EMPLOYEE STOCK OWNERSHIP PLANS FOR RAILROADS

HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

JUNE 21 AND JULY 20, 1979

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

50-086 O WASHINGTON : 1979 HG 96-26

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EMPLOYEE STOCK OWNERSHIP PLANS FOR RAILROADS

THURSDAY, JUNE 21, 1979

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE,
COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 1:45 p.m., in room 2221, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the subcommittee) presiding.

Present: Senator Baucus.

[The press release announcing this hearing follows:]

[Press Release—June 7, 1979]

COMMITTEE ON FINANCE, U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE.

FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE SETS HEARINGS ON THE AVAILABILITY OF EMPLOYEE STOCK OWNERSHIP PLANS (ESOP'S) FOR RAILROADS SUCH AS THE CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD CO. (MILWAUKEE ROAD), AND THE POSSIBILITY OF PROVIDING FOR INTERNAL REVENUE SUPERVISION OF THESE PROGRAMS AND OF SIMILAR OWNERSHIP VEHICLES FOR SHIPPERS WHO UTILIZE SUCH A RAILROAD AND DEPEND ON ITS CONTINUED OPERATION AND FINANCIAL SUCCESS

Senator Max Baucus (D.-Mont.), Chairman of the Subcommittee on Oversight of the Internal Revenue Service of the Senate Committee on Finance, announced today that the Subcommittee will hold hearings on June 21, 1979, on the applicability of the Internal Revenue Code provisions regarding employee stock ownership plans to railroads and the possibility of revising these provisions to promote adoption of these plans by railroad employees and shippers and to provide for Internal Revenue Service administration of them.

The hearing will be held in Room 2221, Dirksen Senate Office Building and will begin at 1:30 p.m.

In announcing the hearings, Senator Baucus pointed out that the Internal Revenue Code contains numerous tax incentives to encourage employers to establish employee stock ownership plans for the benefit of their employees. In addition, the Code sets forth certain restrictions with which these plans must comply in order that the tax incentives will be available for employers and their employees.

Senator Baucus stated that in the course of analyzing the availability of an employee stock ownership plan for the Milwaukee road, it became clear that most railroads cannot utilize many of the tax incentives, and cannot comply with certain of the restrictive provisions, contained in the Code. In addition, the Code contains no provisions for a similar type of plan for those who utilize the railroad services, the shippers. Senator Baucus pointed out that these shippers might have as great an interest in owning a railroad as the employees, and that the Congress should examine ways to encourage this concept at the same time it looks at ways to encourage employee stock ownership plans for railroads.

Witnesses who desire to testify at the hearing should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510 by *no later than the close of business on June 15, 1979.*

Legislative Reorganization Act.—Senator Baucus stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress, "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Committee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

Written Testimony.—Senator Baucus stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies *by July 9, 1979,* to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510

Senator BAUCUS. The hearing will come to order.

The purpose of our hearing today will be to consider the availability of employee and shipper stock ownership plans for financially troubled railroads such as the Milwaukee Road.

In December of 1977, after several years of substantial financial losses, the Chicago, Milwaukee, St. Paul and Pacific Railroad filed for bankruptcy. Stanley E. G. Hillman was appointed bankruptcy trustee.

In August of 1978, Mr. Hillman announced that the Milwaukee was negotiating to sell portions of its track west of Butte, Mont., to the Union Pacific Railroad, and that the rest of the track west of Minneapolis would be abandoned.

This announcement justifiably caused great concern in the affected regions. For the State of South Dakota, this would mean an almost complete loss of rail service. Montana would become the only State in the continental United States to be served by only one railroad.

Similarly, other States would suffer from serious losses of transportation capability and intermodal competition.

In April of this year, the trustee petitioned to abandon some 7,000 miles or three-quarters of the Milwaukee system. All track west of Miles City, Mont., and numerous other lines throughout the West and Midwest would have been affected.

For the first time, States such as Illinois and Iowa faced the prospect of losses of rail service.

The Senate responded to this emergency by passing Senate Joint Resolution 81, a bill I introduced to require continued Milwaukee service for 60 days. The House Interstate and Foreign Commerce Committee reported a similar resolution.

On June 1, the bankruptcy judge denied trustee Hillman's request, stating that only the Interstate Commerce Commission can approve abandonment. Although the judge's decision was welcomed by those of us interested in the railroad's future, the crisis is by no means over.

Very soon, the Milwaukee railroad will again be facing a cash crisis. In this case, the bankruptcy trustee could legally order an abandonment of the entire system.

Also, the Milwaukee intends to have a plan of reorganization ready for filing with the Interstate Commerce Commission some time this summer. The plan undoubtedly will call for abandonment of large portions of the system.

One solution for the Milwaukee's financial problems is employee and shipper stock ownership.

The employee group, SORE, has been advocating employee ownership for the western lines soon after the trustee's announcement that he would abandon these lines. SORE has been very effective in its efforts to continue rail service in the northern tier.

Railroad shippers, members of Congress, rail unions, and State and local officials have expressed interest in this concept. Many of us believe that employee and shipper stock ownership may offer the only opportunity to continue transcontinental Milwaukee service.

There has been significant progress toward employee and shipper stock ownership. Senator Long and I met recently with shippers and employees who assured us that they would seriously consider this approach to solving the Milwaukee's problems.

Senator Long has pointed out, correctly, I believe, that Congress will not provide substantial financial aid for the Milwaukee unless shippers and employees are also willing to make financial commitments.

Our witnesses today fall into three categories. First, we will hear from technical experts who have considerable experience with employee and user stock ownership plans.

Louis Kelso and Norman Kurland will discuss their experiences with employee stock ownership plans. They will also describe steps that need to be taken to develop ESOP's, and discuss Federal legislation that may be necessary to promote this form of ownership.

Second, we will hear from the affected parties. We are honored to have Gov. Tom Judge of Montana with us today. He will discuss efforts by himself and other officials in affected States to pursue the employee and shipper stock ownership concept.

In addition, Paul Schmechel of the Montana Power Co. will discuss the interests of shippers in this type of organization. He will also describe efforts that have been made so far to develop an employee and shipper stock ownership plan for the Milwaukee.

Unfortunately, the timing of our meeting prevents labor representatives from attending. Members of the Rail Labor Executive Organization are tied up with their convention and elections in Florida.

I intend to chair a followup hearing after the July recess to hear from representatives of rail labor.

Labor representatives have been crucial in efforts to keep the Milwaukee operating. They have worked diligently toward passage of necessary legislation.

I am impressed by labor's strong commitment to an employee and shipper ownership plan for the Milwaukee.

Only days after Senator Long and I first met with labor representatives to discuss employee ownership, all of the major unions expressed their willingness to pursue this idea. I cannot commend unions too much for their efforts in this area.

Hopefully, for our followup hearing, rail labor will have continued this effort. I hope that labor will make a commitment to contribute funds for development of the employee and shipper stock ownership plan.

In addition, I would encourage labor leaders to meet with employees in the affected States. This would give all parties a better understanding of the issues involved. I would certainly be willing to attend such meetings.

Finally, we will have representatives of the Federal agencies. I expect these agency people to tell us what they can do to help the employees and the shippers who want to operate the Milwaukee.

If they cannot help, we want them to tell us what Congress should do to make the necessary aid available.

Before we call our first witnesses, I would like to make a few personal comments about the Milwaukee Railroad.

First, I agree with Senator Long that this railroad should not be saved unless its employees, its shippers, its affected communities and States, and other interested parties act collectively to commit their resources, their time, their credit and their cash to help save this railroad.

Second, the Government should not be in the business of running railroads, and the Milwaukee is no exception. Personally, I do not believe this road should be saved unless we can all make a commitment to change the historical downward path of the Milwaukee and to push that railroad into a new orbit of excellence.

I believe we should be visionary. Our country, with its wealth and technological resources, should be second to no one in the world in pursuing the goal of more efficient and more responsive transportation.

Personally, I am growing more optimistic about the Milwaukee road's chances. Six months ago, I did not think the railroad had a chance of surviving. Two months ago, I would have set its survival rate at perhaps 1 in 20. When the Senate acted favorably upon my resolution last month I guess that bumped the odds to perhaps 1 in 10.

And last Saturday, when I met with a group of Milwaukee shippers in Butte—one of whom will testify today—I saw a new spirit of commitment, and I believe the survival rate increased the odds of perhaps 5 to 1.

On the other hand, the potential payoff here is enormous. I heard someone say the other day that it would take more than $3 billion to rebuild the Milwaukee Road today. Knowing what I do about the construction costs of the D.C. Metro system, I suspect that estimate may be on the low side.

Moreover, I know a little about tha ecknkmic potential and future of Montana and other Northern tier States. If nothing else, we learned from the Cannon and Kotkin series in the Washington Post this week that the economic destiny of our Nation is moving west. But the wealth of the West rests on rails, energy and water.

And that wealth is no more than a mirage if we fail to capitalize on the value of our existing rail lines.

With those thoughts as a brief backdrop to this hearing, I would like to switch the burden to witnesses to see what steps they are taking to increase the chances of survival for the Milwaukee Road.

I want to welcome witnesses who are here today. The point of the hearing, as I briefly summarized, is to listen first to a panel of technical experts to gain some advice as to how we can put together a plan that makes sense. The second panel, the Governor of Montana and the President of Montana Power Co., will report on their efforts to get commitments from States and State organizations and shippers, and finally we will here from representatives of Federal agencies.

It is my understanding that one of the witnesses has a time problem. She would ordinarily be in the third panel.

Senator Melcher will be coming this afternoon to say a few words. Senator McGovern and Senator Pressler indicated that they would like to come as well. I further understand that Chairman Long might stop by as well.

When those Members of the Senate do arrive, we will be listening to them, but in the meantime it is my understanding that Ms. Henrietta Singletary, Deputy Assistant Secretary for Rural Development, Farmers Home Administration, has a very severe time constraint.

Ms. Singletary, let's hear from you, if it is convenient for you.

STATEMENT OF HENRIETTA SINGLETARY, DEPUTY ASSISTANT SECRETARY FOR RURAL DEVELOPMENT, FARMERS HOME ADMINISTRATION, DEPARTMENT OF AGRICULTURE

Ms. SINGLETARY. Thank you so much. I appreciate your letting me go ahead since I did have a meeting this afternoon.

I am Henrietta McArthur Singletary, Deputy Assistant Secretary for Rural Development.

Mr. Chairman, we thank you for the opportunity to appear before this committee to discuss employee stock ownership plans among proposals for the purchase of the Milwaukee Railroad. I will direct my initial comments to the involvement of Farmers Home Administration with these plans.

In this proposed employee stock ownership plan, ESOP, the parent company divests itself of a subsidiary for its employees to purchase. Farmers Home Administration can provide a guarantee to an ESOP, secured by assets and stock of the company, which qualifies under Farmers Home Administration regulations.

The transfers of stock are a pretax expense of the company, and the proceeds of the purchase of the stock by the employees are used to retire the guaranteed loans.

Farmers Home Administration has had experience with one ESOP located in Lewiston, Maine. The loan guarantee of approximately $8 million enabled employees of the company to purchase a plant which would have otherwise closed or relocated.

In these transactions, it is necessary to determine that the company being purchased is viable and that the opportunity for repayment of the loan is fairly well assured. This protects employees from making an unsound investment.

The employee's salary can be increased by the amount of his stock purchase to avoid the necessity of reducing the employee's current salary.

The philosophy of the employee's investment in an ESOP is to provide an opportunity to obtain a capital investment in the company with the option at retirement to continue to hold the investment or to cash the stock in at an appreciated value.

The budget authority of Farmers Home Administration's B. & I. division for loan guarantees for fiscal year 1979 has been $1.1 billion; 80 percent of this budgeted amount has been allocated to the State offices of Farmers Home Administration on the basis of individual State rural population, degree of need as measured by income, and unemployment. In addition to the State allocations, the national office retains a reserve of 10 percent for fiscal 1979 and an additional reserve of 10 percent to clear up the backlog from 1978.

The largest State allocation in fiscal year 1979 was $45,780,000 for North Carolina and the smallest was for $1,100,000 for Rhode Island.

When State officials run out of money for projects, they can request additional funds from the national office reserve for worthy projects. Regardless of the demand in a particular State for business credit from Farmers Home Administration, we try to keep funding for each State within allocation limits.

Through May 30 of this year, the demand for larger credits, that is, loan guarantees of more than $10 million, is 400-percent higher than it was in fiscal 1978. In 1978, Farmers Home Administration funded $84 million in large credit loan guarantees, while in 8 months of fiscal 1979, we funded $200 million of these guarantees. We presently have $155 million in approvable applications in the over $10 million category. Any sizable projects would therefore have a greater chance of funding in fiscal year 1980.

Farmers Home Administration has a working policy on B. & I. loan guarantees funding for any single project to $50 million. Any request beyond that amount should first be reviewed at OMB or White House levels. If the Milwaukee Road was purchased by joint financing with the Department of Transportation, and the Economic Development Administration, the Farmers Home Administration could still only provide $50 million.

Please keep in mind also that eligibility for loan guarantees to rural areas is confined to cities or towns of less than 50,000, so that places like St. Paul, Minn., needing facilities, would not be eligible.

In conclusion, I would like to say that the Assistant Secretary for Rural Development and Farmers Home Administration are interested in good rural development projects and in employee stock ownership plans for purchasing businesses or companies. Farmers Home has also agreed with the Department of Transportation to help rehabilitate segments of rural America's railroads.

However, as I indicated earlier, it is extremely difficult for Farmers Home Administration to take on large financial projects of this type, given the extensive demands placed upon its limited funding resources from throughout rural America.

I will be pleased to respond to any questions you may have.

Senator BAUCUS. I appreciate your statement, Ms. Singletary.

Have you had a chance to look at the financial position of the Milwaukee Railroad?

Ms. SINGLETARY. We have not. An application has not been received.

Senator BAUCUS. Even though you have received no application, though, have you gone through the papers or whatever information that might otherwise come to your attention? Do you have any sense of the financial position of the Milwaukee?

Ms. SINGLETARY. We understand the areas you discussed would not be served, and that is a concern of yours, also that the employees are interested in the stock ownership, as an alternative. The dollars needed would be large to make the company whole, so that it could continue to serve this area where the need is.

Senator BAUCUS. Does Farmers Home have any ESOP experience with railroads?

Ms. SINGLETARY. Not with railroads. We do have ESOP experience with other industries. We certainly are in favor of the ESOP type of financing.

Senator BAUCUS. How about transportation?

Ms. SINGLETARY. Not with ESOP and other transportation. We do have other transportation loans.

Senator BAUCUS. What ESOP arrangement does Farmers Home have, or has it had, that more closely approximates the Milwaukee Railroad?

Ms. SINGLETARY. Probably the one we mentioned in Lewiston, Maine. That would probably be the closest one to it.

This was a manufacturing company, a fabric company, and it did work very well. It did help make the company whole and it is turning out to be a very good one.

Senator BAUCUS. A loan guarantee of $8 million?

Ms. SINGLETARY. That is right.

Senator BAUCUS. Would you review, again, the maximum feasible amounts that might be available from Farmers Home?

Ms. SINGLETARY. We do have $1.1 billion that is allocated throughout the country in fiscal year 1979. We have tried to be careful with those very large loans, since loan applications over $10 million have increased so much. We came up with a guideline of $50 million. If we had a loan application of over $50 million, we look at more than just regular credit approval systems. We look at the adjustment, what the $50 million was for, and address the OMB question.

Senator BAUCUS. What is the procedure? Would the organization apply through the National Farmers Home Office or would it have to go through various State farmers home offices?

Ms. SINGLETARY. The most workable procedure, the one we have seen is best for a borrower to follow, is to work very closely with the bank. When the borrowers has a lender who understands the borrowers financial needs, the borrower works with the lender to contact the Farmers Home Administration office in their State. The guarantee is to the lender for a particular borrower.

It is best for us to work through the lender and the guarantee is made through the State office.

Senator BAUCUS. Would it be possible to devise a mechanism which would avoid what I perceive as potential complications in working with a great number of States? As you know, the Milwaukee system transverses several states.

Ms. SINGLETARY. Several States; yes, sir.

Senator BAUCUS. The employees live in several States.

Ms. SINGLETARY. Right.

Senator BAUCUS. Would it be possible, in your judgment, to develop a system where we would not have to go through all of this?

Ms. SINGLETARY. We could work through this way. It would be best for them to choose a lead State to work with carefully and coordinate with the others and with the Washington office. We could certainly be flexible to the fact there would be several States involved.

I would recommend that a lead State or one of the business and industrial loan chiefs at the State level would be a big help to them. They are at the local level and could give particular advice, attention, and work with them closely.

Senator BAUCUS. What is the timing in the processing and application? As you know, the Milwaukee is in a tough financial position. The judge, in his opinion denying the trustees petition to embargo portions of the railroad stated that the cash position probably is such that the Milwaukee cannot continue to operate for more than a few months. By the end of the summer, or by the fall, the Milwaukee is going to be in tough shape. I do not know that we can put together an entrepreneurial, managerial organization to buy the Milwaukee in 3 or 4 months. There would probably be a longer period than that.

But still, time is of the essence. How long does it take to process a Farmers Home Administration loan application? Can you give me some definite guidelines?

Ms. SINGLETARY. The best way is to get the lender and borrowers working closely and preparing the feasibility studies. I think a sound feasibility study on how the borrower intends to handle the financing is important. The more thorough this is the better when they reach Farmers Home. If they worked with Farmers Home, they would know what questions and information are required. This is a credit decision where the information and feasibility have to be prepared.

Senator BAUCUS. Given this situation where it would be a new company what might be the timeframe?

Ms. SINGLETARY. Yes, sir.

Senator BAUCUS. To try to pull a lot of loose ends together and work with the Federal Government, which is not known for its dispatch and speed will take time. What is your most candid, best, most precise estimate as to how long it would take?

Ms. SINGLETARY. You know, once a feasibility study is done, it would not take—I would say within I believe 2 months is better. Henrietta probably is thinking of 1 month in North office. It does not take longer than that—3 weeks.

I was trying to give it a month because it will be a little bit complicated without a feasibility study.

I would say after the study is done.

Senator BAUCUS. What is the lowest interest rate that Farmers Home can provide?

Ms. SINGLETARY. Our interest rate is negotiated with the lender. This is why it is so very important that our borrowers come to us with their lender when the interest rate is determined. It is a guarantee of up to 90 percent of the total amount of the loan.

Senator BAUCUS. Again?

Ms. SINGLETARY. The interest rate is negotiated between the borrower and the lender.

Senator BAUCUS. Close to the prime market rate or several points lower?

Ms. SINGLETARY. It is up to the lender. We would hope that the lender would take it into consideration that with the guarantee of full faith and credit behind up to 90 percent that the interest rate would be reduced some.

Senator BAUCUS. Under the law, the lender could not——

Ms. SINGLETARY. We do not have an interest rate under the law. It is negotiated by lender.

Senator BAUCUS. By the banks?

Ms. SINGLETARY. By the bank.

Senator BAUCUS. No legal impediment?

Ms. SINGLETARY. No, sir.

Senator BAUCUS. To obtain a low rate of interest would be a matter of negotiation.

Ms. SINGLETARY. Yes, sir.

Senator BAUCUS. What is the longest repayment schedule?

Ms. SINGLETARY. We usually go 30 years on real estate loans, but on machinery and equipment the limit is 15 years; on working capital it is 7 years maximum.

Thirty years is in the regulations for real estate and permanent improvements thereto; the loan terms for machinery and equipment and working capital are a matter of regulations also.

Senator BAUCUS. Would Farmers Home look carefully at a joint loan arrangement, jointly with other Federal agencies?

Ms. SINGLETARY. Jointly? We have done that. Yes, sir.

Senator BAUCUS. Is that difficult, or fairly easy to put together?

Ms. SINGLETARY. If we are discussing time, when we need to involve several agencies, time may be a problem.

When we have noticed the necessity and importance of coordination, we certainly are able to get Federal agencies together.

Senator BAUCUS. Could you give me an example of an instance where it has worked well, with EDA, for example, or FRA?

Ms. SINGLETARY. Lake Placid was one we made with EDA.

Senator BAUCUS. In a few sentences, could you describe that company?

Ms. SINGLETARY. Let me describe one with which I am more familiar. We did have a car manufacturer, a very large loan. They did not end up accepting the guarantee, but we certainly were able to work with EDA and develop a position we could stand behind where the two agencies were working together.

Senator BAUCUS. Once the new Milwaukee organization is formed, what kind of technical assistance can Farmers Home provide to the new organization to more quickly expedite the loan guarantee and all the papers that have to be put together?

As you know, at least in rural parts of the country, small communities do not have a lot of expertise. They have a hard time processing loan applications, and I assume the new organization might have some difficulty, too.

What kind of technical assistance is available?

Ms. SINGLETARY. This is why I was insisting that they use the local and State office. Someone closer to the local level can provide information necessary to make a good decision.

This would avoid sending papers to Washington only to have them returned for additional information. It goes much quicker if they work closely with the lender and the business and industrial loan chief at the State level.

Senator BAUCUS. Would the business and industrial grant program be available to provide funds for an ad hoc group to study the feasibility of ESOP's?

Ms. SINGLETARY. We have an industrial park program with $10 million in grant funds this year. It is near the end of the year, but we did have $10 million allocated.

In doing a feasibility study, we do have a program under section 111 of the Rural Development Act of 1972 which provides rural development planning funds. We possibly could help with a feasibility study with an application under the section 111 program.

Senator BAUCUS. The last page of your statement, something caught my eye. You mentioned that eligibility for loan guarantees to rural areas is confined to cities and towns with populations of 50,000 or fewer.

Does that cause a problem in this case where we have a railroad that generally transverses rural America, but nevertheless does pass through a few towns and areas of greater population. Is that a problem?

Ms. SINGLETARY. I have not received a legal opinion. I do not think that would cause any problem, because the employees are scattered throughout the rural communities and the railroad does serve rural communities. We might have to disallow financing for certain parts of the facilities or lines located in definite urban areas. However, EDA if involved, could finance those urban portions since it has no such restriction.

Senator BAUCUS. Thank you very much.

Ms. SINGLETARY. Thank you. Thank you for letting me testify early.

Senator BAUCUS. Thank you very, very much.

[The following was subsequently supplied for the record:]

DEPARTMENT OF AGRICULTURE,
OFFICE OF THE SECRETARY,
Washington, D.C., August 24, 1979.

Hon. MAX BAUCUS,
Chairman, Subcommittee on the Oversight of the Internal Revenue Service, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reply to your June 26, 1979, letter requesting we respond to additional questions to clarify issues discussed at the recent hearing on ownership plans for railroads.

We are pleased to forward our response to those questions.

If we can be of further assistance, please let us know.

Sincerely,

HENRIETTA MCARTHUR SINGLETARY,
Deputy Assistant Secretary for Rural Development.

Enclosure.

IMPORTANCE OF TRANSPORTATION IN RURAL ECONOMIC DEVELOPMENT

Question 1

Question. Are you aware of studies by the Farmers Home Administration, or other agencies in the Department of Agriculture, analyzing the importance of transportation in rural economic development? Does the Department feel that transportation is an important factor in the rural economy?

Answer.

PART A—TRANSPORTATION STUDIES

The Department of Agriculture has done or is in process of doing the following studies relating to the importance of transportation in rural economic development:

Studies available

Rural Development Policy and Rural Public Transportation. Ira Kaye Transportation Research Record 696—Transportation Research Board, National Academy of Sciencies, 1978.

Studies pending

A Pilot Project to Increase the Effectiveness of Planning Transportation Systems in Rural Minnesota. University of Minnesota—Due September 30, 1981.

A USDA Demonstration Project: Evaluation Resources Allocation to Rural Transportation Facilities. University of North Carolina in cooperation with North Carolina A&T State University—Due September 30, 1981.

National Rural Community Facilities Assessment Study. ABT Associates, Inc. (includes transportation) Preliminary due October 1979; final March 1980.

Study of Rural Passenger Facilities: Profile of Predominantly Agricultural Counties. (May be Expanded to include poorest rural counties), Transportation Institute, North Carolina A&T State University—Due September 30, 1979.

PART B—IMPORTANCE OF TRANSPORTATION IN A RURAL ECONOMY

In connection with the recent consolidation of parts of different agencies within Agriculture, Secretary Bob Bergland made the following statement in a news release dated December 13, 1978, which we believe is reflective of the importance he attaches to concentrating on transportation in rural areas:

"We have the experience and dedication in existing USDA transportation units, but there are a number of urgent agricultural and rural development problems and issues which cannot be properly addressed without this consolidation.

"This department can provide greater assistance in solving major transportation issues facing farmers, such as freight car availability, rail line abandonments and regulatory matters."

ASSISTANCE AVAILABLE FROM THE DEPARMENT OF AGRICULTURE TO AN EMPLOYEE AND SHIPPER ORGANIZATION ATTEMPTING TO PURCHASE AND OPERATE PORTIONS OF MILWAUKEE ROAD (RAILROAD) PROPERTY

Question 2

Question. Please provide a detailed description of assistance, both technical and financial, that the Department of Agriculture, including Farmers Home Administration, could provide to an employee and shipper organization attempting to purchase and operate portions of Milwaukee Road property. Please also describe any assistance it could be provided jointly with other agencies including the Economic Development Administration, the Federal Railroad Administration, and the Department of Transportation.

Answer.

PART A—ASSISTANCE

Technical assistance

In the Office of the Secretary of Agriculture, there is an Office of Transportation, which is a group that coordinates the transportation functions of agencies within Agriculture and tries to relate and integrate these functions to national goals and policies.

Farmers Home Administration does not provide technical assistance for borrowers. Since the Business and Industry program is a guarantee program, wherein lenders initiate loans and service them, we have been expecting lenders to detect needs for technical assistance and to initiate courses to fulfill these needs.

It would seem that since the Department of Transportation is the primary agency in national transportation that it would have resources and ready access to technical expertise on rail transportation.

Financial assistance

Farmers Home Administration, an agency within the Department of Agriculture, has four loan programs which together are intended to assist in the credit needs of rural America. Of these four programs, it appears that one program—the Business and Industry Loan and Guarantee Program—would be best suited for financial assistance to the groups pursuing purchase and operation of the Milwaukee Road. Another loan program of FmHA, Community Programs, might be able to be of assistance if the owners and operators were organized as a public body or a nonprofit corporation.

Since it appears that the preliminary plan for purchase of this railroad is to have the employees of the Milwaukee Road purchase and operate the line under an employees stock ownership plan and trust, it is assumed that the trust would be organized for profit. With this kind of organization, the Business and Industry program would seem to be the only available financing vehicle within FmHA, assuming all requirements of 7 CFR 1980 Subparts A and E could be met.

The Business and Industry Loan and Guarantee Program of FmHA operates in "rural America," which generally means any city of less than 50,000 population. The main thrust or goal of the program is to create new jobs and to maintain or save existing jobs.

Loans or loan guarantees can be made for just about any legal purpose, although we do have some administrative restrictions, such as those involving foreign companies, agricultural production and a number of other matters. We do not, however have restrictions against employee stock ownership plans and trusts.

Over the last two years of operations of the Business and Industry program, the preponderance of the financial assistance rendered has been in the form of loan guarantees, wherein the prospective borrower obtains a loan from an approved lender and FmHA guarantees the loans. The highest percentage of loan guarantee we can make by law is 90 percent of the principal amount of the loan plus interest. While we do not have legal limitations on the size of individual loan guarantees for individual projects, we have an administrative limitation of $50 million per project loan guarantee.

There are not sufficient funds left in the FY 1979 authorization to fund a project of $50 million.

PART B—PARTICIPATION WITH OTHER FEDERAL AGENCIES

Farmers Home Administration can participate jointly with other Federal agencies. We have a joint participation agreement on assisting in the rehabilitation of local lines of railroads with Department of Transportation and Economic Development Administration.

Senator BAUCUS. We will turn to our schedule and listen to our first panel of two witnesses. Mr. Louis Kelso is president and chief executive officer of Kelso & Co., Inc. The second witness is Mr. Norman Kurland, Norman Kurland & Associates.

Gentlemen, we are happy to have you here and we would like to hear what sage advice you can give to us.

Mr. KELSO. Do you have a particular format you would like us to follow?

Senator BAUCUS. Since we have a good number of people this afternoon and we do not have an unlimited number of hours, and because you have prepared statements which can be included in the record for anybody to look at and to read at length, why do you not summarize your testimony as cogently and clearly as I know you can. Let's also impose upon ourselves a 10-minute time limit for each person who testifies.

Somebody up here has a bell which will ring, theoretically, after 10 minutes.

I might also encourage you, Mr. Kelso, for my benefit, as well as everyone else here, to speak as much as possible in layman's terms.

I know these employee organizations get pretty complicated and we could get lost trying to figure out where all the arrows and all the boxes go.

What we are really looking for in everyday common, ordinary language is—what is possible here? What can we put together? For my benefi'. pretend you are a taxicab driver and you are explaining to me how you put these employee and shipper stock ownership plans together, in 10 minutes.

