exhibited to us by the SORE staff. To the extent of SORE's ability, our questions were answered and except for a few items, work papers and verbal answers enabled us to develop our restatement of SORE expenses.

Overall Conclusion

As a result of its analysis the Consulting Center has concluded that SORE's projections must be adjusted in a number of respects. The adjustments, and our rationale for making them are discussed in detail in the following pages. To briefly summarize the more significant adjustments: SORE's expenses were 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.

As a result, it is the opinion of the Consulting Center that the SORE proposal, as presently constituted cannot initially and never will achieve selfsustainability. Although long term revenue potential in the area served by the Milwaukee's western lines is relatively promising, the cost of acquiring and rehabilitating the lines to provide proper service, the cost of financing interim losses and annual cash shortfalls, and the cost of acquiring enough rolling stock to carry the traffic, overwhelm the earnings that could be generated from operating the transcontinental line as a separate railroad.

SORE's Assumptions with Regard to Acquisition of Assets *

SORE proposes to acquire the rights of way and railroad property thereon of the transcontinental line from Minneapolis/St. Paul to the Pacific N.W. and associated lines as shown on the map reproduced as Exhibit 1. In addition, SORE proposes to acquire the Milwaukee Motor Transportation Company, shares in certain of the Milwaukee's investments in switching and terminal companies, full ownership of the Milwaukee Land Company, 44% of the Milwaukee's rolling stock and other equipment, and a portion of the Milwaukee's inventory of materials and supplies. SORE's list of these assets, and their respective liquidation values according to a study done for the Milwaukee Trustee by Ford, Bacon & Davis, is reproduced herein as Exhibit 5.

SORE's liquidation value of real property is based on the sum of acreage values by state which can be attributed to the western lines. The liquidation value of roadway property is based on a pro rata share by mileage of the total liquidation value for the Milwaukee's roadway property. The remaining assets, except for the Milwaukee Land Co., are estimated at 44% of Milwaukee totals, on the assumption that the Western lines constitute approximately 44% of the Milwaukee's total rail system. The total liquidation value of these assets, as defined by the firm of Ford, Bacon & Davis amounts to $370 million.

SORE proposes to acquire these assets from the Milwaukee by assuming a pro rata share of the Milwaukee's existing debt. Since the liquidation value of the assets SORE wishes to acquire represent 44% of the liquidation value ($832 million) of all of the Milwaukee's assets, SORE proposes to assume 44% of the Milwaukee's debt. SORE estimates that it will assume approximately $152 million of a mixture of bonds, debentures, and unsecured debt. SORE intends to resume repayment of the interest and principal of the assumed bond and debenture debt according to existing terms of each class of debt. A non-cumulative 6% preferred stock would be issued to the balance of unsecured debt assumed by the new company and SORE estimates it can begin paying dividends on this stock by the fourth or

Exhibit 5

LIQUIDATION VALUE OF ASSETS TO BE ACQUIRED

(000)

I. REAL PROPERTY OF RAILROAD:

Idaho	4029 acres	$2,075
Minnesota	1768	5,000
Montana	26745	6,080
North Dakota	7218	1,500
South Dakota	30941	7,650
Washington	17504	43,057
	88205	$65,362

II. ROADWAY PROPERTY:

Track	$112,752
Signals & Communications	1,188
	$113,940

III. MILWAUKEE MOTOR TRANSPORTATION COMPANY:

Liquidation Value $1,330	44%	$585

IV. OTHER INVESTMENTS:

Longview Switching Company	$ 11
Delta Alaska Terminal, Ltd.	1
Minneapolis Eastern Ry. Co. 40%	10
Minnesota Transfer Ry. Co. 40%	114
Trailer Train	247
	$383

V. MILWAUKEE LAND COMPANY: $110,203

VI. OWNED EQUIPMENT:

Freight Train Cars	44%	$50,568
Locomotives	44%	13,050
Work Equipment	44%	3,673
Motor Vehicles, Shop & Power Plant Machinery	40%	981
		$68,272

VII. INVENTORY (Materials & Supplies): $11,717

TOTAL ASSETS $370,462

Source: SORE Lines West Proposal, p.5

fifth year of operations.

Consulting Centers Assessment & Adjustments to SORE's Asset Acquisition Assumptions

- Assets to be Acquired - In the opinion of the Consulting Center, there are a number of problems with SORE's list of assets to be acquired and with the values assigned to them. These are discussed in turn below.

  (1) Rail Assets to be Acquired Overlap Assets Included in the Milwaukee Trustee's Subcore.

  In an April 1979 report to its reorganization court, Trustee Hillman identified a 2400 mile subcore as being the system he felt the railroad should attempt to reorganize. This subcore was termed the Miles City Subcore in the Milwaukee's May 1979 Strategic Planning Studies Report. As can be seen in the map of that Subcore, Exhibit 6, the Trustee's system overlaps the proposed SORE proposal from Minneapolis/St. Paul to Miles City, Montana.

  When asked about the overlap, SORE staff responded that Trustee Hillman had indicated a willingness to drop the Minneapolis to Miles City extension from his Subcore if the SORE proposal were implemented. For purposes of this report, therefore, the Consulting Center has assumed that the overlap would not exist. Since Mr. Hillman has subsequently resigned as Trustee, and the State

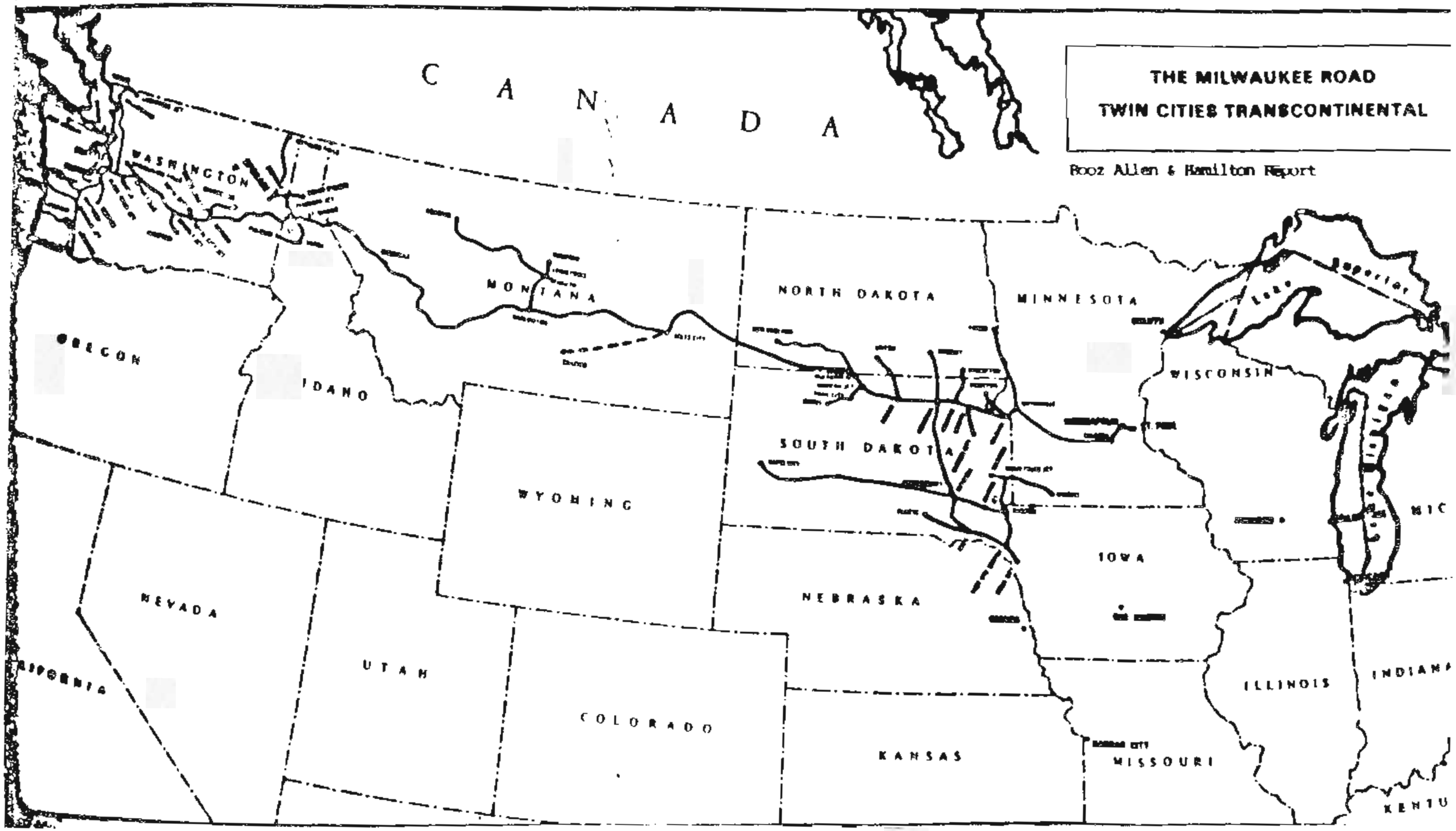
THE MILWAUKEE ROAD
TWIN CITIES TRANSCONTINENTAL
Booz Allen & Hamilton Report
CANADA
WASHINGTON
OREGON
IDAHO
MONTANA
NORTH DAKOTA
MINNESOTA
SOUTH DAKOTA
WYOMING
NEVADA
UTAH
COLORADO
NEBRASKA
IOWA
KANSAS
MISSOURI
ILLINOIS
WISCONSIN
INDIANA
KENTU
MIC
Lake Superior
Lake Michigan

EXHIBIT C

of South Dakota is negotiating with FRA to obtain rehabilitation funds for sections of this line, however, the new Trustee and the South Dakota government will probably wish to have a say in the ultimate designation of this line segment.

(2) Equipment Assets to be Acquired Overlap Assets to be Included in the Milwaukee Trustee's Subcore.

The SORE proposal indicates that it wishes to acquire 44% of the Milwaukee's rolling stock and other equipment. Since the Milwaukee presently owns about 24,000 cars[(1)], one can presume that SORE hopes to acquire about 10,000 cars. According to the Milwaukee's Strategic Planning Studies, however, the Trustee will need 17,000 cars to meet present equipment shortages and provide for long term growth[(2)]. 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 adjustments made are examined in the discussion of net rents.

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(1) Excluding Trailer Train Cars and cars over 40 years old.

(2) Based on Exhibit VI-4, Freight Car Summary, Milwaukee Strategic Planning Studies. This total represents the freight car requirements of the Trustee's subcore excluding the Miles City extension.

(3) SORE's proposed acquisition of the Milwaukee Land Co. is unacceptable.

SORE proposes to acquire the Milwaukee Land Co. a wholly owned subsidiary of the Milwaukee, in addition to the rail assets needed to operate the western lines as a separate railroad. SORE's desire to acquire the Land Company stems from two factors. First, the Land Company owns properties SORE considers essential to its long run viability. According to SORE, "These properties include the proposed Fife Yard site for the new western terminus at Tacoma, the Washington, Idaho and Montana Railroad, and industrial lands which have potential for feeding substantial traffic over the lines of the new company." Second, SORE hopes to use some of the land company's earnings from timber harvesting to help cover debt servicing requirements in SORE's early years and to help cushion future declines in income due to economic slowdowns.

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 Co., particularly for an amount considerably less than its full net liquidation value. The firm of Ford, Bacon and 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 Co. is one of the Milwaukee Railroad's most valuable and most liquid of assets. Indeed, if the Penn Central case can be looked to for comparison, the Milwaukee Land Co. may become the framework around which liquidation of assets not included in the subcore or SORE are managed. The only way SORE could acquire the Milwaukee Land Co. 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. The firm of Day & Zimmerman, in an assessment of the Milwaukee's Estimated Liquidation Value, commissioned by FRA, concluded that the Land Company is "potentially more valuable as a going concern."[1] According to an assessment of a

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(1) <u>Assessment of the Estimated Liquidation Value of the Chicago, Milwaukee, St. Paul & Pacific Railroad</u>, March 2, 1979, prepared by Day & Zimmerman.

Milwaukee's Section 505 Loan Application, the Land Company's average annual pre tax income over the 1972-1976 period was $8.6 million.(1) A five year projection developed by the Land Company indicated the future will be more promising; net income is expected to average $10.8 million over the 1979-1983 period.(2)

For these reasons, and because any objective assessment of the future selfsustainability of the western lines must be based upon the potential earning power of those lines alone, the Consulting Center has assumed that the Land Company would not be among the assets acquired by SORE. Instead, we have assumed that an agreement could be reached among SORE, the Milwaukee Land Co., the Milwaukee Trustee and the reorganization court to allow SORE to acquire the needed yard site at Fife and controlling interest in the Washington, Idaho and Montana Railroad. We have accepted SORE's valuation estimate of rail assets to be acquired to include the purchase of these special assets.

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(1) Analysis of Milwaukee's Interim Corridor Project, 505 Loan Application. prepared by James Hanscom for FRA, July, 1977.

(2) Milwaukee Land Co. forecast prepared by A.L. Nance for R.V. Nugent, Jr., V.P. Finance of the Milwaukee, June 13, 1978.

(4) Minor Problems with Other Assets

A similar problem may exist with respect to SORE's intention to acquire the Milwaukee Motor Transportation Co. That company is also a going concern and its going concern value may be higher than its net liquidation value. According to a report done for FRA[1], trucking earnings contributed \$1.7 million in pretax income to the Milwaukee in 1976. As described by Ford, Bacon & Davis 94% of the net liquidation value of \$1.3 million represents equipment (net of obligations.) Ford, Bacon & Davis did not attribute much value to the operating certificates held by the trucking company but these are often among a motor carrier's more valuable assets[2]. The amount involved is relatively small, however, so the Consulting Center ignored the asset in summing the value of rail assets to be acquired by SORE.

Additional problems may exist with SORE's intention to acquire percentages of the Milwaukee's investments in various terminal and switching 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. Moreover,

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(1) P.3, Analysis of the Chicago, Milwaukee, St. Paul & Pacific Company's Intermin Corridor Project, 505 Loan Application, by James Hanscom

(2) Unless entry provisions in the trucking industry are substantially eased.

the values listed by SORE for these shares are based on book values and may not relate to selling values. Since the values are so insignificant, the Consulting Center has ignored them in the analysis.

- Method of Acquisition

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 Milwukee 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 & Northwestern railroad, the circumstances of that acquisition were entirely different. First, the debt assumed by the employees of the Chicago & Northwestern amounted to approximately $405 million and the book value of the assets assumed amounted to approximately $440 million[(1)]. Second, the Chicago & Northwestern 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.

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(1) Aggregate debt assumed from Moody's Transportation Manual. Book value figure is from balance sheet total as of December 31, 1972, also according to Moody's Transportation Manual.

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. Moreover, creditors have more alternatives open to them in the Milwaukee situation than they did in the case of the Chicago Northwestern because the Milwaukee railroad is currently operating under Section 77 bankruptcy proceedings and the Trustee has already determined that the railroad cannot be reorganized as presently constituted. Since Section 77 requires the Trustee and the court to balance interest of creditors, employees, shippers and the general public, creditors may not be able to block any Trustee proposed reorganization. On the other hand, if such a reorganization cannot be accomplished without federal financial assistance, creditors may be able to argue that the venture is not a true reorganization and that they will agree to it only if the government guarantees the value of securities given them.

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

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guaranteed by the Federal Government.

The Consulting Center's opinions on these points are necessarily speculative but we believe them to be the most consistent with precedent. It should be emphasized however, that these conclusions depend upon legal interpretations of law and precedent and that they should be submitted to legal authorities for verification.

- Revised Assumptions with Respect to Assets

To summarize, the Consulting Center assumed that SORE would acquire the following assets at the following values:

I.	Real Property		
	88205 acres	$65,362,000	(unchanged)
II.	Roadway Property		
	Track	$112,752,000	
	Signals & Communications	1,118,000	
		$113,940,000	(unchanged)
III.	Equipment	55,000,000 (1)	
IV.	Inventory (Materials & Supplies)	11,717,000	(unchanged)
	TOTAL:	$246,019,000	

Secondly, the Consulting Center assumed that SORE would have to obtain a Federally guaranteed loan for this amount or issue securities guaranteed by the Federal Government to the Milwaukee estate which are

(1) Assumes SORE could only acquire 30% of Milwaukee owned freight cars and that acquisition price of the equipment would be net liquidation value not excluding outstanding obligations.

redeemable at some future date for this amount, adjusted for the time value of money. If the securities were redeemable in year 10, for example, the amount issued would have to equal $638.1 million assuming the money could earn 10.0% annually, if otherwise invested.

SORE's Assumptions with Regard to Rehabilitation and Maintenance of Way.

The SORE proposal includes a five year program for rehabilitation of the system's main lines. In SORE's words, "the program has been designed to allow rational upgrading of the plant without the excessive cost which would incur if it were attempted to repair the results of twenty years deferred maintenance in one year." The rehabiliation program is expected to bring the system's main lines up to Class IV standards (60 mile per hour time table speed.) At these speeds, train service should be competitive with other railroads serving the transcontinental route particularly since the Milwaukee's line is reputed to be "the shortest route between Puget Sound and the Midwest as well as the least grade and curvature."

As previously mentioned, rehabilitation of the western main line is critical to SORE's potential success. Without it, SORE cannot hope to offer frequent, reliable service necessary to retain and augment present traffic levels nor to win back time-sensitive traffic. Moreover, without it, SORE cannot achieve planned improvements in equipment utilization (shorter average car cycle days) inherent to its equipment acquisition program. In analyzing SORE's rehabilitation program, therefore, the Consulting Center sought to determine whether SORE's rehabilitation program was adequate to accomplish the desired improvements to the system.

- <u>Summary of the Rehabilitation Program</u>

SORE's rehabilitation program is spread over five years and is designed to rehabilitate the most seriously deteriorated sections of the system's main and secondary main lines. Most of the programmed work calls for replacement of cross ties and ballast although the plan includes installation of new 132 pound rail over 140 miles and the installation of 115 pound second-hand rail over 121 miles. In constant 1977 dollars, the annual amounts to be expended are:

	Cost	No. Miles Improved[1]
Year 1	\$12.3 million	170
Year 2	\$25.9 million	280
Year 3	\$28.2 million	282
Year 4	\$27.2 million	272
Year 5	\$24.4 million	274
TOTAL:	\$118.0 million	1,278

Average Cost per Mile Improved = \$92,000

In addition to the rehabilitation program, SORE's expense

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(1) Based on interpolation of SORE's detailed rehabilitation plan.

projections include annual maintenance of way expenses at normalized levels for the first five years. Normalized levels were calculated by SORE as follows:

	Cost/Mile	No. Route Miles	Cost
Mainlines	$10,000	1,785	$17.7 million
Secondary Mainlines	6,500	595	3.8 million
Branch Lines	3,500	2,038	7.1 million
Total:		4,418	$28.6 million[1]

In addition, SORE included $3.6 million (growing to $7.2 million in year 5) of system programmed maintenance in its expense projections.[2] According to the SORE proposal, this total maintenance of way budget will hold or gradually improve territories not immediately scheduled for major rehabilitation.

The SORE proposal does not provide for the rehabilitation of branch lines because SORE believes the branch lines can continue to be operated if maintained at normalized levels until funding becomes available for their rehabilitation. According to the proposal and conversations with staff, SORE intends to rely upon State and shipper assisted programs to provide funds for branch line rehabilitation.

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(1) This amount was confirmed by SORE's work papers and is included in the General Manager Account in SORE's expense projections.

(2) This amount is included in the Engineer's account in SORE's expense projections.

- Adequacy of Rehabilitation Program

To assess the adequacy of SORE's rehabilitation program, the Consulting Center examined several other estimates for comparison. First was the Milwaukee Railroad's Interim Corridor Rehabilitation Project which was approved and funded by the FRA. As presented in a "Recommendation Package Memorandum"[1] on that application, the Milwaukee's rehabilitation program on that corridor consisted of the following:

	# Route Miles	Total Cost	Cost/Mile
1. Section from Milwaukee Wisconsin to the Minn. St. Line	194[2]	$14.2 million	$73,000
2. Section from Minn. St. Line to Newport, Minn.	119.5	$ 8.2 million	$68,600

According to descriptions of those projects, the bulk of these funds were to be expended on resurfacing and replacing cross ties; very little (a total of 25 track miles) installation of new rail was included in the two projects.

The Consulting Center also reviewed the rehabilitation estimate made by T.K. Dyer in conjunction with Booz Allen & Hamilton's report, The Milwaukee Road Strategic Planning Studies. For the Twin Cities Transcontinental alternative (which as noted earlier is virtually the same system as the SORE Lines West proposal), Dyer estimated the following

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(1) Recommendation Package: Milwaukee Road, Section 505 and Section 511 Projects Docket Nos. RFA 505-76-1 and RFA 511-76-2, Memorandum from RFA-10 to RFA-1, July 31, 1978.

(2) Based on mile post data.

rehabilitation program.[1]

Total Rehabilitation	Net Rehabilitation
Requirement to bring track to competitive levels at the end of 1977	Minimum requirement in excess of ten year normalized maintenance
$258 million	$130 million

There are several important differences between the Dyer estimates and SORE's. First, the Dyer estimate includes rehabilitation of branch lines as well as main and secondary lines. Second, the Dyer estimate was designed to rehabilitate the main line track to Class IV standards from Minneapolis to Miles City, Montana, but only to Class III standards from Miles City to the Pacific Northwest. Third, Dyer's net rehabilitation estimate, which is the one which should be used assuming annual maintenance of way expenses are at normalized levels, was based on a rehabilitation program spread over ten years. If branch line rehabilitation is removed from the Dyer estimate, Dyer's gross rehabilitation program equates to a cost of $59,000 per mile.[2]

Based upon these comparisons, the Consulting Center believes that SORE's rehabilitation program <u>for its system main lines</u>, is adequate to accomplish the intended improvements. This conclusion was buttressed by a

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(1) From Exhibit VI-7, <u>Milwaukee Road Strategic Planning Studies</u>

(2) Based on figures in Appendix L(3), <u>Milwaukee Road Strategic Planning Studies</u>.

telephone conversation with T.K. Dyer. Mr. Dyer stated that he did not doubt that SORE's rehabilitation program was adequate to raise its system main lines to Class IV standards. On the other hand, 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.

- <u>Effect of Inflation on Rehabilitation Estimate</u>

SORE's rehabilitation estimate was based on 1977 prices. Yet the rehabilitation program will be spread over the first five years and will most certainly cost more than planned in current dollars. To estimate the current dollar cost of the rehabilitation program, the Consulting Center multiplied the 1977 annual dollar estimates by the Chase Econometric's June 1979 Long Term Forecast of the Wholesale Price Index for Industrial Commodities as shown in Exhibit 7. According to these calculations, SORE's rehabilitation program will total 166 million current dollars.

- <u>Adequacy of MOW Expenses</u>

SORE's first year maintenance of way expenses total $32.2 million net of depreciation. Allocating $0.7 million of SORE's total estimated retirements and depreciation, the Consulting Center adjusted this number to $32.9 million. This maintenance of way estimate equates to 23% of SORE's first year revenues. By contrast, the ratio of maintenance of way expenses to revenues developed by Booz Allen for its Twin Cities Transcontinental system was 27.3%.

SORE's maintenance of way budget was developed on the basis of system route miles. These mileage figures do not include yards and passing tracks. When questioned about the need for budgeting maintenance of way expenses for these tracks, SORE staff responded that it felt its budget could cover these expenses since the normalized maintenance budgeted for lines to be rehabilitated could be allocated to yards and sidings. In the opinion of the Consulting Center, however, the normalized estimates cannot be manipulated in this manner because they are based on average costs per mile. As a consequence, and because comparisons indicate that SORE's MOW budget may be somewhat on the low side to start with, the Consulting Center added an annual $4.0 million to SORE's maintenance of way budget.

The derivation of the $4.0 million adjustment was as follows:

According to data contained in the Booz Allen report, yards, sidings and passing tracks represent 29% of the Milwaukee's track mileage for main, secondary and branch lines. Since there are fewer yards in the western lines (but passing tracks exist every 4 miles on the transcontinental line according to SORE staff) we assumed these tracks represented only 20% of the western lines total system. We therefore added an additional 883.5 miles to SORE's total route mileage of 4,417.7 miles. Using a maintenance cost of $4,500 per mile for these tracks,

Exhibit 7

EFFECT OF INFLATION ON SORE's REHABILITATION PROGRAM

SORE's ANNUAL REHABILITATION PROGRAM

	1977 dollars	Inflation Factor [1]	Current $ [2]
Year 1	$12.3 mill.	1.22	15.0 mill.
Year 2	25.9 mill.	1.30	33.7 mill.
Year 3	28.2 mill.	1.38	38.9 mill.
Year 4	27.2 mill.	1.47	40.0 mill.
Year 5	24.4 mill.	1.57	38.3 mill.
TOTAL:	$118.0 mill.		$165.9 mill.

(1) Based upon Chase Econometric's June, 1979 Long Term Forecast of the Wholesale Price Index for Industrial Commodities as shown Below:

				Cumulative Increase
1978	=	7.3		
1979	=	8.1	=	1.15
1980	=	6.7	=	1.22
1981	=	6.6	=	1.30
1982	=	6.8	=	1.38
1983	=	6.9	=	1.47
1984	=	6.9	=	1.57

(2) Assuming SOPE's Year 1 is 1980.

as recommended by T.K. Dyer, we determined that SORE should increase its maintenance of way budget by 4.0 million annually. The adjusted MOW budget represents 26% of SORE's revenues in its first year.

- Adequacy of Rehabilitation Assumption for Branch Lines

As mentioned earlier, SORE did not budget any rehabilitation funds for branch lines. Instead, the proposal mentions that SORE will seek such financing from shippers and state and local governments. To determine the likely extent of such financing needs, the Consulting Center made the following calculation. According to Appendix L(3) of the Booz Allen report, gross rehabilitation expenses for the Milwaukee's total branch lines amounts to $173.2 million. Dyer advised us that the net rehabilitation expense for branch lines would be $86.6 million if annual maintenance on these branch lines were held at normalized levels. According to SORE, branch lines on the western lines total 2038 miles or 68% of the Milwaukee's total branch lines. Based on this percentage, rehabilitation of SORE's branch lines would cost approximately $60 million although since SORE's normalized MOW budget of $3500 per mile for branch lines may be somewhat low, a more conservative estimate of the net rehabilitation cost of SORE's branch lines might be $70 million[1]

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(1) Even this figure is probably too low since SORE staff reported that the Milwaukee estimated in an abandonment proceeding it would cost $48 million to rehabilitate only the Rapid City Line.

Based on existing branch line subsidy programs, the Consulting Center has assumed that the cost of rehabilitating these branch lines would come entirely from shippers or state and local governments in the form of grants, not loans. Using the same annualized breakdown proportions of the main line rehabilitation program for the required branch line program the Consulting Center estimates a branch line rehabilitation program of $84 million, inflated.

Consulting Center's Assessment and Adjustments to SORE's Projected Revenues

SORE's revenue projections for the first five years of operations are presented in Exhibit 8. These figures were obtained from a SORE work paper and were based on the following assumptions:

(1) That based on the Milwaukee's revenue flow map 1977 revenues attributable to the western lines were $166 million.

(2) That $35 million of that base should be subtracted to reflect lines east divisions.

(3) That all annual revenues would grow at 3% due to growth in the general economy.

(4) That, based upon a traffic survey done by the Milwaukee and talks with shippers, SORE could recapture traffic lost because of equipment shortages by increasing its ownership (or rentals) of equipment. SORE assumed recapture of equipment sensitive traffic would yield $12 million in revenues in year 1; $15 million in year 2; $13 million in year 3; and $10 million in year 4.

Exhibit 8

SORE's REVENUE PROJECTIONS

Year 1	
Lines West Revenues by Line Segment	$166 million
Less Revenues Attributable to Lines East Division	35 million
Total Base Revenue	$131 million
Additional Revenues Available if Equipment Availability is Improved	12 million
TOTAL:	$143 million
Year 2	
Year 1 Revenues plus 3% growth	$147.3 million
Additional Revenues Available if Equipment Availability is Improved	15.0 million
TOTAL:	$162.3 million
Year 3	
Year 2 Revenues plus 3% growth	$167.2 million
Additional Revenues Available if Equipment Availability is Improved	13.0 million
Additional Revenues from Recapturing Time-Sensitive Traffic	6.0 million
TOTAL:	$186.2 million
Year 4	
Year 3 Revenues plus 3% growth	$191.6 million
Additional Revenues Available if Equipment Availability is Improved	10.0 million
Additional Revenues From Recapturing Time-Sensitive Traffic	10.0 million
TOTAL:	$211.6 million
Year 5	
Year 4 Revenues Plus 3% Growth	$217.9 million
Additional Revenues from Recapturing Time-Sensitive Traffic	10.0 million
Additional Coal Revenues	10.0 million
TOTAL:	$244.9 million

SOURCE: SORE work paper, 2/1/79

(5) That, based upon the same information, SORE could recapture time-sensitive traffic if it could improve transit time and service reliability by increasing the frequency of train service and by rehabilitating the track.

Each of these assumptions will be discussed below.

- Base Revenues Attributable to the Western Lines

SORE's $131 million estimate of the revenues attributable to the western lines is substantially below those made in two other studies reviewed by the Consulting Center. Booz Allen & Hamilton's estimate of revenues attributable to the Milwaukee's western lines in 1977 was $168.8 million.[1] The firm of Reebie Associates estimated that 1977 revenues attributable to the western lines amounted to $189.6 million in a recent preliminary draft report to the Federal Railroad Administration. The Reebie Assoc.'s analysis, however, was based on route miles of 4,265; the Booz Allen estimate was based on a 4500 mile system, virtually the same in size as the SORE proposal.

To reconcile the difference, the Consulting Center attempted to determine whether or not the additional revenues contained in these two studies were related to volume or to assumptions with regard to on-line divisions.

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(1) Exhibit VI-1, 1977 level statistics, the Milwaukee Road Strategic Planning Studies, May 1979, Prepared by Booz Allen & Hamilton Transportation Consulting Division.

We therefore compared each study's assumptions with regard to 1977 levels in carloads. According to work papers, and conversation with staff, SORE assumed that its first year's total carloads would amount to 200,750. 1977 revenue carloads for the Twin Cities Transcontinental system were listed by Booz Allen as 270,000. Reebie Associates' carload figure was 257,495. On the basis of these carload comparisons the Consulting Center determined the differences were related to volume rather than to discrepancies regarding the allocation of division revenues. As a result, if any adjustment was to be made to SORE's base revenue, a similar adjustment would have to be made to SORE's base operating expenses.

The Consulting Center decided not to make any adjustments to SORE's first year revenues for two reasons. First, SORE's estimates were based on 1977 traffic levels. Since that time, traffic levels on the western lines have dropped drastically (traffic is down 70% according to SORE staff) because the Trustee has cut train service on these lines to one train per day in order to save cash and has diverted equipment from the west to the midwest to meet shortages there. Hence, the SORE system may have difficulty reaching its own estimate of 1977 traffic levels in year 1, much less higher ones. Second, SORE staff assumed the new company could recapture in year 1 $12 million of revenues lost due to equipment shortages in addition to its base revenues. While SORE may be overly optimistic with regard to the speed with which it can reverse current trends, the Consulting Center decided to accede to SORE's initial revenue estimate.

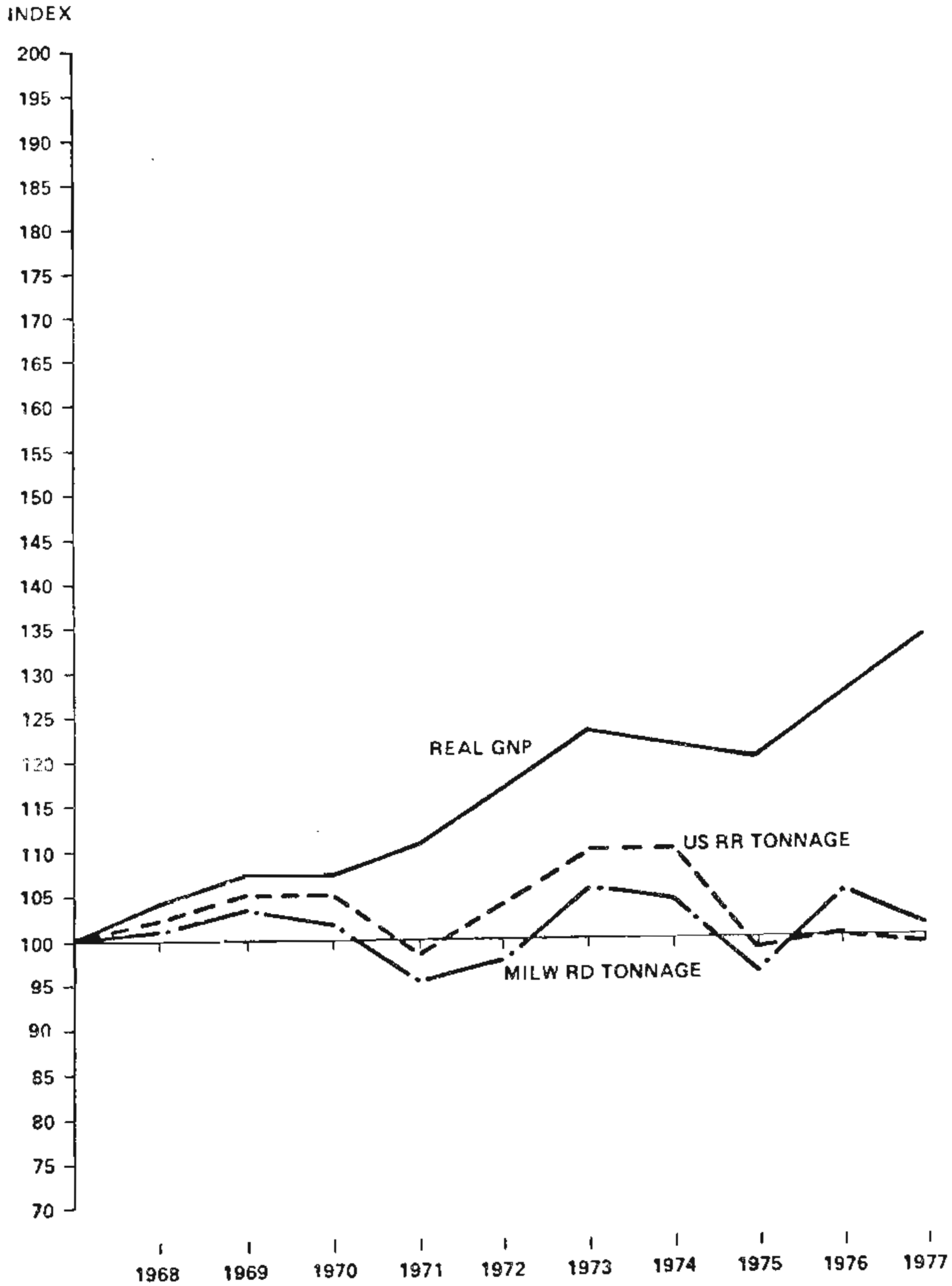
- <u>Assessment of SORE's 3% Annual Rate of Growth</u>

In the opinion of the Consulting Center, SORE's use of a 3% annual rate of growth factor is too optimistic for the following reasons: it ignores cyclical downturns in the economy; it assumes all commodities 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.

As shown in Exhibit 9, historic trends reveal that tonnage on the Milwaukee Railroad and the U.S. rail industry as a whole, has grown more slowly than the GNP. Yet, as shown in Exhibit 10, the Milwaukee's coal traffic, except in the last few years which may reflect the Milwaukee's financial difficulties, has been growing faster than non-coal traffic and faster than the GNP. To better assess the potential growth of revenues on the Western lines, therefore, the Consulting Center first broke down SORE's revenues into coal and all other. This adjustment was made using SORE's estimates of coal carloads and revenues per carload. The Consulting Center then applied separate rates of growth for these two groupings to develop pro forma revenues for SORE's initial six years of operations. The rates of growth used in our analysis were developed by the Consulting Center in conjunction with another assignment and were tied to Chase Econometric's December

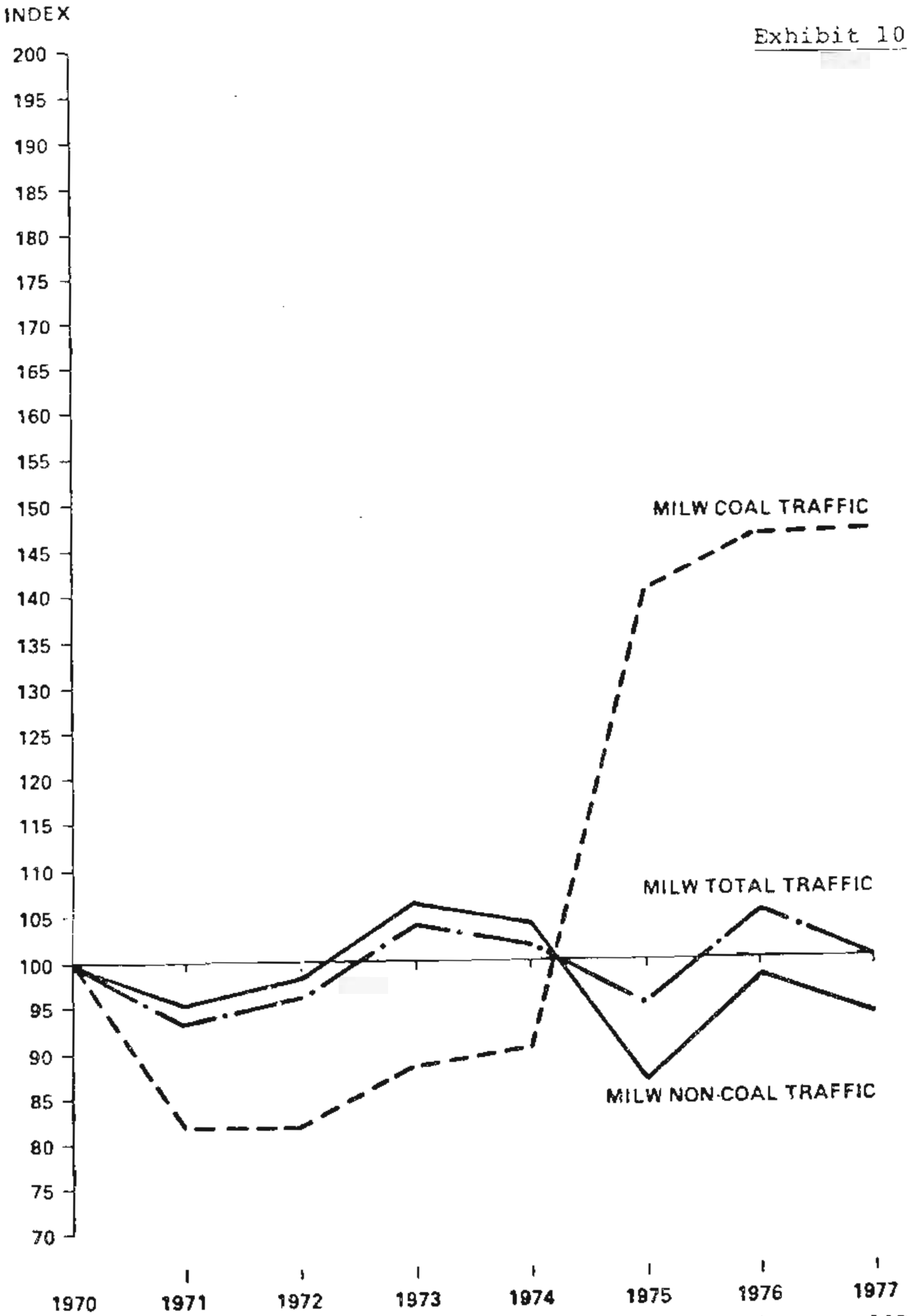
Gross Tonnage
Vs.
Real GNP

Exhibit 9



Milwaukee Road
Total Tons Carried

Exhibit 10



Source: The Milwaukee Road Strategic Planning Studies, May 1979, Prepared by Booz Allen & Hamilton, Exhibit IV-9

1978 long term economic forecast.(1) The Consulting Center's complete set of projections are contained in Appendix C of this report.

The annual growth in revenues used by the Consulting Center to adjust SORE's revenues were:

	($ millions)					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Coal	0	.88	.91	.95	1.0	1.76
All other commodities	0	(2.44)	2.51	2.8	3.15	3.89

Over the six year period these numbers equate to all average annual growth rates for coal of 4.22% and for all other commodities of 1.85%.

- Assessment of SORE's Revenue Gains Due to Recapture of Traffic Lost as a Result of Equipment Shortages

SORE based its equipment-related revenue additions

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(1) This Chase economic scenario includes a high probability of a recession or period of slow growth in 1979 and in 1980. Fundamental to the prospect of a downturn is Chase's assumption that the dollar will deteriorate further in international markets, that OPEC will implement a 15% oil price increase and that the federal government will gradually achieve a balanced budget by 1986. As it turns out, the assumption with regard to OPEC may have been exceedingly optimistic. The following gloomy forecast appear ir Hobart Rowen's column in the June 21, 1979 Washington Post:

"According to word passed to administration officials in Paris last week by a leading cartel producer (not S.Arabia), the price might be pushed to $20 to $21 a barrel next week in Geneva. That would be a whopping 20% over the June 1 weighted avg. price of $17.22, including surcharges, and 57% higher than the 13.34 official OPEC benchmark price at the end of 1978. Anything close to that range would be a staggering burden for the rest of the world, already punchy from a roaring inflation.

It would boost inflation here and in the industrial world by about 1-1.5% within a year or so, (assuming no further real price increases) and slow economic growth by the same 1.0-1.5 points, Carter administration officials estimate. It would just about assure a worldwide recession."

on a study developed by the Milwaukee's traffic department during 1978. Since the study was discounted by some Milwaukee officials, the Consulting Center requested a copy of the study and checked with some of the shipping executives who would indeed influence some of the additional business identified in the study in an effort to evaluate its conclusions. Since the shippers with whom we spoke were anxious to see the Milwaukee western lines remain in operation, they asserted that they would indeed give the Milwaukee more traffic if equipment shortages were met and service made reliable. These remarks reflect good intentions but do not necessarily underpin the additional revenue levels assumed by SORE. Considering the principal competing railroads from whom the western lines would have to win back this traffic (the Union Pacific... operating in conjunction with the Chicago Northwestern, and the Burlington Northern) one could question the reasonableness of SORE's assumptions. Nonetheless, the Consulting Center was impressed by the SORE staff's familiarity with shippers and potential markets in the west and with its plans to try to go after short hauls up and down the west coast, automobile traffic from Japan, the increasing import-export traffic due to the substitution of the American land bridge for the Panama Canal, and efforts to increase traffic originating in the Minneapolis area by developing new relationships with other rail carriers in the Midwest.

SORE did not increase revenues to reflect these possibilities. For this reason and in the interest of giving SORE every reasonable benefit of the doubt, the Consulting Center accepted SORE's assumptions regarding the extent to which revenues could be augmented by increasing its equipment fleet.

- Assessment of SORE's Assumptions with Regard to Time-Sensitive Traffic

SORE assumed that it could recapture time-sensitive traffic by improving frequency and reliability and by increasing transit speeds. As discussed earlier, the rehabilitation program is critical to any improvement in transit times. SORE assumed that it could begin recapturing this traffic as early as year 3. In the opinion of the Consulting Center, SORE's assumption that the rehabilitation program will have yielded enough benefits by that time to recapture time-sensitive traffic is too optimistic. We feel this is particularly true because SORE's projections are already optimistic with respect to the speed with which traffic levels will return to 1977 levels and with respect to the ease with which equipment-sensitive traffic can be recaptured. As a result, we have adjusted SORE's revenues by assuming that all additional time-sensitive traffic would be delayed by one year.

- Revised Revenue Forecast

The Consulting Center's revisions to SORE's revenues are summarized in Exhibit 11. Despite our adjustments, it is our opinion that this revenue forecast is still an

Exhibit 11

CONSULTING CENTER'S ADJUSTMENTS

TO SORE's REVENUES

($ millions)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Base Year - Coal	20.8	20.8	21.68	22.6	23.6	41.6
Base Year - All Other	110.2	122.2	134.8	150.3	169.1	182.3
Total Base Year	131.0	143.0	156.5	172.9	192.7	223.9
Coal Growth	0	0.88	.91	.95	1.0	1.76
Growth All other - GNP related	0	(2.44)	2.51	2.8	3.15	3.39
Addional due to Equipment	12.0	15.0	13.0	10.0	0	0
Additional Time-sensitive	0	0	0	6.0	10	10
Additional Coal Train	0	0	0	0	17.0	0
Gross Freight Revenues	143.0	156.4	172.9	192.7	223.9	239.0
Less Adtj. & ABS	6.9	7.54	8.33	9.29	10.8	11.5
Net Freight Rev.	136.1	148.9	164.6	183.4	213.1	227.5
Switching	1.9	2.0	2.0	2.1	2.2	2.2
All Other	3.0	3.0	3.0	3.5	3.5	4.3
TOTAL OPERATING REVENUES	$141.0	$153.9	$169.6	$189.0	$218.8	$234.0

optimistic one. This is particularly so when one examines average revenue per carload assumptions which underlie them. SORE work papers indicate that revenue yield will increase from an average $712 per car to $840 per car over the five year period. Since the forecast is in constant dollars, one can only conclude that the SORE forecast assumes a very favorable change in commodity mix over time. The Consulting Center did adjust SORE's assumptions with regard to projected carloads; but in the interest of being conservative, we did not change SORE's yield per carload assumptions. Even the adjusted forecast, therefore, remains optimistic.

Assessment and Adjustments to SORE's Operating Expenses

As described earlier, SORE did not have access to enough data to forecast operating expenses in an ICC format nor enough time to develop projections for year 2-4. After reviewing SORE's work papers and clarifying points with SORE staff, the Consulting Center restated SORE's year 1 and year 5 expenses as shown in Exhibit 12. Next, the Consulting Center estimated SORE's operating expenses in years 2-4 by gradually improving SORE's year 1 operating ratio of 97%(1) to its year 5 ratio of 78%. This exercise yielded annual estimates of SORE's net railway operating income. To this figure we then made a series

(1) Based on total year 1 expenses of $167.1 million. This amount was used because the Consulting Center determined that SORE neglected to include $5.5 million of budgeted maintenance of equipment expenses in its first year's total budget and a $1.0 million addition error.