Mr. KELSO. Maybe you would like to lead off with Mr. Kurland.

Senator BAUCUS. Either way.

STATEMENT OF NORMAN KURLAND, NORMAN KURLAND & ASSOCIATES

Mr. KURLAND. Mr. Chairman, it is a great privilege and personal honor to speak before this committee. Its chairman, Senator Long, is the foremost champion of the ESOP's. There are millions of Americans who had benefited in the 2,000 companies that they are now becoming owners of.

Also my pleasure is greatly enhanced by being invited to serve on the same panel with Mr. Kelso, who was my teacher for over 11 years. He has given me something which I would like to discuss today—his remarkable insight and a conceptual framework, both of which are very critical in terms of understanding and analyzing the causes of the demise of the Milwaukee Road and what we can do about it.

I am doubly honored to be here on the same panel with Mr. Kelso.

I am speaking today as the head of a consulting firm that specializes in the design of ESOP's and also as chairman of the Ownership Campaign, representing thousands of working Americans who want to share in a piece of America's future.

I come with no easy answers to the problem that precipitated these hearings: The threatened demise of the close to 7,000 miles of track of the Milwaukee Road. My testimony goes into the mechanics of the ESOP. I would be happy to go over any of those points in the question period.

As good as ESOP is, it is no panacea, and it is fruitless to apply it to basket cases.

Not having access to the relevant facts for the trustees in the present reorganization proceedings of the Milwaukee, such as the Booz-Allen report or the SORE proposal, or any of the other materials before the Department of Transportation, I have no way of personally evaluating whether the ESOP or any other ownership vehicle would work in this case. But some of my insights and experiences in approaching hardship situations similar to this one may be useful in guiding those who are trying to save the railroad.

What makes the Milwaukee Railroad crisis historically relevant is the united and enthusiastic willingness on the part of all the national railway labor leadership to experiment with the ESOP concept, a remarkable shift from the atmosphere of skepticism that the ESOP had encountered back in the days when the ConRail legislation was being formulated.

So if, in any way, the ESOP can help save the Milwaukee Railroad, it should be tried. With organized labor helping to shape the

ESOP, the broad-based popular constituency that Senator Long and other proponents of the ESOP have been trying to surface can, in fact, be mobilized.

First, before going into some concrete cases which I think may be illustrative of how you might approach the Milwaukee Road, I think a few general comments are in order.

Keep in mind that conventional wisdom has generally been inadequate and shortsighted when appraising the potential of reorganizing a company under an expanded ownership strategy.

I can cite, for example, the negative study done by experts hired by the U.S. Railway Association. This involved the proposal by Senator Long, to see whether the ConRail could become a 100 percent employee-owned operation. The experts all voted negatively. They could not find a single good feature about the ESOP.

We ought to keep this negative experience in mind when we are considering whatever conclusions come from the Department of Transportation.

The second situation involved the National Maritime Union, which in 1972 was trying to save the passenger vessels. At that time, even Senator Long was skeptical about the use of the ESOP to save the passenger vessels. Now we have no passenger vessels.

Third, I would also like to discuss the South Bend Lathe case. That is the closest analogy to the Milwaukee Railroad—at least the closest success story for applying a combination of public and private credit for accomplishing a 100 percent ESOP buy-out by all of the employees, without any employee putting up a penny.

It was all done, as I will describe, on the basis of a great initiative taken by the Economic Development Administration to provide low-interest credit for an ESOP job-saving demonstration.

Last a situation that is very relevant to any plan to save the Milwaukee Road is a railroad that I will simply have to call Railroad X at this time. Our firm has been hired by a public agency to explore the possibility of a combination of customer ownership and employee ownership for that railroad, which has been experiencing some of the same difficulties as the Milwaukee Road.

I might add that the public agency has already approved our analysis and proposals, but at this time it is in delicate negotiations with the railroad. Although I cannot name the particular company, I can describe what we are proposing in general terms.

The solution to making the Milwaukee Road work on a profitable basis, I believe, lies in an analytical framework that rejects the traditional and antagonistic "wage system" assumptions which I will call "dog-eat-dog" assumptions. Instead, problem-solvers have to begin thinking in more synergistic terms, the kind of terms where everybody gains—in other words, expanded ownership assumptions.

The basic premises of the new framework is that broadened ownership is better than concentrated collective or Government ownership. A competitive, free market system works better and is more democratic than a regulated economy, but is politically vulnerable when workers lack effective ownership opportunities.

To make the free enterprise system work, especially in such key industries as the railroads, organized labor must begin to negotiate a brand-new kind of labor deal, much like the MMU offer, which I have attached as appendix A of my proposal. This is one major pillar in the new framework. The new labor package would substitute future ownership gains for future wage system gains. By broadening the ownership constituency of a railroad operated on free enterprise principles, government could return to its original limited role in the economy, gradually relinquishing its redistributive and protectionist functions for a freer, more efficient, more democratically owned enterprise system.

The second pillar of this new problem-solving framework involves guiding the transition from today's wage system to a more dynamic and just expanded ownership system. Here, government must lift barriers and provide access to low-cost capital credit for working people, must offer better tax incentives for ESOP's and Customer Stock Ownership Plans or CSOP's, and must develop a new counter-inflationary Federal Reserve discount strategy, all geared to stimulating lower cost new capital formation through ESOP's and CSOP's or what you have called the SSOP or Shipper Stock Ownership Plan. In my testimony I have attached a proposal by the Louisiana Agricultural Commodities, Inc. for a $100 million farmer-worker-owned enterprise aimed at uniting farmers in 18 grain-producing States for the construction of a modernized grain elevator to compete directly for world markets with the Big Five commodity dealers. This paper suggests a hidden new source of capital credit for saving railroads.

There are several basic guidelines for determining the feasibility of reorganizing a failing company like the Milwaukee Railroad to an expanded ownership strategy.

First, you must conduct a feasibility study with competent professionals who accept expanded ownership assumptions and goals, but who can also understand and communicate with those operating within the realities of the present wage system.

Second, you must locate a management entrepreneurial team, ideally within the operating company. This team must have credibility with the union's bankers, suppliers, and customers. It must be capable of competing in the global marketplace and must accept the expanded ownership philosophy.

As a matter of fact, the omission of this management component largely explains why, despite $500,000 in HUD funds, the effort to save the Youngstown Sheet & Tool Co. went down the tube.

Next, the leadership of all the unions affected must be directly involved in developing an innovative, productivity oriented labor package based on ownership assumptions.

And last, you must determine the availability of access to sufficient capital credit to meet both the long-range and short-term capital needs of a Milwaukee Road reorganized along broadened ownership lines.

I spoke today in very general terms. I am afraid I was unable to speak on the specific cases, but essentially, Mr. Chairman, I would conclude the ESOP and the SSOP are certainly worthwhile trying to save this railroad.

I think it is going to be a very difficult job. I read the report only of the master and the court proceedings, and I can see that it will be very difficult to turn the Milwaukee Road around. On the other hand, I think that with the commitment of the various parties that you have been able to bring together, if we can, in fact, get access to sufficient low-interest credit, if we have a feasible project, if the numbers hold up, I believe that this project, as I was able to do with South Bend Lathe, can be turned around and transformed into a successful company.

Thank you.

Senator BAUCUS. Thank you very much, Mr. Kurland. It is all very helpful.

Why do we not bring out some more points later on during the question and answer session. Why do we not now turn to Mr. Kelso.

I want to welcome you, Mr. Kelso, to the hearing. You are no foreigner here. You have been here several times and have lent tremendous advice based upon your talent and experience to this committee, and certainly to Chairman Russell Long.

I want to personally thank you for coming to give us the benefit of additional advice today. I appreciate having you here.

STATEMENT OF LOUIS KELSO, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KELSO & CO., INC.

Mr. KELSO. Mr. Chairman, Senator Baucus, I am most appreciative in being called to attend and participate in these hearings. I want to say that I reciprocate Mr. Kurland's comments. I derive considerable inspiration, as any teacher does, from an able student during many years of pleasant cooperation with him.

I would request—but perhaps this would be automatic—that my written testimony would be made a part of the record.

Senator BAUCUS. Your prepared statement will be, and Mr. Kurland's.

Mr. KELSO. I would also like to congratulate the chairman of the Senate Finance Committee for his superb floor statement on May, 23, 1979, in connection with the introduction of S. 1240, the Employee Stock Ownership Improvement Act of 1979. I hope that that bill will, in fact, get passed because it would greatly facilitate the use of the ESOP tool in connection with the Milwuakee Railroad.

Last, Senator Baucus, I want to congratulate you on your courage in moving into an important matter that involves your State and a number of adjoining States and in taking the initiative in an innovative area where, in general, governmental timidity is rather notorious.

I believe that with this kind of leadership we are on the watershed of change to a rational economic policy.

The U.S. Government, American business, and American labor are equally responsible for the present predicament of our economy and our society. To that list should be added we, the citizens of the United States, who have the duty of being informed about the economy. But though the United States was born in 1776, and the industrial revolution dates from practically the same year, it was not until 1958 that we had a theory—that is to say, a logic diagram—for a private property market economy.

In view of the enormity of our poverty, a poverty that engulfs all the echelons of our society descending below the very top, it should not surprise anyone that our growth rate has been abysmally small and that so many businesses have come to such disastrous ends.

We have an official national economic policy that is totally at loggerheads with the facts of life.

The national economic policy says that we must distribute income and solve inequities of income distribution solely through labor. Meanwhile, scientists, technicians, managers, and engineers spend their time, day in and day out, systematically destroying employment. Nor do they do so for malicious reasons. They do it because cost minimization is part of the logic of private enterprise business.

Business has operated on a strategy that involves only three simple propositions: Maximizing production and sales, minimizing costs, and staying out of trouble.

Business sits back, in the smug belief that this is a total comprehensive philosophy of private enterprise. I say that it is not a comprehensive philosophy. One thing has been left out. It does not explain how the customers get the money to buy, and there is no way to have mass production without having mass consumption in any but a Communist society. There can be no mass consumption unless people have purchasing power. As a practical matter, they cannot for an indefinite period get purchasing power unless they get it legitimately.

There are two ways of getting purchasing power legitimately—one, through selling one's labor; the other, through private ownership of the other factor of production, namely capital, land, structures, machines, and sometimes intangibles such as patents.

As technology changes the input mix, we have clung to this same quasi-socialist, or actually truly socialist, economic policy. We insist on solving our problems through labor, and we have even misled labor into thinking that it can solve its problems solely through labor—that is to say by demanding, irrespective of the law of supply and demand, by demanding progressively more pay for progressively less work.

You need only to state that proposition to know that the Milwaukee and every other business in the United States is going to go bankrupt. You cannot predict exactly when. The timetables differ and the agility of businesses differ. Clearly, if we are to restore the order that nature imposed upon humankind when it arrived on the Earth, we must institutionally compensate for nature's original arrangement whereby along with each month, was born pair of hands, a pair of legs and a strong back to provide productive power to feed that mouth and clothe that body.

As the means of producing goods and services changes, so must the equipment of the individual to engage in production. This means building ownership of capital into the presently noncapital-owning 95 percent of consumer units.

I believe that the conventional wisdom—a term which Mr. Kurland and I both use frequently—totally tends to underestimate the extreme power of motivated people who own a part of the business that they work for to do the unusual, the almost unbelievable.

He cites the South Bend Lathe case. It was a company that was losing money for 9 out of the 14 years that it had been owned by a Chicago conglomerate. When it became employee-owned, it became instantly profitable, and it has grown progressively profitable year after year. Today it is an outstandingly profitable business and could command a price many times what the employees paid for it.

The shippers stock ownership plan contemplated in my proposal would be a variation of the consumer stock ownership plan that has been market-tested in California. It would require some legislation. I would hope that Congress would move swiftly on it, if this route is chosen. It could be done without legislation if the shippers settle for debt instruments, debentures, or something of that sort.

That, perhaps, would solve their problem. Their main interest being assured of transportation.

I want to close by assuring this committee that I will do everything in my power to help make this an example that will move thousands, and hundreds of thousands, of other firms, toward a rational economic strategy: Namely, building ownership into people who do not have it so as to make them economically self-sufficient, and thus economically independent.

Senator BAUCUS. Thank you very much, Mr. Kelso.

Just so that we all know what we are talking about here, why do not one or both of you explain what an employee or consumers stock ownership plan is, so that we all know what the parameters are, and what the framework is for this discussion?

I would suggest, too, that you try to keep it fairly simple. Just outline the bare concepts, and essential theory of it, without going into too much detail.

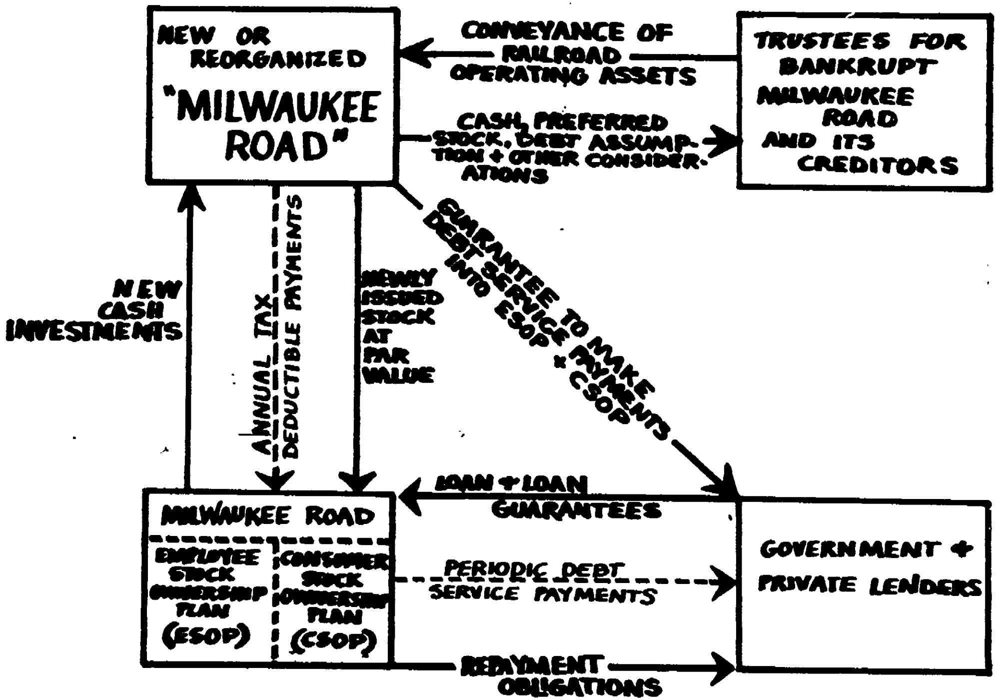
Why do you not state it in your own words?

Mr. KELSO. Mr. Kurland has prepared a diagram. Maybe you want it in the record, though, and perhaps should have it in words.

Senator BAUCUS. We will include the diagram in the record.

[The material referred to follows:]

GENERAL DESIGN FOR EMPLOYEE AND CUSTOMER BUYOUT OF THE "MILWAUKEE ROAD"



Senator BAUCUS. For the benefit of us here, why do you not explain orally what an employee stock ownership plan or a customer stock ownership Plan is and how it works?

Mr. KELSO. Since Mr. Kurland has the diagram, why does he not explain the ESOP and I will explain the shipper stock ownership plan?

Mr. Kurland; I will explain the ESOP. I would like to comment that I do have one difference of opinion with Mr. Kelso on the necessity for legislation for implementing a consumer stock ownership plan. Our legal analysis indicates that it could, or it is very likely that it could, be launched today under the existing law through the same process as we accomplished buy-outs for employees, without requiring additional legislation.

Now, on the employee stock ownership plan, the employee stock ownership plan uses a legal trust that is available under the U.S. tax laws to accomplish employee buy-out of stock in the company without the employees having to put up any of their own money.

Senator BAUCUS. Employees here means management as well as salary and wage-earning employees?

Mr. KURLAND. Exactly. It includes all employees of a company. They each have an account——

Senator BAUCUS. Including the company president?

Mr. KURLAND. Including the president.

The interesting thing about an employee trust under present laws is that it is the only benefit plan under present law and the only tool of the world of investment finance which can be used for buying stock and using all of the future profits for paying off the stock.

In other words, today you could not do it unless you did it through an employee stock ownership plan, simply because part of the future profits now have to be taxed.

But when a company sets up a trust for its employees under section 401 of the tax law, they can borrow money, have the trust borrow the money, and the trust can then buy stock in the company, which then, of course, provides the company with enough cash to do whatever it needs, whether it is an expansion program or whether it is to buy assets from a parent corporation in a divestiture situation. That is how we did it in South Bend Lathe.

Let me explain it in a specific case. In South Bend Lathe, the liquidators were offering $9.2 million for the company. It was about ready to go out of business. We set up a new corporation. The new corporation set up a trust that was going to cover all present and future employees of that company. The Government was willing to provide a 3 percent, 25-year loan. The loan was made to the trust.

The trust took that $5 million—that is what we got; $5 million EDA loan—and that provided half of the buy-out capital, so we were able to buy with that $5 million $5 million of new stock. We still needed another $4.2 million. Once the Government was willing to come forward, then we were able to borrow another $4.2 million from two banks in the Heller Corp.

When you are dealing with the private commercial world at this time in a situation like that, they charge many points above prime. They charge something like 7 points above prime.

Now, what happened was, now you had enough cash to get the company off the ground. You pay off on an employee stock ownership plan. You had to pay out the loan. The loan is all secured by the future profits of the company. This is what makes some lenders willing to put up the money.

They take money that ordinarily would have gone into a regular benefit plan and then drained out of the company. They would use that for servicing the debt.

Every time they pay the debt, it is a tax deductible expense because the same dollar that is used to pay off the lenders is also providing an employee benefit. Under the tax laws, this allowed the debt service to be paid in pre-tax rather than after-tax dollars. For any company, that means it is better from a cash flow standpoint.

What you have is the only tool in the world of investment finance in which you can borrow, repay in pretax dollars, and build the benefits of that capital into all of the employees on a nondiscriminatory basis.

Senator BAUCUS. Why do you not describe a CSOP?

Mr. KELSO. A SSOP, or shippers stock ownership plan, Mr. Chairman, quite naturally would be the subject of a design and feasibility study before it is perfected. In general, its outlines would be something like this.

Shippers through a signed agreement would subscribe to either stock or debentures or to preferred stock or to another form of security of the new corporation. These subscriptions in general would be proportionate to each shipper's anticipated usage, with machinery built into the arrangement for adjusting underestimates and overestimates.

If a shipper says he is going to ship a million tons of coal in a particular year and only ships a half million, it could be adjusted for that. Or if he ships 2 million, it could be adjusted for that. The main thing is to give each shipper financial responsibility proportionate to his anticipated usage.

That commitment would be made to the new corporation and to a special shippers stock ownership trust. Loan financing from the best available sources, or several sources, would then be used to arrange loans into the trust. The trust would buy the appropriate security from the corporation and hold it until it has been paid for by the shipper.

The shipper would pay for his security from his allocated share of the profits of the enterprise year by year. Thus, in effect, he would be utilizing the basic logic of corporate finance.

Corporations buy capital on terms where they pay for it out of the income it produces, and then, thereafter, it goes on producing without additional investment cost.

Senator BAUCUS. Essentially, under both employee and shippers stock ownership arrangement employees would purchase stock in the company somewhat in proportion to their salaries or wages and the shippers would have a subscription somewhat proportionate to their business usage of the railroad.

In addition to the other advantages you have already outlined, the other benefits would be that both employees and the shippers would have additional incentive to make sure that the railroad is operating profitably and efficiently, because those additional profits accrue to their benefit. That is the essential theory here.

Mr. KELSO. That is right.

Senator BAUCUS. In practice, it has worked.

Mr. KELSO. In practice, it has worked. Valley Nitrogen Producers is the best operating counterpart. It was launched in California against the opposition of five major petroleum producers of chemical fertilizers.

Senator BAUCUS. If I understand you correctly, it should work in every business enterprise where you have a managerial team of employees working in skilled and nonskilled labor, when theoretically do they make sense?

Mr. KELSO. The CSOP makes sense only in businesses that, by their nature, have a reasonably long, sustained relationship with their particular customers. Farmers buy chemical fertilizers from their supplier year in and year out. Sometimes they buy them in great quantities, by the train load.

Another absolute natural is the public utility, whether the public utility is a power company, a telephone company, a railroad or whatever. But there is a constant and continuing relationship between the supplier and the consumer. The CSOP would not be appropriate, for example, for a watch manufacturer. If you buy a good watch, you may buy only one in a lifetime.

Senator BAUCUS. Would there be any conflict between management and labor in wages, for example?

Obviously, management has to keep wages down and labor has to keep wages up.

Mr. KELSO. I do not think so, Mr. Chairman. The initial design would involve a very careful study of the facts. The initial design formulas would allocate a portion of the income of the corporation to the employees and a portion of the income to the shippers in accordance with the plan devised by the shippers.

In a sense, they would be partners. The partnership sharing formula would be set up in the corporate articles to begin with.

Mr. KURLAND. Mr. Chairman, in order to launch a feasible ESOP and CSOP, you have to start backwards, from projections for future profits. It is like navigation. Where you start from is from raising questions, like, what must be done to make the company profitable in the future? When you have a company undergoing reorganization, what you have is substantial debt that cannot be paid from present revenues.

Somehow or other, the revenues coming into the company are not really enough to handle all the costs. So what you really have to do is go back to the reorganization process. The beauty of the reorganization process is that allows the company to start off again on a clean slate, with a reduction of its present debt load and future costs, to the point where, initially at least, the company can again operate on a profitable basis.

We could not have saved South Bend Lathe unless we could find ways to produce changes that would convert its future earnings from red numbers to black.

Unless we can start with a company that can project future earnings, I think it is a mistake to begin to talk about financing any buyout through an ESOP, CSOP, or any other kind of expanded ownership plan. It does not make sense to connect people to basket cases.

There have been ESOPs that have been launched in an amateurish way, and they failed. Mr. Kelso recalls—I think it was in 1968—that OEO set up an employee stock ownership plan. That did not work, the company did not have good management. It had a bad marketing situation.

There are situations where I think it would be a mistake on everybody's part to suggest an ESOP.

Senator BAUCUS. There is no use setting up this arrangement up if Milwaukee is going down the tube anyway.

Mr. KELSO. That particular one was set up against our strenuous objections.

Senator BAUCUS. How do you put together a feasibility study? How do you put together a managerial team? Where do you begin?

Mr. KURLAND. The first place to begin is with existing management. Railroad X is a company that has certain services that are not operating profitably. The major company that owns railroad X wanted to eliminate the nonprofitable services. The overall operation is profitable.

What we are suggesting as the first approach is to try to deal within the existing management team. You deal first with the top, or you find——

Senator BAUCUS.You cannot do that in this case. The existing management want a bend in the railroad.

Mr. KURLAND.You necessarily have to put together the kind of entrepreneurial/management team that will have credibility with your lenders. You start with that. If you do not have that or can develop that, you might as well not get started.

As soon as you have a group together that you feel you can take to lenders and lenders will have confidence in, then the next thing to do, is to see what changes can be made in the operation and modernization of the facilities. Get the numbers for that.

I think one of the basic changes will be the negotiation of a new labor deal. The reason that South Bend Lathe became successful was that the money that was previously put into a conventional pension plan, that was causing the demise of the original division, was redirected and used for employee buyout purposes. In other words, unless we had the agreement of the local labor unions that they would terminate the old pension plan, South Bend Lathe could not have been saved. That step is not necessarily in all cases. I am not saying it is necessary in this case.

Mr. KELSO. It did not exist in this case.

Mr. KURLAND. In South Bend Lathe, you had to make a change. The change was that you had to redirect the money that was drained out through the traditional pension system. Those funds became the means by which the workers were able to buy out the company. Had you not done this, the lenders would not have come forward, with sufficeint capital credit to permit the employee buyout to occur.

Senator BAUCUS. You are suggesting, perhaps, that employee severance benefits might be a help.

Mr. KURLAND. It may or may not be necessary. Here's what we are doing with railroad X. We have suggested a number of changes that could increase the railroad's marketing potential. The CSOP is an effective incentive for restoring much of the markets that had been lost in recent years. Many of the customers had abandoned railroad X.

Senator BAUCUS. As I am sure you know, there is a fairly deep-rooted, reluctance on the part of unions and organized labor to participate in these kinds of programs. How do you handle that problem?

If I was a member or an officer of a union, I would look somewhat askance at these arrangements. Is that not a practical problem?

Mr. KURLAND. It has been an enormous problem. Before I joined with Mr. Kelso, I worked with Walter Reuther and so I have some sensitivity toward the feelings of organized labor toward these issues. I might add that I have also worked with the National Maritime Union. I would like to give you an example of the kind of trade-off that a national union is willing to undergo in times of stress. I think where you have a stress situation people are very, very creative, as they were in the South Bend Lathe case.

Shannon Wall, the president of the National Maritime Union, in order to save the last two passenger vessels on the west coast sent a letter to Secretary Krebs asking for 3 percent loan money for an ESOP to buy those vessels. He said, as a trade-off we will offer the following, and all we are looking for is the right entrepreneurial/management team that will accept these conditions.

Here is what they offered. It is in appendix A of my testimony.

They offered a no-strike agreement. They offered their willingness to change the work rules, to become much more flexible than they had been in the past. They agreed that they would cut the overall labor costs by 60 percent, in exchange for which——

Senator BAUCUS. Did they?

Mr. KURLAND. They were willing to, and they offered a 50-percent cut in labor costs to Senator Long back in 1972 to try to save the east coast passenger vessels through an ESOP. In 1978, the NMU offered a cut of 60 percent in labor costs.

No, that deal did not go through.

Mr. KELSO. They were proposing to buy five vessels.

Mr. KURLAND. They wanted to reorganize all of the passenger vessels on the east coast into a sort of a COMSAT type of corporation that would be owned by management and employees.

The important thing, the reason that I cite this, is to show that under crisis conditions, labor unions—when they see that you can offer them expanded ownership benefits, when their members can take their gains in new forms, in the form of stock and cash bonuses out of profits—can help turn the company around so that it can be profitable.

I have served companies that are generating some very substantial stock and cash bonus benefits through their ESOP program.

Senator BAUCUS. Did the employees individually purchase the stock, or did the unions participate as unions?

Mr. KURLAND. Neither. What is given to the employees is simply access to capital credit. Mr. Chairman, through which they can buy stock and pay for it out of the earnings of the underlying capital.

Senator BAUCUS. Have unions sometimes?

Mr. KURLAND. No, just individuals.

Senator BAUCUS. What about unions?

Mr. KURLAND. All the union does is become a facilitator, a catalyst, for helping to bring this about. They help to negotiate a new form of benefit program for their members.

The union itself does not own the stock. They simply bring it about so that their members can acquire the stock, so that their members can get the cash bonuses, productivity bonuses, and so that their members can get dividends flowing through the ESOP.

Mr. KELSO. The problem is to get the individual worker motivated, not to get his union motivated. Communal ownership might have exactly the reverse effect of what you are trying to inspire.

Here I think that the tradeoffs, on the one hand, are very valuable and, on the other hand, are rather harmless for business or labor to make. Needless to say, we have to pull together precise facts.

There are very sizable severance obligations. In waiving or subordinating those severance obligations to whatever debt is incurred to make a buyout feasible, workers are really subordinating obligations that will never be paid anyway, because they are going to keep their jobs.

The very object of the game is to keep the railroad running, keep the people employed, keep the shippers happy, and produce a competitive atmosphere for pricing purposes and in the public interest.

Mr. KURLAND. Senator Baucus, most of the American labor unions, wisely, I think, reject the idea that the union should get into a management position. It is terribly important that we keep the wall of separation between the labor union as an institution and management. I know George Meany has taken a very strong stand against codetermination in Germany, and I agree with him on this point. The approach that Mr. Kelso and I are advocating would not put the union into the kind of a conflict-of-interest that concerns Mr. Meany. Rather, all the ESOP would do is put the union in the position where they would begin bargaining for new forms of opportunities, new kinds of economic gains, rather than seeking gains out of the rigid wage system. In my view, the wage system is the cancer of the free enterprise system, in fact, is the cancer of every economy of the globe. What we are talking about, whether you are talking about the ESOP or the SSOP, is getting workers into an expanded ownership system.

Mr. KELSO. GSOP, or what have you.

Senator BAUCUS. There is some difference of opinion as to whether new legislation is needed for a Milwaukee SSOP. Could each of you very briefly outline what you think may or may not be needed in this case?

Mr. KELSO. I am not ready, Mr. Chairman, to make an absolutely definitive statement. My current belief is: To get to the pretax dollar, in a way in which the shipper can acquire stock on terms where it will pay for itself without his being required to pay taxes on something that he does not get any revenue from to pay taxes with, will require restoring, for the benefit of the corporation, the legislation that was destroyed by the majors after Valley Nitrogen Producers' enormous success in 1965. They simply came tearing back to Washington and closed that loophole—a loophole that enabled the little man to become a capital owner and for farmers to become capital owners.