Exhibit 12

RESTATEMENT OF SORE EXPENSES

BY ICC ACCOUNT[5]

($ millions)

	YEAR 1	YEAR 5
Maintenance of Way[1]	$32.9	$36.7
Maintenance of Equipment[2]	10.3	34.5
Traffic	2.9	3.1
Transportation	69.1	96.9
General & Administrative	15.9	16.8
Rents:[3]		
Locomotive & Net car Hire	23.8	23.1
Trailer Train	4.3	4.5
Total Rents	28.1	27.6
Taxes[4]	2.4	2.2
Total Operating Expenses[5]	$ 161.6[6]	$217.8

(1) Includes depreciation and retirements of $.7 million in year 1 & 5

(2) Includes depreciation and retirements of $1.0 million in year 1 and $1.5 million in year 5.

(3) Includes a recent SORE adjustment to increase its net rents in year 5 from $25.1 million to $27.6 million.

(4) Taxes not including payroll taxes or federal income taxes.

(5) Total operating expenses for years 2, 3 and 4 were estimated by reviewing and projecting discrete components which totaled $172.7, $180.5 and $190.2 million respectively. Total operating expenses in year 6 were projected to be $220.5 million.

(6) Includes correction of $1.0 million addition error.

of adjustments, based on our analysis of the SORE expenses in detail. These adjustments are summarized in Exhibit 13 and discussed below. Since many of the adjustments related to equipment requirements, the Consulting Center's work sheet in this area is included in Appendix D.

- <u>Reduction in Expenses to Reflect Consulting Center's Adjustments to Revenues.</u>

  Since the Consulting Center reduced SORE's future traffic levels, we also had to reduce SORE's operating expenses. In making this adjustment the Consulting Center reduced SORE's volume related expenses in proportion to our reductions of traffic levels.

- <u>Credit to SORE for Lease Costs in Year 1</u>

  As already discussed, SORE cannot acquire the Milwaukee owned cars it had hoped to if the Milwaukee decides to reorganize around a subcore. Hence the lease costs for acquiring Milwaukee leased cars that SORE had included in its expenses were too high. The Consulting Center consequently reduced net rents for year 1.

- <u>Lease Costs Inadequate to Cover Budgeted Equipment Additions</u>

  The SORE proposal and work papers state that SORE intends to acquire 3650 units of additional equipment over the first 3 years. SORE's intention is to acquire these units by means of lease arrangements. The Consulting Center examined SORE's estimates of these costs and determined that they were too low. We therefore increased SORE's net rents to reflect more realistic costs.

Exhibit 13

CONSULTING CENTER's ADJUSTMENTS TO SORE'S NROI

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
NROI (Loss)	(19.6)	(18.8)	(10.9)	(1.2)	1.0	13.5
Adjustments to NROI						
Expense Reduction Due to Lower Volume	0	1.4	3.8	5.7	7.8	10.0
Credit to SORE for Lease Costs in	1.2	1.3	1.4	1.5	1.6	1.7
Leases inadequate to cover budgeted eq. additions	0	(3.0)	(7.0)	(9.0)	(9.3)	(9.3)
Additional Eq. Acq. Costs	(12.2)				(1.4)	(1.4)
Lower TTX usage than assumed	1.1	1.1	1.2	1.3	1.4	1.4
Arithmetic Error - omitted budgeted 5.5 for MOE from total	(5.5)	-	-	-	-	-
Inc. in MOE to account for worse initial bad order ratio than assumed	(1.9)	(.7)				
MOW inc. for yards/sidings	(4.0)	(4.0)	(4.0)	(4.0)	(4.0)	(4.0)
Adjusted NROI	(40.9)	(22.7)	(15.5)	(5.7)	(2.9)	11.9
Erosion due to Inflation	(1.51)	(1.46)	(1.53)	(1.61)	(1.83)	(1.84)

- <u>Lease Costs Inadequate to Provide Level of Equipment Needed to Serve SORE's Traffic Levels (As Adjusted by the Consulting Center</u>

  Despite the increases described above, the Consulting Center determined that SORE's net rent account was not high enough to cover the costs of acquiring enough equipment to serve projected traffic levels particularly in the first year. Accordingly, the Consulting Center further increased the net rent account. We believe we have been very conservative by not taking exception to SORE's projected improvement in on-line car cycle time from 16 days in year 1 to 7 days by year 5. SORE did not adjust the off-line car cycle time of 9 days in its forecast. Indeed an annual rate of improvement in equipment utilization of 15% would be extraordinary; Conrail only realized a 4.7% improvement from April 1978 to April 1979.

- <u>Lower Trailer Train Costs</u>

  Based on carload estimates, the Consulting Center determined that SORE over-estimated expenses related to the usage of trailer train. Accordingly, we reduced SORE's net rent account to reflect the revised estimate.

- <u>Arithmetic Error by SORE</u>

  According to SORE's work papers, SORE's year 1 estimate of maintenance of equipment expenses was $14.8 million. $9.3 million was included in SORE's "mechanical" expense category. The other $5.5 million was meant to be included in the "General Manager's" account but work papers show these funds were not added to that account. Accordingly, the Consulting Center added $5.5 million to SORE's first year operating expenses. (SORE did include this expense in its 5th year expenses.)

- Maintenance of Equipment Expenses Inadequate

  At the present time the Milwaukee Railroad's equipment bad order ratio is among the worst in the country. (The 1977 R1 report shows a bad order ratio of 13.1% for equipment and 46.4% for locomotives, both as of February 28, 1978.) According to SORE staff one reason for the high ratios is that the management has "bad ordered" every car requiring more than $500 in repairs as a cash preserving measure. Many of these cars, SORE asserts, can be returned to service with relatively little effort. Since the Trustee will probably wish to retain the best of the Milwaukee fleet for the subcore, however, SORE's initial bad order ratio will undoubtedly be higher than assumed. Accordingly, we have increased SORE's MOE expenses, but even so, considerable latitude was given to SORE's hopes.

- MOW expenses Increased for Yards/Siding

  As explained earlier in this report, the Consulting Center determined that SORE's MOW budget did not reflect normalized maintenance of trackage contained in yard and sidings. Accordingly, SORE's MOW budget was increased at the rate of $4500 per mile for the miles of track estimated to be in passing track, sidings and yards.

- <u>Adjusted Net Railway Operating Income</u>

  As shown in Exhibit 13, the effect of all these adjustments on net railway operating income is to increase SORE's operating losses of $28.2 million over two years to $95.4 million over five years. According to our adjustments, therefore, SORE's turnaround could not occur until the sixth year of operations.

- <u>Estimate of Cash Flows/Cash Shortfalls</u>

  As reviewed earlier, SORE identified a number of other loans and other requirements that would eventually have to be met by the railroad's cash flow from operations. These included: financing the ESOP loan; financing debt assumed in exchange for assets acquired from the Milwaukee; financing an ERSA loan to cover initial operating losses; financing a capital program needed to rebuild part of a yard in Tacoma, Washington; and financing a Title V loan made to obtain rehabilitation funds. Since SORE has already determined it cannot obtain an ERSA loan and since the Consulting Center's adjustments result in greater losses than anticipated, the Consulting Center has assumed that all cash shortfalls not otherwise identified with specific sources of funding will be financed with debt at an interest rate of 10%.

  In estimating these annual shortfalls the Consulting Center made several other adjustments to SORE's financing requirements. First, we treated the cost of financing assets assumed by the Milwaukee as a separate calculation in order to better focus upon SORE's cash needs due to operating the railroad. Second, we increased SORE's capital program to reflect the cost of building the Tacoma Yard.(1) Third, we increased the initial ESOP loan of $32.1 million to $36.1 million to reflect an arithmetic error in SORE's year 1 Sources and Application of Funds statement. Fourth, the Consulting Center assumed, as did SORE, that the Federal Railroad Administration would extend a loan to SORE for its rehabilitation program under Title V of the 4R Act. For purposes of the analysis we assumed FRA would require no repayment on this loan until the elventh year and that the interest on the loan would be at a 2% rate.(2)

The results of this analysis are shown in Exhibit 14. As seen therein, the Consulting Center projects that SORE's cumulative cash shortfall will be $167.7 million by the end of year 6. Again, this shortfall does not reflect the financing of SORE's rehabilitation program nor the financing of initial assets.

- <u>Outlook Beyond Year Six</u>

According to the SORE proposal, the western lines will begin showing a positive net railway operating income in

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(1) Using $7.5 million as the total capital program is very conservative. Considering the western railroad's capital programs per revenue dollar and taking into consideration the portion of MOW expenses to be perceived as capital items, the Consulting Center believes that a 5 year capital program totaling $30 million would not be unreasonable.

(2) An FRA official connected with this program agreed that such terms were available under the Act but stressed that FRA could not approve the loan unless it was assured that the rehabilitation program was adequate to accomplish the planned improvements and that the loan could be repaid by the railroad.

Exhibit 14

CONSULTING CENTER'S CALCULATION OF SORE'S CASH SHORTFALLS

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Total Adjusted NROI	(42.4)	(24.2)	(16.8)	(7.3)	(4.7)	10.1
Depreciation	1.7	1.9	2.0	2.1	2.2	2.3
Capital Program	(1.5)	(4.0)	(2.0)			
ESOP Loan	(4.5)	(4.5)	(4.5)	(4.5)	(4.5)	(4.5)
Annual Cash Shortfall	(46.7)	(30.8)	(21.3)	(9.7)	(7.0)	7.9
Financing of Shortfalls (cum)	(4.25)	(7.44)	(10.1)	(11.9)	(13.6)	(12.9)
Cum. Shortfall					(162.7)	(167.7) (1)

(1) The effects of financing the main line rehabilitation program and any acquisition loan, if required, are not included in this total since it is assumed that the rehabilitation loan will be federally funded with no payments due until the eleventh year and that the assets would be exchanged for the foregoing of labor claims.

year 3 and thereafter would continue to become more profitable. Work papers show that SORE believes net railway operating income will increase by 11-14% each subsequent 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. The Consulting Center has estimated that net railway operating income will reach $22.3 million by year 10, assuming a continuation of year 6 growth levels and a 75% operating ratio. Over the longer term, we would expect growth in income levels to flatten out.

- Selfsustainability of the SORE system

  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 dollar rehabilitation loan (166 million inflated dollars) 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 ten.

- Government Financing of the SORE Proposal

  SORE's proposal is too risky and too unprofitable to enable it to obtain private capital to finance any of its needs for funds. If the SORE proposal is implemented therefore, it will acquire the following financial assistance from the Federal Government:

(Current $ millions)

	Loan or Federal Guarantee	Guarantee at Redemption *	Grants
Mainline Rehabilitation	$ 166		
Branch line rehabilitation			$ 84
Cash Shortfall	168		
Purchase of Assets		$ 638*	
Employees' Investment in ESOP	36		
Sub-totals:	$ 370	$ 638*	$ 84
Cumulative Federal Involvement			$1,092

* This figure is the redemption value of initial assets of $246 million compounded at 10% per year for ten years assuming no prior payment of principal or interest.

- Other Factors Which May Affect SORE's Viability

There are a number of other factors which might affect SORE's ultimate selfsustainability although the Consulting Center did not make any adjustments to reflect them. One is the possibility that start up costs may be greater than assumed by SORE. This is particularly true given the potential problems involving the sorting out and splitting up of the Milwaukee's equipment fleet between the Trustee's subcore and SORE.

Another is that SORE's equipment acquisitions program and our adjustments to them, are based on SORE's belief that it can reduce car cycle turnarounds from 25 days to 16 days. Since the industry average is 22 days, this improvement is very optimistic. If SORE projected improvement in car cycle time is reduced by one half, total capital requirements would increase by $90.4 million, the car lease expense would increase to $13.3 million per year by the fifth year and every year thereafter, and annual per diem expenses would increase to $3.5 million by the fifth year.

A third problem is that we have not adjusted SORE's assumptions with regard to locomotive requirements since SORE did not attempt to rigorously review these needs and adequate data was not available to make any responsible judgments on our part.

A fourth problem is that the economic outlook is worsening and would affect SORE during its formative years.

REQUIREMENTS FOR SORE TO ATTAIN SELFSUSTAINABILITY

The SORE proposal as presently constituted is not self-sustainable because the earnings generated by the system are not great enough to cover the costs of financing interim losses, equipment acquisitions, and the acquisition of initial assets. In order to achieve selfsustainability, therefore, some way would have to be found to curb initial losses and to lower debt obligations. The Consulting Center has identified several possibilities by which such ends might be advanced. If all these possibilities were realized, the Consulting Center believes SORE's chance of becoming selfsustainable would be greatly enhanced, although further analysis would be needed to develop a definitive judgement as to whether ultimate success is attainable by these means alone. These possibilities are discussed below.

Reducing Interim Losses

As previously discussed, the Consulting Center has estimated that SORE will need to obtain $168 million in debt to finance cash shortfalls in Years 1-5. SORE's initial losses could be reduced and subsequent profits increased if SORE could further improve its ratio of revenues to expenses. Except for the possibility of improving this margin by implementing selective rate increases(1), the Consulting Center does not feel the revenue side of the ratio could be increased much beyond levels already assumed. Operating expenses ould be

(1) Proposed deregulation legislation would enable SORE to do so.

reduced, however, if employees and labor unions were willing to agree to a number of changes which should reduce the company's labor ratio.

Such changes include: changing the basis for employee compensation from the existing rules (such as the 100 mile per day crew law) to ones based on the performance of a specific task or ones based on total hours worked; changing crew consist rules to allow 2-3 man crews instead of 4-5 man crews; changing seniority districts and craft rules to permit employees to perform more than one job or to change jobs to reflect seasonal work requirements.

According to the Milwaukee's 1977 R-1 Report to the ICC, the ratio of employee expense (including wages, pension, health and welfare and payroll taxes) to operating revenues was 55.6%. If this ratio could be reduced to about 40%, SORE should save in the order of $30 million per year. If implemented from the start this amount would just about eliminate SORE's cumulative cash shortfalls for the first five years.(1) Further study would be needed, however, to determine whether such work rules changes are attainable and if they are whether they would result in savings of $30 million per year.

The Consulting Center recognizes that employees and railroad labor unions have been reluctant to agree to work rule changes in the past. If SORE were to be owned and operated by employees, however, this reluctance might be overcome.

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(1) Of course, to the degree earnings are still overstated that much more will be needed from the labor accounts.

Acquisition of Assets

In the opinion of the Consulting Center, SORE will have to pay $246 million (in 1977 dollars) or $638 million (in 1987 dollars) to acquire initial rail assets from the Milwaukee estate. As stated earlier, SORE's potential income could not possibly support this cost. Some other way of financing this acquisition must be found if SORE is to have a chance of achieving selfsustainability. 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.

According to the testimony of Lawrence W. Harrington, Vice President, Management Services for the Milwaukee Trustee, potential labor protection claim costs could total $1.068 billion if the Milwaukee were liquidated, all employees dismissed, and New York Dock Railway Protective Conditions used to calculate employee protection payments. SORE staff has reported that 2800 employees are currently associated with operation of the western lines. SORE has also reported that it would have to employ additional employees, up to a total of 3,500, soon after start up in order to undertake its rehabilitation program and increase traffic levels. Based on a ratio of 3500 employees to 10,833 (the total level of Milwaukee personnel in 1978), labor protection claims for potential SORE employees could amount to $345 million.[1] In view of this potential claim SORE

(1) On the other hand, SORE representatives estimated that labor protection claims applicable to employees on the western lines would total only $60 million.

employees could consider giving up all rights to these claims in exchange for acquiring the rail assets needed to operate the western lines as a separate entity. If this exchange could be accomplished, SORE's beginning equity ratio would be far healthier than now projected in SORE's pro forma. The exchange would also allow SORE to offer liens against these assets in exchange for new financing.

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. As Mr. Harrington testified, resolution of labor protection claims

> "involves the laws and principles governing the Commission and courts, the relative roles of the Commission and the Reorganization Court, and the constitutional rights of creditors and the estate. It is impossible to predict the status or priority of such claims in reorganization or liquidation, the control the Reorganization Court would have over the amount actually paid out, or the limits the constitution places on them."

Nevertheless, there would appear to be enough potential merit to this approach to warrant SORE's consideration of it as a way to acquire the necessary assets from the Milwaukee estate. However, SORE's employees would also have to consider what they would be giving up if SORE's new company did not achieve self-sustainability.

APPENDIX A

Documents supplied by DOT/FRA:

- SORE Proposal for Rehabilitation and Operation of Milwaukee Lines Between Twin Cities and West Coast, Jan 2, 1979
- SORE, Lines West Proposal, April 28, 1979
- The Milwaukee Road Strategic Planning Studies, May 1979, Volumes I and II; prepared by Booz Allen & Hamilton Transportation Consulting Division.
- Liquidation Value of the Chicago, Milwaukee, St. Paul & Pacific Railroad, November 29, 1978, prepared by Ford Bacon and Davis Construction Company.
- Assessment of the Estimated Liquidation Value of the Chicago Milwaukee, St. Paul & Pacific Railroad, March 2, 1979, by Day & Zimmerman, Inc.
- Annual Report (R-1) To the Interstate Commerce Commission for the Year Ended December 31, 1977 of the Chicago Milwaukee, St. Paul & Pacific Railroad Company.
- Annual Report (R-1) To the Interstate Commerce Commission for the Year Ended December 31, 1978 of the Chicago, Milwaukee, St. Paul & Pacific Railroad Company.
- Milwaukee work papers pertaining to potential traffic levels of the western lines; trasnmitted from Thomas F. Power, Assistant to the Trustee to Mr. Danforth Walker, Department of Transportation.
- Traffic Effects Study, the Viability of the Western Lines of the Milwaukee Road, Preliminary Draft Report, June 1979, Prepared by Reebie Associates for DOT, FRA.
- In Re Milwaukee Reorganization Proceedings

  ------ Testimony of Paul F. Cruickshank, Jr.
  ------ Testimony of Peter C. White
  ------ Testimony of Richard V. Nugent, Jr.
  ------ Testimony of Lawrence W. Harrington
  ------ Supplemental Testimony of Thomas F. Powers, Jr.

- FRA Memoranda

  ------ Closing on the Milwaukee Road Section 511 Equipment Repair and Environmental Control Facilities Projects and Section 505 Track Rehabilitation Project, July 28, 1978.
  ------ Recommendation Package; Milwaukee Package, Milwaukee Road Section 505 and Section 511 Projects Docket Nos. RFA-5-5-76-1 and RFA 511-76-2, July 31, 1978.

------ Recommendation Package: Milwaukee Interim Corridor Project, July 14, 1977.

- Chicago, Milwaukee, St. Paul & Pacific Co., Interim Corridor Project 505 Loan Application, Analysis by James Hanscom, July 11, 1977

- Documents Supplied by SORE:

  . Package of Work Papers
  . Copy of a June 13, 1978 Letter and Five Year Financial forecast of the Milwaukee Land Co. prepared by A.L. Nance and sent to R.V. Nugent, Jr., VP Finance of the Milwaukee Railroad.

- In Re Milwaukee Reorganization Proceedings

  ------ Affidavit and Supplemental Affidavit of J. Fred Simpson, February 8, 1979 and March 5, 1979
  ------ Written Statement by the Association To Save Our Railroad Employment in opposition to the Trustee's "Petition for Direction with Respect to Partial Embargo of Freight Operations, Financing Remaining Operations and Related Relief"
  ------ The State of Montana's statement In Opposition to the Trustee's (Embargo) Petition
  ------ The State of Montana's Objections and Responses to the "Report of Special Master, Milton H. Gray, Etc."

Other Documents Used During the Course of Study:

- Moody's Transportation Manual, 1978

- Prospectus For Change, Department of Transportation October, 1978.

- Chase Econometric Associates, Long Term Macro Economic Forecasts, December 1978 and February, 1979

- Association of American Railroads, Equipment Car Cycle Time Report

APPENDIX B

RUSSELL F. MURPHY

Executive Vice President

As Executive Vice President, Mr. Murphy's primary responsibility is to foster the firm's domestic business, particularly in the field of transportation. Toward that end, Mr. Murphy brings extensive expertise in dealing with the management of complex transportation analyses and the evaluation and determination of solving issues.

Mr. Murphy has been the project manager of all the domestic transportation studies undertaken by the Consulting Center.

Prior to joining the Consulting Center, Mr. Murphy was Vice President, Finance and Operations at the United States Railway Association with responsibilities that included the monitoring of Conrail's operational and financial performance. While the Director of the Office of Financial Analysis, Mr. Murphy's primary responsibilities were to forecast earnings, cash flows, and investment needs for the Consolidated Rail Corporation and any strategic alternative under consideration. Prior to joining USRA, Mr. Murphy was Chief of the Industry Analysis Division in the U.S. Department of Transportation and in that capacity was extensively involved in analyses of the transportation industry.

Educational Background:

B.A., Aeronautical Engineering (1958), Polytechnic Institute of Brooklyn
M.B.A., (1963), Harvard Graduate School of Business

PAUL D. JOHNSON

Vice President

Mr. Johnson has over ten years of experience as a rail analyst and planner. He recently joined the staff of the Consulting Center.

At the present time, Mr. Johnson's primary activities are to aid the federal government in the litigation of the value of assets conveyed to ConRail. In his capacity as consultant, he advises the government parties on methods and techniques for evaluating the going concern value of these assets had governmental intervention in the reorganization of bankrupt railroads in the Northeast not been forthcoming. His areas of specialty include rail operations, finance and costing analysis.

Before coming to the Consulting Center, Mr. Johnson was Assistant Vice President, Operations and Finance for the United States Railway Association, where he was responsible for implementing operational and revenue monitoring of ConRail. At the Association, he undertook financial, operational and marketing analysis of railroad mergers and consolidations, using extensive quantitative methods.

His railroad experience includes the Atchison, Topeka and Santa Fe Railroad, where he was Director of Cost Analysis and Research, and the Southern Railway System, where he was a Senior Economist. At Santa Fe, Mr. Johnson was responsible for determining rail transportation costs both for existing rail service and new business proposals; the financial analysis of new asset acquisition; and analysis of economic conditions and their potential impact on business performance. At Southern Railway, he forecasted business volumes and evaluated business performance against expectations. He also evaluated the potential impact of proposed governmental regulations on the rail industry.

Educational Background:

B.A., Economics (1962) Kent State University, Ohio
Graduate studies (1963) Kent State University, Ohio
Course work completed for Ph.D., Economics, University of Virginia.

RICHARD G. TRENERY

Director

Mr. Trenery joined the Consulting Center as senior policy and financial analyst in 1977. To date, he has been a key participant on contracts involving cost analyses, econometric financial forecasting of trucking and railroad industries. In addition to general financial and economic expertise, Mr. Trenery brings extensive experience in statistical analyses.

Prior to joining the Consulting Center, Mr. Trenery, while employed by Conrail, was responsible for the design and implementation of a computerized model which generated multiple year financial forecasts. While at USRA he had comparable responsibilities and was also engaged in a broad based analysis involving the propensity for rail traffic to be diverted to regulated and non-regulated motor carrier transportation.

Educational Background:

B.S., Finance and Economics, (1968), American University
M.B.A., Finance (1972), American University

JANE E. M. HOLT

Director

Mrs. Holt joined the Consulting Center as Senior Policy and Financial analyst in April of 1977. To date she has been a key participant on contracts involving policy and financial analyses of the railroad and trucking industry, including the assessment of the railroad industry's future capital needs for the FRA.

As do other members of the firm, Mrs. Holt brings extensive experience in the field of transportation to the firm. Immediately prior to joining the firm, Mrs. Holt was employed by the United States Railway Association as a financial consultant. In that capacity, she participated in most of the major financial decisions involved in the creation of Conrail as well as in support activities such as developing the process by which the proforma financial statements would be generated, and evaluating the Conrail alternatives. In addition, she wrote the bulk of the Financial Analysis Chapter of the PSP and much of the Capital Structure and Financial Programs Chapter in the PSP.

Prior to this, Mrs. Holt was employed in the office of the Assistant Secretary for Policy at the DOT, where she conducted financial and policy analyses involving all modes of transportation and was awarded a Special Achievement Award and the Secretary's Award for Meritorious Achievement.

Educational Background:

B.A., General studies (1966)....Harvard University
M.B.A., Finance (1970)....Boston University
Executive Education Program....Harvard Business School

APPENDIX C

MILWAUKEE ROAD INDUSTRY TREND TONNAGE PROJECTIONS

COMMODITY	ORIGINATED/ RECEIVED	PROXY RELATIVE MARKET SHARE FACTORS: MILW. W.RAIL	W. RAIL U.S.RAIL	U.S.RAIL PROD.	1977 TOTAL	1981 TOTAL [1]	1986 TOTAL [2]	COMMODITY PRODUCTION INDEX [4] 1967=100: 1977	1981	1986	PROJECTED MILWAUKEE ROAD TONNAGES: 1977	1981	1986
Grain	O	.062	.69	643.6	20.70	24.18	21.55	144.7	132.1	154.0	2995	3194	3319
	R	.007			2.44	2.73	2.43				353	361	374
Other Farm	O	.046	.777	323.6	11.47	8.77	7.59	128.7	126.1	136.9	1476	1106	1039
	R	.007			1.48	1.34	1.16				190	169	159
Coal [3]	O	.045	.264	3372.9	40.16	-	-	123.0	141.2	178.8	4940	-	-
	R	.038			33.41	-	-				4109	-	-
Non Metal	O	.038	.350	1226.4	16.32	14.17	12.72	113.7	124.5	150.9	1856	1777	1919
	R	.006			2.74	2.25	2.01				312	280	303
Grain Mill	O	.082	.619	234.5	11.90	9.85	8.50	146.5	154.3	168.3	1743	1520	1431
	R	.016			2.31	1.92	1.66				339	296	279
Beverages	O	.128	.746	93.0	8.72	9.07	9.19	143.7	166.1	190.5	1253	1507	1751
	R	.008			.51	.57	.57				74	95	109
Other Food	O	.053	.583	389.3	12.29	10.42	9.22	128.9	132.5	141.4	1584	1381	1304
	R	.023			5.21	4.52	4.00				672	599	566
Forest	O	.108	.352	565.1	21.40	20.17	19.09	124.9	131.0	159.0	2673	2642	3035
	R	.008			1.96	1.49	1.41				245	195	224
Other Lumber	O	.048	.725	214.6	6.97	6.41	5.86	144.4	159.3	200.4	1006	1021	1174
	R	.100			14.37	13.37	12.21				2075	2130	2447
Paper	O	.057	.415	85.7	2.03	1.91	1.82	135.2	146.6	169.7	275	280	309
	R	.090			3.18	3.02	2.87				430	443	487
Paper Boards	O	.195	.425	33.7	2.78	2.51	2.29	140.9	158.5	187.1	391	398	428
	R	.045			.64	.58	.53				90	92	99
Other Pulp	O	.077	.351	199.1	5.37	5.28	5.00	140.7	158.0	188.4	755	834	942
	R	.108			7.54	7.40	7.02				1061	1169	1323
Chemicals	O	.011	.560	642.4	3.86	3.81	3.78	162.3	185.5	230.0	626	707	869
	R	.050			18.13	17.30	17.16				2943	3209	3947
Construction	O	.031	.387	507.2	6.00	5.35	4.78	118.1	134.6	162.3	709	720	776
	R	.034			6.66	5.87	5.25				786	790	852
Prim. Metals	O	.062	.202	479.7	6.02	4.87	4.07	114.7	130.9	157.9	691	637	643
	R	.132			12.80	10.36	8.66				1468	1356	1367

February 26, 1979

Trans Equip.	O	.127	.152	240.0	4.88	4.71	4.79				707	761	949
	R	.173			6.66	6.42	6.52	145.0	161.5	198.2	965	1037	1292
·tal Waste	O	.137	.283	249.5	8.40	8.88	8.25				963	1162	1303
	R	.017			1.07	1.10	1.02	114.7	130.9	157.9	123	144	161
Other Waste	O	.080	.295	63.3	1.41	1.37	1.21				196	210	216
	R	.075			1.32	1.29	1.14	138.6	153.2	178.9	183	198	204
All Other	O	.015	.590	1394.4	13.19	10.54	9.42				1678	1553	1673
	R	.011			9.40	7.73	6.91	133.7	147.3	177.6	1257	1139	1227
								Total (ex coal) Tons			35145	35112	38500
								AAGR %				(.02)	1.02
								Total (inc. BA coal) Tons			44194		50549
								AAGR %					1.50

1) 1981 Regional and industry forecasted commodity market share factors were incorporated at the average annual growth (decline) rates for the historic period, 1966 to 1977.

2) 1986 regional and industry forecasted commodity market share factors are developed by assuming a positive impact to deregulation whereas the growth (decline) share factors are applied at 50% of their historic levels beginning in 1982.

3) Coal market share factors were not developed as Booz's shipper survey results were deemed more appropriate.

4) Commodity production growth indexes based on Chase Econometrics, Standard Forecast of December, 1978.

February 26, 1979

APPENDIX D

CALCULATION OF NET EFFECTS OF ADDITIONAL

EQUIPMENT REQUIREMENTS ON NET INCOME

		Year 1	Year 5
L-1	Beginning Fleet Size	24269 (1)	
L-3	Fleet Req. of Eastern Core	17000 (2)	
L-4	Net Equip. available to SORE	7269	
L-5	Residual Fleet after Ret.	7004 (3)	5172 (3)
L-7	SORE carloadings/day excl. TTX	515 (4)	667 (11)
L-8	SORE System Ldgs/day	334 (4)	487
L-9	Foreign Car Ldgs/day	180 (4)	180 (4)
L-10	On-line days	16 (4)	7 (4)
L-11	Off-line days	9 (4)	9 (4)
L-13	SORE Proj. Bad Order Ratio	6% (4)	6% (4)
L-14	Service Reserve Ratio	10% (5)	10% (5)
L-16	Required Fleet	9765 (6)	9085 (6)
L-18	Required Additions	2761	3913
L-20	Cost Per Unit (1977 $)	35349 (7)	
L-22	Capital Cost of Additional Cars ($ millions) net of SORE's planned Purchase of 3650	$97.6 (8)	$9.3 (9)
L-26	Effect of Addt'l Req(by year ($millions)	$12.2 (10)	$1.4 (10)

SOURCE

(1) Booz Allen analysis which netted out useless equipment and trailer train equipment reported in R-1 Reports. SORE staff accepted this estimate as responsible and the one to use.
(2) Booz Allen analysis for subcore not including Miles City link.
(3) Apply 1977 REtirement ratio of .073 to base fleet. Use ½ of this factor in first year then full rate thereafter.
(4) Factors developed by SORE
(5) Factors subsequently acknowledged by SORE staff as required.
(6) Determined by L8 x (L10 + L11) x 1.06 x 101
(7) Derived by adjusting SORE's box car est. of avg. unit costs of $38,000 (1978 $) by Chase Econometrics equipment Infl rate.
(8) SORE only planned to acquire addt'l equip in yrs 2 & 3 (1730 & 1927). Therefore the net effect of addit'l equip will be felt in at least years 1 and 5.
(9) Determined by L5 + 3650 (SORE's additions) less L 16
(10) Derived by assuming annual cost of a 15 yr lease at 12% int rate with 15% salvage value credited in determing lease.
(11) Derived by using new revenue projections & SORE's year 5 yield factor

FINANCIAL ANALYSIS OF THE IMPACT ON LABOR AND LABOR PROTECTION OF THE SORE LINES WEST PROPOSAL

Submitted to:

Office of the Secretary of Transportation
U.S. Department of Transportation
Washington, D.C. 20590

Submitted by:

Mark Battle Associates, Inc.
1019 Nineteenth Street, N.W., Suite 300
Washington, D.C. 20036

July 19, 1979

mark battle associates, inc.

July 19, 1979

Office of the Secretary
U.S. Department of Transportation
400 Seventh Street, S.W.
Washington, D.C. 20590

Re: Submission of Final Report of the Financial Analysis of the Impact on Labor and Labor Protection of the SORE Lines West Proposal

Attention: Mr. W. Danforth Walker, COTR

Gentlemen:

We enclose herewith the Final Report of the Financial Analysis of the Impact on Labor and Labor Protection of the SORE Lines West Proposal. Given the information available from the numerous sources with whom the project team made contact, we believe the estimated labor protection costs and labor impacts provided herein are fairly and objectively presented. Additionally, we have provided our brief analysis of the prospects for an Employee Stock Ownership Plan as a major funding vehicle for implementation of the SORE Lines West Proposal, in the context of the conclusions reached by the Consulting Center, Inc., in its Assessment of the Financial Selfsustainability of the SORE Lines West Proposal of July 9, 1979.

Very truly yours,

John Hall

John A. Hall
President

Enclosure

1019 19TH STREET, N.W., SUITE 300, WASHINGTON, D.C. 20036 (202) 466-2530

TABLES OF CONTENTS

LIST OF EXHIBITS

EXECUTIVE SUMMARY

The Chicago, Milwaukee, St. Paul and Pacific Railroad voluntarily filed a petition for reorganization on December 19, 1977. The court-appointed Trustee of the bankrupt railroad, Mr. Stanley E.G. Hillman, commissioned a study by Booz, Allen and Hamilton, The Milwaukee Road Strategic Planning Studies. On the basis of this study, the Trustee concluded that the railroad could not be reorganized in its current configuration and requested of the U.S. District Court permission to embargo freight services over 7,400 route miles of traffic, including a substantial percentage of the lines west of St. Paul, Minnesota, the subject of this report.

Subsequently, Save Our Railroad Employment (SORE), a group of present and furloughed employees of the Milwaukee Railroad who were faced with the potential loss of employment in the event of liquidation or in the eventuality that the proposed embargo was approved, submitted on April 28, 1979, the SORE Lines West Proposal to acquire and operate the Milwaukee's transcontinental lines and associated operations west of St. Paul, Minnesota. A map of the lines proposed for operations by SORE is presented as Exhibit A.

On June 11, 1979, the Office of the Secretary of the U.S. Department of Transportation (DOT)[1] requested that Mark Battle Associates, Inc. (MBA), conduct a Financial Analysis of the Impact on Labor and Labor Protection of the SORE Lines West Proposal. This report is the result of that analysis.

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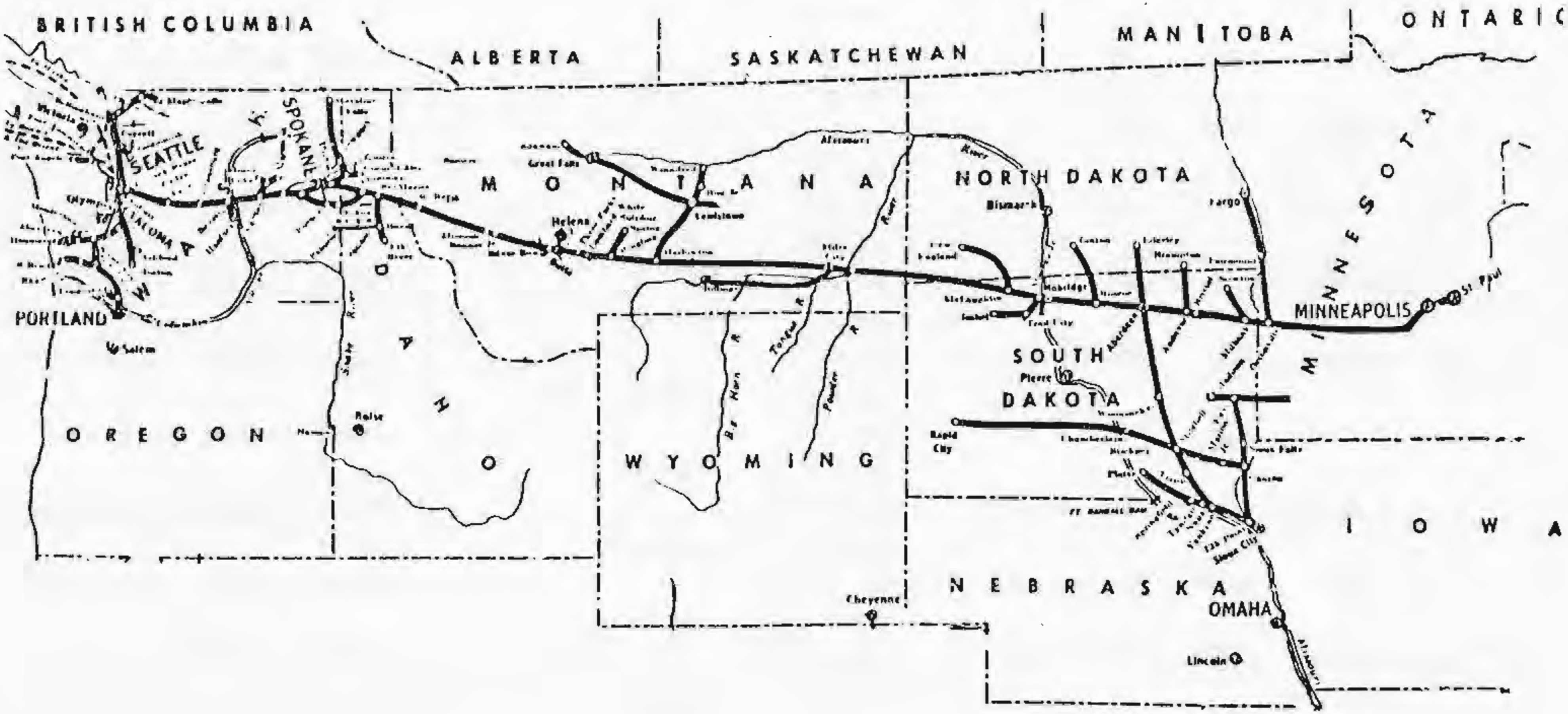
[1] A simultaneous study was conducted for DOT by Consulting Center, Inc. (CCI), an Assessment of the Financial Selfsustainability of the SORE Lines West Proposal. Results of the CCI study are the basis of selected MBA conclusions in the Scenario 4 analysis.

EXHIBIT A

MAP OF SORE LINES



S.O.R.E.

Lines West Proposal

The objectives of this study were to determine the financial impact on labor and the potential cost of labor protection under the four scenarios described below:

Scenario 1. Lines west of the Twin Cities have an embargo imposed on traffic.

Scenario 2. Lines west of the Twin Cities have trackage abandoned under existing ICC abandonment procedures.

Scenario 3. Lines west of the Twin Cities are reorganized in accordance with the SORE proposal.

Scenario 4. The SORE proposal is implemented in the form of a traditional employee stock ownership plan.

Additionally, MBA was requested on June 26 to extensively examine, in the context of Scenario 4, the dimensions and limits of an ESOP as the major vehicle for raising capital in conjunction with acquisition of Lines West, or to examine the prospects for the ESOP to assume a more dominant role than proposed by the SORE group.

Study Findings and Conclusions

The estimated costs of labor protection and the financial impact on labor under each of the four scenarios examined are presented below.

- SCENARIO 1--LINES WEST OF THE TWIN CITIES HAVE AN EMBARGO PLACED ON TRAFFIC

Depending on subsequent decisions by the courts and by the ICC, this scenario could result in either one of the following three developments:

Scenario 1A. Embargo goes into effect, Milwaukee Road service west of the Twin Cities is shut down and the ICC does not impose directed service on the affected lines.

Scenario 1B. Embargo goes into effect and the ICC imposes directed service by a separate carrier for up to 240 days on Lines West of the Twin Cities.

Scenario 1C. The courts rule, after potentially protracted litigation, that the imposed embargo is a defacto abandonment as defined under 79 USC § 10903.

The estimates for labor impacts and protection costs[2] under each of the alternatives under Scenario 1 are summarized below.

Scenario	Estimated Labor Protection Cost	Estimated Financial Impact on Labor		
		Number of Lines West Employees Losing Jobs Over Long Term (5 years)	Number of Lines West Employees Losing Labor Protection Over Long Term (5 years)	Number of Lines West Employees Facing Reduction in Wages and Fringes
Scenario 1A--Embargo, no directed service	$31 million to $167 million (5 years)	3,534 (100%)	2,207 (62%)	2,207 (62%)
Scenario 1B--Embargo, directed service imposed	$31 million to $167 million (5 years)	3,534 (100%)	2,207 (62%)	2,207 (62%)
Scenario 1C--Embargo is ruled to be a defacto abandonment	$83 million to $521 million (6 years)	3,534 (100%)	0 (0%)	0 (0%)

[2]The estimated labor protection costs and the accompanying estimated financial impacts on labor for each scenario required making a number of assumptions. These assumptions are provided in detail in the body of the report (see Chapter II).

- SCENARIO 2--LINES WEST OF THE TWIN CITIES HAVE TRACKAGE ABANDONED UNDER EXISTING ICC ABANDONMENT PROCEDURES

Under an ICC-sanctioned abandonment, all affected employees would be entitled to either the Oregon Short Line Conditions or conditions no less protective than the Amtrak Conditions with respect to the portions of the railroad sought to be abandoned. (The substance of these provisions is described in Chapter II.) Depending upon subsequent decisions by employees now operating lines west of the Twin Cities (such as whether to elect to take a lump-sum separation pay or wage continuation payments), total labor protection costs over a six-year period could range from $83 million (if all eligible employees receive a one-time lump-sum separation payment) to $521 million (if all eligible employees receive wage continuation payments over the full six-year period).

The estimates of labor impacts and protection costs[3] are summarized below:

Scenario	Estimated Labor Protection Cost (6 years)	Estimated Financial Impact on Labor		
		Number of Lines West Employees Losing Jobs Over Long Term (5 years)	Number of Lines West Employees Losing Labor Protection Over Long Term (5 years)	Number of Lines West Employees Facing Reduction in Wages and Fringes
Scenario 2--ICC Abandonment	$83 million to $521 million	3,534 (100%)	0 (0%)	0 (0%)

---

[3]The estimated labor protection costs and the accompanying estimated financial impacts on labor for each scenario required making a number of assumptions. These assumptions are provided in detail in the body of the report (see Chapter II).

- SCENARIO 3--LINES WEST OF THE TWIN CITIES ARE REORGANIZED IN ACCORDANCE WITH THE SORE PROPOSAL

Scenario 3 is based upon the assumption that the SORE Lines West Proposal is viable as is and assesses the labor protection costs and the financial impacts on labor accordingly. (Scenario 4 considers the revised projections for selfsustainability as prepared by the Consulting Center, Inc.)

Spokesmen for SORE have indicated that all employees currently employed on lines west of the Twin Cities would be employed by the reorganized company. Also, recently furloughed Lines West employees and other new employees are also to be hired. Under these conditions, and assuming the financial viability of the SORE proposal, there would be no labor protection costs and no adverse financial impact on labor as no jobs would be lost, no labor protections would be foregone and no employees would face a reduction in wages or fringes.

- SCENARIO 4--THE SORE PROPOSAL IS IMPLEMENTED IN THE FORM OF A TRADITIONAL EMPLOYEE STOCK OWNERSHIP PLAN

If sources of necessary funding are otherwise available to meet the capital and operating needs of a new Lines West railroad, then there is no reason why an employee stock ownership plan could not be used as a conduit for that funding and, at the same time, to vest stock ownership in the employees. The ESOP could be either of the stock bonus or stock purchase variety, although SORE proposes only a Kelso-type stock bonus plan. Utilizing EDA grant money available as loans from the communities served, as well as funds borrowed under Farmers Home Administration guarantees, the Lines West ESOP could provide the estimated initial cash of $60 million required during the first year of a five-year program. It should be made perfectly clear, however, that the use of an ESOP does not assure funding availability. There is certainly no magic in a Kelso-type ESOP (where the employer corporation pays twice for the funds made available to it through the ESOP as explained on page II-45). Moreover, in the case of Lines West, there is no clear-cut tax benefit to Lines West, and it is that tax benefit that makes an employee stock ownership plan feasible for most corporations. Without the tax deductible feature, an ESOP can, from the employer's viewpoint, be merely a serious drain on cash flow given the fact that a fixed payment schedule must be observed in order for the ESOP to repay its loans of public moneys. It is the very question of projected cash flow that determines the utility of an ESOP, not the reverse. In short, the Lines West railroad first must be perceived as a viable option with regard to the future of the Milwaukee Road--viable in terms of economic feasibility. If that is the conclusion of the funding agencies, then the use of an ESOP should definitely be considered in an overall plan for the Milwaukee Road. Additional options, including other means of employee participation in ownership, should perhaps be considered. For example, it is clear that the new venture would benefit from maximizing equity investment while minimizing its debt burden and demands on cash flow. Another approach could be an employee stock purchase plan with consideration of government guarantees along with perhaps the stock bonus approach. In point of fact, an ESOP-type approach might be appropriate for employee ownership participation in whatever final plan evolves from the Milwaukee Road reorganization.

CHAPTER I

FINANCIAL ANALYSIS OF THE IMPACT ON LABOR AND LABOR PROTECTION OF THE SORE LINES WEST PROPOSAL

Background and Objectives

The U.S. Department of Transportation (DOT) retained Mark Battle Associates, Inc. (MBA), to conduct an analysis of the financial impact on labor and the potential financial cost of labor protection under the SORE Lines West Proposal to acquire and operate the Chicago, Milwaukee, St. Paul and Pacific Railroad Company's lines between St. Paul, Minnesota and the Pacific Northwest. Additionally, a like analysis of labor impacts and costs was to be conducted on three alternative scenarios:

- Lines west of the Twin Cities have an embargo placed on traffic
- Lines west of the Twin Cities have traffic abandoned under existing ICC abandonment procedures
- The SORE Lines West Proposal is implemented in the form of a traditional employee stock ownership plan (ESOP)

This study was also designed to determine whether a traditional ESOP can be utilized under a revision to the financial framework of SORE, in which the ESOP plays the dominant role in the financing, while other aspects of the SORE proposal remain as presented by SORE or in accordance with adjustments recommended in the Assessment of the Financial Selfsustainability of the SORE Lines West Proposal as prepared by the Consulting Center, Inc., July 9, 1979.