Without careful and close analysis, I am not sure about the answer to your question. I do know that if the shippers were willing to take debt instruments, it probably could be done without legislation. If they wish equity stock, as the employees will get, my suspicions are that we will have to have some legislative changes.

Senator BAUCUS. Mr. Kurland?

Mr. KURLAND. As I said earlier, my legal counsel, the people I am associated with, feel that CSOP legislation is not absolutely necessary. We think it can be accomplished under existing law.

There are two tax incentives for a CSOP. One, we have to look at in terms of how you repay the debt. Well, the repayment of the debt will take the form of the use of patronage refunds, similar to a co-op. But any corporation can get a deduction for patronage refunds.

It is a legitimate business expense, and many of the co-ops do that.

Using that to service debt is also done with co-ops, and therefore we feel it can be done within a corporate form. But in any event, the CSOP could easily be structured as a co-op, if that was any problem.

Senator BAUCUS. As I listen to both of you and studied the basic market problems, it is obvious to me that we need some kind of miracle worker here. We need some man or woman with tremendous experience, imagination, and talent, with diplomatic skills and understanding of the political process, who can go to work in pulling all the loose ends and all the different, diverse statutes, and people who are necessary together to get this thing moving.

I would ask each of you by the end of June, if you could, to provide me and officers of any new Milwaukee organization with suggested names.

I am going to be making the same request of everyone else involved with the Milwaukee situation. Obviously, I cannot solve all the problems. I do not think you can. We need somebody to work full time on reorganizing the Milwaukee in the next 6 months who will be paid.

It is my understanding that various organizations have begun to raise the money now to pay the necessary fees to this person or persons.

If you could provide some names in the next week or so I would appreciate it.

Mr. KELSO. You are talking about an interim manager.

Senator BAUCUS. An interim manager who could put together the managerial team, the entrepreneurial team, and begin to make the applications that are necessary to and get the railroad back on the track.

Mr. KURLAND. Could I suggest that out of the banking world, as Ms. Singletary said, I think it is the key that we are able to have credibility with the ultimate lenders. It would be very important, in my view, that most of that funding come out of private banks, even though the Government can help stir that up.

I would turn to the leaders of the banking world who have already been financing railroads in the past and find, from within that world, the kind of people that they have faith in, that if credit was accessible, if the government said we will provide low-interest credit for a reorganized Milwaukee, they can say those people can run that railroad.

Senator BAUCUS. Thank you very much. You have been very helpful.

I appreciate your testimony.

Mr. KELSO. It was a pleasure being here.

Mr. KURLAND. Thank you.

[The prepared statements of Messrs. Kelso and Kurland follow:]

Statement of Norman G. Kurland

Mr. Chairman, it is a great privilege and personal honor for me to speak before this distinguished Committee. You, Mr. Chairman, are recognized as America's foremost champion of the Employee Stock Ownership Plan, or "ESOP". Millions of working Americans in over 2,000 companies now own a piece of their companies because of ESOP. But not many people realize how close the ESOP came to being prematurely buried when our nation's private retirement system was undergoing reform in 1974, before Senator Long came to the rescue. And today, of course, the ESOP is alive and kicking, with eight ESOP laws and several more in active gestation, thanks to the effective delivery skills of Senator Long.

And my pleasure at being here today is profoundly enhanced by being invited to serve on the same panel as Louis O. Kelso, the father of the ESOP concept and many other monumental and original contributions to human thought, which somehow I was unaware of before 1965. As my teacher for over eleven years, Louis Kelso has given me something for which I can never repay him, a solid understanding of his remarkable insight and conceptual framework for analyzing and solving some fundamental social and economic problems that previously seemed unsolvable. Mr. Kelso's theoretical breakthroughs, I predict, will someday earn him the Nobel Prize for Economics he so richly deserves. So as his former Washington Counsel and close associate, I am doubly honored to be here today.

I come here today as the head of a consulting firm that specializes in the design of ESOP's and other ownership-broadening vehicles of finance and as Chairman of the Ownership Campaign, representing thousands of working Americans who want to share a piece of the action in America's future. But I must confess at the outset that I come with no easy answers to the problem that precipitated these hearings, the threatened demise of close to 7,000 miles of track of the Milwaukee Road, for reasons that were eloquently prophesied by writers such as Ayn Rand in her angry novel, ATLAS SHRUGGED. As good as the ESOP is, it is no panacea and it is fruitless to apply it to basket cases. Not having access to the relevant facts before the Trustee in the present bankruptcy proceedings of the Milwaukee Road, such as the Booz-Allen study and the proposal of the Association to Save Our Railroad Employees (SORE) or any of the materials now being studied by the U.S. Department of Transportation, I have no way of evaluating whether the ESOP or a shipper ownership vehicle would work in this case. But some of my insights and experiences in approaching hardship situations similar to this one may be useful for guiding those who are trying to save the railroad. What makes the Milwaukee Road crisis historically relevant, however, is the united and enthusiastic willingness on the part of all the national railway labor leadership to experiment with the ESOP concept, a remarkable shift from the atmosphere of skepticism the ESOP had encountered, with few exceptions, among the leadership of the AFL-CIO when we first offered it in connection with the present Conrail system in 1974. So if in any way the ESOP can save the Milwaukee Road, it should be tried. With organized labor helping to shape the ESOP, the broad-based popular constituency will rapidly surface that the Chairman and other proponents of the ESOP have been trying to cultivate.

<u>Some Examples Relevant to the Milwaukee Road Crisis.</u>

In the face of the Milwaukee Road's current problems, it may be appropriate to refer back only five years ago when Senator Long first became an advocate of the ESOP concept. The setting was the Senate debates over the establishment of Conrail. Senator Long urged his colleagues to consider converting the failing northeast rail system into a 100 percent employee-owned private corporation through a leveraged ESOP, precisely the same formula that was later adopted by South Bend Lathe (with some last-minute help from Senator Long). The final Conrail legislation merely called for a study by the U.S. Railway Association of the ESOP. Such a radical departure from conventional methods for reorganizing a company was then too much to swallow, particularly by those with a vested interest in the traditional "wage system". But the advice Senator Long offered Conrail in 1973 is as timely today as it was then and should be heeded by every railroad facing a productivity crisis:

> . . .not having the same opportunities to accumulate growing ownership stakes as the few who own most of today's railroad stock, workers had no incentives to make the simple formula for profits work.
>
> The ESOP. . . would enable the entire railroad work force to purchase, as individuals, without savings newly issued common stock on credit tied to the capital requirements of the new system and secured by its future profits. Each worker would thus be placed in a position where his own efforts toward cost mini-

> mization and increased production would directly influence the size of his dividend checks and the value of the capital estate which he can acquire during his working lifetime. . . We can reasonably anticipate that strikes and slow-downs, antiquated work rules, featherbedding, resistance to automation, and unreasonable wage demands-- all seemingly unsolvable problems up to now-- would gradually disappear once workers are placed in a position to realize how these activities work against the interests of consumers as a whole, but also against their individual self interests. . . .But they must first be. . . given maximum incentives to make the system profitable.

While Conrail initially ignored Senator Long, to the growing anguish of American taxpayers, the employees of South Bend Lathe, Inc. followed his advice to the letter. The experience there, which is perhaps my proudest achievement to date, is now widely heralded as the classic case for saving jobs through an employee buyout, where 100 percent of the equity was acquired by an employees' trust representing 100 percent of the employees using 100 percent leveraged financing. No cash outlay on the part of any employee was required, since the buyout funding came wholly from private and public credit sources and was secured by the company's own assets and its projected stream of future profits. The point we proved is that access to capital credit is the key to restructuring future ownership patterns, even in a company that many of my associates treated like a hot potato because of what appeared to be five consecutive years of inadequate or no profits.

To understand why the ESOP worked in the South Bend Lathe case and why persons who tried to imitate it failed in their effort to save 5,000 jobs at the Youngstown Sheet & Tube Campbell Works, one has to recognize that a successful ESOP strategy involves a delicate blend of sound management principles with a radically new bargain with organized labor based on gradually shifting all interested parties from antagonistic and feudalistic "wage system" thinking, to synergistic "expanded ownership" thinking. Let's examine the history of South Bend Lathe to see what this means.

South Bend Lathe, founded in 1906 by two brothers, is a name synonomous with excellence among machine tool manufacturers. During the 1960's it was acquired as a division of Amsted Industries and moved with close to 500 employees into the former Studebaker car assembly plant in South Bend, Indiana. Because the name Studebaker represents a classic basket case in American industrial history, South Bend Lathe's turn-around becomes even more symbolic.

When U.S. machine tool sales began to decline in the early 1970's, South Bend's profits dropped to the point where the conglomerate Amsted began to think about selling the division. After a costly strike by its Steelworkers local, followed by an increase in wage and pension costs that Amsted considered prohibitive, followed by additional pension costs imposed by passage of ERISA, the decision was clear. When no buyer emerged, Amsted turned to the liquidators. And that's when the members of Steelworkers' Local 1722 and the management of South Bend Lathe heard about ESOP. They came to my office in Washington in February, 1975. Liquidators had offered $9.2 million for the property and equipment. Out of desperation, the workers were willing to take a 15 percent pay cut to match the purchase price. But that was insufficient and unnecessary. What was needed was four basic elements:

(1) A management/entrepreneurial team capable of competing in the global market place and commanding respect from the banking community, organized labor, and suppliers and customers. Dick Boulis, the president of the division for over ten years, and his top executives and sales force had these credentials.

(2) A detailed feasibility study of the company and its prospects for the future. A Booz-Allen study had already been performed, providing the solid foundation of facts upon which a creative ESOP reorganization strategy could be designed.

(3) A willingness on the part of organized labor to adopting an innovative productivity-oriented labor contract, based on sharing the ownership risks and future gains from the "ownership system", while holding the line on inflationary or non-productive "wage system" gains. As will be explained below, the flexibility of the workers and their capacity to bring unit labor costs to the level where the company could become cost-competitive in the global market place is generally the decisive factor in determining the feasibility of ESOP financing in a crisis situation.

(4) Access to sufficient capital credit, at reasonable rates to meet up to 100 percent of the capitalization needs of the company as an independent operating unit. Because of the U.S. Economic Development Administration's willingness to provide $5 million through a 3 percent, 25-year "soft" loan to an employees' trust to demonstrate the ESOP concept, two banks and a commercial lender provided the balance of $4.2 million (at much higher interest rates) to match the liquidator's offer of $9.2 million.

Within four months from the day they arrived at my office, South Bend Lathe became virtually an instant success story. Not only were 500 jobs saved. The company has become one of America's most renowned 100 percent employee-owned companies. A major key to this company's success was a radical and unprecedented overhaul of its labor agreement which substituted ownership benefits (stock accumulations, productivity bonus payments, and dividends) for traditional, costly, and rigid "wage system" benefits. Our analysts determined from the outset that the company could not be saved if it continued the costly pension plan negotiated between Amsted and the United Steelworkers Union. Upon closing the deal with Amsted, a new company was formed and Amsted terminated the old pension plan, insuring the older employees full pension benefits when they reached retirement age. But to save the company, the local union agreed to convert future employer contributions (which formerly represented pure cash drains out of the company to pension middlemen) into funds for paying off the loans to buy their own company. Since traditional pension benefits are staple items of every collective bargaining package, the workers' decision to drop the pension plan for those whose rights had not yet vested is probably unprecedented in labor circles. At South Bend Lathe, it was not a difficult dilemma: the workers saved their jobs and their future is now solidly invested in their own company. Most healthy companies, it should be noted, keep their pension plans when they adopt an ESOP.

Within a month after the employee buyout, production suddenly jumped 10% and expenses from poor workmanship plunged 70%. Within 22 months, all three private sector loans, totaling $4.2 million (one at 7% above the prime commercial rate, then 8%) have been fully repaid. The company is cash-rich and is seeking acquisitions. Major Chicago banks now come to the company offering prime rate loans. Since 1975, absenteeism and turnover rates have declined; productivity has improved; sales have increased 34%; the average employee's income has increased by 45%, including seven cash bonuses paid out of profits; earnings per share have more than tripled (from $20.30 to $69.48); the average ESOP account holds more than $6,000 in company stock; and the company contributes more than double the amount per worker to its ESOP than its competitors pay into their pension plans.

An intensive study by the Survey Research Center of the University of Michigan of South Bend's ownership sharing program was conducted about 18 months after the buyout. It concluded, "The most unequivocal support for the effectiveness of the plan comes from the employees themselves who indicate through interviews an unusually high level of morale, motivation, and commitment to the success of the company."

Not everything has gone smoothly at South Bend Lathe. While the program is still strongly supported by the Steelworkers' local at South Bend Lathe, national and regional USW officials do not share their enthusiasm, mainly because of the unprecedented pension plan decision. This problem could have been avoided had there been more active participation of USW leadership in the process of shaping South Bend Lathe's ESOP strategy. Fortunately for the Milwaukee Road, this will not be a problem here.

On a much smaller scale, the prime example of the new kind of "social contract" that organized labor must begin to negotiate with management can be found at Allied Plywood Corporation in Alexandria, Virginia. Few companies are as profitable or offer a more harmonious working environment than this 20-employee, 25-year old firm, which adopted an ESOP two years ago to enable the former owners to gradually sell their ownership interest to the other employees. Workers there are no longer part of the traditional "wage system." For the past two years, for example, an average truck driver who makes $8,000 in base wages made over three times that amount in "ownership system" gains, including over $17,000 in monthly and year-end cash bonuses and $7,000 in company stock each year, all out of profits. As you would imagine, productivity there is high, turnover is practically non-existent, and absenteeism averages less than two days per employee per year. Job security is enhanced there since even in the worst of months and worst of years, the worker-owners of Allied Plywood can tighten their belts and ride out the rough times together. Their monthly cash bonuses may be smaller or even non-existent, but their jobs and ownership stakes rest on more solid grounds than their competitors, whose workers remain shackled to the higher, more rigid, and less harmonious wage system. This is the ultimate promise the ESOP holds out to labor unions undergoing re-examination of their traditional strategies.

The most advanced labor deal ever offered by a national union, to my knowledge, was that offered by Shannon Wall, President of the National Maritime Union in March, 1978. (See appendix.) The NMU threw its weight behind an "ownership sharing" package, fashioned along the lines of the Allied Plywood model, to save the last two U.S. flag passenger vessels on the West Coast, but could not find the right management/entrepreneurial team to accept that offer. This points out the critical need for a top management team who are willing to share ownership opportunities with their non-management workers. As an associate of Mr. Kelso in 1972, I was retained by the NMU to try to save the East Coast passenger vessels. As Chairman Long, who then also chaired the Senate Maritime Affairs Subcommittee, will recall, even he was skeptical of the NMU's last-minute ESOP proposal in 1972. But that was before Mr. Kelso and I spent four hours with him on November 27, 1973 to convince him to join four other Senators on the ESOP proposal I designed to convert Conrail into a 100 percent employee-owned railroad. The rest is history.

The example most relevant to that of the Milwaukee Road crisis involves a client who I cannot identify at the moment. My firm has been retained under contract with a public agency to study the feasibility of designing a buyout program for the employees and customers of a railroad in a somewhat similar financial condition as the Milwaukee Road, which I will call "Railroad X". The considerable work we have already done for this client will certainly be useful to those trying to save the Milwaukee Road. I am pleased to report that our client has approved our work and analysis but is not yet ready to approach the company or unions, pending other sensitive negotiations. But within the next sixty days, I think this project will generate much excitement and discussion.

Railroad X has been deteriorating for years. It has standard contracts with the major railway labor unions. While some of its operations are still profitable, others have been losing money and require continuing subsidies. Proposition 13 fever makes those subsidies extremely vulnerable and Railroad X management continually threatens to abandon these services, assuming they can get ICC approval. Working with one of the top financial consultants in the railroad industry, our firm has determined that the situation is destined to go from bad to worse.

We studied various ownership management schemes to save Railroad X, including public ownership. We studied the capital improvements needed to improve services and the various public and private sources for funding these needs. We studied the competition and the political realities affecting the future of Railroad X, including the impact on the communities it served. We looked into the severance pay problem. We developed several estimates of the value of the company for buyout purposes. The numbers developed by the railroad consultant suggested that any of the conventional ownership/management schemes, even after the capital improvements were in place, would not save the railroad, unless subsidies were increased beyond our estimates of politically acceptable levels. The only difference between the various alternatives we studied was not whether the railroad would collapse, but when.

The only feasible option developed by the rail consultant I worked with (I regret he could not join me today because his identity would expose our conclusions prematurely to Railroad X) was a unique combination of an Employee Stock Ownership Plan and Customer Stock Ownership Plan or "CSOP". (There is no practical difference between a Shippers Stock Ownership Plan and a Customer Stock Ownership Plan that I can detect.) By enabling the employees to combine with the regular customers to buy the controlling interest in Railroad X, the numbers suggested that the capital improvements could be financed and the threatened services could be restored and dramatically improved over time. But even more importantly, the figures showed that this could be done profitably, with subsidy levels gradually reduced and then eliminated over an eleven-year period. Railroad X could then become a tax contributor instead of a tax burden.

<u>The Plan for Saving Railroad X Through a Buyout by its Employees and Customers.</u>

In analyzing the problems of Railroad X, we posed several questions to ourselves.

Under extremely adverse economic conditions, is there any solution to the structural problems facing our free enterprise system? Is there a way to hold controllable costs in check and still accelerate productivity and capital growth of the private sector, while spreading equitably and efficiently the fruits of private enterprise? Is there a way to restore competitive market forces, so that the laws of supply and demand can replace rule by clout in securing economic values? Is there a way to begin to cut the need for subsidies, to infuse new private and public sector funding into modernizing a privately-owned and managed rail system, to motivate employees and their unions to raise productivity and hold down labor costs, to create a new unity of interest between railroad management, owners, employees, their union representatives, and bankers?

An answer suggested itself. It works because it would be directed to the self-interests of all the parties. Although it has never been tried to save a railroad, we thought it would work with Railroad X. And we felt certain it would not require any additional Congressional legislation. With appropriate administrative interpretation, it could be accomplished all within existing laws and with existing resources.

The key concept is ownership sharing, a tradition as deeply imbedded in the fabric of America as our democratic political ideals. In fact, many would argue, as did Jefferson and Adams, that our political ideals can never be realized without a democratization of ownership of productive property. Ownership sharing today need not involve taking property away from anyone. Rather, it depends primarily on future gains and equitable sharing of future ownership opportunities.

In the case of Railroad X, an ownership sharing strategy would rest on three legs: an Employee Stock Ownership Plan, or "ESOP", a Customer Stock Ownership Plan, or "CSOP", and an adjustment of labor understandings that would substitute higher gains from expanding ownership benefits for more costly traditional labor benefits. The new bargain would not require reductions in previous wage and benefit levels,although this could be left to negotiation. It would offer the many unions in the picture a new way to get "more and more", in the words of Samuel Gompers. Future increases, coming in the form of cash bonuses and equity sharing, would be ~~linked~~ directly with profit increases of the company.

Let us here turn to the first leg of the stool, the ESOP, and its potential benefits to Railroad X, its employees, the various unions who negotiate with its management, and bankers who make loans to help meet its capital budget requirements.

<u>What is an ESOP?</u>

In formal legal terms an Employee Stock Ownership Plan is an employee benefit plan which is "qualified" under Section 401(a) of the Internal Revenue Code. It usually uses a stock bonus plan as its core element, but it may be combined with a money purchase plan and even a profit sharing plan to increase its flexibility. Because of its potential for strengthening the free enterprise system, Congress has given ESOP's some special incentives not available to other benefit plans.

An ESOP is an instrument designed to lift all workers of a company out of the traditional wage system, into a system of ownership sharing. By creating a direct proprietary interest among all workers individually in ownership concerns such as capital formation, productivity and corporate profits, an ESOP goes well beyond most profit sharing programs. And it builds a direct ownership stake in each worker, in sharp contrast to the remote "collective" interest of workers in most pension and profit sharing plans.

An ESOP combines many elements into a single package. It is an employee benefit program. It is an incentive and productivity program for all employees. It is a retirement program. It is a reward system, working best when a modest base salary is supplemented with cash bonuses and equity shares, linked to the proceeds of operations. It is a two-way accountability and communications system between management and non-management employees. It is a means for workers to participate as stockholders in corporate direction. It is an in-house tax-exempt stock exchange, for both new equity issuances and repurchase of outstanding shares. It is a tax-deferred means for workers to accumulate equity. It can offer workers a source of current dividend incomes. An ESOP is all of these and more; but one of its most unique features is that it is a basic innovation in corporate finance.

An ESOP is the only tool in the world of investment finance that can generate new sources of capital credit for corporate growth or transfers of ownership, insulate its eventual owners from direct personal risk in the event of default, and allow repayment of its entire debt in pre-tax corporate dollars. The so-called leveraged ESOP works on forward credit, secured by and repaid from future profits. Whereas traditional uses of leveraged corporate credit work only for present owners, the ESOP uses credit for the benefit of employee-stockholders.

How Does an ESOP Work?

A company sets up a "qualified" ESOP trust. The primary purpose of the trust is to acquire stock of an employer as "deferred compensation" for the benefit of all employees. No cash is required on the part of employees to become owners. They in effect "earn" their ownership rights when their employer contributes company stock to the trust or cash to buy company stock.

Where a large block of stock is to be purchased for employees from present owners or as stock newly issued for capital expansion, the trust can borrow funds for stock purchase, creating a leveraged ESOP.

Assume the company needs $1 million for new plant and equipment and has a bank willing to extend it credit of that amount. Models I and II in the diagram appearing on the following page show graphically the difference between conventional debt financing and ESOP financing.

If a company borrowed $1 million directly, it has to earn $2 million, of which it must pay $1 million in corpporate taxes (assuming a federal and state marginal tax rate of 50%) and $1 million to the bank to repay the loan principal. Interest, not principal, is normally tax deductible.

Instead of borrowing directly, the company has the ESOP trust borrow $1 million on behalf of all employees. The trust invests $1 million in the company. In exchange, the company issues $1 million worth of stock to the trust and invests the proceeds in plant expansion.

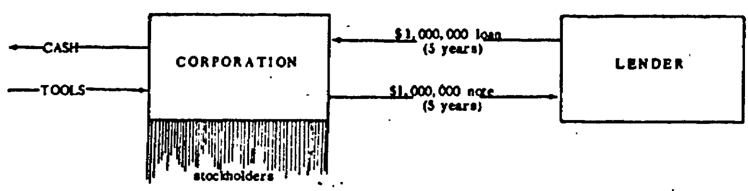
The stock, of course, is not distributed immediately. It is first held in an "unallocated account". Stock becomes allocated to individual accounts only as the loan is repaid. Actual distribution of shares is generally postponed until the employee retires.

The real security behind the loan to the trust, however, is the same as under any conventional loan: that is, the general credit and the capacity of the company's management and non-management employees to generate future profits. Under a leveraged ESOP, the bank will not only require traditional forms of security for the loan but also a guarantee that the company will synchronize its future cash contributions to the trust in amounts sufficient to repay the trust's outstanding debt obligations. Without these cash payments, the ESOP won't work. But by repaying the capital credit through an ESOP trust, the company improves its cash position. Why?

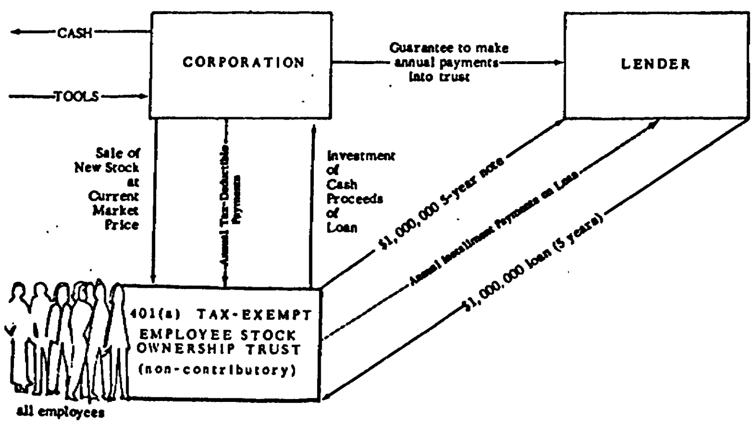
By servicing the capital expansion debt with the company's cash contributions to the trust, the loan is repaid in pre-tax dollars. Up to certain limits a contribution to a qualified trust is tax-deductible. Thus, the company no longer has to earn $2 million to repay the bank, making it a far more serviceable loan. And the tax deduction of $1 million produces $500,000 in extra tax savings for the company compared to a straight loan.

How much more cash savings will result from increasing labor productivity associated with employee ownership will vary from company to company. But studies show a positive relationship between profitability and the extent of company stock held be employees.

MODEL I
CONVENTIONAL CORPORATE FINANCE



MODEL II
EMPLOYEE STOCK OWNERSHIP FINANCING



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There is an additional savings to the company: the same dollar spent for the company's new plant and equipment creates an additional dollar for raising employee benefits. In contrast to the traditional "wage system" forms of employee benefits -- which are wholly cash drains on the company, never help meet the company's own capital requirements, and have no direct influence on labor productivity -- ESOP benefits enable workers to join the "ownership system".

What is a CSOP?

A CSOP is a flexible tool, aimed at enabling all regular customers of a highly capital intensive enterprise like a railroad or utility to become owners on a systematic and equitable basis, so that they can participate as stockholders in the decision-making and fruits of the enterprise. Eligibility and many other details in developing and operating the CSOP would have to be worked out in advance. Like the ESOP it depends on access to capital credit. And how the ownership pie should be divided among employees and customers is a vital issue to be discussed below.

A trust would be set up, with individual stock accounts for each customer tied to monthly billing accounts. It would be empowered to borrow from public and private sources, use the funds to buy company shares, allocate shares to each customer's account, receive tax-deductible patronage refunds from the company in the form of cash or company stock, and repay any debt of the CSOP with pre-tax corporate dollars. The CSOP could acquire stock in one of three ways, as a leveraged CSOP, unleveraged CSOP, or contributory CSOP.

The Leveraged CSOP

Under a leveraged CSOP the trust would borrow money to invest either in outstanding stock (held now by other stockholders) or to buy newly-issued or treasury stock directly from the company. As in a direct loan to the company, the CSOP's loan would be secured by a binding commitment by the company to pay out of its pre-tax net profits sufficient patronage refunds to customers participating in the CSOP program to enable the CSOP to repay its stock acquisition loan. The company's commitment to make patronage refunds would normally be backed up by the general credit of the railroad, generally taking the form of a corporate guarantee of the trust's loan obligation and, in some cases, reinforced by a pledge of other railroad assets.

The loan would be without recourse to the CSOP beneficiaries, thereby insulating them from personal liability in the event of default on the loan.

The CSOP loan would be repaid out of pre-tax corporate net earnings, distributed in the form of patronage refunds. Under the Federal tax laws, patronage refunds made by a corporation to its customers are tax-deductible business expenses, the same as contributions an employer makes to a qualified ESOP. The patronage refund payments to the trust would be synchronized with the debt service obligations of the leveraged CSOP. Thus, a leveraged CSOP would have the same financing advantage as a leveraged ESOP, attracting external credit repayable with pre-tax dollars.

The entire block of stock acquired with the proceeds of a loan would first be held in an unallocated account in the CSOP until the shares were paid for. As the loan was repaid shares would be released in equal installments and allocated among the CSOP accounts of individual participants. A major advantage of the leveraged CSOP is that the customers gain control of a sizeable block of stock as well as the material advantage of capturing any appreciation of value of the stock over the repayment period. This generates an immediate and risk-free advantage to attract new customers, with a built-in proprietary stake for every participant to continue and urge others to begin patronizing the system.

The Unleveraged CSOP

In an unleveraged CSOP, credit is not used for acquiring company stock. The railroad can contribute either stock or cash as patronage refunds out of pre-tax profits. Because a stock contribution is a non-cash expense for tax purposes, this further improves the cash flow position of the company by the full amount of the refund. Patronage refunds taking the form of cash can be used to make quarterly, semi-annual, or annual purchases of outstanding stock from other outside stockholders, including the company's ESOP. The disadvantage of the unleveraged CSOP is that the initial overall equity stake held out to railroad customers may be too small to capture the attention of potential customers and attract them away from competitive modes of transportation. Also, CSOP participants would lose any appreciation of equity values that they might have gained from the larger block of shares that they could purchase under a leveraged CSOP.

The Contributory CSOP

Neither the leveraged nor the unleveraged CSOP requires any cash outlays by the railroad user, other than the normal charges for rail services. A portion of the buyout price of stock could conceivably be met by offering customers an opportunity to buy shares with cash, directly or through a contributory CSOP. A disadvantage of this approach is that it involves a "sale" of securities and thus imposes normally costly registration and legal fees of a public stock offering. Where stock is acquired under a "patronage refund" program aimed basically at increasing revenues, customer base, and profitability of a company, a "sale" is not involved.