Methodology

The approach to conducting this analysis included the following basic steps:

1. Literature Review--A wide range of documents, papers, transcripts of testimony and other literature was assembled and reviewed by the project team. A listing of bibliographical references is included in the Appendix.

2. Conduct Interviews--A number of individuals knowledgeable with respect to the facts in the subject case were interviewed by project team members.

3. Analysis and Reporting--Due to the brief time frame available for this effort, methods of collecting and analyzing data did not always permit the team to validate information sources. As a result, a number of assumptions were made and are noted in the text. Wherever possible, sources of data used for calculations throughout this study were validated through a second source.

Contents of the Report

The first section of this report is the Executive Summary, which briefly summarizes the project findings. Chapter I provides the background, objectives, methodology and contents, and Chapter II presents the analysis and findings under each of the four scenarios.

CHAPTER II

ANALYSIS AND FINDINGS

SCENARIO I

Lines West of the Twin Cities Have an Embargo Imposed on Traffic

Background

The Trustee of the Milwaukee Road, Mr. Stanley E. G. Hillman, requested on April 23, 1979, permission from the reorganization court to embargo rail services over the majority of the lines proposed for acquisition by SORE. The objective of this scenario analysis is to determine the financial impact on labor and the financial cost of labor protection in the event traffic on the Lines West is embargoed.

Labor Protection Costs

With respect to the law, if the western lines were simply shut down (embargoed), Section 77 of the Bankruptcy Act, 11 USC § 205 would not provide any protection to the employees who would simply be furloughed. Additionally, no employee protections would normally be imposed by the ICC in an embargo. The Milwaukee could immediately cease all Lines West operations after it moves the present traffic off the lines. It could start abolishing immediately unneeded positions while traffic is being removed and, once removed, could abolish all other positions except those few needed for the security of the facilities. For purposes of this analysis, it has been assumed that all positions would be abolished within a six-month period.

However, all of the Shop Craft Unions[1] and the Brotherhood of Railway, Airline and Steamship Clerks (BRAC) currently have agreements with the Milwaukee Road requiring employee protection in the event of discontinuance of service, whether the cessation is based upon an ICC-sanctioned abandonment, an embargo or other cause.

The total costs of labor protection for affected members of unions covered with labor protection under Scenario 1 could range from as low as $31 million to a worst case of $167 million. Yearly allocations and calculations are provided in Exhibits 1.A. through 1.E. These figures may be deceptive, however; the Milwaukee reputedly does not have the funds to provide the labor protection payments short of full liquidation. It is probable that long and costly arbitration proceedings and/or litigation would be required to enforce the applications as the estate is likely to challenge the labor protection agreements. It could take years before final decisions are made. In the interim, Shop Craft and BRAC employees would be limited to Railroad Unemployment Insurance Benefits (see Exhibit 2).

Members of other unions[2] are not covered by labor protections under an embargo and affected employees not covered would be entitled to Railroad Unemployment Insurance Act benefits only. Railroad Unemployment Insurance (RUI) benefits shall not exceed $25.00 per day and may continue for a period of up to 260 days maximum. The qualification requirements and benefits are briefly described in Exhibit 2.

---

[1] The Shop Craft Unions include the Sheet Metal Workers International Association, the International Association of Machinists and Aerospace Workers, the International Brotherhood of Firemen and Oilers, the Railway Carmen of the U.S. and Canada, the International Brotherhood of Boilermakers and Blacksmiths and the International Brotherhood of Electrical Workers.

[2] A full list of unions and the membership of each currently employed on lines proposed for acquisition by SORE is provided in Table 1.

TABLE 1

TOTAL EMPLOYEE ROSTER FOR LINES WEST
(By Union Membership)

	Union	Number of Employees
Shop Craft	Sheet Metal Workers International Association (SMW)	15
Shop Craft	International Association of Machinist and Aerospace Workers (IAM)	78
Shop Craft	International Brotherhood of Firemen and Oilers (F&O)	120
Shop Craft	Railway Carmen of the U.S. and Canada (Carmen)	216
Shop Craft	International Brotherhood of Boilermakers and Blacksmiths (B&B)	30
Shop Craft	International Brotherhood of Electrical Workers (IBEW)	103
	Brotherhood of Maintenance of Way Employees (M of W)	466
	Brotherhood of Railway, Airline and Steamship Clerks (BRAC)	765
	Brotherhood of Locomotive Engineers (BLE)	317
	United Transportation Union (UTU)	1,050
	American Railway Supervisors Association (ARSA)	102
	Brotherhood of Railroad Signalmen	103
	American Train Dispatchers Association (ATDA)	29
	Railroad Yard Masters of America (YM)	40
	Officials	100
	TOTAL	3,534

EXHIBIT 1

SCENARIO 1: EMBARGO IMPOSED ON LINES WEST

A. Worst Case Labor Protection Cost Estimates

Year	Number of Employees Furloughed From Lines West[1]	Number of Employees Eligible for Labor Protection Under Embargo[2]	Number of Employees Required Under Directed Services	Contingent Labor Protection Cost Estimations
1980	1,534 (for 8 mos.) / 3,534 (for 4 mos.)	1,327	2,000 (for 8 mos.) / None (for 4 mos.)	Up to $35 mm
1981	3,251	1,195	None	Up to $33.7 mm
1982	2,991	1,099	None	Up to $33.2 mm
1983	2,752	1,010	None	Up to $32.6 mm
1984	2,532	930	None	Up to $32.2 mm
			Total	Up to $166.7 mm

Note: In Scenario 1, only the Brotherhood of Railway and Airline Clerks (BRAC) and the Shop Craft employees are entitled to labor protection payments. The legal opinion is that the ICC would not impose protection payments under an embargo situation. However, due to collective bargaining agreements, both BRAC and Shop Craft employees are entitled to up to five years of payments.

[1] Total Milwaukee employees--10,266 as of April 30, 1979; total Milwaukee employees on Lines West--3,534 as of June 26, 1979 (see Table 1). From 1981 through 1974, an attrition level of eight percent (the industry average) is assumed.

[2] In 1980, the number is the sum of Shop Craft and BRAC employees. In 1981, a 10 percent attrition level (employees reaching retirement age, finding employment elsewhere, etc.) is assumed. In subsequent years, an attrition level of 8 percent (the industry average) is assumed.

EXHIBIT 1 (Continued)

B. Labor Protection Cost Calculations Where All Eligible Employees Take Lump Sum[1]

Year	Number of Eligible Employees[2]	Number of Employees Taking Lump-Sum Separation Pay	Average Annual Company Cost Per Employee	Average Lump Sum Separation Pay Per Employee[3]	Total Separation Pay[4]	Total Protection Cost[5]
1980	1,327	1,327	$26,400	$23,638	$31,367,600	$31,367,600

[1] This protection cost is the same (if all eligible employees take lump sum) whether or not there is directed service.

[2] Total BRAC employees (Lines West) or 765 plus total Shop Craft employees (Lines West) or 562 equals 1,327.

[3] See Table 2.

[4] Average separation pay per employee multiplied by the number of employees taking lump-sum separation pay.

[5] Sum of total wage continuation payments and total separation pay.

TABLE 2

LUMP-SUM SEPARATION PAY

According to Milwaukee management, the average per day rate of compensation per employee is $74.98. For our calculations, this number has been rounded off to $75.00. Eligible employees who opt for a lump sum settlement receive a certain number of days pay based on length of service. The schedule is based on the Washington Job Protection Payment Agreement of 1936:

> Section 9. Any employee eligible to receive a coordination allowance under Section 7 hereof may, at his option at the time of coordination, resign and (in lieu of all other benefits and protections provided in this agreement) accept in a lump sum a separation allowance determined in accordance with the following schedule:
>
> | Length of Service | Separation Allowance |
> |---|---|
> | 1 year & less than 2 years | 3 months' pay |
> | 2 years & less than 3 years | 6 months' pay |
> | 3 years & less than 5 years | 9 months' pay |
> | 5 years & less than 10 years | 12 months' pay |
> | 10 years & less than 15 years | 12 months' pay |
> | 15 years and over | 12 months' pay |
>
> In the case of employees with less than one year's service, five days' pay, at the rate of the position last occupied, for each month in which they performed service will be paid as the lump sum.
>
> (a) Length of service shall be computed as provided in Section 7.
>
> (b) One months' pay shall be computed by multiplying by 30 the daily rate of pay received by the employee in the position last occupied prior to time of coordination.

The percentage of various Milwaukee employees eligible for 30 days' pay to 360 days' pay is:

No. Employees	Allowance	Daily Rate
8.57 %	30 days	$75.00
2.87	90	75.00
1.95	180	75.00
5.90	270	75.00
80.73	360	75.00

Therefore, the total separation pay for all employees of Lines West is:

	No. Employees	Allowance	Daily Rate	Amount
	303	30 days	$75.00	$ 681,750
	101	90	75.00	681,750
	69	180	75.00	931,500
	208	270	75.00	4,212,000
	2,853	360	75.00	77,031,000
Total	3,534			$83,538,000

This amounts to an average of $23,638 per employee.

EXHIBIT 1 (continued)

C. Labor Protection Cost Calculations with Directed Services
Where One-Third of Eligible Employees Take Lump Sum

Year	Number of Eligible Employees[1]	Number of Employees Taking Lump Sum Separation Pay (Assumes 33-1/3%)	Average Annual Company Cost Per Employee	Average Lump Sum Separation Pay Per Employee[2]	Total Separation Pay	Number of Employees To Receive Wage Continuation Payments[3]	Average Wage Continuation Payment Per Employee[4]	Total Wage Continuation Payments[5]	Total Protection Cost[6]
1980	1,327	442	26,400	$23,638	$10,448,000	885 (for 4 months only)	$26,400	$15,576,000	$26,024,000
1981	797	Applicable in first yr. only	28,250	Applicable in first yr. only	Applicable in first yr. only	797	28,250	22,515,000	22,515,000
1982	733	Applicable in first yr. only	30,200	Applicable in first yr. only	Applicable in first yr. only	733	30,200	22,136,000	22,136,000
1983	674	Applicable in first yr. only	32,340	Applicable in first yr. only	Applicable in first yr. only	674	32,340	21,797,000	21,797,000
1984	620	Applicable in first yr. only	34,600	Applicable in first yr. only	Applicable in first yr. only	620	34,600	21,452,000	21,452,000
1985	570	Applicable in first yr. only	37,000	Applicable in first yr. only	Applicable in first yr. only	570 (for 8 months)	37,000	14,100,000	14,100,000
								TOTAL	$120,235,000

[1] In 1980, the number is the sum of Shop Craft and BRAC employees.

[2] See Table 2.

[3] The year one (1980) figure is the difference between the total number of entitled employees and those taking lump-sum separation payment. The year 1981 reduction is due to a 10 percent attrition factor. Subsequent years have an 8 percent (industry average) attrition factor.

[4] The carrier is obligated to compensate each employee according to length of service and average annual pay. Total compensation includes the employee's wages, fringes, salary increases and cost-of-living increases. Table 3 shows how the numbers were calculated.

[5] This figure is the result of multiplying the total number of employees receiving wage protection payments by the average wage continuation payment. For "directed services," a four-month payment period is used instead of the full-year figure.

[6] The sum of total wage continuation payments and total separation pay.

TABLE 3

AVERAGE ANNUAL COST PER EMPLOYEE

Milwaukee management has indicated that the average annual wage per employee is $18,000. The total cost to the company includes the fringes which average 33 percent of base pay. Therefore, in 1979 the cost per employee is $24,000. The following table indicates the company's expected cost, including wage increases and cost of living increases. The calculation for 1980 assumes a 5 percent wage increase and a 5 percent cost of living increase or 10 percent overall. A 7 percent increase is assumed for each subsequent year. **This is** within the President's wage guidelines.

Year	Increase	Annual Average Employee Cost
1980	5% wage; 5% cost of living	$26,400
1981	7%	$28,250
1982	7%	$30,200
1983	7%	$32,340
1984	7%	$34,600
1985	7%	$37,000

EXHIBIT 1 (continued)

D. Labor Protection Cost Calculations Without Directed Services

Year	Number of Eligible Employees[1]	Number of Employees Taking Lump Sum Separation (Assumes 33%)[1]	Average Annual Company Cost Per Employee	Average Separation Pay Per Employee[1]	Total Separation Pay[1]	Number of Employees to Receive Wage Continuation Payments[1]	Average Wage Continuation Payment Per Employee[1]	Total Wage Continuation Payments[1]	Total Protection Cost[1]
1980	1,327	442	26,400	$23,638	$10,448,000	885	$26,400	$23,364,000	$33,812,000
1981	797	Applicable in first yr. only	28,250	Applicable in first yr. only	Applicable in first yr. only	797	28,250	22,515,000	22,515,000
1982	733	Applicable in first yr. only	30,200	Applicable in first yr. only	Applicable in first yr. only	733	30,200	22,136,000	22,136,000
1983	674	Applicable in first yr. only	32,340	Applicable in first yr. only	Applicable in first yr. only	674	32,340	21,797,000	21,797,000
1984	620	Applicable in first yr. only	34,600	Applicable in first yr. only	Applicable in first yr. only	620	34,600	21,452,000	21,452,000
								Total	$121,712,000

[1] See footnotes 1 through 6 on Exhibit 1.C.

EXHIBIT 1 (continued)

E. Labor Protection Cost Calculations Where All Eligible Employees Take Five-Year Payout Without Directed Services

Year	Number of Eligible Employees[1]	Average Annual Company Cost Per Employee	Number of Employees To Receive Wage Continuation Payments[1]	Average Wage Continuation Payment Per Employee[1]	Total Wage Continuation Payments[1]	Total Protection Cost[1]
1980	1,327	$26,400	1,327	$26,400	$35,032,800	$35,032,800
1981	1,194	28,250	1,194	28,250	33,730,500	33,730,500
1982	1,099	30,200	1,099	30,200	33,189,800	33,189,800
1983	1,010	32,340	1,010	32,340	32,663,400	32,663,400
1984	930	34,600	930	34,600	32,177,500	32,177,500
					Total	$166,794,000

[1] See footnotes 1, 3, 4, 5 and 6 on Exhibit 1.C.

EXHIBIT 2

RAILROAD UNEMPLOYMENT INSURANCE ACT
Brief Outline: Qualification Requirements and Benefits

QUALIFICATION REQUIREMENTS

An employee shall be a "qualified employee" if the Board finds that his compensation will have been not less than $1,000.00 with respect to the "base year"[1] and if such employee has had no compensation prior to such year, that he will have had compensation with respect to each of not less than five months in such year.

BENEFITS[2]

Daily Rate: Sixty percent of the daily rate of compensation for employee's last employment in the base year but shall not exceed $25.00 per day of such unemployment.

Duration of Benefits: Maximum number of days of unemployment within a benefit year:[3]

Normal unemployment benefits: 130 days within a benefit year except the total amount of benefits paid an employee shall not exceed the employee's compensation in the base year. (Earnings in excess of $775.00 in any months shall not be taken into account.)

Extended benefits: An unemployed employee who has exhausted his "normal benefits" in a benefit year shall be entitled to the following additional benefits:

- Less than 10 years service--65 days but total extended benefits shall not exceed 50 percent of the employee's compensation in the base year. (Earnings in excess of $775.00 in any month shall not be taken into account.)
- Ten years and less than 15--65 days.
- 15 years and over--130 days.

[1] Base Year = Completed calendar year immediately preceding the "benefit year."

[2] These RUI benefits are not payable while the employee is eligible and is receiving compensation under any agreement providing protective payments or under any conditions imposed by ICC. However, RUI benefits will commence at the expiration of such payments and will continue so long as the employee is unemployed for the duration as outlined above.

[3] Benefit Year = Twelve-month period beginning July 1 of any year and ending June 30 of the next year.

Alternative Labor Protection Requirements

It is conceivable that any of three situations could arise in the event of an embargo.

1. The ICC could impose "directed service" by another carrier for up to 240 days on shut-down portions of the Milwaukee. Under this arrangement, the Federal government would be responsible for compensating the directed carrier or carriers handling the service for any losses incurred, plus a six percent profit. It is not clear at this time exactly how many Milwaukee employees would be used to perform such services. Mr. Lawrence Harrington, Vice President of Management Services for the Milwaukee Trustee, estimated 2,000, whereas the directed railroad may use far less than that number and prior to the expiration of the 240 days, shippers would, no doubt, be encouraged and would find other means of moving their traffic. Thus, over this period, the need for service and employees may decrease. For purposes of this study, however, 2,000 employees were assumed. The employees not used by the directed railroad, approximately 1,500, would be furloughed immediately; those used would be furloughed as the demand for service declined; and all would be furloughed at the end of 240 days. Under this arrangement, the estimated labor protection costs could range from $31 million if all eligible employees take a lump-sum separation payment to $120 million if only one-third of the eligible employees take the lump-sum separation payment (see Exhibits 1.B. and 1.C). It is possible that no eligible employees would take the lump-sum separation payment. In that event, the total labor protection costs would be $167 million (see Exhibit 1.A.).

2. The ICC could refrain from imposing directed services. Under this arrangement, estimated labor protection costs could range from $31 million to $167 million (see Exhibits 1.A, 1.D and 1.E).

3. The courts could rule, after potentially protracted litigation, that a proposed embargo is a defacto abandonment as defined in 49 USC § 10903. In such a case, the abandonment procedures of the Interstate Commerce Commission would be applied. The resulting labor impacts and protection costs are described under Scenario 2.

Impact on Labor

In both of the above-cited cases in which an embargo is actually effected, the impacts on labor are dramatic (1 and 2 above). In each case, all 3,500 employees lose their jobs within 240 days. In both cases, 2,200 employees are not provided with labor protection and 1,300 are provided with contingent labor protection in the event of victory in probable litigation against the estate. Also, in both cases, all furloughed employees' "actual wage levels" are likely to be reduced to the Railroad Unemployment Insurance levels of up to $25.00 per day; the exception being the 2,000 employees retained for directed service for 240 days. In the case of this group, seniority by craft and class determines which employees are retained. Where junior employees are replaced by senior employees, the seniors are likely to incur reductions in wages. Since many individual decisions will be made, it is difficult to project the number of employees which would be so affected.

SCENARIO 2

Lines West of the Twin Cities Have Trackage Abandoned Under Existing ICC Abandonment Procedures

Statutory Framework

In the case of an abandonment, the procedures of the Interstate Commerce Commission (ICC) would be applied as set forth below:

11 USC § 205(o) states:

> The trustee or trustees from time to time shall determine what lines or portions of lines of railroad and whatever property of the debtor, if any, should be abandoned or sold during the pendency of the proceedings in the interests of the debtor's estate and of ultimate reorganization . . . [U]pon order of the judge . . . authorizing any such abandonment or sale, but only with the approval and authorization of the Commission when required by Chapter I of Title 49 . . . the trustee or trustees shall take all steps and carry out all proceedings necessary for the consummation of any such abandonment or sale in accordance with the order of the judge . . . .

The language of the bankruptcy law clearly required ICC approval of any abandonment authorized by a judge in a proceeding to reorganize a bankrupt railroad. The case law clearly holds that railroads being reorganized under Section 77 are not exempt from the provisions of 49 USC § 10903 (formerly 49 USC § 1a), which mandates ICC approval of any abandonment or cessation of service by a railroad. Thompson v. Texas Mexican Railway Company, 328 U.S. 134 (1946); Smith v. Hoboken R.R. Warehouse and S.S. Connecting Co., 328 U.S. 123 (1946). See In re Central Railway Co. of New Jersey, 485 F.2d 208 (3rd Cir. 1973), cert. denied 414 U.S. 1131 (1974).[3]

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[3] It should be noted that Judge Henry J. Friendly has, on at least two occasions, suggested that imminent cashlessness could relieve a debtor railroad from these requirements. In re Penn Central Transportation Co., 384 F. Supp. 895, 919 (1974); Matter of Valuation Proceedings Under §§ 303(c) & 306, 439 F. Supp. 1351, 1376 (1977).

Therefore, any proposal for the abandonment of facilities of the Milwaukee Railroad will have to be approved by the ICC pursuant to the procedures set forth in 49 USC § 10903, et seq.

49 USC § 10903(b)(2), formerly 49 USC § 1a(4), states:

> On approval, the Commission shall issue to the rail carrier a certificate describing the abandonment or discontinuance approved by the Commission. Each certificate shall also contain provisions to protect the interests of employees. The provisions shall be at least as beneficial to those interests as the provisions established under Section 11347 of this title and Section 565(b) of Title 45.

The Interstate Commerce Act thus requires that any abandonment authorized by the Commission contain provisions to protect the interests of railroad employees. The reference to 45 USC § 565(b) is to the so-called "Amtrak Conditions" set forth in the legislation which created the National Rail Passenger Corporation ("Amtrak").

The employee protective conditions which the Commission routinely applies to all current abandonment situations are set forth in Oregon Short Line Railroad and the Union Pacific Railroad Company--Abandonment--Goshen, 354 ICC 76 (1977). These conditions spell out in great detail the protections provided to railroad employees and the financial burden which must be borne by the railroad in providing these protective conditions.

Therefore, the ICC would be required in approving any abandonment proposal for the Milwaukee Railroad to impose either the Oregon Short Line (OSL) Conditions or conditions no less protective than Amtrak Conditions with respect to the portions of the railroad sought to be abandoned.[4] Although the Interstate Commerce Act

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[4] This assumes that the abandonment plan would be part of a reorganization of the railroad pursuant to Section 77, not a liquidation of a totally insolvent railroad.

requires the ICC to balance a variety of factors in determining the appropriateness of the abandonment, including the financial condition of the railroad, the imposition of protective conditions is mandatory and may not be avoided by the Commission even though compliance by the railroad with such protective conditions might be financially burdensome.

Labor Protections

The Oregon Short Line Conditions, as promulgated by ICC, include a modification of Sections 4 and 5 of the Washington Job Protection Agreement (Washington Job Agreement of May 1936) requiring the railroad to give the representatives of the employees 90 days advance notice of the proposed abandonment together with all details affecting the employees and require the consummation of implementing agreements with each union prior to effecting the abandonment. Failing agreement, either party may submit the unresolved issues to final and binding arbitration. The neutral arbitrator has authority to set forth the terms of the implementing agreement.

The OSL Conditions, then, impose as a combination with the above "notice and agreement" provisions, the Amtrak Conditions. These Conditions give the employees a maximum of six years (not to exceed years of service prior to date affected) protection against any financial loss from such employment including protection against any loss of fringe benefits such as, but not limited to, free transportation, health and welfare, and hospitalization coverage, pensions, etc.

To protect the employee against financial loss, the Conditions provide that the employee will receive no less in compensation each month during his protective period than the monthly average of the total compensation received during the 12-month period immediately preceding the date affected, including overtime and all monies as well as arbitraries received by the employee. This monthly guarantee is reduced during the protective period by other ouside earnings. If the affected employee has sufficient seniority to continue employment with the railroad, his guarantee is termed a "displacement allowance" and is reduced by his continued railroad earnings. If he displaces an employee, that employee immediately becomes eligible for these same protective conditions.

If the employee is required to move his place of residence to continue his railroad employment, the Conditions require the railroad to reimburse the employee for all moving expenses and if he owns a home, to protect him from any loss in its sale from its fair value.

If the employee cannot obtain another position with the railroad, the employee is furloughed, that is, he continues to retain his employment relationship with the railroad and retains his seniority but there are no jobs available to him. The employee guarantee, when furloughed, is termed a "dismissal allowance" and is computed in the same manner with the same duration as the "displacement allowance." Such allowance is also reduced by other outside earnings. Both the displacement and dismissal allowances are increased by subsequent general wage increases.

A furloughed employee who qualifies for a dismissal allowance also has the option of resigning from the services of the railroad and accepting a "separation allowance" in lieu of all other benefits. The separation allowance is determined as follows:

Length of Service	Separation Allowance
Less than one year	5 days pay for each month worked
One year, but less than two years	90 days pay
Two years, but less than three years	180 days pay
Three years, but less than five years	270 days pay
Five years or more	360 days pay

Labor Protection Costs

Under an ICC-imposed abandonment of Lines West of the Milwaukee Road, labor protection costs could range from an estimated low of $83 million (in the unlikely event that all employees elected the less lucrative lump-sum separation payment) to a high of $521 million (in the worst case in which all employees elected the full six-year wage and fringe benefits payment option). Yearly allocations and calculations are provided in Exhibits 3.A. through 3.D.

Impact on Labor

The positive implications regarding the impact on labor should the ICC approve the abandonment of Lines West of Twin Cities and impose in its order employee protecrion would be the equivalent of wage payments given the employees for up to six years (80 percent of Milwaukee employees have six or more years of service) or until new employment is found; in addition, the fringe benefits, such as hospitalization and health and welfare benefits, are continued for the employee and family at no expense to the employee during this period. At the end of the protective period, if the employee is still unemployed, he becomes eligible for RUI benefits. All employees are entitled to the labor protection payments; approximately 80 percent would be entitled to wage continuation payments at full salary levels for six full years due to their length of service.

EXHIBIT 3

SCENARIO 2: ICC ABANDONMENT CONDITIONS IMPOSED ON LINES WEST

A. Worst Case Labor Protection Cost Estimates[1]

Year	Number of Employees Furloughed (Assumes 8% Attrition)	Number of Employees Eligible for Labor Protection Payments Under Abandonment[2]	Contingent Labor Protection Cost Estimations
1980	3,534	3,534	Up to $93 mm
1981	3,180	3,180	Up to $90 mm
1982	2,862	2,862	Up to $86.4 mm
1983	2,634	2,634	Up to $85 mm
1984	2,423	2,423	Up to $83.8 mm
1985	2,229	2,229	Up to $82.4 mm
		Total	Up to $521 mm

Note: In Scenario 2, all employees are assumed to be entitled to labor protection payments. It is assumed that the ICC would impose the Oregon Short Line Conditions and each affected employee would be entitled to a choice of lump-sum separation pay or up to six years of wage continuation payments with each amount based on length of service.

[1] Total Milwaukee employees--10,266 as of April 30, 1979; total Milwaukee employees on Lines West--3,534 as of June 26, 1979.

[2] All eligible employees of Lines West.

EXHIBIT 3 (continued)

B. Labor Protection Cost Calculations Where All Eligible Employees Take Six-Year Wage Payments Option

Year	Number of Eligible Employees[1]	Number of Employees Taking Lump-Sum Separation[2]	Average Annual Company Cost Per Employee	Number of Employees To Receive Wage Continuation Payments[3]	Average Wage Continuation Payments Per Employee[2]	Total Wage Continuation Payments[2]	Total Protection Cost[2]
1980	3,534	None	$26,400	3,534	$26,400	$93,297,600	$93,297,000
1981	3,180	None	28,250	3,180	28,250	89,835,000	89,835,000
1982	2,862	None	30,200	2,862	30,200	86,432,400	86,432,4 0
1983	2,634	None	32,340	2,634	32,340	85,184,000	85,184,000
1984	2,423	None	34,600	2,423	24,600	83,835,800	83,835,800
1985	2,229	None	37,000	2,229	37,000	82,473,900	82,473,900
						Total (worst possible case)	$521,058,000

[1]All employees of Lines West.

[2]See Scenario 1 footnotes.

[3]The 1980 figure is the difference between the number of eligible employees and those taking the lump-sum option. The 1981 figure assumes 10 percent attrition for 1980; thereafter an 8 percent attrition rate is assumed.

EXHIBIT 3 (continued)

C. Labor Protection Cost Calculations Where One-Third of All Eligible Employees Take Lump Sum

Year	Number of Eligible Employees[1]	Number of Employees Taking Lump Sum Separation[1]	Average Annual Company Cost Per Employee	Average Separation Pay Per Employee[2]	Total Separation Pay	Number of Employees To Receive Wage Continuation Payments[1]	Average Wage Continuation Payments Per Employee	Total Wage Continuation Payments[1]	Total Protection Cost[1]
1980	3,534	1,177	$26,400	$23,638	$27,846,000	2,357	$26,400	$62,224,800	$90,979,800
1981	2,121	Applicable in first yr. only	28,250	Applicable in first yr. only	None	2,121	28,250	59,918,250	59,918,250
1982	1,951	Applicable in first yr. only	30,200	Applicable in first yr. only	None	1,951	30,200	58,920,200	58,920,200
1983	1,795	Applicable in first yr. only	32,340	Applicable in first yr. only	None	1,795	32,340	59,845,300	59,845,300
1984	1,651	Applicable in first yr. only	34,600	Applicable in first yr. only	None	1,651	34,600	57,124,600	57,124,600
1985	1,520	Applicable in first yr. only	37,000	Applicable in first yr. only	None	1,520	37,000	56,240,000	56,240,000
								Total	$382,117,000

[1] See footnotes in Exhibit 3.B.

[2] See Table 1.

EXHIBIT 3 (continued)

D. Labor Protection Cost Calculations Where All Employees Take Lump Sum

Year	Number of Eligible Employees[1]	Number of Employees Taking Lump Sum Separation[1]	Average Annual Company Cost Per Employee	Average Separation Pay Per Employee[1]	Total Separation Pay[1]	Total Protection Cost[1]
1980	3,534	3,534	$26,400	$23,638	$83,538,000	$83,538,000
					Total	$83,538,000

[1] See footnotes in Exhibit 3.B.

The remaining 20 percent, or approximately 700, having less than six full years of service, would receive labor protection costs for a period not to exceed their years of service prior to the date affected.

The negative implications are that the Trustee has indicated that there is no money available to pay <u>any</u> employee protective payments and any claims for such would have to eventually be settled by the estate. Again, this would require years of litigation, during which time the only benefits available to the employee would be those provided under the RUI Act. Other negative implications, of course, involve the immediate loss of employment for all 3,500 workers.

SCENARIO 3

Lines West of Twin Cities Are Reorganized in Accordance with the SORE Lines West Proposal

For the purpose of analyzing the financial impact on labor and the cost of labor protection for Scenarios 3 and 4, both are treated as one since the results would be identical (see Exhibit 4).

Spokesmen for SORE indicate all the employees (approximately 3,500) currently employed on Lines West of Twin Cities would be employed by the reorganized company. SORE spokesmen also contend the decline in traffic on Lines West is directly tied to the railroads' decline or deterioration in service to the shippers. SORE's primary objective is to improve and provide additional service as quickly as possible.

This plan, along with a plan for an accelerated rehabilitation program, will require the recall of currently furloughed employees and the hiring of additional new employees to provide improved services to the shippers. Under these conditions and assuming the financial viability of the SORE proposal, there would be no adverse financial impact on labor, as all the present employees would be continued in employment resulting in the payment of no employee protection. Thus, there would, of course, be no employee protection costs. Nor would there be any financial drain on the Railroad Unemployment Insurance Fund. There is also no basis for assuming that any employees would face a reduction in wages and fringes, although this is a possibility on a voluntary basis under a stock purchase plan discussed in Scenario 4.

EXHIBIT 4

SCENARIOS 3 AND 4: EMPLOYEE STOCK OWNERSHIP PLAN

Worst Case Labor Protection Cost Estimates[1]

Year	Number of Employees Furloughed	Number of Employees Retained by SORE	Number of Employees on Directed Services	Labor Protection Obligation
1980	None	3,534+	None	None
1981	None	3,534+	None	None
1982	None	3,534+	None	None
1983	None	3,534+	None	None
1984	None	3,534+	None	None

Note: Under the Scenarios 3 and 4 all employees eligible for protection payments are employed; therefore, no labor protection liability is incurred.

[1] Total Milwaukee employees--10,266 as of April 30, 1979; total Milwaukee employees on Lines West--3,534 as of June 26, 1979.

Focus of Analysis on ESOP

Because questions regarding the labor protection costs and the financial impact on labor are moot assuming viable operations, and given the focus of Scenario 4 on the potential of a traditional ESOP as a mechanism for financing the SORE proposal, the balance of the analysis of Scenario 3 is focused on ESOP considerations and characteristics as a basis of comparison with Scenario 4.

Financial Characteristics of the SORE Proposal

According to the SORE proposal, the Milwaukee Road's western lines employees are proposing to acquire and operate the Twin Cities transcontinental routes. The railroad filed a petition for voluntary reorganization under Section 77 of the Federal Bankruptcy Act on December 19, 1977, and presently operates under the management of a Trustee. The Milwaukee is owned by the Chicago Milwaukee Corporation, a holding company listed and actively traded on the New York Stock Exchange.[5] In addition to the Milwaukee Railroad, the holding company owns a profitable manufacturer of food preparation and storage equipment, a porcelain enameling services company, an institutional wholesale food and equipment business, a concrete paving firm and a metal fabricator. The railroad owns a motor carrier, a land company with substantial holdings and income, and interests in a number of terminal and belt-line railroads.

Total assets of the Milwaukee Road were carried on its 1978 year-end balance sheet at $898,346,000, and at $880,210,000 on March 31, 1979. Liabilities at the latter date included current liabilities of $112,099,000,

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[5] Closing price of the common stock June 27, 1979, as reported by The Washington Post newspaper, was $15.00; the closing price of the preferred was $38.50.

reserves and other liabilities of $28,412,000, long-term debt of $307,323,000, deferred liabilities and income taxes of $102,877,000 and shareholders' equity of $268,504,000. The net loss for the first quarter of 1979 was $44,004,000, which almost equaled the loss for the entire previous year of $49 million.

A report on the estimated liquidation value of the assets of the Milwaukee Road, including its investment in the Milwaukee Land Company and the Milwaukee Motor Transportation Company, was submitted to the Trustee on November 29, 1978. The total estimated liquidation value of $832,166,000 is based on conditions existing as of December 31, 1977. By far the most significant classes of assets reflected in the estimate are the railroad's physical properties of an estimated liquidation value of $646,161,000 and the land company investment estimated at $110,203,000. The properties figure includes real estate estimated at $228,458,000, roadway estimated at $276,353,000 and equipment at $141,350,000. No going concern value was included in this estimate.

The assets of the Milwaukee Road proposed to be acquired under the SORE proposal have an estimated liquidation value of $370 million, calculated as follows (dollar amounts are in thousands):

I. REAL PROPERTY OF RAILROAD (in thousand acres):

Idaho	4,029 acres	$ 2,075
Minnesota	1,768	5,000
Montana	26,745	6,080
North Dakota	7,218	1,500
South Dakota	30,941	7,650
Washington	17,504	43,057
	88,205 acres	$ 65,362

II.	ROADWAY PROPERTY:	
	Track	$112,752
	Signals and Communications	1,188
		$113,940
III.	MILWAUKEE MOTOR TRANSPORTATION COMPANY:	
	Liquidation Value $1,330 44%	$ 585
IV.	OTHER INVESTMENTS:	
	Longview Switching Company	$ 11
	Delta Alaska Terminal, Ltd.	1
	Minneapolis Eastern Railway Company (40%)	10
	Minnesota Transfer Railway Company (40%)	114
	Trailer Train	247
		$ 383
V.	MILWAUKEE LAND COMPANY	$110,203
VI.	OWNED EQUIPMENT:	
	Freight Train Car (44%)	$ 50,568
	Locomotives (44%)	13,050
	Work Equipment (44%)	3,673
	Motor Vehicles, Shop and Power Plant Machinery (40%)	981
		$ 68,272
VII.	INVENTORY (Materials & Supplies):	$ 11,717
	TOTAL ASSETS	$370,462

This figure represents approximately 44 percent of the estimated liquidation value of total Milwaukee assets of $832 million as of December 31, 1977. The SORE proposal also includes assumption of a pro rata share of Milwaukee debt, i.e., 44 percent of $345 million[6] or $152 million. Included in the proposal for the new railroad are 4,400 miles of lines and upwards of 3,500 employees, initially.

The proposal cites the need for approximately $118 million for rehabilitation of the main line between St. Paul and Tacoma, with $60 million fresh cash required during the first year of a five-year program. Sources of these funds are suggested to be financing under the Emergency Rail Services Act ($15,600,000), the Railroad Revitalization and Regulatory Reform Act ($12,300,000), and an employee stock ownership plan (ESOP) ($32,108,000).

The SORE proposal envisions the incorporation of a new Lines West railroad to be owned by the present employees on the Milwaukee transcontinental routes and perhaps other Milwaukee Road employees. At the same time, an employee stock ownership plan would be established to provide for the mechanics of vesting ownership in the employees and also to assist in obtaining additional financing (working capital) required to operate the new line. According to the SORE estimates, the net liquidation value of the Lines West proposed asset structure, including the Milwaukee Land Company, is approximately $218 million, based on year-end 1977 figures ($370 million less $152 million). Assuming 3,500 initial employees, the pro rata liquidation value attributed to each employee, if 3,500 participate, is approximately $62,000.

The Lines West ESOP, as suggested above, would contribute $32 million borrowed from interested governments, but actually made available from the

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[6] This figure excludes debt recently incurred to rehabilitate the Chicago to Twin Cities line. The interim balance sheet dated March 31, 1979, shows total liabilities not including capital of $550,711,000.

Department of Commerce's Economic Development Administration (EDA) grants (under Title IX of the Public Works and Economic Development Act of 1965, as amended in 1974). The loans would be repaid from Lines West cash flow at which time the new Lines West common stock may begin to be allocated to individual employee accounts as provided in the trust agreement which is part and parcel of the ESOP. (An employee stock ownership trust is referred to by the acronym ESOT, to indicate that it qualifies under Section 401(a) of the Internal Revenue Code[7] for certain tax advantages.) Section 401(a) and the following sections are the key tax code provisions for employee pension and benefit plans, including bonus, profit-sharing and stock ownership plans, all so-called "deferred compensation plans," which means that the participant employees are taxed only upon actual receipt of benefits on retirement, for example, and the contributing employer is entitled to a tax deduction based on the amounts contributed to the program, subject to certain limits specified in the tax code.

The ESOP proposed by the SORE group is a "stock bonus money purchase pension trust," which may qualify under Section 401(a) for total annual employer contributions of up to 25 percent of total covered compensation. The fact that the ESOP is coupled with a means (the EDA grant money) to provide needed capital to the employer (Lines West) indicates that it is a "Kelso-type" plan, named after its best known proponent. Complicating the SORE proposal for employee ownership by an ESOP is a companion proposal for joint ownership, via a shippers' stock ownership plan (SSOP), along with a

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[7]26 USC 401(a).

number of important shippers. Under present law, the latter proposal is of questionable feasibility.

As is explained in the following sections, it is technically and legally possible to vest ownership of Lines West in its employees. It should be kept in mind, however, that ESOPs, while advantageous tax-wise to profitable firms, can perhaps become a burden to a struggling, unprofitable firm, especially if a fixed repayment schedule must be observed.

The ESOP Approach in the SORE Proposal

Section 401(a) of the Internal Revenue Code offers tax advantages both to employer corporations as well as employees with respect to a number of various employee benefit plans. Included are various types of employee stock purchase and stock bonus plans. These are essentially employee pension plans in the eyes of the Internal Revenue Service (IRS) with the employer allowed to deduct the fair market value of contributed stock or cash contributions for the purchase of stock at fair market value. A fund or trust is utilized to receive employer contributions and to administer individual employee participation.

The SORE proposal includes an ESOP in the form of a traditional employee stock bonus plan (no employee contribution) utilizing the "Kelso" idea combining the ESOP with employer financing (in the amount of $32 million). However, instead of an employer (Lines West) guarantee, it appears necessary to seek the required financing under a U.S. government program such as Title IX of the Public Works and Economic Development Act of 1965 (as amended in 1974), administered by the Economic Development Administration (EDA) of the Department of

Commerce or the Farmers Home Administration B&I loan guarantee program, depending on the availability of funds under either one or both programs. For example, the Lines West employee stock ownership trust might borrow the $32 million from a public grantee of the EDA. The purpose of Title IX is to provide communities with special economic development and adjustment assistance required by sudden and severe economic dislocation. Loss of employment resulting from discontinuance of the Milwaukee transcontinental lines would perhaps qualify communities, or states, for EDA grants under Title IX.

The ESOT would then purchase shares of Lines West with the $32 million added to working capital, the carrier also agreeing to contribute to the ESOT funds sufficient for repayment of principal, with interest, to the grantee of the amount borrowed. In the meantime, the ESOT-owned shares collateralize the loan until Lines West tax-deductible payments to the ESOT are sufficient for release of the shares which are then allocated to individual participating employee ESOT accounts. The allocations of share ownership are pursuant to the agreement between Lines West and the ESOT in establishment of the trust. An example of an EDA-supported ESOP by means of a public grantee of Title IX funds is the South Bend Lathe, Inc., which was spun off to employees by Amsted Industries, Inc., in 1975.

While the traditional ESOT normally involves an employer guarantee and employer tax benefits, these two factors may not necessarily be present under the SORE proposal for Lines West. The obvious reason is that Lines West is not expected to be profitable for the first several years of operation under SORE. Accordingly, its guarantee would perhaps not be acceptable to a private lender. Hence, the EDA involvement. Also, as a loss operation, the deductibility of payments to the ESOT would be of little immediate value to Lines West. In any case, deductibility would be questionable under an IRS ruling[8] regarding Section 401(a) to the effect that the borrowing by the trust must be for the exclusive benefit of the employees and not to benefit an employer unable to find his own sources of funds.

Additional complicating factors present in the proposed ESOP involve participation by present and future Lines West shippers. Aside from the obvious problems under statutes and Interstate Commerce Commission regulations prohibiting kickbacks to shippers, and the exclusive dealing relationship implicit in a significant stock ownership role, an ESOP cannot be utilized for this purpose. The important tax advantages of an ESOP--to the employees as well as employer--are not available unless the plan qualifies under the relevant code provisions. Obviously, with shippers participating, present law would not permit deductibility of Lines West payments for stock acquisitions by shippers. Moreover, such payments would be considered taxable income to shippers receiving the stock and, of course, to the shippers stock ownership plan (SSOP) itself. It is considered premature to assume that legislation granting ESOT-type tax advantages to an SSOP can be expected, in view of Treasury Department opposition in the past to proposed liberalized tax treatment for Kelso-type ESOPs.

The SORE proposal, as it relates strictly to the ESOP and not to SSOP as well, in fact, would seem to provide an advantageous means of stock ownership by Lines West employees. Not only would there be no risk of loss to employees

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[8] Rev. Rul. 71-311.

arising from stock purchases or assumption of employer or ESOT debt or guarantees, but they would also enjoy the tax benefits afforded by a qualifying plan. Up to 25 percent of compensation would be deductible by the employer and not attributable as income to the employees. Assuming covered compensation of $18,000 per employee per year, Lines West could deduct, therefore, up to $16 million in contributions to the ESOT (but not the SSOP under the present law). Dividends and shares would not be taxable to the participating employees until actually distributed. Moreover, distribution of shares is eligible for special tax treatment under certain circumstances and, in any case, is deferred until the time of actual distribution. The employer deductible feature is relevant only in cases in which taxable income is present, though nothing would prevent a plan which otherwise qualifies from receiving contributions out of "cash flow." The main points of emphasis, however, are that under the SORE proposal:

- Ownership of the entire Lines West rail system may be wholly vested in its employees without any cost or financial obligation to them.
- The acquisition of capital stock under the SORE-proposed ESOT carries distinct tax advantages unique to qualifying employee benefit plans.

In addition to the acquisition of ownership without cost to themselves, the employees will continue to be covered under the provisions of the railroad retirement system established by the Railroad Retirement Act of 1935, as amended in 1974.

The Chicago & Northwestern and Conrail experiences suggest that operating union employees were not willing to trade their traditional wage system for "a piece of the action." The Conrail situation is described briefly elsewhere herein. Less than ten percent of Chicago & Northwestern employees participated in the sale of that railroad and those were mostly management personnel. Unless faced with the alternative of absolute loss of income, it may be expected that present employees will view cautiously acquisition of ownership in a Lines West railroad. In conclusion, if the various parties do agree, i.e., the courts, the Federal government, labor, creditors, then Lines West stands a chance of being first as a rail carrier owned by its rank-and-file employees.

SCENARIO 4

The SORE Proposal Is Implemented in
the Form of a Traditional Employee Stock Ownership Plan

The financial impact on labor and the costs of labor protection in Scenario 4 are identical to those described in Scenario 3, assuming viable operations by SORE management of the Lines West. This scenario analysis focuses on the traditional ESOP characteristics and considerations.

Our review of literature describing the development and usage of traditional employee stock ownership plans (ESOPs) resulted in the project team's conclusion that an excellent document prepared by the Congressional Research Service of the Library of Congress would make a valuable contribution to the reader's understanding of ESOPs before the presentation of our analysis. As a result, descriptive ESOP materials appearing on the following pages (II-36 through II-52) have been reproduced from the Congressional Research Service Publication 77-189E (except for duly noted analytical passages appearing on page II-45 which were authored by MBA staff).

Traditional Employee Stock Ownership Plans[9]

The concept of employee stock ownership has long been debated as a method of achieving greater productivity for the employing firm and greater income for the employee. It is one of several proposals, including profit-

[9]This section through page II-44 is reproduced from Peter Henle and Jane G. Gravelle, Employee Stock Ownership Plans, Including Recent Legislation and Selected References, Congressional Research Service, No. 77-189E, August 11, 1977, pp. 1-10.

sharing, labor-management productivity committees and productivity-sharing arrangements, that have been adopted in various situations to provide greater worker participation in business.

Many different types of employee stock ownership plans (ESOPs) can be found today throughout American industry. One traditional type is the stock purchase plan designed to encourage employees to utilize their own funds to acquire company stock while remaining an employee. Typically, the company concerned contributes to the plan in various ways including establishing a system of payroll deduction for employee stock purchase, arranging for reduced or no brokerage fees in stock purchase, or making a company contribution (often 20 to 25 cents for each dollar contributed by the employee) to supplement employee funds. Sometimes stock purchase plans are part of a more general employee retirement or savings plan.

For a number of leading American industrial firms, including American Telephone and Telegraph, an employee stock purchase plan dates back to the early 1900s. These plans became more popular during the 1920s, although some of these did not survive the depression of the 1930s. A 1966 survey indicated that one-fifth of the firms whose securities were listed on the New York Stock Exchange has an employee stock purchase plan. In addition, such plans were also well represented among banks and insurance companies.[10] However, the practice is far more prevalent among larger rather than smaller firms.