Another disadvantage of the contributory approach is that many of the potential users may be unwilling to risk what limited savings they have in an industry whose securities over the last several decades have lost their "blue chip" status. Without doubt, the advantages of almost universal participation in ownership that can be spread among all present and potential users of the system would be lost to the extent that rail customers would have to find cash to buy stock in the South Shore. Besides, to the extent that the profitability of the overall system improves, such cash outlays may be unnecessary. CSOP shares, if properly financed, should and can pay for themselves wholly out of future profits.

Formula for Allocating CSOP Shares

The allocation of shares acquired by the CSOP should be rather simple, especially if integrated into a system of computerized monthly billings, as in most utilities.

Shares acquired by the CSOP would be allocated to individual CSOP accounts based on each participant's relative use of the railroad's service. This is an easy operation for a computer to tabulate. The results can appear directly on each customer's monthly bill.

The trust would hold regular voting common stock of the railroad. It would, however, be "restricted stock", subject to a right of first refusal in order to allow the CSOP, the Company or the ESOP to purchase the stock at the same price offered by any third party buyer.

The Issue of "Control" in an ESOP/CSOP Owned Company: A Delicate but Manageable Problem.

Who gets how many shares and who votes those shares is always an issue in a leveraged buyout. This problem becomes slightly more complicated when an ESOP is coupled with a CSOP.

Today's laws are extremely flexible for resolving this problem, thus permitting all the parties having a vested interest at stake to work out a solution tailored to their own competing interests. Some companies pass the voting power on stock held by the ESOP Trustees to the employees. Others do not, figuring that the Trustees are legally bound to vote in the best interest of the ESOP beneficiaries, a paternalistic but certainly an understandable mindset within today's feudalistic "wage system". Since I believe it eventually will work itself out, in most cases I would not force this issue. A giant step toward full ownership is better than no step at all.

In a crisis situation, however, I feel that a voting passthrough on all allocated and vested stock will help unite all parties and increase trust and confidence between management and the new owners to whom they should be accountable. The South Bend Lathe ESOP passed through the vote, for example, and it seems to be working well, despite the fact that the non-management workers are still represented by the United Steelworkers. Two-way communications are improved by the voting pass-through.

Under a leveraged ESOP or CSOP, the creditors have a major voice in resolving this issue. It is their funds, after all, that are at risk. The initial block of stock will either be pledged as collateral on the trust's debt or it will be held in an "unallocated account" until the stock is paid for. Although the control issue is negotiable, the creditors usually place enormous power in the hands of the new management team during the loan repayment period. For without a management team that inspires confidence in the the lenders, no loan would be made to initiate the ESOP or CSOP.

So even if voting power is initially controlled by top management, they remain subject to oversight and accountability to all affected parties, including the unions and the workers. Then as the stock is allocated and vested, the vote also can be passed through.

To label employee-stockholders as "amateur managers", as some ESOP proponents do, confuses this highly complex issue. Certainly there is a valid distinction between "ownership" and "management". Granted, not all stockholders are qualified to manage a company. But it is unjustified to treat mature individuals who acquire ownership under an ESOP or CSOP as "second-class stockholders." It is demeaning. And it is inconsistent with the basic premises of a democratic society. To hold otherwise, one would have to argue that the ballot should be denied to anyone not qualified to hold public office. It misses the basic point about democracy and reflects a lack of faith in the capacity of rank and file people to defend their own interests.

The owners of ESOP and CSOP held stock should therefore have the same kinds of information, voting privileges, access to stockholders meetings, and other ownership powers that are enjoyed by other shareholders. To build in checks and balances and some continuity of management policy, a staggered-term board of directors is probably desirable in making a transition from a highly centralized ownership structure like the railroad today to one where ownership is being systematically broadened through ESOP/CSOP mechanisms.

Productivity Implications

In a recent study completed by the Select Committee on Small Business of the U.S. Senate, entitled "The Role of the Federal Government and Employee Ownership of Business", January 29, 1979, the Committee concluded:

> Employee ownership of companies has worked. The Overwhelming preponderance of evidence shows that employee owned firms are both more profitable and productive than conventional firms and that employee ownership results in better working conditions for everyone. Most importantly, where employees have bought their companies, it results in the preservation of jobs that would otherwise be lost.
>
> In a study in the plywood industry, . . . employee owned firms had 30 percent higher productivity and 25 percent higher wages than conventional firms. . . In the Survey Research Center (of the University of Michigan) Study of 100 employee-owned firms, profits were 1.5 times higher in employee-owned firms than non-employee-owned firms, and the greater the equity owned by employees, the higher the profits. . . Managers surveyed in the study reported much higher levels of employee satisfaction with employee ownership compared to the prior conventional ownership of their companies. They also contended that employee ownership improved productivity and work atmosphere.

Some additional evidence of the productivity impact of a well-designed ESOP was given to the Senate Finance Committee in its July 19-20, 1978 hearings on ESOPs and General Stock Ownership Plans (GSOPs).

For example, a spokesman for Lowe's Companies, Inc., a building materials retailer with over 4,000 employees, credited his company's ESOP for the following advantages Lowe's enjoyed over the top five non-food retailers in the country:

> The range of the top five retailers, according to Fortune Magazine ranges from $25,000 sales per year to $49,000 sales per year. Last year, the average Lowe's employee accounted for $123,000 in sales per year.
>
> In terms of net profit before tax per employee, the five leading retailers ranged from $1,000 per employee to about $3,500 per employee. Lowe's last year was $8,800 net profit, before tax, per employee.

E-Systems, Inc., an electronics manufacturer with over 9,000 employees, told the Joint Economic Committee on December 12, 1975 of its experiences during the three years following its adoption of an ESOP:

> Employee turnover has declined 50%. . . Our absenteeism has declined. . .suggestions submitted have increased 140 percent with a marked increase in suggestions regarding cost and waste reduction and efficiency improvements . . . sales are up 30 percent and profits are up more than 60 percent. . . union grievances have declined. There seems to be an attitude of mutual problem solving rather than certain groups within the company taking adversary roles as has sometimes occurred in the past. . . this improvement certainly cannot be totally attributable to our ESOP but we feel that it was a major contributor; however, the real, more significant benefits. . . are expected to occur over the long-term future of the plan as it gains momentum, because that is the purpose of ESOP.

The Profit Sharing Research Foundation of Evanston, Ill. has also concluded that companies that are substantially owned by their employees out-perform their competitors as measured by return on sales and return on stockholders' equity. The PSRF explains:

> It makes sense that employees, individually and as a team, will more likely strive for excellence -- if they have a direct stake in the results.

The Role of Labor Unions in Employee-Owned Companies.

Some of the more visionary leaders of the American labor movement, like the late Walter Reuther of the United Auto Workers (whom I was once privileged to work with as the Director of Planning of a national coalition group he chaired), Shannon Wall of the National Maritime Union, and Glen Watts of the Communications Workers, have recognized employee stock ownership as the next step forward toward the goals of industrial democracy and as a natural and healthy means of revitalizing the democratic trade union movement. Even the former head of the leftist-oriented West Coast Longshoremen's union, Harry Bridges, has approved this concept as a way of ending the class struggle between labor and capital.

C. L. Dennis, former President of the Brotherhood of Railway and Airline Clerks, an AFL-CIO organization representing about one-third of the union members affected by Conrail, is an enthusiastic supporter of employee stock ownership. When a group of employees purchased the Chicago & Northwestern Railway, Mr. Dennis sent this message to the WALL STREET JOURNAL:

> "In my opinion, the effort of the employe group is one of the most refreshing ideas to come down the tracks in a long, long time. Employe ownership, it seems to me, has much to offer in strengthening our railroad system in the areas of labor-management relations, and of giving the employes the opportunity to participate in a more meaningful way in the fruits of the capitalistic system. Certainly, it is an encouraging development in the midst of talks about nationalization of railroads, which I think is misguided and unfortunate.
>
> "In short, here's a new idea, a fresh approach that deserves to be tried. If it works, and I believe it will, everyone--the workers, the industry, and, most importantly, the general public--will be the winners. And isn't that, after all, what capitalism and free enterprise are all about?"

Other labor leaders have viewed the ESOP with greater skepticism. Some have suggested that it threatens the union as a basic institution within a democratic society. In asking the question, "How can we bargain with ourselves?", they force to the surface one of the most difficult issues to be faced by a worker-owned company where the workers already have a union or are in the process of forming one: What is the role of the union vis-a-vis management in such a company?

As I have pointed out in some of my writings, if we did not have unions within modern industrial economies, we would have to invent them. Ideally, in worker-owned firms, the institutional functions of a union and the institutional functions of management should, to the maximum feasible extent, be clearly delineated and separated by a jurisdictional "wall of separation". This is somewhat analogous conceptually to the separation-of-powers and "creative tensions" that were deliberately erected between the executive, judicial and legislative branches of the Federal Government and between the Federal and State governments, as functional power centers, by the geniuses that created the U.S. Constitution. As under the 9th and 10th amendments of the Constitution, this separation of power at the institutional levels of a corporation is intended to try to guarantee that the ultimate source of power remains with "We the people" and that "individual sovereignty" is the ultimate check on the natural abuses of concentrated power. Hence, within a worker-owned corporation, a union, as a highly specialized "social tool", should avoid crossing the jurisdictional boundary between it and management, which in the power distribution system of a corporation also plays a highly specialized and critical role.

When an individual worker wears his "stockholder hat", he is involved in the management (or control) side of an enterprise and delegates his powers through his representatives on the board of directors to hired management, whose primary function is to make the day-to-day operational decisions aimed at maximizing corporate profits. When that same worker wears his "union member hat" he delegates his power to an association specially designed to promote his interest as a worker and to handle his personal grievances vis-a-vis management. If his union representative steps over to management's side, an immediate conflict-of-interest results at the institutional level: Each worker, particularly if he is a person known for novel or dissident ideas, will no longer have an effective advocate for protecting his individual rights as a worker. If he is fired by management without just cause, who will be there to protect his rights?

Once we separate out the legitimate role of management from that of the labor union, the dilemma expressed earlier by skeptical union leaders can be resolved. When a union leader thinks he has the skills to become a manager and thinks that the workers, wearing their "stockholder hats", will entrust their stake in property and profits to his "control", he can resign his union post and compete for a management job or a seat on the company's board of directors. If the workers feel that he has greater skills as a labor representative than as a manager, he will be rejected by the stockholders and may seek to be re-appointed to his union post. In this way, the workers themselves, as the persons most directly affected, can resolve the conflict, by weighing their competing self-interests in the outcome. In this way also, the labor union can continue to play an independent and constructive role within worker-owned firms and in so doing avoid the confusion and turmoil experienced in German and Scandinavian co-determination schemes (where union leaders are arbitrarily placed on management boards and ownership rights are not provided to the workers themselves).

Most of the U.S. labor leaders I have spoken to on this subject agree with the approach outlined above. This protects the institution of the union, while offering it many new and challenging issues to bargain over in the future. Many of them also recognize the limitations of the present "wage system" and seem prepared to take the leap into a "planned ownership system", where at least on some issues -- productivity, new capital formation, maximizing profits, seeking new markets, and ownership sharing -- they can finally begin to meet management on some common grounds.

An interesting side-note in terms of focusing the union officials on new ownership goals is that through an ESOP strategy, a new incentive system can be automatically developed for the union officials themselves. For example, the union can add a "check-off" on capital to supplement their traditional "check-off" on the labor earnings of their members. Then the revenue picture of the union will begin to reflect the fundamental new turn in labor/management relations that the ESOP offers. Thus, ownership sharing might become the key to working out a new "social contract" between labor and capital that could prove beneficial to a company, an industry, and to the general economy.

Under the ESOP, there will be a major structural advance in the evolutionary development of the business corporation as a social institution. It will similarly produce important advances in the democratic labor union as a social institution. They are both in primitive stages of their evolutionary development, and as a consequence, society is suffering and the economy is not working right. Reluctantly, those who view the future through a rear-view mirror may, by force of today's crisis of U.S. industry, have to learn new ways. They will have nothing to lose but their complacency.

Perry Prentice of TIME, Inc. observed:

> "Business and labor are both in the same boat and it is almost suicidal for workers to think they can prosper by making it less profitable (or completely unprofitable) to employ them. The most glaring example of this kind of suicide is the Maritime union which was so successful in getting all the wage increases it demanded that the American flag vanished from the seven seas. . . . Railroad labor has been almost equally successful in pricing itself out of the market. . . .
>
> "Admittedly these may be extreme examples of labor pricing itself out of work, but union leaders would be wise to recognize before it is too late that they are harnessing the profit motive to disemployment when they force wage increases far in excess of productivity gains. . . .
>
> ". . .[S]uccess will depend on . . .every worker

> (realizing) that his own bread is richly buttered on the same side as his employer's and will have a maximum incentive to maximize productivity and minimize waste in order to increase his own income."

Of course, the ESOP creates its own unique set of problems to be coped with, both by management and unions. But at least it offers the democratic trade union movement a new frontier to conquer, one beyond the limited horizons of the outdated "wage system" and a whole new set of benefits to bargain over on behalf of today's propertyless workers. Viewed in its broadest perspective, a union has little to lose and literally eveything to gain in terms of future ownership opportunities for its membership.

Conclusion.

Perhaps there is not enough time to save the Milwaukee Road. Perhaps this will be just another case where the patient's cancer was left undetected and untreated until too late. If so, there will certainly be more cases like this in the future. We will therefore all be the wiser if we learn something from this sorry situation.

But then again, there may still be hope for the new therapy being proposed by Mr. Kelso and me.

In large measure, Congress holds the key as to whether we will act boldly and expeditiously in the present crisis, or whether we wait for the next victim of our seriously defective economic policies. Again, let us heed the wisdom of the Chairman of this Committee in a situation similar to this one.

In his floor statment of December 11, 1973, Senator Russell B. Long clearly outlined the choices available to Congress and the USRA in designing the financial architecture of the new regional rail system:

> "What an irony of history that our railroads -- the key to the rise of America to industrial and agricultural greatness, and now even more vital to the development of a freer, more prosperous, and more environmentally hospitable economy yet to be built -- took the wrong turn over a century ago, leading the rest of American industry headlong into pinnacle ownership, the concentrated ownership of capital.
>
> "Our railroads today have been the first to arrive at

a deadend in that road. We, the members of this Congress, more than a century later, are now given a second opportunity to provide a prototype design for the pattern of ownership of the American economy.

"We could take the first course and further exacerbate the already intensely concentrated ownership of productive capital in the American economy.

"Or we could join the rest of the world by taking the second path, that of nationalization.

"Or we can take the third road, establishing policies to diffuse capital ownership broadly, so that many individuals, particularly productive workers, can participate as owners of industrial capital.

"Mr. President, the choice is ours. There is no way to to avoid this decision. Non-action is a political decision in favor of continued, and indeed increased, concentrated ownership of productive capital.

"Which of these three ownership alternatives make the most common sense, the most political sense, the most social sense, indeed, the most moral sense?"

APPENDIX A

National Maritime Union of America

Affiliated with: The American Federation of Labor and Congress of Industrial Organizations
AFL-CIO Maritime Committee
International Transportworkers Federation

National Headquarters:
346 West 17th Street, New York, N.Y. 10011 · (212) 924-3900
Cable Address: ENEMU, N.Y.

Affiliates: United Marine Division / Brotherhood of Marine Officers / Boat Builders & Marine Employees Union

Office of the President

March 16, 1978

The Honorable Juanita M. Kreps
Secretary of Commerce
14th and Constitution Avenue, N.W.
Washington, D.C. 20230

Dear Madam Secretary:

I look forward to meeting with you the week of March 20. The importance and urgency of the subject matter for discussion prompts me to provide you with some advance information for your study and consideration.

We urgently request that the EDA, under its economic development program, make available for the acquisition and operation of two passenger vessels, a Title IX loan of six million dollars at three percent interest rate for eight years and a four million dollar Title II loan guaranty or lease guaranty with an employee stock ownership trust to provide majority ownership by the employees.

Such loan and loan guaranty would provide direct employment to about 600 seafarers and the attendant multiplier effect could reach as high as 1,800 jobs in Hawaii and on the west coast of the United States. It is estimated that almost 75 percent of such jobs would be filled by minorities.

The NMU is prepared to assist in raising through private sector sources four million dollars under Title II loan or lease guaranties. A company, Trans-Pacific Cruise Corporation, has already invested $840,000 on research, development and promotion of passenger ship operations on the west coast and Hawaii. At the same time the NMU has expended more than $100,000 on its own research to determine the economic viability of passenger ship operations in the domestic trade of the United States and how to utilize the Employee Stock Ownership Trust in collective bargaining to realize capital accumulation by NMU membership.

The Hon. Juanita Kreps March 16, 1978

The NMU has developed a dramatic and far reaching collective bargaining approach to passenger ship operations to prove its dedication, commitment and willingness to make the necessary sacrifices to ensure an economically viable operation as follows:

1] An ongoing no strike provision.

2] Crew reductions and labor cost reductions of up to 60 percent with requisite work rule changes.

3] Reduction in existing wage scales and fringe benefits.

4] Wage scales to be subject to reductions in the event of non-profitable operations and increases with negotiated cash bonuses if profitable in conjunction with employee ownership and capital accumulation.

5] The application of ESOT concept of employee ownership as trade-off for certain of the contract efficiencies and cost reductions. Our research shows that a heavily subsidized operation, which proved to be economically non-viable in the past, can be turned around to a successful operation without subsidy through ESOT trade-offs.

The NMU favors low interest credit rates for capital formation and to achieve broader capital ownership for employees as promoted by the Joint Economic Committee in its 1976 Annual Report.

The National Maritime Union has exerted every effort to revitalize passenger ship operations under the American Flag. We earnestly request equal government support to carry out the mandate of the Congress of the United States to foster the development and encourage the maintenance of an adequate and well balanced merchant marine to promote the Commerce of the United States, and to aid in the national defense. The time is right and the current availability of two passenger ships, the Mariposa and the Monterey currently owned by the Pacific Far East Lines, require swift and affirmative action by the administration to keep these vessels operating without recourse to subsidization.

Your prompt cooperation in this request is greatly appreciated.

Sincerely,

Shannon J. Wall

Shannon J. Wall
President

SJW/jlk

cc: President Carter

APPENDIX B

A TWO-TIERED FEDERAL RESERVE DISCOUNT RATE POLICY: A NEW SOURCE OF LOW-INTEREST BANK LOANS TO MEET THE PRODUCTIVE CREDIT NEEDS OF AMERICAN FARMERS

The Problem. As a major weapon in their gameplan to curb inflation, particularly that caused by excessive consumer spending, the Carter Administration and the Federal Reserve System have indiscriminately raised interest costs across-the-board. Today, national interest rate policy makes no distinction between production credit and consumer credit. Yet, production credit affects only the supply of marketable goods and services; and consumer credit, aimed solely at the demand side of the economic equation, helps increase purchasing power whether or not there is an increase in marketable goods and services. This across-the-board, non-selective interest rate policy makes neither political nor economic sense. It is counter-productive, and, in fact, helps fuel inflation.

Farmers in particular are hurt by this lack of selectivity in setting interest rates for supply-oriented credit. Already weakened by rising property taxes and inflationary prices for their energy, fertilizer, machinery, land and other costs of production, the farmer's ability to survive is further threatened by interest rates of about 12 percent for commodity loans and up to 18 percent for machinery loans. These high interest costs for producing farm commodities drain off dollars needed by farmers to remain economically viable. These high interest costs must also be passed on to housewives in the form of higher grocery costs. The net impact of high interest costs for production credit is more farm bankruptcies, more land is taken out of production and an escalating risk of eventual shortages of farm commodities. Thus, the secondary impact of high interest rates to farmers is reduced supply and therefore more, not less, inflation.

The Solution. The Federal Reserve System, using its existing statutory powers under Section 12, Paragraph 2 of the Federal Reserve Act of 1913, should establish a two-tiered Federal Reserve discount policy. Reserve Banks would reduce their discount rates selectively to 0.5 percent or less to its member banks. Local commercial banks serving farmers could in turn make production loans to farmers at the "true cost" of capital credit, around 3 percent rather than at today's prime rates of 11.5 percent and higher.

The floor on all interest costs is the Federal Reserve discount rate, which is set by Federal Reserve Banks. Today the discount rate is 9.5 percent. Adding in the risk of default and profits for lending institutions, another 2 percent, brings the effective prime rate (the cost commercial banks charge their best customers) to 11.5 percent. Today's high interest rates merely reflect what bankers must pay under the present single-tier interest rate policy for using "other people's money." It reflects the market cost of money borrowed from American and foreign savers. But accumulated savings is not the sole source of credit within an advanced monetary system.

A second source of credit is known as "pure credit," which is the essence of a central banking system. Under Section 12, paragraph 2 of the Federal Reserve Act of 1913, Federal Reserve Banks are empowered to discount "eligible commercial, industrial and agricultural paper," as defined by the Federal Reserve. This second source of credit and money-creation involves the sale of "eligible paper" to a Reserve Bank from a member bank.

At one time discounts were a much more important tool of the Federal Reserve's money-creating policies. In fact, this method was originally viewed as the basic means by which the Federal Reserve System would lubricate the expansion of American agriculture, commercial and industrial development. This power has not been exercised for decades. A two-tiered discount rate policy would call for the selective use of the Federal Reserve's discount power (on a demonstration basis, possibly), geared wholly and exclusively to economically feasible loans to farmers and farmer-owned enterprises.

The 0.5 percent discount tier would not involve taxpayer subsidies (as in the Department of Commerce 3 percent loans for ESOPs) nor would it involve borrowings by the Federal Reserve System or the U. S. Treasury, deficit spending or government-administered loan programs. It would not involve direct loans or direct allocations of credit by the Federal Reserve. It would merely reflect the actual cost to the Federal Reserve System of administering its discount process and regulating the supply of money and bank credit that would be generated by this proposal. There would be no "free lunch" to the farmer-borrowers, who would pay it to local banks having access to the Federal Reserve "discount windows." Perhaps the Farm Credit System could also be granted this privilege, subject to Federal Reserve restrictions and conditions.

It should be noted that a discount rate of 9.5 percent would still apply for consumer credit, government loans, or other non-productive uses of credit. Thus, the Administration's policy for dampening demand would still continue.

<u>Mechanics of Borrowing</u>. A farm or group of farmers with a feasible investment project would go to their local bank and borrow money at a competitive rate above the 0.5 percent cost of money, say 3 percent. The bank would take the note (which presumably would be secured by a mortgage and other collateral) and discount it at the discount window of the nearest Federal Reserve Bank at 0.5 percent, leaving the lender a margin of 2 to 2.5 percent to cover the risk of default and profits. (The interest charged the farmer could be higher or lower, depending on competition among banks and differences in risks among borrowers.)

<u>Limitations on the Use of a 0.5 Percent Discount Rate</u>.

1. Local banks should determine the feasibility of production loans, and the relative risk of default on loans, subject to oversight and supervision by Federal and State bank regulators.

2. Production credit should be curtailed once a region reaches levels of full production.

3. No lower-tier credit should be made available for consumer loans; home improvements; home purchases; speculation in commodities, money market paper, or other marketable securities; loans to local, state or federal governments; and for any other purposes not geared directly to production (supply) of marketable goods and services.

4. To minimize abuse and discriminatory access to low-interest credit by outside foreign and domestic investors, such credit should be made available on an individual basis, subject to specified limits, to each farmer and his wife and to persons employed in an agriculturally related enterprise.

A Specific Demonstration Project Involving Low-Interest Credit to Farmers. On March 20, 1979, the Louisiana Agriculture Commodities, Inc. was formed by farmers belonging to the American Agriculture Movement of Louisiana. This new venture will raise $100 million to build grain storage and loading facilities at Lake Charles, Louisiana, plus barges to haul grain down the Mississippi, store it, and ship it to domestic and foreign customers. It will be a totally integrated operation designed to enable farmers to get a fairer price for their commodities on world markets. Initially, the project calls for one 6 million bushel elevator and one loading berth. Subsequently, another berth will be added.

A key feature in this venture is its ownership sharing strategy. The corporation will be jointly owned by its employees as well as all farmers (including those in other states) who sell their commodities through its facilities under long-term supply contracts. The financing strategy calls for a wholly leveraged capitalization, using 3 percent credit channeled partially through an ESOP (employee stock ownership plan) trust and the balance through a farmer stock ownership trust.

The loan will be secured and paid for, to the extent permitted by law, by corporate pre-tax profits from the venture. Roughly $10 million in initial equity will be reserved for employees and $90 million for farmers. The annual allocation of stock to farmers will be geared to their commodity sales to the corporacion, subject to a ceiling to prevent concentrated ownership by giant agribusinesses. All stock would be restricted and subject to a right of first refusal, in order to keep the stock from being acquired by outside investors.

To launch this program, Lousiana Agriculture Commodities, Inc. is raising $100,000 among 500 founding members, and will seek an additional $400,000 for organizational expenses, either through a line of credit from Louisiana banks or from Farmers Home Administration sources.

Beyond the Demonstration Stage. This strategy affects all American farmers. Their support can be sought immediately, particularly farmers in such key agricultural states as the Midwest grain belt, California, Texas and Florida. Gilbert L. Dozier, the Louisiana Commissionerof Agriculture, has given his *commitment to mobilize support for this effort among the various State Commissioners of Agriculture. The Louisiana Congressional delegation has been asked to play a leading role in advocating this program in Washington. The leadership of the American Agriculture Movement has demonstrated its commitment in its March 1, 1979 tractorcade to the Federal Reserve Board of Governors, where a follow-up meeting is tentatively scheduled for early April, 1979. The staff of the Federal Reserve Board has been studying a paper prepared by the AAM's financial consultant to the project, justifying a two-tiered discount rate policy for the Federal Reserve.*

The implications of this proposal are far-reaching and profound. But it is based on common sense. The question therefore, is not whether it can and should be implemented. The question is when.

FOR FURTHER INFORMATION, CONTACT
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Statement of Louis O. Kelso

ESOP'S INVENTOR TELLS CONGRESS:

EMPLOYEE-SHIPPER STOCK OWNERSHIP PLAN CAN SAVE THE MILWAUKEE ROAD BUT CONGRESS MUST SWITCH TO A NEW ECONOMIC POLICY TO BUILD CAPITAL OWNERSHIP INTO ALL EMPLOYEES AND CITIZENS IF IT WANTS TO SAVE THE U.S. ECONOMY.

Washington, D.C., June 21. Can the Milwaukee Railroad threatened with dismemberment in bankruptcy court, its assets to be sold off for exploitation by fatcat financiers after the example of the Penn Central, be rescued and rehabilitated through a plan that would build ownership of the reborn enterprise into its employees and shippers? Should a railroad which has been losing money at the rate of nearly one-half million dollars per day be rescued even if possible?

Yes to both questions, Louis O. Kelso, originator of Employee Stock Ownership Plan (ESOP) financing and author of the employee-shipper stock ownership plan that he, along with powerful congressional supporters, believes capable of restoring the Milwaukee to health, told a Congressional sub-committee Thursday.

But the rescue can only be accomplished by a plan which corrects the cause of The Milwaukee Road's decline, Kelso cautioned. That cause is a defective national economic policy that forces U.S. workers, including railroad employees, to demand more and more pay for less and less real work input, instead of receiving a rising portion of their income from the wages of their privately-owned capital. Kelso's design for the Milwaukee would build stock ownership in the newly-structured enterprise into the approximately 7,000 employees involved in the Minneapolis west operations, as well as into the shippers who contract to use the Milwaukee's facilities.

Testifying before the Oversight Sub-committee of the Senate Finance Committee, Kelso, who has seen his best-known financing invention, ESOP, a double-barreled technique that enables employees to acquire sizeable holdings of corporate stock while raising low-cost capital for the corporation, move from his own drawing board into an estimated 2,000-3,000 U.S. corporations, depending on whether the statistics come from the U.S. State Department or the office of ESOP's first senatorial advocate, Senator Russell B. Long of Louisiana, chairman of the Senate Finance Committee. Senator Long attended the Thursday hearings called by the Oversight Subcommittee's chairman, Senator Max Baucus, to discuss the Milwaukee's fate. If the Milwaukee Road is destroyed, the 7,000 jobs involved in the eastern operations would, of course, be lost. The impending cannibalization of the Milwaukee is being fought by the governors of the six states the road serves, as well as the congressional representatives, and labor and community leaders, from the affected regions.

Kelso reminded Congress that the long western lines of the Milwaukee, connecting the Great Lakes with the midwest, the Rocky Mountain states and the Pacific coast, will be a vital transport link in the U.S. economy's energy shift from petroleum to coal. To allow the railroad to be dismantled, on the very eve of a change in energy dependence essential to avoid the U.S. economy's speedy ruin, would be the height of congressional responsibility. But the rescue must not take the usual form of deficit financing of a railroad enterprise that continues to suffer from the same structural defects as the predecessor line. That approach Kelso described as "hopeless, futile and never-ending."

To properly restructure the Milwaukee road, as well as the hundreds of business enterprises which hover on the edge of bankruptcy for similar reasons, or else are force-fed into the semblance of health through government boondoggle appropriations, Congress must also restructure the national economic policy that is responsible for the Milwaukee's decline along with the decline of the U.S. economy.