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[10] Mitchell Meyer and Harland Fox, "Employee Stock Purchase Plans," Studies on Personnel Policy, No. 206 (National Industrial Conference Board, 1967).

In addition to such stock purchase plans for all employees, many firms as part of their executive compensation program have adopted stock option plans for higher levels of management under which the employee is offered an option to purchase company stock at the current market price without actually making payment until sometime in the future. Later, if the price of the company's stock should rise, the employee can exercise his option to purchase the stock and thus benefit from the appreciation in value. Moreover, for a qualified option the gain in the value of the stock is not taxed until the stock is sold, and the gain will be taxed at capital gain rates when sold if certain conditions are met. (The difference between the option price and fair market value at the time of the option may, however, be subject to the minimum tax.) The rationale behind such stock options plans is that this type of favorable treatment is necessary to assure the firm of retaining the valued experience of individuals with high managerial ability.

More recently, an increasing number of firms have been adopting a somewhat different type of stock ownership plan in the nature of a stock bonus plan, one in which a separate trust is created to receive contributions from the employer in the form of shares of stock to be held and allocated among the individual employees. Stock allocated to an employee accumulates over a period of years to be distributed whenever employment is terminated, normally upon retirement. In this form, the stock ownership plan is a form of compensation to the employee having somewhat similar characteristics as an employee pension or deferred profit-sharing retirement plan. (Corporations are allowed to deduct the fair market value of contributed stock, just as they are allowed to deduct contributions to pension- and profit-sharing plans.)

Both deferred profit-sharing plans and employee stock ownership plans utilize the device of a fund or trust to receive employer contributions and both represent a form of supplementary compensation to the employee, aimed primarily at providing a source of income at retirement. The central characteristic of a deferred profit-sharing plan is that the employer contributions to the plan are based on profit--no profit, no contribution. The central characteristic of an ESOP is that the individual employee can acquire title to shares of stock in the firm for which he works. Thus, one plan (profit-sharing) focuses on the formula for the employer's contribution while the other (ESOP) focuses on the granting of ownership rights to the employee. However, the difficulty of classifying plans is illustrated by the plans which relate the employer's contribution to profits and also provide a fund to purchase shares of the firm's stock to be allocated to individual employees.

One variant of this type of stock ownership that has gained special attention in recent years represents the work of Louis O. Kelso, San Francisco lawyer-economist. The "Kelso Plan" is a broad proposal to improve economic performance by giving employees a share in ownership of their firms. The key element in a Kelso Plan is a method of utilizing an employee stock ownership plan to help the employer borrow money from the capital market. The plan operates as follows. The company establishes a qualified tax-exempt trust under the Internal Revenue Code. When the corporation requires funds for expansion, instead of going directly to the money market, the trust borrows the necessary funds which, in turn, are invested in shares of stock of the corporation, the shares being sold at their fair market price. The corporation has the use of the borrowed funds and guarantees to the lenders that it will make sufficient annual payments into the trust to meet principal and interest payments on the loan. The stock is owned by the trust on behalf of participating employees and, as the principal and interest payments are made, the shares of stock become free of any lien and are allocated to each employee's individual account. An important question is whether the stock is to have voting privileges and, if so, who will exercise those voting rights.

Dividends may be treated a variety of ways depending on the plan. Under some plans, the dividend payments on stock are used to reduce the amount the corporation must pay into the fund. In other cases, dividends on allocated stock are additional payments into the trust or paid directly to the employees. As will be seen later, the level of dividends paid and the use of these dividends has a significant impact on the tax benefits and the net cost of the plan to the corporation.

A vesting requirement is typically included under which the employee becomes entitled to his allocated stock only as he meets certain service requirements. Most employees are fully vested by the time they have completed ten years of service.

Typically, the employee receives his vested allocated shares of stock or cash equivalent only at retirement or upon termination of employment, although in some cases, certain types of emergency distributions are permitted. In case of death, the employee's stock passes to his estate or named beneficiary.

Mr. Kelso has written extensively regarding his plan.[11] His main thesis can be summarized as a belief that:

1. Increased output depends primarily on increasing inputs of capital.

2. Greater ownership of such capital by a firm's employee will provide a second income to workers enabling them to share more directly in the increased output resulting from the increments of capital input and giving them greater incentives to increase their productivity and their interest in the profitability of the firm.

Also, Kelso has said, "All we're doing is cutting the average worker into the capital gains pie."

Although these newer types of employee stock ownership plans have attracted greater interest in recent years, they have not yet been widely adopted. Employee stock purchase plans continue to operate in many major corporations. A number of firms, including Hallmark Cards, Inc., whose profit-sharing plans have been built upon a broad diversified portfolio, have recently switched investment philosophies to concentrate their funds' investments in the stock of their own company, thus, in a sense, adding to the ranks of firms with employee

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[11] Louis O. Kelso and Mortimer J. Adler, The Capitalist Manifesto (New York: Random House, 1958), 265 p.; Louis O. Kelso and Patricia Hetter, "Corporate Social Responsibility without Corporate Suicide," Challenge, July/August 1973, pp. 52-57; Louis O. Kelso and Norman G. Kurland, "Financing Economic Growth and Environmental Protection to Strengthen the Market Power of Consumers," Testimony to the Subcommittee on the Environment of the House Committee on Interior and Insular Affairs, January 31, 1974; Louis O. Kelso and Mortimer J. Adler, The New Capitalists, A Proposal to Free Economic Growth from the Slavery of Savings (New York: Random House, 1961), 109 p.; Louis O. Kelso and Patricia Hetter, Two-Factor Theory: The Economics of Reality: How to Turn Eighty Million Workers into Capitalists on Borrowed Money and Other Proposals (New York: Vintage Books, 1968), 202 p.

stock ownership plans. However, these plans have generally retained their profit-sharing character since employer contributions continue to be related to profits.

There are perhaps 300 Kelso-type stock ownership plans. The first of these in 1957 involved the Peninsula Newspapers, Inc., Palo Alto, California, which utilized an ESOP to avoid a takeover by another newspaper chain. A large proportion of plans are located in California, including the Brooks Camera Company, a chain of retail photographic stores. Many Kelso plans have developed in special financial situations such as cases where a large firm wishes to divest itself of a subsidiary corporation, where the owners of a closely-held corporation wish to sell their stock, or where the firm is threatened by a takeover action from another company. Although most firms with Kelso-type plans are relatively small, the group does include some larger firms, including E-Systems, Inc., a Dallas electronics and aircraft systems concern with 7,000 employees.

Tax Treatment

Employee stock ownership plans receive certain special treatment under the present tax laws, but this treatment is essentially the same as other benefit programs designed to supplement employee compensation through employer contributions to a trust, such as a funded pension program or profit-sharing plan.

If such an employee stock ownership plan meets the test set forth in Section 401(a) of the Internal Revenue Code, it would benefit from special tax treatment (generally applicable to qualified pension, profit-sharing and stock bonus plans), as follows:

1. Contributions to such trusts are deductible by the employer, but not taxable to the employee until actually received. In the case of Kelso-type financing, employer payments to the trust would be deductible up to 25 percent of employee compensation. Since these contributions are used to pay principal and interest, the effect is to allow an apparent deduction for repayment of the loan, which is not allowed in conventional financing.

2. The trust is tax exempt so that earnings of the trust are not taxed currently.

3. Dividends paid to the trust in a Kelso-type plan are not subject to taxation until actually paid out to the employee. While in the trust, they may accumulate earnings tax-free. Any dividends paid to employees are taxable to the recipient; however, the tax law allows an exemption for the first $100 ($200 for a joint return).

4. Distributions to employees are eligible for special tax treatment under certain circumstances, including capital gains treatment or averaging for certain lump-sum distributions and, in the case of the death of an employee, certain exemptions of payments from income and estate taxes.

In addition to the special rules for taxing distributions, the benefits from the treatment of pension plans result primarily from two features:

1. Because deductions for contributions are taken before such contributions are taxed to employees, taxes on this income are deferred. A deferral of taxes is like an interest-free loan, with the benefits equal to earnings on the deferred taxes.

2. In the case of retirement plans, an employee is likely to be paying tax at a lower rate when he begins to receive his annuity since his income subject to tax is likely to be lower, not only because he is no longer at work but also because he may benefit from such provisions as the exemption of social security benefits, the tax credit for the elderly, and the additional personal exemption for the elderly.

The Corporation's View of the Employee Stock Ownership Plan

A number of benefits can accrue to the corporation which initiates an employee stock ownership plan but, at the same time, certain risks can be involved.

The basic benefit claimed by proponents of employee stock ownership plans is improved productivity and greater efficiency as employees gain a greater financial stake in the enterprise. Whether or not an employee stock ownership plan would have this result is difficult to gauge. There is no general rule that can be applied. For large corporations concerned about morale of rank-and-file production workers, it seems doubtful that dispensing what would have to be a relatively few shares of stock to each employee would mean greater employee loyalty and higher productivity. More important would be the corporation's record over the years in dealing with its employees. On the other hand, if the corporation's work force is limited and includes a high proportion of white collar or technical employees, the opposite may be true and the distribution of stock through the ESOP may prove to be a meaningful incentive that will enhance employee performance. In the case of a bankrupt railroad, where the very jobs of the employees are at stake, substantial improvements in productivity would clearly be in the interest of the employees and the new management. Work rules would seem to be a particularly desirable target where meaningful changes could result in significant effects on profitability.

Certain very real advantages of utilizing an ESOP also occur as a result of tax law. An ESOP carries with it the special tax treatment accorded all pension, profit-sharing, and stock bonus plans.

[MBA analysis]

However, as suggested above in the previous section, the unique tax advantage claimed for a "Kelso-type" ESOP may be overstated, if it exists at all. It is claimed that the employer corporation under a Kelso plan is permitted to deduct payments of principal as well as of interest paid into the employee stock ownership trust (ESOT) sufficient to enable the latter to make timely payments to its lender. However, the employer corporation is not actually permitted to deduct principal payments; in fact, it has not borrowed any funds. It has instead:

- Guaranteed a loan
- Issued its fully paid capital stock to the ESOT for consideration (the funds the ESOT borrowed)
- Agreed to make tax-deductible contributions to the ESOT under a tax code provision available for any qualifying pension, profit-sharing, or stock bonus plan

What may be overlooked or not considered by Kelso plan proponents is that the employer corporation has already repaid the cash advanced by the ESOT the moment the fully paid stock is issued. Further payments to the ESOT to enable repayment of the loan to purchase the shares means the corporation pays twice, notwithstanding that the second series of payments is tax deductible as permitted under the tax code. To put it another way, the employer corporation is just as well off in an economic sense if it chooses to reject this ESOP approach in favor of a direct sale of its securities to institutional investors in conjunction with a separately established employee stock ownership plan, or simply to borrow directly instead of through the ESOP, then deducting the fair market value of its shares subsequently granted the ESOP.

But, the ESOP might appear attractive for several other reasons.[12] For example, if the ESOP served as the corporation's major retirement plan, it would have many of the advantages of a profit-sharing retirement plan, but, in addition, it would have greater flexibility in that the company's contributions need not be profits in each year. Moreover, an ESOP plan would not be subject to certain restrictions regarding investments enacted in the Employee Retirement

[12] This section through page II-47 is reproduced from Henle and Gravelle's report, pp. 11-13 (see footnote 9).

Income Security Act of 1974. Of course, corporations already heavily committed to supplementary compensation programs would find an ESOP less attractive unless it were willing to drop or modify its existing programs. It should also be noted that the Internal Revenue Code places a ceiling of 25 percent of compensation (as well as specific individual ceilings) on the amount that a corporation can contribute to qualified trusts and still receive special tax treatment.

Another advantage of the ESOP system for a corporation might be its use as an executive compensation plan or as supplement to an existing plan. It should be noted that benefits under an ESOP are allocated in proportion to individual compensation. Thus, the plan, like most deferred compensation plans, will tend to favor the more highly compensated employees or, as one proponent of ESOP indicated:

> Since the ESOT enables employees to acquire stock ownership with pre-tax funds, requires no employee contributions, avoids the necessity for employees to use accumulated savings or individually borrowed funds in order to purchase stock, and enables the corporation to deduct the full cost of the benefits, the ESOP is frequently superior as an executive compensation device to stock option plans, restricted stock purchase plans and other similar plans which reduce employees' take-home pay.[13]

Finally, for closely held corporations, the ESOP can be utilized to provide a buyer for the purchase of company stock from controlling shareholders, minority shareholders or outside investors, thus eliminating one of the possible reasons why a company might be forced to "go public" and issue publicly available shares of stock.

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[13] John D. Menke, "The Employee Stock Ownership Trust: A New Trend in Employee Benefits and Corporate Finance," Chartered Life Underwriter's Journal 29: 31-36 (January 1975).

Despite these clear-cut financial advantages, certain costs or risks accompany any ESOP. To begin with, when a corporation takes the step of involving its employees in a stock ownership arrangement, it is not only demonstrating its faith in the enterprise but also expressing some confidence that in the future the price of the stock will rise. Otherwise, the gains to the employees are likely to be quite limited (see next section). If this does not occur, the adverse employee reaction is likely to more than offset the benefits that may have followed adoption of the plan.

Moreover, the special tax advantages under a Kelso-type plan of financing required new capital through the ESOP trust also involves a certain cost. That cost occurs because this method of financing establishes a continuing obligation for a company, the issuance of additional shares of stock which will have a continuing claim on any dividends long after the particular capital venture for which the funds will be raised has been fully repaid.

Under an ESOP, the tax deduction for "principal" acts to offset additional cost of dividends during the term of the loan. Depending on the level of dividends paid and the way the plan is set up, the tax saving may or may not completely offset the additional costs incurred in paying dividends on outstanding stock. The following are ways in which dividends might be treated:

- Dividends could be used to reduce the corporation's payments to the trust until the loan is paid off.
- Dividends on unallocated stock could be used to substitute for principal and interest payments with dividends on allocated stock paid to employees.
- Dividends paid on the stock could be paid over to the trust or passed through to employees, with the dividends an addition to payments for principal and interest.

The Employee's View of the Employee Stock Ownership Plan[14]

Since, under an ESOP, the individual employee is not asked or required to make any contribution in order to receive his shares of company stock, it would seem that he cannot possibly lose and, therefore, should be a strong supporter of the proposal. In a number of cases, this has been true. Some employee stock ownership plans (with or without profit-sharing) have helped to enhance employee loyalty to the firm and have yielded participants substantial payments upon retirement. Employees of Sears Roebuck, for example, are noted for their support to their profit-sharing, stock ownership plan which has paid out handsomely as the Sears stock appreciated.

However, the chief beneficiaries under these plans are typically the longer-service managerial employees whose level of compensation entitled them to significant stock accumulations under the plan. Employees as a group, especially those holding manual jobs, do not seem very interested in pushing for an ESOP, and a number of union organizations have declared themselves as strongly opposed to ESOP. Recently, the labor unions in the railroad industry, including both operating and nonoperating groups, after hearing a detailed presentation of the Kelso plan in connection with the provisions of the Regional Rail Reorganization Act, adopted a resolution rejecting the proposed ESOP as "contrary to basic trade union principles and not in the best interest of railroad workers or the unions which represent them."[15] (Recently,

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[14] This section through the summary on page II-54 is reproduced from Henle and Gravelle's report, pp. 18-20 and 24-29 (see footnote 9).

[15] "Labor" (weekly newspaper of railroad labor unions), March 30, 1975.

however, the United Transportation Union at its convention took action in a resolution to support legislation that would continue the operation of the Milwaukee Road as a whole. No interest has been shown by the railroad unions to support any employee ownership plan except of the entire railroad by all employees.)

What reasons might there be for this employee and union skepticism regarding ESOP? The following points are suggested:

1. The employee and his representative are naturally suspicious of getting "something for nothing." The employee may wonder whether the employer, in fact, will be expecting something in return--perhaps greater effort at the workplace, perhaps reduced employee pressure for a wage increase or benefit liberalization the next time the company's bargaining agreement comes up for renewal. Under such circumstances, the employee might reason, he is not so certain that he would prefer ownership of company stock if in return the employees were denied certain improvements in wages or benefits.

2. As a basic retirement plan, the ESOP system has certain deficiencies from the standpoint of the employee. Payments into the funds, for example, are entirely dependent upon employer decisions. There is no actuarially determined full funding goal to be achieved, nor is the employer required, as in profit-sharing retirement plans, to provide a certain portion of each year's profit. Moreover, investments of the trust are generally confined to one type of security, the employer's stock. The trust is not subject to the normal fiduciary standards of diversification that are written into the Employee Retirement Income Security Act of 1974. Consequently, there would be considerably greater risk of fluctuations in value for the retirement fund than would be found in the typical employer-financed and funded retirement plan.

3. The employee may also wonder whether the shares of company stock that he will receive will actually represent a substantial addition to his earnings. This, of course, will depend upon the details of the particular plan the company has established. If the ESOP has been instituted as a form

of retirement, the individual employee is credited periodically with his share of the stock accumulated in the trust. The rate at which the employee accumulates stock depends on the amounts that the corporation places in the ESOP.

Recent Congressional Action

A number of legislators, led by the Chairman of the Senate Finance Committee, have expressed a strong support for employee stock ownership, including, in some case, a specific interest in the Kelso plan. At least in part because of the support of these legislators, the following five recent enactments have made special reference to employee stock ownership plans.

Railroad Reorganization

The Regional Rail Reorganization (3R) Act of 1973 (P.L. 93-236) includes a provision that could lead to adoption of some type of employee stock ownership plan in the final reorganization of the bankrupt railroads of the Northeast and Midwest. Under the Act, a nonprofit government corporation, the U.S. Railway Association (USRA), will plan the financial and physical structure of a new private business enterprise, the Consolidated Rail Corporation, which will take over the operating assets of the bankrupt railroads. The USRA is responsible for performing certain emergency functions regarding the bankrupt railroads, but the association is also assigned the responsibility of developing a "final system plan" for the new private corporation that will be subject to ultimate review and approval by Congress.

The final system plan, according to the Act, is required to set forth, among other things:

> . . . the manner in which employee stock ownership may, to the extent practicable, be utilized for meeting the capitalization

> requirements of the Corporation, taking into account: (A) the relative cost savings compared to conventional methods of corporate finance; (B) the labor cost savings; (C) the potential for minimizing strikes and producing more harmonious relations between labor organizations and railway management; (D) the projected employee dividend incomes; (E) the impact on quality of service and prices to railway users; and (F) the promotion of the objectives of this Act of creating a financially self-sustaining railway system in the region which also meets the service needs of the region and the Nation. (Section 206 [e][3]).[16]

Thus, Congress has indicated its interest in utilizing some type of employee stock ownership plan for meeting the capitalization requirements of the new Consolidated Rail Corporation.

Pension Reform

The pension reform legislation (Employee Retirement Income Security Act of 1974; P.L. 93-406) sets standards and regulates activities of all private pension plans in such different areas as vesting (circumstances under which the employee becomes entitled to a pension at retirement), funding, fiduciary standards for administering pension funds, reporting and disclosure to participants and public authorities.

With reference to employee stock ownership plans, the new law provides certain special treatment in the sections setting forth standards of conduct for plan trustees and administrators. Employee stock ownership plans (defined in Section 407) are exempted from the following:

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[16] By an amendment to the 3R Act (92 Stat. 2397), which was approved November 1, 1978 (after the document quoted above was published), the amount authorized to be invested by USRA in Conrail was increased from $1.1 billion to $2.3 billion. The Act also provided that of the $1.1 billion increase, at least $345 million be used to fund the acquisition of Conrail securities by an ESOP. [MBA insert]

1. The requirement for diversification of plan investments (Section 404)

2. The requirement that not more than ten percent of plan assets be invested in employer securities and employer real property (Section 407)

3. The prohibition of party-in-interest transactions as applied to a loan to an employee stock ownership plan, providing the loan is primarily for the benefit of participants and beneficiaries and does not carry an excessive rate of interest (Section 408)

These provisions were designed to permit employee stock ownership plans to continue generally accepted methods of operation.

Trade Act

Title II of the Trade Act of 1974 (P.L. 93-618) establishes various types of Federal programs to alleviate economic hardship caused by import competition. A new feature of the law is provision for adjustment assistance for communities (Title II, Chapter 4), supplementing assistance previously available to workers and firms.

The aim of the new community adjustment assistance program is to create new job opportunities in areas adversely affected by increased imports. Communities meeting specified criteria, as administered by the Secretary of Commerce, will be eligible for a variety of assistance programs, including technical assistance and direct grants for land acquisition and development, public works and public services.

As one method of attracting new investment to eligible areas, the Secretary of Commerce is authorized to make loan guarantees to acquire, construct or modernize plant facilities. In reviewing applications for loan guarantees under the Act, the Secretary is required to give preference to corporations which agree to place 25 percent of the principal amount of the loan into a qualified trust under an employee stock ownership plan providing the plan meets certain criteria set forth in the Act.

Tax Reduction Act

The Tax Reduction Act of 1975 (P.L. 94-12) contains a provision to encourage contributions to employee stock ownership plans. The Act increased the investment tax credit from 7 percent to 10 percent for 1975 and 1976. However, a corporation may take an 11 percent credit for the first year if it invests the additional one percent credit in an employee stock ownership trust. Because the investment tax credit reduces the company's tax liability dollar for dollar, the cost of these contributions will be borne entirely by the government, i.e., there will be no sharing by the corporation of the costs. There are some special restrictions accompanying this provision, including a requirement that the participants be immediately vested.

Tax Reform Act

The Tax Reform Act of 1976 (P.L. 94-455) made several changes affecting investment tax credit ESOPs, including the extension of the 11 percent to 1980. Beginning in 1977, the Act allows employers an additional one-half percent investment credit (to 11-1/2 percent), provided that the employer agrees to transfer the additional one-half percent to the ESOP in the form of employer securities and provided that the employees make matching one-half percent contributions to the ESOP. The Act also modified some of the rules relating to both Tax Reduction Act ESOPs and the new Tax Reform Act ESOPs. Higher securities and provided that the employees make matching one-half percent contributions to the ESOP. The Act also modified some of the rules relating to both Tax Reduction Act ESOPs and the new Tax Reform Act ESOPs. Higher contribution limits are imposed and provision is made for reimbursing employers for the administrative expenses of ESOPs, among the changes effected by the Act.

Summary

Employee stock ownership is not a new idea. Stock purchase and stock option plans have been in existence for over 50 years, largely as an incentive for more effective performance by management and executive personnel. More recently, employee stock ownership has been suggested as a method of giving greater stimulus to the job performance of a much wider group of employees. It also has the attraction of being able to serve as a basic employee retirement plan and as a tax-saving device for obtaining additional capital. The proposal has won considerable support and has been specifically recognized in four major recent congressional enactments.

Options for Expanded ESOP Funding of SOAR[17]

A fundamental question as regards the SORE proposal is to what extent an ESOP may be utilized to satisfy the total financing needs of the proposed Lines West railroad. Obviously, the assumption is made that somehow all parties in interest such as creditors, labor, stockholders, shippers, local and state governments and the Federal government can agree upon a plan. Otherwise, the matter will be decided ultimately by the courts. For example, the rights of secured creditors under indenture restrictions may constitute a formidable

[17] This section through page II-59 is a continuation of MBA's analysis.

obstacle to the conveyance of assets to the new railroad. Moreover, the opposition of nonparticipating Milwaukee Road employees from other divisions may prove fatal to such a plan. Necessary support by shippers and various governmental bodies may not be sufficiently forthcoming. The ESOP must have a source of funds. Guarantees will be required, especially if private sources of new funds will be sougnt. With each passing month, the net value of the railroad diminishes due to substantial operating losses causing a huge debt pileup, coupled with a deteriorating asset base due to "deferred" maintenance. This means even higher rehabilitation costs with less revenues and resources available to meet those costs--and even "normal" maintenance--all compounded by a general and persistent inflation.

The assumption is accepted by Mark Battle Associates that the cash flow, rehabilitation costs for main and branch lines, interest expenses and assets and liabilities are as estimated in the Assessment of the Financial Selfsustainability of the SORE Lines West Proposal, prepared by the Consulting Center, Inc. In any case, it must be stressed that the use or non-use of an ESOP is not the determining factor in evaluating the SORE proposal as a feasible alternative for operation of the Milwaukee transcontinental lines as a separate railroad. The adoption of an ESOP approach will not make a critical difference in the future success or failure of such a venture. Employee ownership, if deemed a desirable alternative with respect to the transcontinental lines, any other segments of the Milwaukee or even the entire system, may be effected without an ESOP. In point of fact, the two essential features of a traditional ESOP are missing in the case of the Milwaukee, including Lines West:

- A profit-making, tax-paying employer able to benefit from a tax deductible contribution to a qualified employee benefit plan
- An employer with sufficient financial strength and creditworthiness to secure private institutional financing (loan) on behalf of its ESOP by means of its guarantee, as well as the ability to then make regular payments through contributions to the ESOP sufficient for the latter to amortize its debt

If CCI is correct in its predictions, it would perhaps be five years or more before Lines West might successfully approach the capital markets for a conventional loan or for equity capital. The net result is that Lines West must be able to enlist the financial support of not only the Federal government, but perhaps also of state and local governments and even that of shippers and employees. Even then, public sector financing, either through guarantees or direct loans will not be readily obtainable unless a strong case can be made for the likelihood of success for Lines West. Unfortunately, there is no unique contribution to be made by an ESOP to that case.

CCI makes the following pertinent estimates and assumptions:

- Lines West will not succeed in acquiring the net assets of the Milwaukee Land Company valued at $110 million.
- The adjusted value of assets that would be acquired is $246 million, and securities in that amount, guaranteed by the Federal government, would be issued to the estate to mature in ten years.
- The cumulative cash shortfall will be $167.7 million, including finance costs, over the initial six-year period of operation.[18]

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[18] CCI estimates that were there a reduction in total employee compensation from 56 percent to 40 percent of operating expense, the resulting earnings of about $30 million per year would virtually eliminate the cumulative cash shortfall.

- Main line rehabilitation costs adjusted upwards to $166 million are not included in the projected shortfall and must be obtained by a loan under the 4R Act.

- Branch line rehabilitation costs adjusted upwards to $84 million are also not included in the projected shortfall and must be obtained from whatever source is available.

In addition to the Railroad Revitalization and Regulatory Reform Act as a source for needed financing, other Federal programs that offer some promise are Title IX of the Public Works and Economic Development Act of 1965 (as amended in 1974) and the Farmers Home Administration business and industrial (B&I) loan guarantee program.[19] These are potential sources for ESOP-financing of the Lines West initial cash requirements and branch line rehabilitation in particular. For example, EDA grants to states or local communities may be lent to the Lines West making contributions out of cash flow to the ESOP for repayment of institutional loans (in the case of the B&I program) or to a development fund maintained by local governments (in the case of EDA grants). However, even assuming that Lines West succeeds in minimizing its cash shortfall through efficient operations and obtains necessary 4R Act funding for main line rehabilitation, additional funds must be available for rehabilitation of branch lines. This might be accomplished through an ESOP. It would be particularly appropriate for branch line rehabilitation to be carried out with the support of shippers and local governments being served, utilizing perhaps the Farmers Home Administration program for communities under 50,000. The B&I loan guarantee practical limit of $50 million could be supplemented by

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[19] Officials at EDA recently indicated that all Title IX funds for the fiscal year ending September 30, 1979, are committed. Additional Title IX funds are expected to be available as of October 1, 1979. Officials at the Farmers Home Administration recently indicated that all funds for the current fiscal year had not been committed as of June 30, 1979.

additional funds or guarantees from shippers and local governments. Working capital might be sought under the EDA program. These funds would purchase common stock from Lines West and would collateralize a loan from communities served for perhaps an additional $50 million until repaid from cash flow generated by the railroad. Though both programs might be utilized through an ESOP, the projected operation must stand entirely on its own merits in terms of funding eligibility. Moreover, it is not at all certain that funds of such magnitude will be available to SORE under these programs, nor that needed support from the states, communities and shippers will be forthcoming.

SORE also has proposed a shippers' stock ownership plan as an additional source of financing. Legal questions detailed elsewhere in this document as well as the inability to qualify under Section 401(a) of the Internal Revenue Code for tax benefits suggests this concept may be premature for the present.

Thus far this discussion has centered upon the stock bonus plan type ESOP. Also qualifying under Section 401(a) is the stock purchase plan type ESOP. If it came to the point where actual loss of employment was imminent by means of liquidation of the entire system, Lines West employees or perhaps system employees might conclude that some cash contribution toward their shares of stock would be preferable. This might be the case during the earlier years when the railroad itself might be less able to make payments to the ESOP for repayment of loans. In fact, such an approach might be appropriate with respect to the entire system inasmuch as a number of problems--such as bondholder-protected-by-asset liens, other security holders with legally protected interests, "non-Lines West" employees and Lines West nonparticipating employees--are perhaps much more solvable on a system-wide basis. Such an approach would not necessarily rule out continuing equity participation by existing shareholders, as any reorganization plan must, of course, meet the judicial test of "fairness."

Although the corporate-wide reductions in employee protections as payment for stock in an ESOP appears tempting to many, employee protection imposed by the ICC cannot be materially changed by negotiations between management and labor as upheld by the U.S. Supreme Court in Norfolk and Western Railroad v. Nemitz, 405 U.S. 37, November 1971. Therefore, any contribution, either through payroll deduction or otherwise, the employees could be expected to make toward ESOP from any monies due them from ICC-imposed protective conditions would have to be on an individual voluntary basis.

APPENDIX

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The following legislative materials were also used:

- Railway Labor Act
- Railroad Unemployment Insurance Act
- Railroad Revitalization and Regulatory Reform Act of 1976
- Subtitle IV of Title 49, United States Code

PROJECT TEAM

RESUME

JOHN HALL

Mr. Hall, President of Mark Battle Associates (MBA), is experienced in financial management, transportation planning, policy analysis, marketing research and assessing problems in business management and operations. He has directed over 15 major projects and has served as corporate officer on another 40 projects and studies over the last seven years.

He is currently serving as Project Director on a study for the Department of Transportation's Office of the Secretary to analyze the legal and institutional barriers to railroad restructuring and to recommend alternative solutions to overcome these barriers.

He recently served as Project Director on a study designed to meet the transportation needs of the elderly and handicapped for the Washington Metropolitan Area Transit Authority and the Metropolitan Washington Council of Governments. This study included a random survey of 750 target residents, projections of the size of the target population, constructing demand models and estimating latent transit demand, developing vehicle and program alternatives, cost effectiveness evaluations of alternative solutions and planning the implementation of an action plan. Mr. Hall also directed, for the Urban Mass Transportation Administration, a major four-city case study exploring the problems and characteristics of mass transit use by the elderly and handicapped.

He directed ridership and systems research for a dial-a-ride system for the State of Rhode Island and for a rural bus system in Annapolis, Maryland. Additionally, he developed the minority business utilization program for the Metropolitan Atlanta Rapid Transit Authority. For the Federal Highway Administration, he served as Principal Investigator on a study to determine the cost effectiveness of freeway lighting as a means of reducing traffic accidents.

For the nation's second largest family laundry and dry cleaning plant, he developed a major restructuring of their corporate marketing strategy. This effort involved consumer surveys of customers and noncustomers, group depth probes of salesmen and supervisors, a demographic analysis and overall strategy development. Mr. Hall has been involved in a wide range of marketing research projects including marketing planning for the small business exporter with sales of $1 to $10 million per annum. He headed for UMTA a study of marketing techniques in use by 58 transit systems throughout the United States, including five in-depth case studies. This project resulted in two companion manuals for transit planners.

In a study for a large commercial bank, he structured and served as corporate officer on a bank location feasibility study in which the nine best alternative areas for locating the bank's next branch were identified and evaluated in the context of the bank's long-range corporate objectives. The study resulted in three rank-ordered alternative locations for the bank and the advantages and disadvantages of each.

Further experience was gained while serving for four years as Staff Assistant to U. S. Senators Thomas Eagleton and A. S. Mike Monroney, where he researched and analyzed pending legislation, covered committee hearings, was responsible for the selection of armed service academy nominees, wrote press releases and edited speeches.

Mr. Hall received his B.A. degree in Accounting and Economics from Howard University and his M.B.A. from Harvard Graduate School of Business Administration.

RESUME

A. R. LOWRY

Mr. Lowry is a Consultant with Mark Battle Associates. He has extensive experience with the railroad industry. He began work as a track man and crew caller with the Union Pacific Railroad; he has also worked as a telegrapher, agent, communication chief and train dispatcher.

As Assistant to President and Executive Vice President of The Order of Railroad Telegraphers, he was delegated by the Board of Directors the administration and operational authority of the Union. He represented the President and was a member of the negotiating teams handling negotiations of national agreements including, Employee Protections, Health and Welfare, Wages, Vacations, Holidays, Away-From-Home and Travel Expenses, etc., and merger agreements involving Penn Central, Seaboard Coast Line, Union Pacific and Rock Island railroads. Mr. Lowry was the chief negotiator for several nonoperating unions in the negotiation of the Burlington Northern merger conditions. He also was the chief negotiator representing the Telegraphers Union and the Brotherhood of Railway and Airline Clerks in the Southern Pacific System Total Operations Processing System, which involved six carriers and 14,000 employees. He was also the chief negotiator for the Union in negotiations of the following merger agreements: Norfolk & Western-Virginia Railroad; Norfolk & Western-Nickel Plate, Wabash, Wheeling and Lake Erie railroads, Penn Central, Union Pacific and Rock Island railroads.

Mr. Lowry supervised ten Vice Presidents in the negotiations of collective bargaining agreements throughout the United States and Canada. He personally handled the arbitration procedures and arguments under Section 13 of the Washington Job Protection Agreement for 15 years, as well as supervised the processing of disputes going to the National Railroad Adjustment Board, Public Law Boards and arbitration panels.

He was also elected President of the Union and merged the Union with the Brotherhood of Railway and Airline Clerks. He then became President of Transportation Communication Division and International Vice President and a member of the Executive Council and Finance Committee. He served as a labor member to the Department of State's Foreign Service Selection Board with responsibility of selecting and promoting career State Department officers.

As Director and Assistant Vice President Labor Relations, Mr. Lowry negotiated Appendix C-2 Amtrak Labor Protection Agreement covering 21 railway labor unions as required under the Rail Passenger Service Act of 1971; negotiated the transactions, assumption of functions, agreements under the Rail Passenger Service Act involving 10,000 employees and 17 railroads; negotiated the agreements required in Section 504(f) of the Railroad Revitalization and Regulatory Reform Act of 1976 transferring 8,000 employees to Amtrak, involving 17 unions; and negotiated basic collective bargaining agreements with 17 railroad labor unions.

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Andras R. Petery
Professional Resume of
Certified Financial Analyst

PROFESSIONAL CREDENTIALS

1977 Mr. Petery has been associated with Morgan Stanley as a Senior Financial Analyst since January, 1977. His specialization is in the Railroad and Motor Carrier Companies.

For three consecutive years, Institutional Investor has designated Mr. Petery as a leader among Certified Financial Analysts who monitor the area of Freight Transportation.

1969 to 977 He passed the examination requirements of a Chartered Financial Analyst in 1969 and joined the firm of Wood Struthers and Winthrop, Inc. as a Senior Transportation Analyst specializing in railroad and motor carrier companies. Mr. Petery was elected Vice President in 1971, and Member of the Board of Directors of that firm in 1973.

1963 to 1969 In November, 1963 he joined Kidder Peabody & Co., Inc. as a Research Analyst specializing Transportation with particular emphasis on the railroad and motor carrier industries. Mr. Petery was elected Assistant Vice President in December 1967.

Education: HARVARD GRADUATE SCHOOL OF BUSINESS ADMINISTRATION

1961 to 1963 He earned the degree of Master in Business Administration in June, 1963. Second-year studies emphasized Financial Management. Membership included investment Management and Marketing and Finance Club, International Business Club, and Marketing Club.

BABSON INSTITUTE OF BUSINESS ADMINISTRATION,
Wellesley, Mass.

1958 to 1961 — Awarded Bachelor of Science degree in Business Administration with Distinction in June, 1961. Majored in Economics. On Dean's List 1958-1961. Elected to Beta Gamma scholastic honorary, 1961. Member of A.K. Psi Professional Business Fraternity. Received the Princess Illeana Scholarship 1958-1961.

1957 to 1958 — WILBRAHAM ACADEMY, Wilbraham, Mass.

Awarded degree in the college course in May, 1958.

Military — Entered 6 Months Program of the U.S. Army Reserve in February 1963. Received Honorable Discharge in February 1969.

Residence — Mr. Petery resides in the State of Connecticut

RESUME

ARNOLD G. MONTGOMERY

Mr. Montgomery is a Senior Associate at Mark Battle Associates with an extensive background in marketing and finance. He is currently serving on a study for the Department of Transportation's Office of the Secretary to analyze the legal and institutional barriers to restructuring the U. S. railroad industry and to recommend alternative solutions to overcome these particular barriers. In this effort, Mr. Montgomery was responsible for all labor analyses and recommendations.

He also assisted MBA in conducting a new branch location feasibility study for a Washington, D.C. bank.

As the Acting President and Comptroller of Sink Iron Works, Inc. in Philadelphia, Mr. Montgomery handled the overall operations and the accounting for this job shop iron fabrication plant, owned by the Philadelphia Council for Equal Business Opportunity. For the Responsive Management Group, as Partner/Consultant in the Minority Business and Community Economic Development Division, he was engaged in numerous activities including the following major projects: venture acquisition analysis and advice for Mississippi community development corporation; feasibility study for municipally owned brick manufacturing company; preparation of budget and long-range financial plan for Mound Mayou Community Hospital; board of directors training for Wisconsin community development; preparation of six case studies to serve as models for Opportunity Funding Corporation proposed equity financing mechanism; evaluation of Cooperative Assistance Fund portfolio of program-related investments and loans; feasibility study of minority-owned nonprofit wholesale produce operation in Chicago for Lilly Endowment, Inc.; conference planning and implementation for National Congress of Community Economic Development Annual Meeting; and initial location and feasibility study for large-scale minority-owned agribusiness venture in the Southeast.

While serving as Vice President for Planning and Research for the Model Cities Economic Development Corporation, Mr. Montgomery's duties included representing the Executive Director in the areas of real estate, organizational and large-scale project development. For the National Council for Equal Business Opportunity, Inc. he held the positions of Staff Associate and Associate Director of Training. In the former role, he was responsible for providing general business packaging assistance, financial planning and marketing technical assistance to minority- and community-owned ventures. In the latter position, he designed the training curriculum and provided program supervision.

Mr. Montgomery received his B.S. and M.S. degrees in Physics from Howard University and his M.B.A. from Harvard Graduate School of Business.

RESUME

ALVIN LEE MORSE

Mr. Morse is a Senior Associate at Mark Battle Associates (MBA). With in-depth experience in both the public and private sectors, his activities with MBA include currently serving on a study for the Department of Transportation's Office of the Secretary to analyze the legal and institutional barriers to restructuring the U.S. railroad industry and recommend alternative solutions to overcome these barriers. In this effort, Mr. Morse was responsible for the analysis of mortgage covenants as barriers to rail restructuring.

Mr. Morse also served as Project Director on a study for the Small Business Administration. For this effort, he developed a training program for small business persons in solving the problems of exporting to foreign countries with emphasis on export financing.

For the Maritime Administration, he served as Assistant Project Director in the data collection and analysis of data on the recruitment and retention of employees with critical skills in the major Gulf Coast shipyards.

As Assistant Project Director on an effort for the Federal Highway Administration, Department of Transportation, Mr. Morse assisted in collecting and analyzing data to determine the cost/benefits of reduced lighting on interstate highways.

Prior to joining MBA, he served for more than four years as Counsel, Committee on Banking and Currency, U.S. House of Representatives. As full Committee Senior Counsel, he had responsibilities for all legislative action, including hearings, "mark-up" sessions, Committee reports and floor action. Areas of legislative activity included housing, economic development, urban mass transit, Federal credit programs, small business, money and banking, financial institutions, etc. The problems of small banks in meeting the credit needs of rural communities received his special attention as staff counsel.

Mr. Morse formerly served as a member of the Board of Directors of the Interracial Council for Business Opportunity of Greater Washington,

Mr. Morse received his B.A. in Philosophy and History and his M.B.A., L.L.B. and J.D. from Emory University.

AFFILIATIONS

American Bar Association (International Law Section)
Georgia Bar Association (International Law Section)
Inter American Bar Association (Commercial Law Committee)
American Society of International Law
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MAJOR PROJECTS AND PUBLICATIONS

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RESUME

JOHN THOMAS SCHELL

Mr. Schell is a partner in the law firm of Peabody, Rivlin, Lambert & Meyers in Washington, D.C. He is admitted to practice before the bars of Virginia and the District of Columbia.

For Mark Battle Associates (MBA), Mr. Schell is currently providing consulting services on a study for the Department of Transportation's Office of the Secretary to analyze the legal and institutional barriers to restructuring the U.S. railroad industry and to recommend alternative solutions to overcome these particular barriers. For this effort, his area of study included railroad reorganizations, specifically those conducted under Section 77 of the Bankruptcy Act.

For over a year Mr. Schell served as a consultant to the Interstate Commerce Commission in its Office of Public Counsel. This office was established by the Regional Rail Reorganization Act of 1973 to protect the interests of shippers, communities and other users of rail service who would not otherwise be represented in the reorganization of the Penn Central Railroad and other bankrupt carriers in the Northeast United States.

He has been active in all phases of general practice with major emphasis on corporate matters, administrative law, antitrust and utility regulation. He has been most heavily engaged in public utility regulation before state and Federal agencies, primarily on behalf of public interest groups. He has been involved in nearly a dozen telephone and electric rate cases on behalf of consumers before the Virginia State Corporation Commission. He has participated as counsel in two licensing proceedings involving environmental and safety issues in Virginia before the Nuclear Regulatory Commission. He has testified on utility matters before the Rhode Island Public Utilities Commission, the Connecticut Public Utilities Control Authority and the Energy and Power Subcommittee of the House Committee on Interstate and Foreign Commerce. He has also represented consumer groups before regulatory commissions of other states and practiced before the Federal Power Commission.

Prior to entering private practice in 1972, Mr. Schell lived in Norfolk, Virginia, where he served as Counsel to the Lieutenant Governor of Virginia. His legal responsibilities included assisting the Lieutenant Governor in legislative matters in the Virginia General Assembly. He has practiced law in Charlottesville, Virginia, and surrounding counties, served as a consultant on the Virginia criminal justice and law enforcement systems and served in the Adjutant General's corps of the United States Army. In 1969 and 1970. he was an initial founder and Executive Vice President of the Research Group, Inc., Charlottesville, Virginia.

Mr. Schell was educated at Huntsville High School, Huntsville, Alabama (graduated in 1963); Auburn University, Auburn, Alabama (B.A., History, 1967); and the University of Virginia Law School, Charlottesville, Virginia (J.D., 1970).

RESUME

LEWELLYN A. BROWN

Mr. Brown is a Senior Financial Analyst. He holds the M.B.A. in Finance and Investments from the George Washington University (M.B.A. Thesis: "Profit Optimization in Common Stock Portfolio Management"), and is currently an advanced doctoral student in Business Administration (Finance and Investments) at the University of Maryland. He has been a registered Investment Advisor with the Securities and Exchange Commission since 1969. He also holds the B.B.A. in Economics from City University of New York. He has lectured in Finance and Investments on a variety of subjects at the American University and the George Washington University. Mr. Brown has provided periodic consulting services to Mark Battle Associates (MBA) since 1973. He retired from the U.S. Army as a Lieutenant Colonel in 1974, with over 20 years of service.

For MBA, Mr. Brown is currently serving as a Senior Associate on a study for the Department of Transportation's Office of the Secretary to analyze the legal and institutional barriers to restructuring the U.S. railroad industry and to recommend alternative solutions to overcome these particular barriers. His specific areas of study for this effort included the analysis of abandonments and/or downgrading as an alternative to rail restructuring.

Since 1974, Mr. Brown has provided investment counseling, portfolio management and financial consulting services for LABCO Management, Inc., an investment management company duly registered with the Securities and Exchange Commission. He has also been actively involved in mortgage and property investments and financing during this period.

During his service in the U.S. Army, he was Chief of the Worldwide Race Relations and Equal Opportunity Planning Group, Office of the Deputy Chief of Staff for Personnel, U.S. Army, and he planned and administered the Department of the Army's Race Relations and Equal Opportunity Conference at Fort Monroe, Virginia. This was a program designed to evaluate the effectiveness of existing RR/EO programs Army-wide, to obtain feedback on problems being encountered in the field and to receive suggestions and recommendations on the future direction of the Army's RR/EO effort.

He served as Chief of the Resource Management and Programming Branch on the Special Staff of the Deputy Chief of Staff for Personnel, and managed \$9.5 billion of the annual Army budget. He devised a planning, programming and budgeting approach to reconcile the accounting or historical objective of the Comptroller of the Army with the rapid-response managerial requirements of the Deputy Chief of Staff for Personnel to assure accuracy satisfactory to the House Armed Services Committee of the U.S. Congress. He also simplified the costing of Army forces structuring so that multiple alternatives could be easily and quickly examined for decision-making purposes; and he reduced an 18-hour planning cycle to one hour for a significant saving and improved the accuracy of costing through aggressive forward planning.

Additionally, Mr. Brown was Chief of the Plant Group of the Cheyenne Project and Configuration Management Officer. This was a research and development effort to design and test for production on an advanced aerial fire support system consisting of new heliborne weapons and a new rigid rotor helicopter. He saved the U.S. Army $1.5 million in negotiations with Lockheed Aircraft Corporation in the area of helicopter design and modification.

As Personnel Staff Officer of the Volunteer Army Division of the DA Staff, he translated broad policy changes into implementing actions and programs at the operating level in response to directions of the President of the United States and the Chief of Staff of the Army to convert to a strictly volunteer Army. Tasks included numerous tests and evaluations of small-scale implementations and the management and accountability for $20 million.