"The economies of the world," declared Kelso, "have been delivered into a state of crisis by an outmoded economic policy that tries to distribute mass income and purchasing power as pay for employment. This policy collides head-on with science and technology, which, after 200 years of industrialization, have largely shifted productive input from people to things. Today in the U.S. economy, the bulk of goods and services are not produced by labor at all but by tools, machines, structures and other capital instruments. In a private property economy, you cannot uphold mass production, or maintain economic growth at a rate high enough to keep ahead of employment-destroying technology, unless workers, management, professionals, civil servants, and ultimately all consumers, receive a growing proportion of their total income from capital investments," insists Kelso.

Inflation in the U.S. and in other market economies is the inevitable consequence of a clash between the realities of modern production and this totally outmoded national economic policy, continued Kelso.

The substitution of myths for those realities is what has lead our economists to give us uniformally bad advice on the cause and cure of inflation and unemployment, he pointed out.

Kelso says we must invest our way out of this inflation, and that credit for doing so is unlimited.

Expenditures during the coming decade of between $5 and $10 trillion on basic private sector new capital formation will, if structured to radically broaden corporate ownership and to avoid making the rich any richer, reverse inflation, build market power into all consumers, create two to three generations of full employment, and shrink to a fraction of their size the various government agencies devoted to attacking the effects of poverty while leaving its causes untouched. The taxpayers' incomes will rise; the purchasing power of their money will grow; and their taxes will fall to a fraction of present levels, maintains Kelso.

"U.S. economic policy calls for solving the income distribution problems for all consumers through full employment. At the same time, science, engineering, and management of business, industry and agriculture, strive ceaselessly to eliminate employment and its costs. Relentless and unending inflation flows naturally from the attempts of government to reconcile these irreconcilables, all of which take the form of monetizing welfare. Money representing welfare is inflation in its essence," he said.

The monetary system of a nation with a market economy is an accounting system. Its principal function is to keep track of what each participant in the economy contributes to production, and therefore of the income to which each is entitled. It is also intended to reflect changes in the value of assets at the time of sale or purchase resulting from operation of the market forces of supply and demand.

Erosion of the value of the monetary unit occurs when particular participants in the economy are paid incomes without contributing to production an equivalent market value in useful goods and services. This occurs when welfare is paid in any form. It occurs when labor is paid more than the free-market competitive value of such labor, whether this is caused by laws (such as minimum wage laws), coercion, fear of coercion, or whatever. Such excess payments are not pay for production, but rather welfare payments disguised as wages.

If funds accumulated in banking and other lending institutions are inadequate -- as they will be -- to bring into existence trillions of newly-formed capital the U.S. needs within the decade, then, suggests Kelso, ESOP financing paper should be made directly discountable with the Federal Reserve Bank, with regulated interests rates charged by the lenders at 3% or less. This merely involves shifting our present policy of monetizing welfare to a policy of monetizing self-liquidating productive capital, which in well-managed business enterprise pays for itself not once but over and over in cycles.

By this means, says Kelso, the U.S. can achieve full employment for two to three decades.

The poor, says Kelso, over reasonably-long working lifetimes, can be made affluent. As capital financing costs are paid off, the expanded economy becomes deflationary, with the value of money increasing, as goods and services continue to be produced profitably and competitively.

Second incomes from capital, paid to employees after their new capital holdings have paid for themselves, will enhance the market power of those with unsatisfied needs and wants. This "second income" is the wealth produced by capital -- not monetized welfare such as is used today to close the purchasing power gap. The accelerated growth of the economy, Kelso noted, will make the poor richer without making the rich poorer.

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KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

GREENSBORO, N.C. SAN FRANCISCO LOS ANGELES

TO THE SENATE FINANCE COMMITTEE, OVERSIGHT SUBCOMMITTEE

IN THE THREATENED ABANDONMENT OF SERVICE ON AT LEAST THE LONG WESTERN LINES OF THE MILWAUKEE RAILROAD, THE COUNTRY'S FIFTH LARGEST RAILROAD, ONE THAT SERVICES, OR IF REHABILITATED WOULD SERVICE, SOME OF THE UNITED STATES' MOST IMPORTANT COAL AND GRAIN FIELDS, ON THE EVE OF A VIRTUALLY CERTAIN NATIONAL SHIFT IN PRIMARY ENERGY RELIANCE FROM PETROLEUM TO COAL, THE CONGRESS OF THE UNITED STATES AND THE AMERICAN PEOPLE ARE AGAIN CONFRONTED WITH THE INEVITABLE CONSEQUENCES OF AN ABSOLUTELY ERRONEOUS AND ULTIMATELY SUICIDAL NATIONAL ECONOMIC POLICY. NOW, IN THIS INSTANCE OF CRISIS IT IS TIME FOR CONGRESS TO FACE UP TO ITS OBLIGATIONS TO EACH OF THE FOLLOWING:

--CHANGE THE NATIONAL ECONOMIC POLICY TO A CAPITALIST ECONOMIC POLICY;

--APPROPRIATE THE FUNDS TO REHABILITATE VITAL ENTERPRISES THAT HAVE BEEN DAMAGED OR VIRTUALLY DESTROYED BY THE NATION'S PRESENT ECONOMIC POLICY, BEGINNING WITH THE CRITICALLY IMPORTANT LONG WESTERN LINES (MINNEAPOLIS TO SEATTLE, TACOMA, PORTLAND, ETC.) OF THE MILWAUKEE RAILROAD;

--RESTRUCTURE THE BASIS OF OUR MONETARY SYSTEM TO SHIFT IT FROM THE MONETIZATION OF WELFARE, AS DICTATED BY OUR PAST AND PRESENT QUASI-SOCIALIST ECONOMIC POLICY, TO THE MONETIZATION OF SELF-LIQUIDATING PRODUCTIVE CAPITAL, AS DICTATED BY CAPITALIST ECONOMIC THEORY;

--TERMINATE FOR THE FINANCING OF NEW CAPITAL FORMATION AND ALL FEASIBLE INDUSTRIAL PROJECTS THE RUINOUS AND INFLATIONARY HIGH INTEREST RATES THAT ARE DESTROYING OUR ECONOMY AND STALEMATING ITS GROWTH AND ITS POWER TO PROVIDE FULL EMPLOYMENT;

--SET IN MOTION THE FORCES THAT INSTITUTE THE STRUCTURAL CHANGES THAT WILL HALT INFLATION IN ITS TRACKS AND INITIATE AS A LONG-TERM TREND THE HARDENING OF OUR MONEY;

--FINALLY, PROVIDE AS AN EXAMPLE TO THE WORLD, A WORKABLE, EFFICIENT, HOPEFUL AND HAPPINESS-SPREADING ECONOMIC SYSTEM THAT AN ECONOMY INCORPORATING CAPITALIST PRINCIPLES ALONE CAN PROVIDE FOR BOTH ADVANCED INDUSTRIAL SOCIETIES, AND THOSE THAT DESIRE TO ADVANCE.

TESTIMONY BY LOUIS O. KELSO, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF KELSO AND CO., INCORPORATED, AN INVESTMENT BANKING FIRM SPECIALIZING IN CAPITALISTIC SOLUTIONS TO ECONOMIC AND FINANCING PROBLEMS, BEFORE THE OVERSIGHT SUBCOMMITTEE OF THE SENATE FINANCE COMMITTEE OF THE UNITED STATES CONGRESS

June 21, 1979

111 PINE STREET, SAN FRANCISCO, CALIFORNIA 94111 [415] 788-7454

INDEX OF EXHIBITS

THE HISTORICAL PERSPECTIVE: A TIME OF CRISIS

The press and the serious journals published in or about the United States for the past several years have been replete with warnings to the effect that the American economy is on the brink of a serious crisis--perhaps even collapse. So pervasive is this literature, and so prominent its authors in the fields of politics, economics and sociology, that no point would be served here by quoting from it or by attaching extracts as exhibits.

The economic reality that lies just below the not-quite-placid surface is ominous. Our governmental expenditures in industry and in government at all levels, made partly or wholly to promote increased employment, have strained the nation's resources to the point of bringing on a multi-faceted taxpayers' revolt. Dozens of our major industries are hard-pressed to maintain their competitive position even within our own domestic markets against lower cost and higher quality foreign products and services. Unemployment is rising, and there is every reason to anticipate it will continue to rise, at the very time that inflation is again reaching towards historic records. We seem paralyzed to cope with the energy shortage created by the simultaneous tapering-off of domestic production of petroleum and readiness of the OPEC nations to push their advantage to the maximum in progressively raising prices. We are stumbling in bringing to bear much-touted technological leadership to develop alternative sources of fuel, although we possess a sizable portion of the world's best reserves of coal and shale.

How can one explain why the economy of a perhaps still great nation serves it so badly that a great and vital institution like the Chicago, Milwaukee, St. Paul, and Pacific Railroad Company (The "Milwaukee Road" or the "Milwaukee") falls into bankruptcy and is threatened with dismemberment at the very moment in history when its complete rehabilitation and reactivation as a vibrant and successful railroad enterprise may be a crucial factor in extricating us from an energy crisis? In other words, what is the flaw in our economy that threatens to prevent us from solving a second energy crisis before we have fairly begun to solve the first one -- the petroleum shortage crisis?

First, let us examine the physical facts about the resources to which -- absent a miracle -- we shall have to rely on to solve our present energy disaster. Then let us examine the institutions, among them our defective economic policy, which seem to render us powerless to act.

ASSUMING THAT OUR ABILITY TO EFFECTIVELY TRANSPORT OUR HIGH-GRADE COAL RESERVES TO THE POINTS OF USAGE, AND TO DEVELOP THE APPROPRIATE TECHNOLOGY FOR THAT USAGE, IS OUR MAIN MEANS FOR SUBSTITUTING FOR A DIMINISHING PETROLEUM SUPPLY, HOW VITAL A LINK IN THIS SOLUTION IS THE MILWAUKEE RAILROAD?

Too often one agency of government operates in a vacuum in regard to overall public policy. Effective oversight by Congress is needed to bring together a better and more unified understanding of the knowledge that we have already accumulated. The problem of the Milwaukee Railroad presently before this Oversight Subcommittee of the Senate Finance Committee, provides us with a poignant example.

During the period 1976-1978, the transportation consulting firm of Manalytics, Inc. of San Francisco conducted two extensive studies for the Electric Power Research Institute of Palo Alto, California. The study consumed thirty-one man-months of work by highly skilled and experienced technical experts. EPRI, as it is known, is funded by major electric utilities of the United States. By way of background, Manalytics has conducted many studies for the Federal Railroad Administration, Transportation Systems Center of the U.S. Department of Transportation, Maritime Administration and other Federal agencies.

The first study was titled "Coal Transportation Capability of the Existing Rail and Barge Network, 1985 and Beyond." This study developed an assessment of the capability of the existing U.S. transportation network to accommodate increased movements of coal. Major current and potential coal producing areas and major locations of coal consumption were identified in order to determine the major coal movement origin/destination pairs. Other commodity movements competing for the same transportation services were also identified and forecast to 1935. The resulting commodity flows were then input into the Federal Railroad Administration rail network model which contains the more than 14,000 railroad links within the United States. Potential constrained segments requiring upgrading to prevent circuitous routings were identified.

The second study, "Coal Transportation Costs," developed a computerized model which estimated the cost impacts of avoiding the congested points identified in the first study either by rerouting the coal around congested areas or by changing the mode of transport.

These studies were presented at the Electric Power Research Institute "Coal Supply Seminar" to interested government officials on January 31, 1978, here in Washington, D.C. I am attaching as Exhibit I to this written testimony a list of governmental attendees at the seminar. Twenty-two congested points were identified as requiring correction by rerouting the coal around congested areas or by changing the mode of transport. The twenty-two points which are general areas of congestion (including the regions surrounding the named cities as well as the cities themselves) are:

Los Angeles	Des Moines
Houston	Topeka
Baton Rouge	Kansas City
Dallas	Milwaukee
Lubbock	Chicago
Pocatello	Detroit
Butte	Cleveland
Casper	Springfield
Pierre	St. Louis
Denver	Oklahoma City
Omaha	New Orleans

The Chicago, Milwaukee, St. Paul and Pacific Railroad clearly impacts ten and perhaps twelve of these areas.

What did the study indicate with regard to costs of upgrading and rerouting of coal because of congestion? For coal moving from Montana and Wyoming to Midwest and South Central utilities alone the estimate is $93 million per year or 6% above the cost without congestion.

What seems entirely clear from these reports is that those who have peered into the near future to evaluate the importance of railroads to the usage of coal as a fuel substitute found that if our existing railroads were entirely rehabilitated and certain interconnect links modified to diminish congestion, the entire network, of which the Milwaukee Railroad would be one of the most important links, would only be able to handle the transportation of the nation's coal to 1990, and only then with the most intensive usage of the entire network as it existed in 1978.

Is it in the "public interest" to allow the Milwaukee Railroad to be dismembered on the eve of its probable full utilization being required to accommodate a change in national energy · 'imary dependence from petroleum to coal?

IN THE SOLVING OF PROBLEMS, THE RIGHT QUESTIONS ARE MORE IMPORTANT THAN THE RIGHT ANSWERS.

With Congress, as with individuals, when a serious and socially significant problem requires solution, it is of grave importance that the inquiry begin with the right question or right questions. Indeed, it is more important to begin with the right question than it is, initially, to find the right answer. For wrong answers to the right question will in time be disputed and refuted and the right answers found. But individuals, and even entire societies, can be deterred indefinitely from solving their problems if they fail to formulate the right question -- identify the right problem -- in the first place. The right answer to the wrong question solves nothing.

The economy of the United States is not working well, and has not been working well for nearly half a century. It has performed much better for the rich than for the poor. It has performed much better for the 5% who, as all qualitative studies in recent years have shown, alone own non-residential productive capital, and perhaps for an additional 2% or 3% of lucky people and financial geniuses. But it has performed, and is performing, very poorly for the 90-plus percent majority of consumer units who do not own viable holdings of productive capital.

To own such a viable holding of productive capital is, in the pragmatic and economic senses of the word, to be rich. To not own a holding of productive capital from which an individual or a family (consumer unit) can derive a viable income stream is, in a very practical sense of the word, to be poor and indefinitely chained to the process of work, for whenever one is prevented from working, for whatever reason, his work income stops. In the absence of accumulated financial savings amounting to a viable capital estate, the individual, to continue to exist, must become, either openly or covertly, a ward of charity. Except for top executives who help themselves to unconscionable retirement income systems, neither pensions nor Social Security nor any other arrangements will suffice to solve the non-workers's income problem for more than a brief interlude if the ratio of parasites (that is those who must take out without putting in) to producers passes beyond a tolerable level.

No purpose would be served here to discuss what that tolerable level is. For present needs, it suffices to note that we have long ago passed it. Our taxpayers' revolts, our ever-rising national and corporate debt, and our burgeoning trade deficits in international affairs all tell us the same thing. Our economy is degenerating.

The economy of an advanced industrial society, if it is to function satisfactorily for the great majority, if not for all of those who live upon it, must be built upon a comprehensible logic. In short, it must be a "system", for the word system implies logic. And the logic diagram, or the theory of the economic system, must be comprehended, articulated and blueprinted, so that those concerned with running it have an operating manual to which they can turn when the "system" needs adjustment or alteration because it is failing to meet its performance objectives.

We have been deluded by generations and schools -- priesthoods -- of economic theorists who either are unaware that, to function satisfactorily, a complex economy must be built upon a systems concept, or they have myopically focused on some petite aspect of the economy, as do the monetarists, for example, and proclaim that their recommended adjustments to that petite aspect will solve either all the problems, or certain major problems of the economy itself.

Years ago, in the early stages of the Great Depression, when I became aware of the co-existence of staggering poverty and privation throughout our land and throughout most of the world, side-by-side with the potential capability, in terms of resources, manpower, technical know-how, good will and zeal, to produce the goods and services equivalent to a general high standard of living, I launched a personal research program that led me to recognize something basic. There was no theory of capitalism! In other words, there was no logic diagram for a private property, free-market economy to which a legislator, a businessman, a banker, a financier, a jurist, or any of the participants in the universal game of producing and consuming goods and services, could turn for answers to an economic malaise.

To be sure, there were many logical components that virtually everyone recognized as parts of a capitalist, or private property, free-market economy: The device of money or a monetary system; the process of barter for use in trade; the idea of banking and central banking; the idea that the only fair and impartial determinate of economic value (Aristotle would say the only "just" transaction in the marketplace) must be determined in workably free competitive markets through the interaction of the laws of supply and demand -- Adam Smith's great contribution; double-entry bookkeeping, invented by the Italians in the 14th Century; the division of labor in order to increase overall production and reduce overall errors and waste; the idea of insurance of various types of risk, so that casualties of diverse sorts could be borne to a small degree by a wide base of population, etc. But there was no capitalist economic system. There was no theory of capitalism.

THE DISCOVERY OF THE THEORY OF CAPITALISM, THE LOGIC DIAGRAM OR OPERATING HANDBOOK FOR ECONOMIES RECOGNIZING TWO FACTORS OF PRODUCTION, THE SANCTITY OF INDIVIDUAL PRIVATE PROPERTY IN EACH OF THE TWO FACTORS OF PRODUCTION; THE ONLY SYSTEM THEORY OF ECONOMICS IN HISTORY AND THE ONLY ECONOMIC SYSTEM CONSISTENT WITH AND SUPPORTIVE OF A POLITICALLY FREE SOCIETY.

The theory of capitalism dates from the publication in 1958 (Random House, New York) of THE CAPITALIST MANIFESTO, by Kelso and Adler. (See Exhibit II attached hereto.) The year 1776 (or 1775) is the date from which most historians date the beginning of the Industrial Revolution. The former was, of course, the birthday of the United States of America as well. The world could have been spared immeasurable toil, suffering, privation, and strife if the theory of capitalism had been discovered in the same year that these other two momentous events took place. Unfortunately, with the publication in that same 1776 by Adam Smith of THE WEALTH OF NATIONS, only a small component, though a very vital one, of the theory of capitalism was born. Smith gave us the vitally important truth that there can be no means of objectively determining value of goods, services, labor, or whatever, so far as economic value is concerned, except through the operation of the law of supply and demand in reasonably competitive markets. Only under these circumstances can value be truly determined, for only under workably free competition can buyer and seller each be immune from the arbitrary will of the other. But only with the full theory of capitalism does a businessman, a legislator, a political chief executive, an administrator, or a court have a body of logic to which he can turn when economic doubts arise or economic institutions seem to be malfunctioning, to set things aright. More or less dominated by the classical school of economics initiated with the writings of Adam Smith and J. B. Say, corrections in economic systems and in business enterprises were made on the basis of expedients and of the relative economic power of competing forces. The survival of the fittest was an accepted doctrine with no apparent awareness that, absent the theory of capitalism, "fitness" in this sense was more or less synonymous with "might." During the one-hundred-eighty-three years that spanned the beginning of the Industrial Revolution and the discovery of the theory of capitalism, the solution to economic problems, or at least what passed for solutions, could be made only on the basis of economic doctrines that universally accepted the labor theory of value in one form or another. This is the idea that only labor produces wealth or value and that the productive input of capital instruments (generally speaking, land, structures, and machines and certain intangibles, like patents and "firms" that possess the characteristics of capital instruments) should be attributed to the workers who work with them.

The theory of capitalism, simple enough in its essence, merely asserts that the human factor (labor in all its forms) and the non-human factor or capital (everything external to man that is capable of being owned under the prevailing laws of private property and is capable of being employed in the production of goods or services) each produces or contributes to the production of goods and services in the same identical senses: physical, economic, political, and moral. The function of technological change, that restless and relentless main source of all change in history, a phenomenon arising from man's deciphering the laws of nature and making nature work for him solely through his capital instruments, is relentlessly to shift the burden of production off the human factor and on to the non-human factor. Because human economic morality is built upon the idea that what the individual takes from the economy should be based upon and proportioned to the value of what he contributes to the production of goods and services in the economy, it is clear that only in the world of finance can the imbalances generated by technological change be corrected. Finance is the matrix in which new capital formation is planned, or changes in the ownership of productive capital are engineered, and in which the ownership of capital is determined.

If, as the true productiveness of labor is relatively diminished, business finance is so conducted as to broaden the base of its ownership, and to build that ownership into consumer units that either possess none of it, or inadequate amounts of it, the mass production of economic goods and services could go merrily on, and the enjoyment of consumption by all consumer units would increase in a synchronized manner. The vast discontinuities that arise from the possession of unsatisfied needs and wants by the many and the concentrated ownership of productive power in the form of concentrated holdings of capital by the few would not arise. In the absence of the theory of capitalism, and the knowledge of what the logic of that theory requires of the truly capitalist economy, the ownership of productive capital was determined simply by greed, by force, by chance, by fraud and by theft.

CAPITALISTIC TECHNIQUES OF FINANCING ECONOMIC GROWTH AND THE BROADENING OF CAPITAL OWNERSHIP EVENTUALLY TO INCLUDE EVERY CONSUMER UNIT

Lacking the logic diagram setting forth the theory of capitalism, it was inevitable, following the decision of the case of Ford Motor Company in the Supreme Court of Michigan* that the U.S. economy could not begin to finance a significant fraction of its requirements for new capital formation attendant upon the accelerating pace of the Industrial Revolution, much less the automation revolution in which we find ourselves today, so long as the owners of corporate stock were permitted to enjoy the major right of private property in their holdings of capital stock. That is, so long as the owners of stock could collect the wages of their capital -- the full proportionate return on net worth of the corporation, represented by the shares which they own. While private property in the means of production, both according to Karl Marx and according to Kelso and Adler, is the essence of a capitalist economy, our states, one after another, proceeded to abolish private property in corporate stock and to substitute for it the right of the shareholder to receive a few crumbs from the stream of wealth his capital produces when and if those crumbs are brushed off the table by the appropriate Board of Directors in the form of the declaration of dividends. The result of this was some good news and some bad news:

- We did, though by no means adequately, finance a mediocre rate of economic growth -- between 3% and 4% per year -- for over half a century;

- Since most new capital formation was financed by the "plowing-in" of earnings made possible by the destruction of private property in capital ownership, which builds growth into a stationary stockholder base, the whole vast productive array of capital goods in our economy came to be owned by the pinnacle 5% or so of consumer units.

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* Dodge, et al. vs. Ford Motor Co., et al. (1919), 204 Mich. 459, 170 NW 668.

Since the whole function of technology is to transfer the burden of production from the human factor (labor) to the non-human factor (capital instruments, generally speaking land, structures and machines), thus making capital owners progressively more economically productive and those who own only their labor power to contribute to the processes of production progressively less productive, it was clear that some new and different expedients were called for.

The revolutionary Administration and Congress that came onto the scene with President Franklin Delano Roosevelt in 1932, devoid even of knowledge that the logic diagram for a private property, free-market economy (which they did not repudiate as their goal) did not exist, were therefore free to go about legislating and through Executive Orders attempting to patch-up the broken down economy with more and more ad hoc expedients.

The two great lines of expedients that were innovated in the 1930's and which have been repeated in countless variations ever since were:

1. Congress voted through a series of laws, beginning with the National Labor Relations Act, to repeal the law of supply and demand as it applies to the price of labor; and

2. Congress began, and has continued down to date, experimenting with a vast variety of attacks on the effects of poverty, while leaving its causes, generally speaking, totally untouched. If people did not have enough food, they were given aid to families with dependent children, aid to the handicapped, aid to the blind, food stamps, etc., etc. If they could not pay their medical bills, they were given Medicare, Medicaid, Veterans hospitalization privileges, etc., etc. If they could not afford to educate their children, education was subsidized in hundreds of different ways. Etc. Etc.

By not asking the right question, namely, "Why are people poor?", we have preoccupied ourselves with implementing various answers to the wrong questions; answers that avoided, until the economy of World War II took over, an economically oriented internal revolution of force and violence. We did set in motion, however, those destructive forces -- inflation, rule by force, and anarchy -- from which only the adoption and implementation of a capitalist economic policy can now save us.

Had we asked in the 1930's, or subsequently, the right question, namely, "Why are people poor?", we would certainly have instantly perceived the right answer, namely, "Because they are not rich.", i.e., they do not own holdings of productive capital of sufficient size to enable them, through that capital ownership, to produce the lifestyles they reasonably desire to live.

From the right answer to the right question comes the intelligence as to the respective roles in the economic order to be played by business, government and employees in general. Too many people had become unproductive and our productive power and potentially expandable productive power had become too vast. Since mass production can only be supported by mass consumption, except in times of war (one of the expedients upon which we have repeatedly relied), the right answers were not forthcoming immediately.

With the right economic questions, and the theory of capitalism, our proper economic goals become clear:

1. To restore and to greatly accelerate the growth rate of the U.S. economy;

2. To make possible the financing of new capital formation at sufficiently high levels and low costs to facilitate and maintain a high economic growth rate and to achieve, for two or three decades at least, legitimate full employment through the private economic sector;

3. To reverse inflation and initiate long term hardening of the dollar;

4. To attack the cause of poverty by facilitating the building of significant ownership of productive capital and second sources of income into the U.S. private sector labor force and their families and eventually into all consumers;

5. To protect the quality of our environment as the economy grows and to finance the new capital formation and jobs that growth will require;

6. To increase the revenues of the Federal Government without increasing tax rates;

7. To expedite the achievement of self-sufficiency in energy by eliminating all institutional barriers to financing growth in energy-related enterprises, while lowering the cost of capital therein and building broad ownership of the resulting newly created capital into employees and into energy consumers without impairing their consumer goods purchasing power;

8. To reduce labor relations controversies at their source, by unifying the interests of labor, management and stockholders;

9. To take the initial steps to vest the dominant form of ownership of capital goods in our economy -- the ownership of corporate stock -- with the rights of private property, i.e., a claim of right to the proportion of the net corporate earnings represented by that stock; and

10. To initiate reforms in the tax laws intended to enable

U.S. consumers to become self-supporting, so that ultimately welfare, in any form, will not be necessary and Social Security can be reduced in scope to those few who will still need it.

THE THEORY OF CAPITALISM (OR TWO-FACTOR THEORY AS IT MAY WITH EQUAL PROPRIETY BE CALLED) AND EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) FINANCING CAN BE ILLUSTRATED WITH AN EXPLANATION AS TO WHY, IN AN ADVANCED INDUSTRIAL ECONOMY, SUBSTANTIAL INCOME-PRODUCING CAPITAL MUST BE OWNED BY CORPORATE EMPLOYEES, AND HOW -- WITH VERY SLIGHT CHANGES IN BASIC BUSINESS STRATEGY -- THIS CAN BE EFFECTIVELY ACCOMPLISHED THROUGH ESOP FINANCING: THE MOST POTENT INSTRUMENT FOR THE PURPOSE, THE MOST ADVANTAGEOUS TO THE CORPORATION, AND THE MOST BENEFICIAL TO THE EMPLOYEES

Although two-factor economics, or the theory of capitalism, is a new and fundamental concept, it is simple and straightforward. The reasoning runs as follows:

1. While it is true that people, participating in the economy through the performance of their various tasks, are a basic source of productive input, they are not the only source of productive input.

2. Non-human things, such as land, structures and machines, and, particularly in service enterprises, intangible capital such as patents and "firms", also make productive input into the economy.

3. The division of the input sources into two types is both necessary and adequate, because the ownership of labor power cannot be concentrated, while the ownership of non-human things can easily be concentrated. It is, after all, an individual's property in an input factor that entitles him to receive what it produces.

4. Under the logic and morality of a market economy, productive input into the economy is the basis for the individual's right to receive income from it. Economic outtake is conditioned on economic input. To accountants and businessmen, this relationship is simply double-entry bookkeeping. To economists, it is "Say's Law" or "Say's Identity". To moralists, it is the Puritan Ethic, or simply the principle of economic justice defined by Aristotle. To lawyers, it is the principle of private property, under which the owners of capital and the individual owners of labor power are accorded the income equivalent of what each privately-owned input factor contributes to production.

Figure 1:

SAY'S LAW: THE BASIC LAW OF TWO-FACTOR ECONOMICS

For every dollar spent, somebody gets a dollar in economic value. Say's Law is simply a prose statement of the principle of double-entry bookkeeping, which is the logic of a private property, market economy.

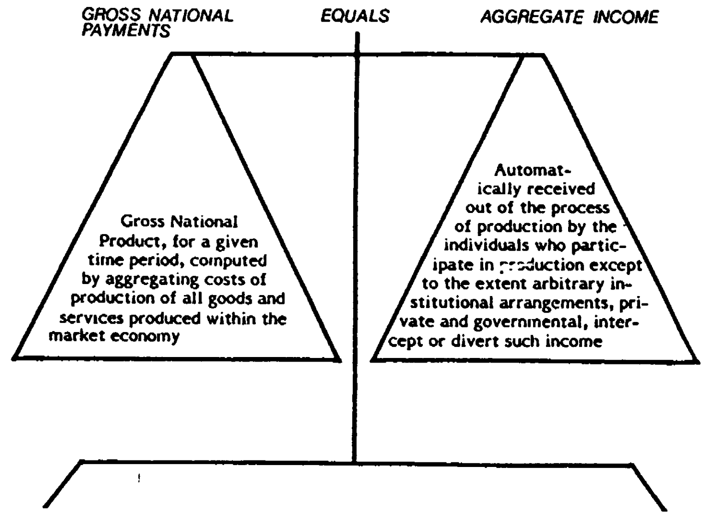


Figure 2:

SAY'S LAW ILLUSTRATED ON THE BASIS OF 1973 STATISTICS (IN BILLIONS)

<u>Gross National Product</u>

Less adjustments for capital consumption allowances, indirect business tax and non-tax liability, business transfer payments and other minor adjustments.

CONSUMER COSTS OF:

Agriculture, forestry, and fisheries	$ 37.8
Mining	9.7
Contract construction	57.5
Manufacturing	291.9
Transportation	39.3
Communications	21.7
Electric, gas, and sanitary services	19.8
Wholesale and retail trade	151.5
Finance, insurance, and real estate	118.9
Services	133.6
Government and government enterprises	162.9
Foreign trade and transactions	9.6
	$1,054.3

<u>Participant Income</u>

Income Automatically Arising out of Production and Received by the Participants in Production

INCOME OF PARTICIPANTS IN:

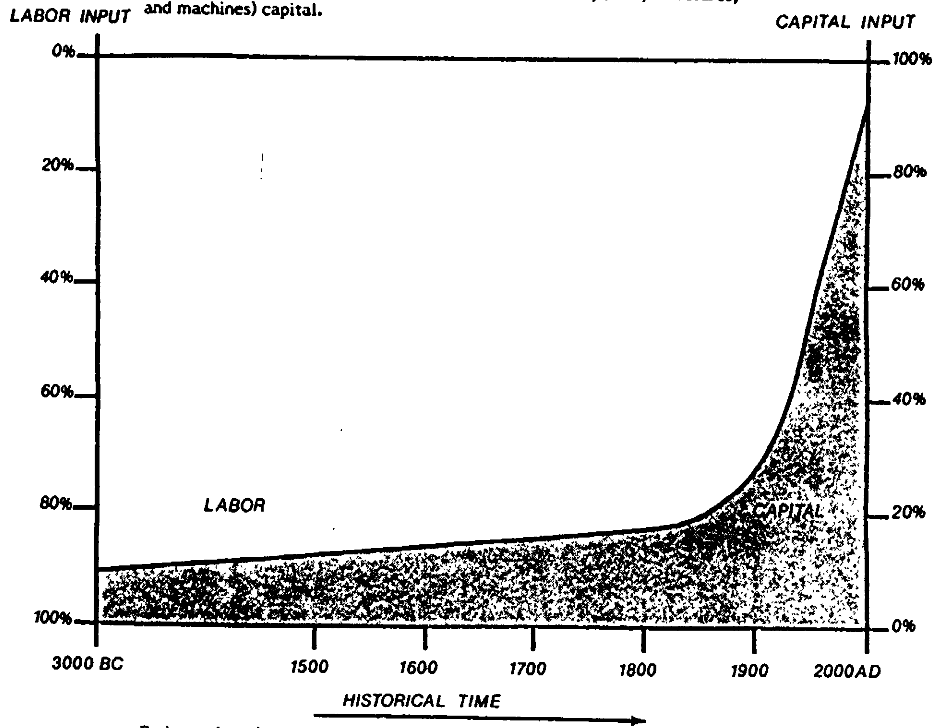
Agriculture, forestry, and fisheries	$ 37.8
Mining	9.7
Contract construction	57.5
Manufacturing	291.9
Transportation	39.3
Communications	21.7
Electric, gas, and sanitary services	19.8
Wholesale and retail trade	151.5
Finance, insurance, and real estate	118.9
Services	133.6
Government and government enterprises	162.9
Foreign trade and transactions	9.6
	$1,054.3

5. Technological advance, which is the phenomenon responsible for the Industrial Revolution, as well as our own automation revolution, and all of the intermediate revolutions brought about by science and technology, changes, and is intended to change, the input mix. It shifts the burden of production off labor (the human factor) and onto capital (the non-human factor). Technological change does not operate directly on labor. It cannot increase the productiveness of a mature individual worker. It increases the productiveness of machines, tools, structures, land and processes. The economic productiveness of human workers -- what they can accomplish with their unaided muscles or minds has not changed during the course of history, if the value of that productiveness is determined objectively and competitively by the free operation of the law of supply and demand.

Figure 3:

THE FUNCTION OF TECHNOLOGICAL CHANGE

The function of technological change is to shift the burden of production off the human factor, labor, and onto the non-human factor, (land, structures, and machines) capital.



Estimated on the assumption that the value of each factor's input is determined in reasonably competitive markets.

6. In the United States economy, the world's most advanced, the process of technological change has gone so far that most of the goods and services today are produced by capital instruments; only a minor portion of the productive input is made by people. With rare exceptions, it is capital that produces affluence. Labor, in a free labor market, can normally produce only subsistence. The relative distribution of aggregate personal income between workers (roughly 3/4ths) and the owners of capital (1/4th) does not reflect the relatively higher productive input by capital because our governmental economic policy (the Employment Act of 1946), and hundreds of pieces of implementing legislation, attempts to repeal the law of supply and demand as it applies to the value of labor. This is the purpose of minimum wage laws, coercive fixing of wages, vast governmental make-work programs, government subsidies to industry and other government entities to "create" jobs, etc. The costs of all such efforts enter into the costs of production, directly or indirectly, and thus are inflationary precisely because they are not reflected in the increased production of goods and services by labor. Such costs, neither representing increased labor input nor labor shortages, are, in fact, disguised welfare. They are injected into the costs of the same quantities of goods and services that, prior to the coerced increases, would have been produced at lower costs. These attempts to overvalue labor constitute one of the principal means by which we monetize welfare.

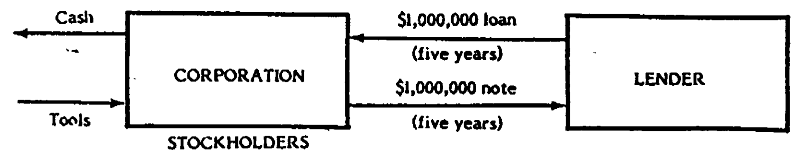
7. The shifting of the input mix from labor to capital would cause no economic problem, even under competitive labor markets, if the declining productiveness of labor were offset by increasing individual capital ownership, i.e., if, as technology diminished the productive role of the human factor, workers simultaneously acquired ownership of enough productive capital to compensate for their loss, or even better, enough capital to provide what few labor-dependent persons have ever achieved, a truly affluent standard of living.

8. Unfortunately, traditional techniques of finance, including the traditional pattern of lending by the Small Business Administration, do exactly the reverse of what the situation logically requires. They insure that all newly-formed capital will be automatically owned by those who own all existing capital. Under these techniques, the $100 billion-plus of new capital formation that comes into existence each year in the U.S. economy becomes owned by a tiny proprietary class -- approximately 5% of consumer units. If averaged over the past 15 years, less than 5% of new capital formation in the corporate sector (which produces more than 85% of total private sector goods and services) is financed by means other than out of direct cash flow or borrowings repaid out of cash flow.

Figure 4:

CONVENTIONAL CORPORATE FINANCE

- Including internal cash flow, borrowings repaid from after-tax cash flow, accelerated depreciation, depletion, and investment tax credit, but excluding sale of new stock to the public for cash



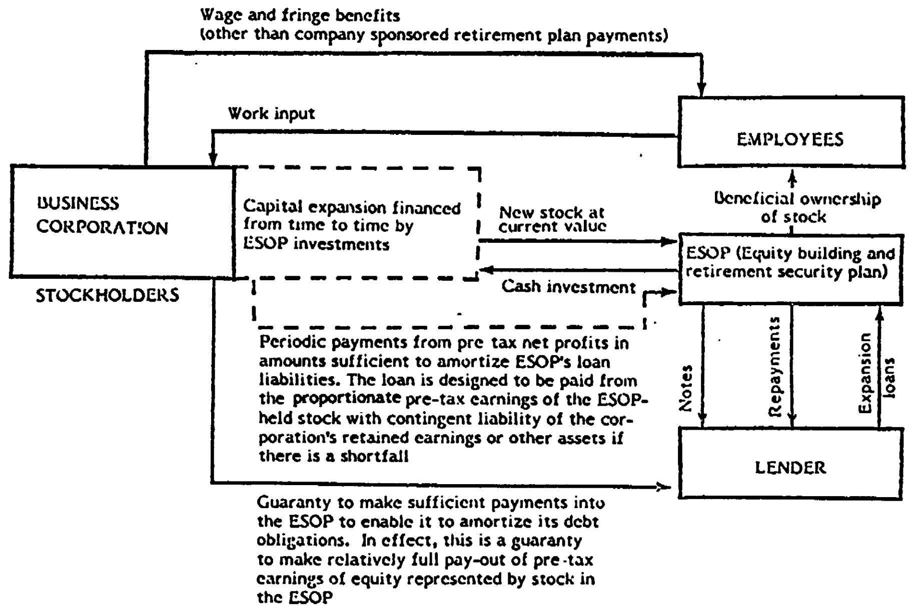
These methods of financing new capital formation have one common characteristic: They do not create a single new stockholder. The portion of new capital formation (less than 5%) financed by sale of equity stock to the public does not alter this propensity. Every qualitative study of stock ownership to date shows that ownership of virtually all individually-owned productive capital is lodged in the top 5% of consumer units. These are the families who have excess funds to buy newly-issued stock. Conventional finance has created this monopoly of the power to produce goods and services through ownership of productive capital.

9. The logic of business finance is to invest in productive capital that will pay for itself within a reasonably short space of time, normally three to five years, and then go on throwing off wealth indefinitely, its productive power being replenished through good management that, by research and development, keeps the firm's products relevant to market demand and through depreciation funds set aside out of gross income before net income is computed. Two-factor financing techniques, of which the most widely used today is the Employee Stock Ownership Plan or ESOP, makes this logic available to employees.

Figure 5:

BUSINESS CORPORATION FINANCED BY A PROPERLY DESIGNED ESOP

Intended simultaneously to (1) finance growth of the corporation and provide second incomes for the employees (if the stock is dividend paying and, after shares are paid for, the dividends can pass through the ESOP currently to the employees) and (2) to build retirement security in the form of equity capital ownership.



10. ESOP financing, on the one hand, provides low cost capital, through the use of pre-corporate-tax funds, to finance corporate growth, and on the other hand, builds ownership into workers without diminishing their take-home pay or calling upon their small or non-existent savings.

11. With minor legislative changes to provide capital diffusion insurance (modeled after FHA insurance) for lenders that make sound ownership broadening loans and to make the financing paper held by lenders discountable at a rate not in excess of the administrative costs of the Federal Reserve Bank, two-factor techniques could provide means for financing unlimited growth, while building market power, economic security, and growing current second incomes from capital* into the masses of workers; thus the market power of potential consumers would rise in step with the productive output of the economy.

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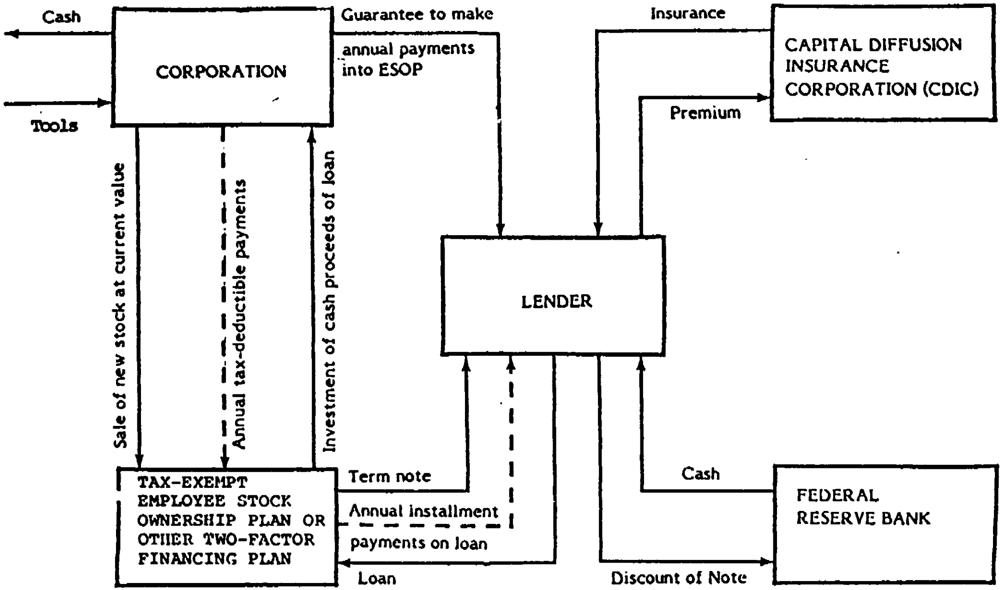
* Where the stock in the ESOP pays a dividend, the plan often provides that, after each particular share of stock is paid for, the dividends on it shall currently pass through the trust into the pockets of the beneficial owner-worker.

Figure 6:

FINANCING ECONOMIC GROWTH *

Financing economic growth by monetizing productive capital while building market power into consumers through ESOP financing



* An elaboration of this central logic diagram for the financial structure of a capitalist economy is set forth in Appendix V hereto.

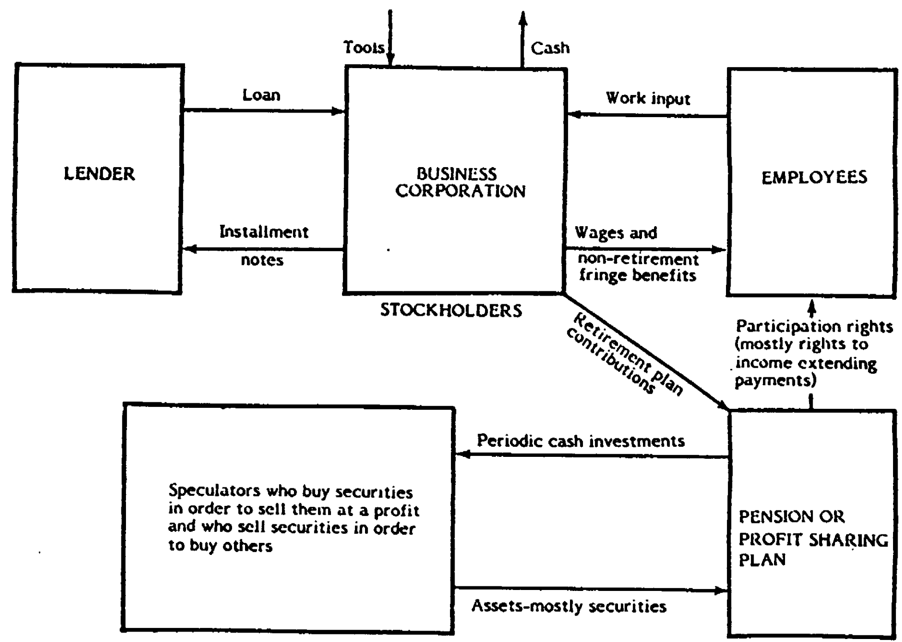
12. Inflation is eliminated. Institutional barriers, such as lack of "money" to finance solid, self-liquidating economic growth are eliminated; legitimate leisure, built upon the ownership of a holding of productive capital that will enable a man or woman to produce a viable income, becomes possible over a reasonable working lifetime; and the burden of public taxes imposed upon producers to support the non-productive and under-productive can ultimately be virtually eliminated. Fully productive households and individuals do not need to be subsidized.

13. The ESOP is an enormous cost-saver for the corporation which, sooner or later, can substitute it for a fixed-benefit pension plan, or any other pension plan or conventional profit sharing plan. All payments by the corporation into these conventional plans are pure cost.

Figure 7:

CONVENTIONAL FINANCING OF A BUSINESS CORPORATION

Conventional financing of a business corporation, other than by sale of new stock to the public for cash, with conventional pension or profit sharing plans invested wholly in assets purchased from sources other than the employer-corporation.



Compared with the ESOP (see Figure 5), not only does the identical dollar paid by the corporation to build stock ownership into employees also finance corporate growth, but corporate growth can be accomplished on pre-tax dollars. By comparing the ESOP (Figure 5) with conventional economic security-building plans (Figure 7), you will see that the ESOP enables the corporation to gain three dollars of advantage for each dollar spent. And it conforms to the sound economic goal of enabling employees, who work hard and well over a reasonable working lifetime, to retire singularly well off.

14. Finally, because the economic goal implicit in two-factor theory is to expand the U.S. economy (and any other economy that adopts it) sufficiently to enable all consumers to live well -- general affluence -- while also producing the technology to protect the environment, a change to a two-factor policy* by business and government could give us 25 years or more of legitimate full employment. This would be time enough for society to adjust to a world in which each person will spend less time in economic work and more time in the work of civilization.

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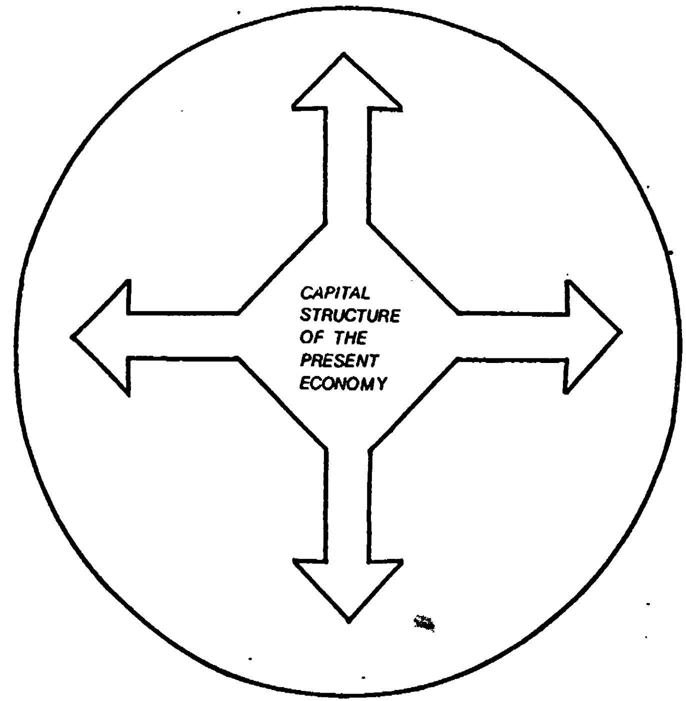
* Such a change in national economic policy was recommended by the Staff of the Joint Economic Committee in its Annual Report for 1976, pp. 171-173, inclusive. This extract is attached as Exhibit VI hereto.

Figure 8:

OBJECTIVE OF TWO-FACTOR ECONOMICS

Capital structure of the present economy, owned by 5% of consumers, expands ten-fold to create the SECOND ECONOMY, owned primarily by the 95% of consumers who now own no capital



<u>IT IS TIME TO STOP FLOUNDERING IN ECONOMICS -- THE DOCTRINE OF LAISSEZ FAIRE IN ECONOMICS IS NO MORE SENSIBLE THAN THE THEORY THAT THE WORLD IS FLAT IS SOUND IN ASTRONOMY, NAVIGATION OR GEOGRAPHY, OR THAT DISEASE IS CAUSED BY THE SPONTANEOUS GENERATION OF GERMS IN MEDICINE. NOR ARE ANY ECONOMIC DOCTRINES OTHER THAN THE THEORY OF CAPITALISM USEFUL AS GUIDES IN MAKING ADJUSTMENTS TO OUR INTENDED PRIVATE PROPERTY, FREE-MARKET ECONOMY.</u>

The theory of capitalism, or two-factor economics, holds that there is a very crucial place for government in business and that there are critically important and necessary relationships between government and business. But it goes further and gives us the means to determine what those relationships should be, how they should be designed and their respective roles to be fulfilled. The perils of our failure to use the operating manual for a capitalist economy in repairing the defects of our economy are simply that we are acting on expediency, improvising, guessing, and naturally, failing to solve our problems in the economic order.

The Employee Stock Ownership Plan (ESOP) is simply a logical application of the theory of capitalism. So is the Consumer Stock Ownership Plan (CSOP) or, as applied to freight railroads like the Milwaukee, the Shipper Stock Ownership Plan (SSOP) of which one large and enormously successful working model has been functioning for 20 years. This latter device is the capitalist counterpart of the cooperative which comes to us from the socialist tradition. The name of the corporation is Valley Nitrogen Producers, Inc., a major producer of agricultural chemicals in the State of California. This is a concept that should, when combined with ESOP financing for employees of the enterprise involved, totally dominate railroad financing, public utility financing, savings and loan association financing, bank financing, insurance company financing, and a number of other areas, but its existence is unknown to most people, and the useableness of the device was inadvertently destroyed by Congress about 1965 at the behest of some monopolistically inclined lobbyists. Exhibits III and IV hereto briefly describe the CSOP and its operating model.

The General Stock Ownership Plan (GSOP) is yet another application of the logic of two-factor economics, or the theory of capitalism, to large scale enterprises. It is provided for (in part) by Subchapter U, adopted by Congress as part of the Revenue Act of 1978 (enacting Title VI of the Internal Revenue Code of 1954, as amended), and a specific application of that technique has been under debate at the state level in the State of Alaska during the term of the legislature just ended. While the proposed Alaskan General Stock Ownership Corporation law was not adopted in the past session by the Alaskan legislature, the bill providing for it did pass favorably through the several committees to which it had been assigned. Through Subchapter U of the Revenue Act of 1978, Congress has given the states a temporary opportunity, for five years, to experiment with the GSOP concept.

The overall program based upon the theory of capitalism for the unlimited financing of business and the simultaneous building of viable capital holdings into major segments of the economy (necessarily politically designated segments) was blueprinted by Adler and Kelso in THE NEW CAPITALISTS, published in 1961. This is the FINANCED GENERAL STOCK OWNERSHIP PLAN (FINGSOP). My overall study of financing tools built upon the theory of capitalism has convinced me that there are only limited applications for FINGSOP for qualifying businessmen until Congress and the U. S. economy have adequately experimented with the ESOP and CSOP techniques, although it is clear that specific areas of economic cancer could be attached anytime from this point forward by FINGSOP: the elimination of Social Security, the elimination of welfare, making the handicapped and mentally disabled economically productive, etc.

THE SCOPE OF THE ECONOMIC CRISIS CONFRONTING CONGRESS IS MACROCOSMIC; THE RESTRUCTURING OF THE FEW KEY ELEMENTS OF THE ECONOMY NECESSARY TO INSTITUTE A CAPITALIST SYSTEM AND TO MAKE THE MILWAUKEE RAILROAD A VIABLE RAILROAD SYSTEM OFFERS THE OPPORTUNITY TO BEGIN TO SAVE THE U. S. ECONOMY AS A WHOLE, AS WELL AS THE ECONOMIES OF THE WESTERN WORLD FROM SELF-DESTRUCTION THROUGH RELIANCE UPON OBSOLETE EXPEDIENTS CARRIED OVER FROM THE PRE-THEORY OF CAPITALISM ERA

It is evident on every hand, as noted at the outset of this testimony, that the U. S. economy, in failing to restructure itself as a capitalist economy, is set on a suicide course. Our entire Northeast Corridor railroad system, serving some of our most important industrial areas, collapsed in bankruptcy early in this decade. Without resort to the theory of capitalism, it was restructured into a greatly reduced entity that survives only with massive governmental subsidies. Our entire passenger train system was, in effect, "nationalized." (See "The Sad State of the Passenger Train," a *Time* essay, Exhibit V attached hereto). The ebbing strength of many of our most basic industries is reflected in the enactment of the Trade Protection Act of 1974 by this Congress. Indeed, defective economic policy has led us to tolerate the death of some of our most vital and important industries: our ocean-going passenger vessel industry; large segments of our radio, television, and electronics industries; virtually the whole of our Alaskan bottom fish industry has been taken over by foreign fishermen and seafood processors. Since the end of World War II, we have postponed the collapse of our defective economy through the politically pointless military ventures of Korea and Vietnam. Our unfavorable foreign trade balances, with some slight fluctuation, grow year by year. Our ability to fight unemployment with inflation, and then fight inflation with unemployment, aside from being politically unacceptable at all times, seems to have come to an end as we incur rising inflation and rising unemployment simultaneously.

Clearly, the time has come for Congress boldly to attack our defective, one-factor economic policy and with equal boldness to adopt an economic policy based upon the theory of capitalism. At least one major committee of Congress already has recommended that this be done. (See the extract from pages 170-173 of the Staff Report of the Joint Economic Committee of Congress attached hereto as Exhibit VI).

Since our present national economic policy is set forth in the Employment Act of 1946, this policy change might come about most naturally through the adoption of an amendment to the Employment Act of 1946. A proposed draft of such a policy has been prepared and is attached hereto as Exhibit VII.

IS DEFICIT FINANCING ALWAYS A ONE-WAY STREET?

Long before the United States adopted the general theory of John Maynard Keynes as our national economic policy through the Employement Act of 1946, the United States has been incurring increasing national debt year by year. According to Mr. Keynes, in his GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY*, while deficit financing is appropriate to years of recession or depressed economic activity, such budgetary deficits could and should be paid off in years of prosperity. Without the theory of capitalism, unfortunately, Mr. Keynes was unable to see that technology marched along at almost as rapid a pace during boom years as in depression years--indeed, perhaps at a more rapid pace. Thus, the redundancy of labor increases, and the inadequacy of the purchasing power of labor derived only from wages or salaries or other labor income continues to grow, irrespective of the economic cycle. Thus, the necessity constantly to increase governmental expenditures for boondoggle, in order to disguise the rising number of people on welfare, is little affected by the change from recession to prosperity. My own estimate is that at least 85 percent of the Government budget is devoted to welfare, of which approximately 51 percent is admitted to be such; I estimate another 35 percent or so actually to be used in financing boondoggle--mostly military boondoggle.

One might well conclude from this that if deficit financing is to be used as an instrument of government economic policy, it is a one-way street. It will grow year by year whether we are in recession or in prosperity or in a state between.

I submit, however, that such conclusions are unwarranted. Without assigning blame either to business or to government for their tardiness in recognizing and acting upon the theory of capitalism (after all, I was 200 years late in developing it!), I think that the fragility of many of the major areas of our economy, of which the railroads are only one, has advanced so far as the result of our defective national economic policy and defective business policies stemming from the same source that we must be reconciled to making vast deficit financing expenditures in order to accelerate the transition to a capitalist economy, and to avoid a disastrous breakdown of our present economy.

But there is an enormous difference between deficit financing that monetizes welfare, as virtually all Keynesian-type deficits do, and monetizing self-liquidating productive capital in the course of accelerating the growth of the economy and broadening the base of capital ownership through techniques of finance based upon capitalistic theory. Productive capital in well-managed businesses pays for itself not just once, but repeatedly, in cycles of differing lengths depending upon the business itself, and the condition of the economy. Such well-managed businesses, using research

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* New York, Harcourt, Brace, 1936

and development to keep their products relevant to market demand and sound accounting to set aside sufficient depreciation to restore their capital instruments as they wear out, before computing net income, continue to produce wealth (goods and services) long after their initial financing or acquisition costs have been returned. Thus, by expanding our economy through capitalistic deficit financing that spreads economic autonomy throughout all consumer units of the society, we not only set in motion the forces that enable us to liquidate the national debts as well as private enterprise debts thus incurred, but to eliminate the debts and deficits accumulated during our long misguided romance with one-factor economics.

All businesses, most of our citizens, and the economy as a whole have been hurt by prolonged general ignorance of the theory of capitalism, and our consequent failure to innovate the policy changes it commands us to make. Nothing less sweeping and ambitious than a domestic "Economic Marshall Plan" is required to rebuild and rehabilitate our waning economy, as exemplified by the Milwaukee Railroad, and then go on to multiply the economic power of the United States.

The restoration of the Milwaukee Railroad as a profitable working railroad, providing increased employment and spectacularly improved service as a result of its economic restructuring by means which intensely increase the economic motivation of its employees and its shippers, would be an appropriate first step in turning the American economy around and in making it clear to the world what our economic policy is based upon: the theory of capitalism.

A FULL IMPLEMENTATION OF THE FRAMEWORK OF LAWS REQUIRED TO MAKE THE ADOPTION OF CAPITALISTIC TECHNIQUES OF FINANCE BY BUSINESS IRRESISTABLY ATTRACTIVE IS NATIONALLY URGENT

The CAPITALIST MANIFESTO was published in 1958. Two additional books, innumerable writings, articles in the public press and in business and learned journals, and testimony before at least fifteen committees of the Congress have not yet proven sufficient to initiate a broad-front movement towards clarifying our economic policy, accelerating our growth, and broadening our base of capital ownership. Some beginnings have been made. In a publication by the United States Department of State entitled, "Making New Capitalists--A Creative Response to Income Inequities," it is estimated that some 2,000 ESOPs have been adopted in the United States as of April, 1978. The office of Senator Russell B. Long, Chairman of the Senate Finance Committee, has recently estimated this number at 3,000. (See Exhibit VIII attached hereto).

Nevertheless, only a tiny fraction of the approximately $175 billion of new capital formation that takes place each year in the U. S. economy is so structured that it makes the noncapital owning masses owners of stock representing productive capital. Fewer than one in 100 corporate divestitures involves sales by conglomerates of subsidiaries to the employees of the subsidiary, although the financing of such acquisition through ESOPs normally can be easily arranged. Even the anti-trust division and our federal courts in rendering judgments in anti-trust litigation show no interest in using their powers to see that every possible effort is made to assure that a divestiture is acquired by the employees of the company being divested. Clearly, this is an area where Congress should step in and amend the anti-trust laws--all of them--to make certain that, if feasible, employee acquisition takes place following every corporate divestiture under the anti-trust laws. (See Exhibit IX attached hereto).

In order to further assure that techniques of finance that broaden capital ownership and provide lower cost capital to business will be made irresistibly attractive both to corporations and to their employees, the provisions of H.R. 462, introduced into the 94th Congress by Congressman William Frenzel of Minnesota, a bill which was not reported out of the Ways and Means Committee, should be adopted into law at the earliest possible date. The provisions of that bill would shorten by years the period of change to a truly capitalist economy, and would serve to notify the entire world that the United States is no longer adrift without an economic policy. (A copy of H.R. 462 is attached hereto as Exhibit X).

Much progress toward broader capital ownership could be achieved if Congress would cut the capital gain rates of the personal and corporate income tax by 50% or more for people or corporations who sell stock to ESOPs. It is now well established that merely cutting the capital gain rates, a reduction mainly of interest to speculators in the secondary securities markets, did virtually nothing to promote the financing of new capital formation. This would not be true of cuts in the capital gain rates resulting from selling to ESOPs for, at the very least, broader capital ownership and the distribution of second incomes (incomes from capital) would be promoted, and the sellers, for the most part, inevitably would be close-holding stockholders satisfying their requirements to prepare for estate liquidity and the like. The net effect would be to transfer more capital stock to ESOPs, where it stays in the tax system, and to reduce the amount of stock transferred to general purpose foundations, where it pretty much disappears from the reach of the tax system.

MODIFICATIONS IN THE FEDERAL BANKING LAWS, THE FEDERAL RESERVE ACT, AND RELATED LEGISLATION TO RENDER A DEATH-BLOW TO HIGH INTEREST RATES AND TO SHIFT THE U.S. ECONOMY FROM THE MONETIZATION OF WELFARE TO THE MONETIZATION OF SELF-LIQUIDATING PRODUCTIVE CAPITAL ARE INDISPENSABLE BOTH TO ESTABLISHING A HEALTHY CAPITALIST ECONOMY, AND TO INCREASING THE LEVEL OF PRODUCTIVENESS AND OF ECONOMIC ACTIVITY WITHIN THE U.S. ECONOMY TO ENABLE GOVERNMENT TO REGAIN ITS FISCAL HEALTH.

The defective strategy of business enterprise has been caused by the failure of the western industrial nations during the first 200 years of the Industrial Revolution to discover or develop the theory of capitalism. Government must now correct this defective strategy both within the private and public sectors by espousing and implementing the theory of capitalism and by assuming leadership in the education of the American people on the implications of that change in economic policy in all areas of public and private life.

Capitalism does not imply governmental "hands-off" or *laissez-faire*. Rather, the adoption of a capitalist economic policy *implies* governmental structuring of the monetary and banking systems to conform with that policy and to engage in the minimum of bureaucratic regulation required to implement conformity to a capitalist economic policy.

The steps necessary to bring about that change in the monetary system, to engineer the switch from monetizing welfare to monitizing self-liquidating productive capital, are outlined in a letter to President Gerald R. Ford, dated January 17, 1975, and the summit statement prepared for the President's Summit Meeting on Inflation convened in Washington, D.C., September 27-28, 1974, attached hereto as Exhibit XI.

No single piece of legislation intended to establish a capitalist economic policy and to carry that policy into constructive action exceeds this recommendation in importance.

<u>THE COLLAPSE OF THE MILWAUKEE RAILROAD, LIKE MOST OTHER BREAKDOWNS OF MAJOR ENTERPRISES AND INDUSTRIES IN THE U.S. ECONOMY, FLOWS, DIRECTLY OR INDIRECTLY, FROM A DEFECTIVE ECONOMIC POLICY. THIS DEFECTIVE POLICY IS NOT JUST AN OFFICIAL POLICY ADOPTED BY GOVERNMENT THROUGH THE EMPLOYMENT ACT OF 1946, BUT AN IDENTICAL AND RELATED ECONOMIC POLICY FOLLOWED BY THE PRIVATE SECTOR AND INDIVIDUAL CORPORATIONS IN IT.</u>

The western lines of the Milwaukee Railroad in particular, because of their crucial significance to our national energy problem -- and, if we fail to solve this problem, the downfall of our economy is inevitable -- are of immediate and urgent importance. Congress should take the steps necessary to make certain that the Milwaukee is rescued. But the rescue should not take the usual form of deficit financing of a railroad enterprise which continues to suffer from the same structural defects as its predecessors. This approach would be hopeless, futile and never-ending.

A plan to revitalize the Milwaukee Railroad should include the restructuring of the economic policy that is responsible for the railroad's downfall, as well as the restructuring of the enterprise itself. This dual economic and operational plan for enabling the Milwaukee Railroad to take over and conduct its business should be built upon the principles of a new capitalist economic policy which Congress can no longer delay espousing.

From every point of view, it would appear that no single matter before Congress now or which will come before Congress in the future, could be more urgent and vital than the adoption for the United States of an economic policy built upon the logic diagram that flows from the theory of capitalism. Happily for both Congress and the United States, the urgent business of rehabilitating the Milwaukee Railroad and the important business of heading the Nation in a sound economic direction converge. The two goals, in my opinion, can be initiated and accomplished together. Although the task of rehabilitating the Milwaukee Railroad is vastly smaller than that of revitalizing America's economic policy, the implications of restructuring this defunct rail system on sound capitalist logic would make the United States what it has never been and is not today -- the first truly capitalist economy on earth. The consequences of a capitalist economic policy that works as well for <u>all</u> people as the pseudo-capitalist economies of the past have worked for the pinnacle few would reverberate around the earth.

<u>THE WIDESPREAD ASSERTION THAT NO COMPREHENSIVE AND COHESIVE ECONOMIC POLICY EXISTS IN CONGRESS, OR IN THE ADMINISTRATION, OR IN THE PRIVATE SECTOR, SHOULD BE LAID TO REST BY CONGRESS TAKING DECISIVE ACTION IN ADOPTING THE ONLY POSSIBLE, DEFENSIBLE ECONOMIC POLICY FOR THE UNITED STATES: AN ECONOMIC POLICY BASED UPON THE THEORY OF CAPITALISM.</u>

The time to make a watershed change in the economic policy of the United States, and thus initiate a watershed change in the economic policies of the world, is the moment that the need for such change becomes incontrovertibly clear. It is submitted that all evidence points to the fact that the time for economic innovation is at hand. It is further submitted that a modest but, nevertheless, decisive and sound first step in the right direction would be for Congress, the Federal District Court sitting in the case of the bankruptcy of the Milwaukee Railroad, its trustee, the employees and the Milwaukee Railroad and its creditors, with expeditious planning, to cooperate in the launching of a new railroad enterprise. Such an enterprise should set out to rehabilitate and put in first class condition the railroad facilities, particularly the long western lines so critically important to the national interest as well as to the communities through which they pass, with all the single-minded enthusiasm displayed by the German and Japanese peoples in rebuilding their countries after World War II. Such a model, which I believe to be entirely feasible from every standpoint, would be an appropriate launching pad for the many and more far-reaching changes discussed above.

Respectfully submitted,

KELSO & CO., INCORPORATED

By Louis O. Kelso
Louis O. Kelso, President & Chief Executive Officer

June 21, 1979

EXHIBIT I

1/25/78

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EXHIBIT II

SUGGESTED READING ON TWO-FACTOR ECONOMICS

Books

THE CAPITALIST MANIFESTO by Louis O. Kelso and Mortimer J. Adler (Originally published by Random House, New York, 1958. Republished 1975 and presently available through Greenwood Press, 57 Riverside Avenue, Westport, Connecticut 06880, Tel. (203) 226-3571.)

THE NEW CAPITALISTS by Louis O. Kelso and Mortimer J. Adler (Originally published by Random House, New York, 1961. Republished 1975 and presently available through Greenwood Press, 57 Riverside Avenue, Westport, Connecticut 06880, Tel. (203) 226-3571.)

TWO-FACTOR THEORY: THE ECONOMICS OF REALITY by Louis O. Kelso and Patricia Hetter (Random House, New York, 1967; Paperback Edition, Vintage Press, 1968)

Testimony

Testimony by Louis O. Kelso before the Joint Economic Committee, U.S. Congress, December 11-12, 1975, on "Employee Stock Ownership Plan Financing and Other Financing Concepts Based on Two-Factor Economics"

Testimony by Louis O. Kelso, Norman G. Kurland and Patricia Hetter before the Senate Finance Committee, U.S. Congress, March 31, 1976, on "Major Tax Revisions and Extension of Expiring Tax Cut Provisions"

Reports and Publications

"ESOPS: An Analytical Report" prepared for the Profit Sharing Council of America, Chicago, Illinois, by Hewitt Associates, Deerfield, Illinois

"Employee Stock Ownership Plans" prepared by The Committee of Publicly Owned Companies, New York, New York

"A Symposium on Employee Stock Ownership Plans", The American University Law Review, Spring 1977, Volume 26, No. 3, prepared by The Washington College of Law, American University, Washington, D.C.

"Making New Capitalists -- A Creative Response to Income Inequities" prepared by the 1977-78 Twentieth Session, Executive Seminar in National and International Affairs, Department of State

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EXHIBIT III

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CONSUMER STOCK OWNERSHIP PLAN (CSOP)

For Building Equity Ownership Into
Public Utility Consumers

A brief functional description of the technique for building capital ownership into public utility consumers will be useful here.

1. Escrow accounts with any designated banks, or with the public utility itself, would be established for each of the public utility's consumers.

2. By law the public utility would be given the power to mandate (that is, require) the subscription by each of its service consumers to their proportionate part (based on their relative estimated needs) of a ten-year moving capital budget of the public utility, covering the total capital formation requirements, except those financed through the utility's ESOP. Payments on this subscription would be synchronized with the utility's cash requirements. Methods for adjusting the subscription for over- or under-estimated needs would be designed.

3. Funds for the payment of each consumer's subscription would be provided by a consortium of banks, insurance companies, and perhaps savings and loan firms.

4. The subscriptions by each consumer would be payable solely and exclusively from the dividends received by the consumer from the public utility.

5. The public utility would be contractually committed, or perhaps legally required, to make a full pay-out of the proportionate earnings attributable to employees acquiring its stock through ESOPs and consumers acquiring its stock through capital-ownership financing escrows. Such dividends would be made deductible from corporate income for tax purposes, both at the state and federal levels.

6. The public utility's ESOP loan paper, and its consumer loan paper, would be made directly discountable with the Federal Reserve Bank at the minimal discount rate (1/2% at most, I estimate) as outlined in my written testimony to the Joint Economic Committee (see Pages 16-22).

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7. The effective interest rate to the borrower (the ESOP or the consumer escrow) would not exceed 3%, and perhaps more closely approximate 2%, including generous bank profits.

8. Until the public utility's consumer stock has been paid for on a share-by-share basis, the dividends received would not be taxable to the consumer. However, as soon as the stock is paid for, again on a share-by-share basis, the dividends would become taxable income to the consumer, and would have the effect of offsetting, that is, reducing, the consumer's public utility service bill.

9. Thus the overall effect of the application of two-factor principles to public utility financing would be to hold down costs of production, on the one hand, by providing employees with an increasing second income through their capital ownership and motivating them to restrain their demands for progressively more pay in return for progressively less work (as at present), while, on the other hand, raising the power of the public utility consumer to pay his or its public utility bills. The payout period on most financings would be four to five years, I estimate, at the contemplated interest rates.

10. The low interest rate involved in the use of pure credit in such financing is not, in any sense of the word, "subsidized" by government. It is simply the use of pure credit (the power of people to contract with each other in contracts payable in money, in a society where all may enforce or defend their rights under such a contract) for the purpose of building self-sufficiency and productive power into the consumers of the society and for the purpose of motivating the employees in the economy. Nothing involved in the transactions enters into the government's income or capital accounts in any way. No governmental debt, deficit or subsidy is involved.

THE CONSUMER STOCK OWNERSHIP PLAN

A Technique of Finance Derived from Two-Factor Economics for Providing Virtually Unlimited Low Cost Capital to Finance Sound, Well-Managed, Regulated Public Utilities while Building Ownership into Consumers in Proportion to Their Relative Consumer Needs for the Utility's Services

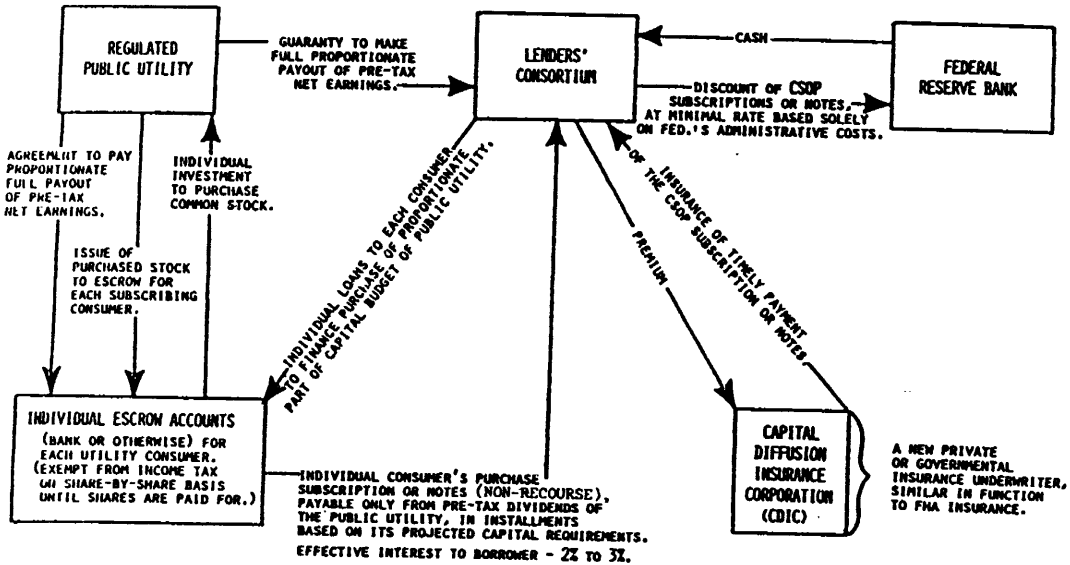


EXHIBIT IV

Valley Nitrogen Producers, Inc., A California Corporation
The First Consumer Stock Ownership Plan*

In 1957, a number of farmers, led by a small independent fertilizer distributor from Modesto, California, by the name of Carl Haas, came to Kelso from the San Joaquin Valley. They said they were suffering from the Government's plan to reduce each year the number of acres on which they would be accorded cotton-support allotments under the Government's cotton allotment program, and that they nevertheless desired each year to produce larger cotton crops. There is only one way to do this, they explained, and that is to use progressively more nitrogenous fertilizers: Anhydrous ammonia, ammonium sulfate, ammonium phosphate, various dry and liquid mixes, etc.

*Explanatory Note - The Consumer Stock Ownership Plan (CSOP) is a technique of corporate financing, designed by Louis O. Kelso and based on the principle of two-factor economics.

In *The New Capitalists*, written by Louis O. Kelso and Mortimer Adler and published by Random House in 1961, Kelso and Adler pointed out that the logic of corporate finance is planned investment under which businesses acquire capital assets on terms where they are expected to pay for themselves within a reasonable period of years--normally three to five years; that the assets will thereafter proceed to throw off net income virtually indefinitely, sufficient funds being set aside out of gross income as depreciation to constantly renew the productiveness of such assets before net income is computed. Naturally other considerations are also requisite: competent management, intelligent research and development, constant market analysis, etc.

Nevertheless, said Kelso and Adler, given that logic, the question of who become the owners of the capital assets once, they have paid for themselves, is strictly a matter of:

-- Financial design of the enterprise.

-- Legal design of the enterprise.

-- The identity of the ultimate beneficiaries of the extension of credit.

For example, when a corporation, using conventional methods, finances its growth by borrowing, the stockholders are the non-recourse beneficiaries of the credit extended. When the assets have paid for themselves, the stockholders of the corporation become the owners of the added assets, and thereafter the net income produced by the assets accumulates and/or is distributed for the benefit of the stockholders who are the owners of the corporation.

In the manufacturing of nitrogenous fertilizers on a commercial scale, the starting point is anhydrous ammonia, a product made by a nitrogen-fixation process, using nitrogen from the air and huge quantities of natural gas to provide the other principal ingredient, hydrogen. Such chemical plants must be large to be efficient, and must be operated continuously except for planned down-time for maintenance and occasional breakdowns.

Prior to Kelso's meeting with Carl Haas and his farmer friends, the price of anhydrous ammonia (and proportionally of all other nitrogenous fertilizers in which anhydrous is the basic ingredient) had been maintained for many years by several major petro-chemical producers (the "majors") at around $250 per ton. The farmers who came to Kelso insisted that this was an unreasonable price, and that their profit-ability depended upon their getting lower fertilizer costs. This, they were convinced, required their building their own fertilizer complex, the cost of which at the beginning would range somewhere in the $20 million area, and when expanded to serve their purposes (as it ultimately was), would require $100 million or more investment.

To do the task efficiently, Kelso realized the financial and legal design would require the certain characteristics:

-- Investment subscriptions would have to be proportioned to long-term fertilizer needs.

-- Subscriptions would have to be bankable, even though designed to be paid from dividend revenues.

-- Corporate income tax should be avoided, or in any event, kept to a minimum.

-- Investors would have to be contractually committed to buy their total requirements of fertilizer from the new corporation ("VNP") for as long as the anti-trust laws would permit. After research, Kelso concluded this would take seven years.

-- The wages of capital, i.e. the corporate net income, would, as a matter of contractual commitment to stockholders, be paid out fully and regularly, after debt service and operating reserves only, to the stockholders. This was made possible by the arrangement that locked the amount of subscription to the stockholder's estimated fertilizer requirements, and committed him to buy his total requirements from the corporation.

-- The corporation was given sufficient characteristics of a farmer-cooperative for tax purposes (although it was a business corporation for other purposes), so that its income, under the tax laws prevailing until about 1965, would be subjected to virtually no tax. Its commitment to pay out net earnings to shareholders, plus depreciation approximately equivalent to its debt service, made this possible.

-- The then prevailing tax laws provided that dividends of a farmer cooperative, applied to payment of stock purchase price, would not constitute taxable current income to the stockholder. Only after the farmer's stock was paid for did subsequent dividends constitute taxable farmer-stockholder income, and then only as a reduction of farming costs [thus increasing farm profits], since such dividends were contractually adjustments of the farmer's purchase price for his fertilizer.

Thus all the characteristics of a Consumers' Stock Ownership Plan (CSOP) were present. Bank loans against the subscriptions paid for the plants as built. The payout of dividends was such that most stockholders paid for their subscription installments out of their dividends. So long as stock was being paid for, corporate income was free of tax and stockholders were not taxed on dividend income applied to stock purchase price.

The real power of these financing techniques to build highly capital-intensive enterprise, with some $100 million ultimately required, and to make significant stockholders out of some 9000 farmers, most of whom had never before owned a share of stock, was demonstrated by the fact that the plants paid for themselves notwithstanding that, just as VNP's first plants began production, the majors dropped the price of anhydrous ammonia from the $250 per ton area to $66 per ton, and proportionately reduced the prices of other fertilizers. In its subscription agreements, VNP was contractually committed to sell to its stockholer-customers at the prices established by the majors, so these reduced prices automatically became VNP's reduced prices.

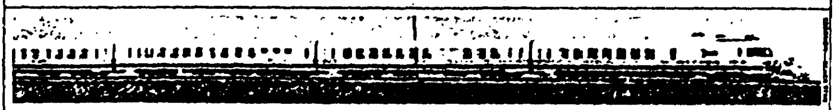
The end result was not just to add considerable wealth to the farmer-stockholders, but to save all farmers of the State, Kelso estimates, well over $1 billion in fertilizer costs during the 15-year period before a world-wide fertilizer shortage drove up fertilizer prices.

Clearly, any regulated public utility with relatively modest Federal and state legislative changes, is an even more apt vehicle for CSOP financing. Even better if CSOP financing is used in tandem with ESOP financing that builds a reasonable proportion of ownership into employees.

Kelso & Co., Incorporated
November 8, 1976

EXHIBIT V

Time Essay



The Sad State of the Passenger Train

Certain public services are so obviously desirable that they are beyond debate in modern urban societies. The thought of doing without schools, parks, hospitals, street lighting and such could scarcely enter a civilized mind. The ever wandering human species recognized roads as obvious necessities soon after man began meandering across the earth. Later, mechanical wonders that aided travel were put in the same category. Today every ranking industrial nation nurtures the use of cars, buses and airplanes. Along with these, railroads are treated as indispensable in every well-developed country—except one.

The amazing exception happens to be the U.S., a nation that pioneered in railroading with more vigor and daring than any other in the 19th century. It also did so on a grander scale, binding an immense continent with tracks and producing trains of such magnificence that they moved Nathaniel Hawthorne to exclaim: "They spiritualize travel!" Most Americans once agreed, and even today travelers lucky enough to wind up on a good train find this way of traveling superior in every way to the fumes and peeves of the throughways and the sardine-can intimacy of the time-rupturing jet planes. Yet, in spite of the heroic past, the U.S. has let its passenger rail travel system fizzle and sputter down into a national embarrassment.

Today service is scant, schedules are unreliable and amenities are often sparse. The equipment includes, in the forthright phrase of Amtrak President Alan Boyd, "a lot of junk." The situation might be called ridiculous if only in light of the universal recognition of the passenger train as the most expedient mode of moving large numbers of people from city to city. In an energy-short era, the railroad, fully exploited, offers the most fuel-efficient means of public transport.

The plight of U.S. passenger travel is downright humiliating when it is compared with the superb services of, say, Japan, France and Britain. British trains run so close to the mark that passengers carp about a five-minute overdue arrival. Japan's celebrated bullet trains, at up to 130 m.p.h., make the U.S. counterparts seem like earthworms. Naturally such service does not come free. Britain subsidizes its trains at a yearly rate of $728 million, Japan (with less than half the U.S. track mileage) at $4.1 billion and France at $930 million.

When Amtrak was created eight years ago there was hope for improved U.S. passenger trains, and there was even some progress. But now, with the country still needing to do a great deal better, it stands at the verge of deliberately doing worse. Reason: a Department of Transportation plan that would amputate 12,000 miles from Amtrak's 27,500-mile system. It would also wipe out some popular trains, including the Washington–New Orleans *Crescent* and New York–Canada *Montrealer*. This would be accompanied by slashes in Amtrak funds, forcing the company into offering truncated services at higher fares.

Though the plan would likely reverse the recent trend of growing ridership, Transportation Secretary Brock Adams insists that it is constructive. Still, he has pushed it in Congress mainly as a handy device for saving perhaps $300 million a year. Congress, which must reject or acquiesce in the scheme by May 22, has so far seemed woefully ready to let it go into effect without substantial changes.

Rail travel advocates fear that, on top of the sudden loss of almost half of Amtrak's system, the plan might mark the beginning of the end for all significant intercity rail services in the U.S. Even if it may be too late to stop the DOT plan, it is not too late to examine how the U.S. came to such a shabby pass.

The amputation plan embodies a whole bundle of questionable notions that have long clouded the prevalent American view of passenger rail service. A conspicuous one among them was evident in the chartering of Amtrak, which was directed to function as a profit-making organization. The cold fact is that no national passenger system, in the final accounting, ever pays its own way. Amtrak's succession of deficits ($600 million this year) was inevitable, and the DOT reaction rested on yet another flawed notion: the remedy for an insufficient passenger system is to cut it back and make it even less sufficient. These and other peculiar notions—including the specious belief that Americans do not really like to ride railroads—add up to a sort of official mythology of passenger travel in the U.S.

The odd thinking that has long held sway in national rail travel policy springs out of a stubborn resistance to rail travel as a public service justified not by profits but by its contribution to social convenience and well-being. After all, municipalities everywhere subsidize local mass transit and recognize the obvious need to do so. Washington still thinks of automobile transportation as strictly private, even though the Federal Government alone has invested some $48.6 billion in roads since 1971. Airlines are similarly considered private, even though they would be as financially strapped as Amtrak if they were billed for only the nearly $2 billion the public pays each year for the air traffic control systems. Every attentive citizen, finally, becomes aware of the inextricable public-private money mix that sustains all transport. But the strangest thing—and perhaps the most revealing—is that nobody gets worked up about it except when the issue of railroads comes up.

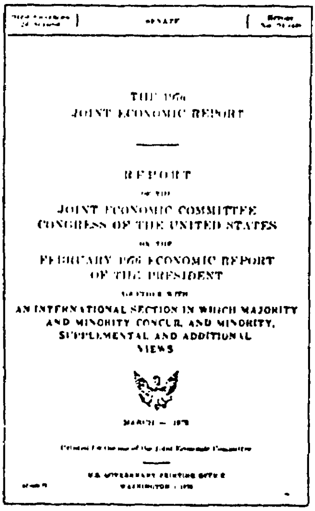
This peculiar official sentiment is linked, underneath, to a mental picture of the railroad industry that lingers from the past. The trains that used to inspire novelists and songwriters were contrivances of freebooting laissez-faire capitalism, and they became symbolic monuments to a time that believed that any enterprise that could not make a profit deserved to die. In fact, though, an extensive passenger-train network tenuously survived into the 1940s, when, suddenly needed for war duty, it worked profitably at capacity. Then, in the postwar period, when the nation lavished attention and money on the development of air and highway transport, rail travel sank into the red. One reason was that the mail subsidies that used to help pay the basic cost of a passenger train were increasingly handed to truckers and airlines. Passenger trains fell into the trend of continual service cutting that both reduced chances for a comeback and encouraged Americans to turn more and more to cars.

Despite this unfortunate history, the nation that has so superbly cultivated highway and air travel could plainly do just as well by rail travel if it chose. The energy crunch alone, which is already creating a surge of new riders on Amtrak's long-run trains, is good cause for so choosing. But there are many other reasons for doing so, not least that train travel at its best, in addition to being highly efficient, is perhaps the most attractive form of travel for millions. Before any obviously desirable passenger system can be built, however, the country will have to realize that it is not the passenger train, but only its thinking about it, that is obsolete.

— *Frank Trippett*

EXHIBIT VI

EXTRACT FROM PAGES 170-173 OF THE 1976 JOINT ECONOMIC REPORT OF THE JOINT ECONOMIC COMMITTEE


THE 1976 JOINT ECONOMIC REPORT

REPORT OF THE JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES ON THE FEBRUARY 1976 ECONOMIC REPORT OF THE PRESIDENT TOGETHER WITH AN INTERNATIONAL SECTION IN WHICH MAJORITY AND MINORITY CONCUR, AND MINORITY, SUPPLEMENTAL AND ADDITIONAL VIEWS

MARCH — 1976

"Today's fears of capital shortage may turn out to be reminiscent of the growth-rate controversy of the early 1960s. In the wake of two back-to-back recessions from 1957 to 1961, many observers feared that the American economy was trapped in a pattern of sluggish growth and was destined to lose ground on its world-market competitors and perhaps even to be overtaken by its adversaries of the Communist world. America's confidence in her technological leadership was shaken by the early successes of the Soviet space programs. In fact, however, the American economy at that time was on the brink of one of its most prolonged periods of growth and prosperity with rapid investment and productivity gains.

Today again, after two business recessions between 1969 and 1975, separated by a period of great economic turbulence and very high interest rates, many observers fear that investment levels will not be adequate to avert future shortages and the associated inflationary pressures. The financial strength of many businesses has been sapped, and they are uncertain about the future. Substantial investment resources must be diverted for pollution control and expansion of energy supplies.

Again, however, the economy has the potential for sustained growth and productivity gains with subsiding inflation. A significant advantage over the earlier period is the present rapidly growing labor force. Thus, policies should be tailored to generate a prompt recovery of output and a sustained longer-run expansion.

Broadening the Ownership of New Capital

Wealth in the United States is concentrated in the hands of a relatively small fraction of the population. Unfortunately, the data on wealth are sparse. The last comprehensive attempt by the Federal Government to measure its characteristics and distribution was made by the Federal Reserve Board in 1962. It was estimated that more than three-quarters of the country's total wealth was owned by less than one-fifth of the people, while more than one-quarter was owned by just the top 0.5 percent. The Federal Government should remedy the lack of up-to-date information on personal wealth through periodic surveys and comprehensive reports on this subject.

The distribution of wealth reflects in large part the pattern of ownership of non-residential capital with corporate shares being one of its principle forms. This category of wealth is much more concentrated than total wealth, with the top percentile of the personal income distribution owning 51 percent of the market value of individually owned corporate stock and receiving 47 percent of the dividends. Meanwhile, the new capital assets generated by businesses, which in recent years have averaged well over $100 billion annually, redound largely to the benefit of these persons who already have great wealth.

The number of shareholders, moreover, declined by some 18 percent from 1970 to 1975, and data suggest that young people today are not purchasing stocks in significant volume. Balancing this declining role of the individual investor has been the rise of financial institutions, which since 1950 have more than trebled their share of the market value of stock holdings.

To begin to diffuse the ownership of capital and to provide an opportunity for citizens of moderate incomes to become owners of capital rather than relying solely on their labor as a source of income and security, the Committee recommends the adoption of a national policy to foster the goal of broadened ownership. The spirit of this goal and what it purports to accomplish was endorsed by many of the witnesses at our regional hearings.

Without getting into specifics, the types of programs which could be established to help meet this goal will be outlined. Such alternative methods of broadening capital ownership are under study by the Committee.

In the individual firm, employee ownership can be encouraged directly through tax incentives to the employees to purchase stock or to firms to place newly issued stock into the hands of their employees. The latter approach, known as Employee Stock Ownership Plans (ESOPs), was examined in recent hearings by the Committee.

An alternative plan involves multifirm funds which would receive tax-favored contributions from affiliated firms and issue nonnegotiable fund certificates to the employees. This type of fund, which has been in operation in France and West Germany, may diversify its portfolio, although it may be limited to particular industries and regions.

Providing ownership opportunities not just to employees but to citizens at large could be accomplished through various devices. One example would be the establishment of funds which would accumulate personal savings on a tax-preferred basis and use them to acquire a diversified portfolio of equity shares in corporations. For instance, individuals with earned income not exceeding $20,000 could be allowed to save up to $3,000 a year in one or more funds and to deduct this amount from their taxable incomes.

Whatever the means used, a basic objective should be to distribute newly created capital broadly among the population. Such a policy would redress a major imbalance in our society and has the potential for strengthening future business growth.

> To provide a realistic opportunity for more U.S. citizens to become owners of capital, and to provide an expanded source of equity financing for corporations, it should be made national policy to pursue the goal of broadened capital ownership. Congress also should request from the Administration a quadrennial report on the ownership of wealth in this country which would assist in evaluating how successfully the base of wealth was being broadened over time."

EXHIBIT VII

"The Individual Economic Self-Sufficiency Act of 1977"
Or
"The Equal Economic Opportunity Act of 1977"

An Act to declare a national policy (1) on facilitating the full employment (as herein defined) of all able-bodied and competent persons, (2) on the full participation in the production of economic goods by all consumer units in the economy, (3) on the protection of private property in individual labor power and in the ownership of capital as the factors of economic production, and for other purposes . . .

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Short Title:

SECTION 1. This Act may be cited as "The Individual Economic Self-Sufficiency Act of 1977" or "The Equal Economic Opportunity Act of 1977".

Declaration of Policy:

SECTION 2. Congress declares it is the continuing policy and responsibility of the Federal Government to recognize, and to encourage the citizens of the United States to recognize that:

A. The work of people is of two kinds, corresponding in general to the two aspects of humans, animal and spiritual: one of these is the work of producing economic goods and services to satisfy people's need for creature comforts and economic security, and the other is the work of producing the goods of civilization which administer primarily to the mind and spirit of man, including the arts, the sciences, religion, education, philosophy, statesmanship, and the like.

B. There are two methods or means which people may engage in the production of economic goods. These are through human labor and through capital; that capital consists of all those things which are external to people, are privately ownable under the prevailing system of laws, and which are capable of being engaged in production.

C. Capital, as the result of technological advance (including automation), plays (and increasingly since the beginnings of the industrial revolution has played) an expanding role in the production of economic goods and services, while human labor plays (and presumably will always play) the dominant and unlimited role in the production of the goods of civilization. The purpose and end of all productive activity, both economic and of the goods of civilization, is the consumption and enjoyment of such goods by people.

D. It is the policy of the United States to assure and protect the integrity of private ownership of the means or methods of production by the individual citizens of this nation and by others authorized to own, and owning, productive property herein; that in the case of the production of economic goods and services, the functional essence of such private ownership lies in the right and privilege of the individual owner of each productive factor so engaged in production to receive, as a matter of right, the product of the thing owned; that this principle of private property is equally applicable to the income or wealth produced by the labor power privately owned by the worker and to the income or wealth produced by the nonhuman factor owned by the capital owner; that the right and privilege of private property in the means of production is meaningless in a free economy and free society unless the value of the income or wealth produced by such means of production is (except in the case of legally authorized and regulated monopolies) freely and impartially determined by the forces of supply and demand in workably free, competitive markets; that this principle of private property in the means of production is embodied in the principle of distribution of economic goods and services (or their purchasing power equivalent), of the private-property, free-market economy of the United States, which is "from each according to what he produces, to each according to what he produces."

E. The nature and function of technology is to provide the means by which man harnesses nature and makes her perform for him the work of producing economic goods and services; that through progress in technology, man transfers the burden of economic production from the labor to the capital; that the promise implicit in technology is the reduction in the severity of the burdens of labor, or the elimination altogether of many types of human toil of people for the production of economic goods and services, and thus to free people to devote ever more fully their energies to the advancement of civilization through the more disciplined and difficult work of producing the goods of civilization, so that the full employment of peoples' energies must consist increasingly, as technological progress moves forward, in their devoting their energies, efforts, and powers to the production of the goods of civilization.

F. The freedom and dignity of each consumer unit (household) within the American economy, whether it be comprised of an individual or of two or more individuals, requires that each such consumer unit produce, and that it constantly have the power and opportunity to produce, within the limits of the overall capacity of the economy, the purchasing power equivalent of the economic goods and services which it reasonably desires to consume; that the recognition of this right on the part of each household imposes upon the Government of the United States and upon the governments of the several states of the Union, to the extent they shall by appropriate legislation concur herein, a social responsibility to foster the institutions under which citizens may produce the economic goods and services, and may acquire the private ownership of the means of producing the economic goods and services necessary to provide themselves with individual economic well-being and security or economic self-sufficiency, and to render unnecessary any citizen's being or becoming an object of economic welfare distribution based upon need in any form.

G. The production of wealth (i.e., economic goods and services) is a means to an end, and is not an end in itself; that labor should never be considered a "resource" to be "fully employed" in the production of economic goods and services if those economic goods or services can be effectively produced by the non-human factor of production; that the end to which the production of wealth is a means is the living of a good, comfortable, secure, creative and law-abiding life for individual citizens.

H. The market value of the economic goods and services produced by a free-market economy within a given period of time is approximately equal to the aggregate purchasing power distributed as a direct result of the productive process to those who participate, either through employment of their privately-owned labor power or their privately-owned capital, or both, in the process of economic production.

I. Any consumer unit of this economy that consistently produces, either through its privately-owned labor power, its privately-owned capital, or both, wealth and income in excess of what it reasonably desires to consume and reasonably needs to provide it with economic security, under conditions wherein any other consumer units in the economy are consistently deprived of the opportunity to produce sufficient economic goods and services or the purchasing power equivalent thereto equal to what they reasonably desire to consume and to provide themselves with economic security, is thereby seeking to excessively concentrate its ownership of personal economic power to produce wealth and thus to indulge its greed; that it is the policy of the United States to discourage and prevent greed where it interferes with the individual economic productive rights of citizens of the United States.

J. Unlike the production and employment of economic goods and services, the production and enjoyment of the goods of civilization is an end in itself, and the need of society for the goods of civilization is unlimited; that the ultimate goal of a free society is to maximize the production and enjoyment of the goods of civilization, not for economic reward, for they are things that are inherently desirable and that ideally would not be produced for economic reward, but for their intrinsic value, for the contributions to society and humanity which they comprise, and for the achievement involved in their creation and contribution.

K. Assuming the availability of land and natural resources, each mature individual other than those who suffer physical or mental infirmity, is born with the private ownership of the means (his labor power) to contribute, in a pre-industrial, pre-automated economy, to the production of economic goods and services for the satisfaction of his creature needs and desires; that as technological change moves through the advanced stages of automation, the burden of production of economic goods and services falls increasingly upon capital, thus reducing and in some cases eliminating the economic productiveness of the human factor of production; that under these conditions, the freedom, dignity and general affluence of individuals requires that the Government of the United States and the governments of the several states of the Union, to the extent that each of them, by appropriate legislation, shall concur herein, promote and foster the institutions under which citizens may maintain and increase their economic productiveness through their lawful and orderly acquisition of increasing quantities of the private and individual ownership of capital.

SECTION 3. The Congress declares that it is the continuing policy and responsibility of the Federal Government to use all practicable means consistent with its needs and obligations and other essential considerations of national policy, with the assistance and cooperation of industry, banking, finance, agriculture, labor and state and local governments, to coordinate and utilize all its plans, functions and resources for the purpose of creating and maintaining, in a manner calculated to foster and promote free competitive enterprise and broad, effective, individually-owned, private property in capital, and the institutions and agencies necessary thereunto, and the general welfare, conditions under which there will be afforded full opportunity for every consumer unit, or household, comprised of one or more individuals, able, willing and seeking to produce the wealth (income) which its member or members reasonably desire to consume, to produce such wealth and income, either through useful employment, including self-employment, or through a combination of the two, and to promote the maximum production of wealth and income for all households in the economy with a minimum of personal toil and drudgery.

SECTION 4. Economic and Leisure Work Report of the President.

A. The President shall transmit to the Congress not later than January 20th of each year an economic report (hereinafter called the "Economic Report") setting forth:

1. The rate of production of economic goods and services, the levels of participation in economic production by the households of the economy, the extent to which such production is being achieved respectively through labor, and through privately-owned capital, the levels of purchasing power of the households of the economy and the extent to which they result from employment, the private ownership of capital, and from other sources, and the levels and composition of production needed to carry out the policies declared in Sections 2 and 3 hereof;

2. Current and foreseeable trends in the rate of production of economic goods and services, the levels of participation in economic production by the households of the economy, the levels of employment, the levels of capital ownership, and the economy resulting respectively from participation in production through employment, through the private ownership of the nonhuman factor, and from other sources;

3. The degree to which the value of labor and the value of productive capital are determined by the forces of supply and demand in workably free competitive markets, or are administered, manipulated or controlled by private persons, by private corporations, or by public agencies, or otherwise;

4. The extent to which goods and services are being produced by government or government-owned agencies or entities or by nonprofit corporations;

5. The levels of concentration of the ownership of capital, and the extent to which greed in connection therewith may be impairing the right of all households within the economy to produce the wealth or income which they reasonably desire to consume;

6. The availability and adequacy of private and/or governmental institutions or agencies for facilitating by financing and by other lawful means the purchase or acquisition of productive capital by households with sub-viable capital holdings;

7. The levels of idleness or failure to engage in creative work within the society, and current and foreseeable trends therein;

8. The extent to which the economically available creative talents and energies of the citizens are fully engaged in contributing to the work of civilization, including the arts, the sciences, religion, education, philosophy, statesmanship, etc., the current and foreseeable trends therein and recommendations for changes and improvements therein;

9. The degree of effectiveness of the laws, both Federal and of the several states, providing for the protection and integrity of private property in the ownership of each of the means or methods of production;

10. The levels of technological improvement, and the adequacy thereof, under the prevailing state of development in the physical sciences and in engineering, to maximize the production of goods and services within the economy with a minimum input of human toil and drudgery;

11. The extent to which wealth and income may be distributed within the economy on the basis of need rather than on the basis of contribution to production, and of current and reasonably foreseeable trends therein and recommendations for the minimization thereof;

12. The levels of technological advance within the various industries, and the current and foreseeable trends therein, and recommendations for the acceleration and improvement thereof;

13. A review of the economic programs of the Federal Government and of the several state governments relating to each of the foregoing during the preceding year and of their effect upon the production of goods and services, the production of the goods of civilization, the minimization of toil, the private ownership of the means of production, the existence of workable and free competition within the markets of the economy, and upon the existence and extent of idleness or the failure to fully employ the creative talents and energies of the people of the United States, and of the means available for the minimization and elimination of such idleness;

14. A program for carrying out the policy declared in Sections 2 and 3, together with such recommendations for legislation as he may deem necessary or desirable.

B. The President may transmit from time to time to the Congress reports supplementary to the Economic Report, each of which shall include such supplementary or revised recommendations as he may deem necessary or desirable to achieve the policy declared in Section 2 and 3.

C. The Economic Report, and all supplementary reports transmitted under Subsection B of this Section shall, when transmitted to Congress, be referred to the Joint Committee created by Section 6.

SECTION 5. Council of Economic Advisors.

A. The Council of Economic Advisors (hereinafter called the "Council") created in the Executive Office of the President by the Employment Act of 1946 is hereby designated as the Council of Economic and Leisure Work Advisors under and for the purposes of this Act. The Council shall continue to be composed of three members who shall be appointed by the President by and with the advice and consent of the Senate, and each of whom shall be a person who, as a result of his training, experience and attainments, is exceptionally qualified to analyze programs and activities of the government in the light of the policy declared in Sections 2 and 3 of this Act and to formulate and recommend national economic policy to promote full participation in the production of economic goods by all households in the economy, broader and more effective private capital ownership, production, the expansion of privately-owned competitive enterprise, the full utilization of the creative energies and talents of all citizens and residents of the United States and its territories, and the minimization of human idleness. The President shall designate one of the members of the Council as Chairman and one as Vice Chairman, who shall act as Chairman in the absence of the Chairman. The incumbents of the Council of Economic Advisors established by the Employment Act of 1946 holding office on the effective date of this Act shall hold such offices in the Council of Economic Advisors hereunder, subject to the provisions of this Act.

B. Employment of Specialists, Experts and Other Personnel.

The Council is authorized to employ, and fix the compensation of, such specialists and other experts as may be necessary for the carrying out of its functions under this chapter, without regard to the civil-service laws, to employ such other officers and employees as may be necessary for carrying out its functions under this chapter.

C. Duties.

It shall be the duty and function of the Council:

1. To assist and advise the President in the preparation of the Economic Report;

2. To gather timely and authoritative information concerning economic development and economic trends, both current and prospective, to analyze and interpret such information in the light of the policy declared in Sections 2 and 3 of this Act for the purpose of determining whether such developments and trends are interfering, or are likely to interfere, with the achievement of such policy, and to compile and submit to the President studies relating to such developments and trends;

3. To appraise the various programs and activities of the Federal Government in the light of the policy declared in Sections 2 and 3 of this Act for the purpose of determining the extent to which such programs and activities are contributing, and the extent to which they are not contributing, to the achievement of such policy, and to make recommendations to the President with respect thereto;

4. To develop and recommend to the President national economic policies to foster and promote free competitive enterprise, full and effective private ownership of capital, rapid growth in the number and proportion of households owning viable capital estates as a means of increasing their economic productiveness, avoidance of economic fluctuations or diminution of the effects thereof, and to maintain the maximum economic productiveness of all households within the economy of the United States either through employment, the private ownership of productive capital, or through a combination of the two, as the current state of technology may determine, and thus to promote the growth and expansion of the purchasing power of the households of the economy;

5. Continuously to study and from time to time to formulate and to recommend to the President means for determining:

(a) the actual needs of the civilian economy for employment of labor after the elimination of all pretended or false employment, featherbedding, or employment which has been governmentally or privately synthesized for the sake of effecting a laboristic distribution of wealth rather than to fulfill an actual need for such employment under the prevailing state of technology;

(b) the size (by dollar value) of capital estate (herein called a "viable capital estate"), generally capable, if owned by households of various sizes, of enabling such households to participate in the production of economic goods and services sufficiently to provide a reasonable degree of affluence and private economic security and economic self-sufficiency, including economic self-sufficiency after retirement from the labor force of the economy or inability to find adequately remunerative employment within the economy, within the capability of the economy as a whole, which determinations shall be for the purpose of fixing from time to time the minimum goal of capital ownership for all households of the economy which it is the policy of this Congress to encourage;

(c) the size (by dollar value) of capital estate (herein called a "monopolistic capital estate"), which, if owned by households of various sizes, would tend to enable them continuously to participate in the production of economic goods and services in excess of a level necessary to provide the standard of living or economic life-style reasonably desired by such household and thus necessarily to deprive other households of the opportunity to participate in the production of economic goods and services sufficiently to provide a reasonable degree of affluence and security and self-sufficiency within the capacity of the economy as a whole;

6. Continuously to study and from time to time to formulate and recommend to the President means for implementing the policy of the United States to foster the institutions and conditions under which households of the economy can build their privately-owned economic power to enjoy a reasonable degree of economic self-sufficiency as a result of their participation in production through their private ownership of one or both of the factors engaged in production, and thereby to minimize the extent to which such households need rely upon any form of Social Security or socially distributed welfare within the economy;

7. To make and furnish such studies, reports thereon, and recommendations with respect to matters of Federal economic policy and legislation as the President may request.

D. Annual Report.

The Council shall make an annual report to the President in December of each year.

E. Consultation with Other Groups and Agencies; Utilization of Governmental Services and Private Research Agencies.

1. In exercising its powers, functions and duties under this chapter:

(a) the Council may constitute such advisory committees and may consult with such representatives of industry, banking, finance, science, agriculture, labor, consumers, state and local governments, and other groups as it deems advisable;

(b) the Council shall, to the fullest extent possible, utilize the services, facilities and information (including statistical information) of other Government agencies as well as of private research agencies, in order that duplication of effort and expense may be avoided.

F. Appropriations.

To enable the Council to exercise its powers, functions and duties under this chapter, there are authorized to be appropriated such sums as may be necessary.

SECTION 6. Joint Economic Committee.

A. The Joint Economic Committee, created by the Employment Act of 1946, is hereby designated as the Joint Economic and Leisure Work Committee under and for the purposes of this Act. It shall be composed of seven Members of the Senate, to be appointed by the President of the Senate, and seven Members of the House of Representatives, to be appointed by the Speaker of the House of Representatives. The party representation on the Joint Committee shall, as nearly as may be feasible, reflect the relative membership of the majority and minority parties in the Senate and House of Representatives.

B. Duties.

It shall be the duty and function of the Joint Economic and Leisure Work Committee:

1. To make a continuing study of matters relating to the Economic and Leisure Work Report;

2. To study means of coordinating programs in order to further the policy of this Act;

3. As a guide to the several committees of the Congress dealing with legislation relating to the Economic Report, not later than March 1 of each year (beginning with the year 1977) to file a report with the Senate and the House of Representatives containing its findings and recommendations with respect to each of the main recommendations made by the President in the Economic Report, and from time to time to make other reports and recommendations to the Senate and House of Representatives as it deems advisable;

4. Continuously to study, formulate and recommend to the Congress means for raising the economic productive power of those households of the economy that are not already affluent, in order thereby to raise their economic power to consume, including, but without being limited to, the following:

(a) promotion of the acceleration of technological progress in the means of producing increased quantities and improved quality of goods and services and the minimization of the use of human toil required for such promotion;

(b) simultaneously increasing the rate of new capital formation within the civilian economy of the United States and, to the extent required to achieve and maintain a high and reasonable standard of living for all households in the economy, while reasonably protecting the physical environment of the United States and its possessions, the rate of production and consumption therein of consumer goods and services;

(c) developing means of extending private ownership of capital to a rapidly expanding number and proportion of the households of the economy:

i) through improved and/or new methods of financing the acquisitions of equity capital ownership through the use of pure credit in such manner as to create future savings by households devoid of present or past savings, as well as out of current and past savings;

ii) through modifications of the estate and gift tax laws and through discouraging or prohibiting the use of gifts, testamentary or otherwise, or of other practices or devices, to unreasonably concentrate the ownership of capital within particular households;

iii) through methods of financing new capital formation in commerce and industry in ways which enable workers having sub-viable capital estates to purchase and pay for additional capital interests and through promoting reasonable and adequate diversification in such holdings;

iv) through coordination of antitrust policy and the policies hereby declared, including means of financing the purchase by households having sub-viable capital estates of assets of corporations subjected to divestiture decrees pursuant to any antitrust laws of the United States;

v) through facilitating the establishment and financing of new enterprises and the ownership of such enterprises by a maximum number of households theretofore owning sub-viable capital estates;

vi) through the development of a system of investment preferences of newly issued securities of high investment quality for those households which have sub-viable capital estates;

vii) through such other tax, credit, and other devices or institutions as will be effective for that purpose within the policies hereby declared, together with appropriate restrictions on the use of such devices for speculative purposes or to create concentrated or monopolistic capital holdings;

viii) through the preliminary use of the credit system to promote new capital formation under the ownership of households having sub-viable capital estates, and through a diminishing use of credit to support the purchase of consumer goods and services as the increased participation in production and the creation of second sources of income (i.e. capital income) by all households of the economy through increased capital ownership is achieved;

(d) ascertaining and recommending to the Congress the elimination of governmental practices which encourage the concentration of the ownership of capital;

5. Continuously to study and formulate means for making effective in both the legal and economic sense the laws of private property as they apply to labor and capital including, but not limited to, the following:

(a) the elimination, over a reasonable transition period, of the corporate income tax and other taxes which are levied in such manner as to intercept the income arising from production by the capital factor before it reaches the hands of the individual owners thereof, together with adjustments in the personal income tax laws so as to prevent them from raising more than the necessary revenues required by government;

(b) the formulation of legislation designed to encourage or require mature corporations (corporations having reasonable access to external sources of financing new capital formation including sources of financing new capital formation developed pursuant to the policies of this Act) to pay out to their stockholders 100% of their net earnings, after setting aside only reasonable operating reserves;

(c) the development and encouragement of freely competitive markets within which the value of the methods or means of production, both labor and capital, is determined, provided, however, that the necessity of maintaining a general high level of purchasing power shall take precedence over a competitive decline in the value of the labor where it is not substantially offset by an increased participation by households involved in the production of goods and services through ownership of capital;

6. Continously to study, and from time to time to formulate and to recommend to the Congress means for facilitating the full employment of all able-bodied and competent persons:

(a) to the extent necessary, under the prevailing state of technology, in the production of economic goods and services sufficient to provide a generally affluent economy and economic self-sufficiency; and

(b) to the extent that the production of a high and adequate level of production of economic goods and services and economic self-sufficiency by all households can be maintained through the full and effective employment of capital and the freeing of a maximum number of individuals from the necessity of performing toil in economic production, the production of the goods of civilization, including the arts, the sciences, religion, education, philosophy, statesmanship, and the like;

7. Continuously to study and from time to time to formulate and to recommend to the Congress means for extending and deepening the understanding on the part of all citizens of the meaning and implications of the policies hereby declared and adopted.

C. Vacancies.

Vacancies in the membership of the Joint Committee shall not affect the power of the remaining members to execute the functions of the Joint Committee, and shall be filled in the same manner as in the case of the original selection. The Joint Committee shall select a Chairman and a Vice Chairman from among its members. The members of the Joint Economic Committee created by the Employment Act of 1946 who are holding office thereon at the effective date of this Act, shall hold such offices on the Joint Economic Committee hereunder, subject to the provisions of this Act.

D. Hearings.

The Joint Committee, or any duly authorized subcommittee thereof, is authorized to hold such hearings as it deems advisable, and, within the limitations of its appropriations, the Joint Committee is empowered to appoint and fix the compensation of such experts, consultants, technicians, and clerical and stenographic assistants to procure such printing and binding, and to make such expenditures, as it deems necessary and advisable. The Joint Committee is authorized to utilize the services, information, and facilities of the departments and establishments of the government, and also of private research agencies.

E. Appropriations.

There is authorized to be appropriated for each fiscal year, the sum of $25,000,000, or so much thereof as may be necessary, to carry out the provisions of this Act, to be disbursed by the Secretary of the Senate on vouchers signed by the Chairman or Vice Chairman.

SECTION 7. The Employment Act of 1946 is hereby amended as herein set forth, effective on the date this Act becomes effective.

EXIBIT VIII

MAKING NEW CAPITALISTS - A CREATIVE RESPONSE TO INCOME INEQUITIES

TWENTIETH SESSION

EXECUTIVE SEMINAR IN NATIONAL AND INTERNATIONAL AFFAIRS

DEPARTMENT OF STATE

1977-78

SUMMARY

Influenced by the controversial theories and proposals of San Francisco lawyer Louis O. Kelso, the Congress of the United States is in the process of making a major commitment to a policy aimed at broadening the ownership of equity capital.

Kelso's central thesis, which has been developed in a series of books and articles, is that the proportion of production attributable to capital is steadily increasing, while that attributable to labor is declining; at the same time, ownership of income-producing property is becoming increasingly concentrated as a result of the way in which the creation of new capital is financed. The principal element in his proposed solution to the resultant imbalances and inequities in the system is a fundamental change in the way capital creation is financed. This would result in the establishment of many new viable capital estates through the operation of Employee Stock Ownership Plans (ESOPs) and a Financed Capitalist Plan which uses insured loans to support the creation of such estates for those not employed by profitable private companies.

Kelso's writings have in general been ignored or treated with disdain by the economics profession. However, his main point regarding capitalism's persistent tendency to lead to undue concentration of capital ownership, and the need to broaden this owner ship, finds support in the writings of some distinguished economic thinkers, i.e., Von Thunen, Keynes, and J. E. Meade.

Under the leadership of Senator Russell Long, Chairman of the Senate Finance Committee, who has become convinced of the merits of Kelso's arguments, the Congress has passed in the last several years a series of laws encouraging the establishment of ESOPs. These include a provision for an additional increment to the investment tax credit on the condition that it be passed on to the company's employees through the establishment of a specially defined ESOP called a TRASOP (Tax Reduction Act Stock Ownership Plan).

The experience with ESOPs has generally been quite favorable, although the estimated 2000 of them tend to be concentrated in relatively small, closely held firms, for which they present a number of special advantages. TRASOPs, however, which are of interest to large capital intensive firms, have caused a particular set of concerns which raise questions about the viability of that approach and require separate consideration.

In the next round, Congress will be considering legislation to further encourage ESOPs as well as legislation to deal with potential abuses. The future of the TRASOP will have to be resolved. Further, important new legislation calling for a pilot program to test the viability of the Financed Capitalist Plan is expected to be introduced. The need is for the Congress, drawing fully on the expertise of the economic and financial communities as well as the

Executive Branch, to proceed with a searching and systematic examination of the whole range of alternatives for broadening particpation in the capitalist system, including profit sharing, stock bonus and option plans, pension plans, and individual retirement accounts, as well as the Kelso-inspired ESOP and Financed Capitalist Plans. The interactions among these techniques, and the potential impacts on the economy of various strategies to broaden equity ownership, need to be studied in greater depth than has yet been done.

Executive Seminar in National
and International Affairs

April 1978

ACKNOWLEDGEMENTS

I want to express my special appreciation to Louis O. Kelso, who let me intrude with an early morning phone call to his hotel room for an extended conversation that must have had a jarring effect on his Washington schedule. His vision of universal capitalism and the dogged determination with which he has pursued it may yet have a major impact on the structure of capitalism. His former associate, Washington lawyer Norman Kurland, also gave me an essential early infusion of enthusiasm and hard information. Another early contact who provided an invaluable roadmap to key people and material was Jack Curtis on the Staff of the Senate Finance Committee.

I gratefully acknowledge the help given me in sorting out the issues by Stuart Speiser, a New York lawyer and chronicler of the Kelso movement, who combines an unbounded sympathy for universal capitalism with a cautious and questioning attitude towards the techniques that have been tried or proposed to achieve it. Dr. Robert Hamrin, until recently on the Staff of the Joint Economic Committee, was also particularly helpful to me in my attempt to gain a sound overall perspective. For giving me a direct sense of the remarkable motivational and productivity impact that employee ownership can have, I am especially thankful to Samuel Jones, President of the Katz Agency in New York, a 100 percent employee owned company.

For my liberal education in the broad context of employee benefit schemes, I am most beholden to Lawrence O'Connor and Walter Holan of the Profit Sharing Council, and am especially thankful to have been invited to attend their regional conference in Atlanta. Bert Metzger of the Profit Sharing Research Foundation generously shared with me his vast scholarship in this area and gave me a sense of the history of employee ownership that I could not have obtained in any other way.

It isn't possible for me in the space available to individually acknowledge or express my gratitude to the many other people who have helped me in my effort to understand what is happening in the complex and dynamic area of employee ownership and broadened capitalism in general. If I succeed in saying something sensible and useful about this important issue, that will stand as a monument to their patience and generosity in assisting me. If I do not achieve that ambitious purpose, the failure is entirely my own, and they will be just as happy that I haven't mentioned their names.

PREFACE

Given the limited time available to complete it, I started this project with the idea of narrowing the scope as much as possible, perhaps to looking just at Employee Stock Ownership Plans (ESOPs) and, even more narrowly, at their impact on labor relations or productivity. It quickly became apparent to me that this was an instance in which to narrow was to distort. ESOPs could not be properly understood except in the context of Louis O. Kelso's concept of universal capitalism and in relation to other techniques that have been used or proposed for broadening the ownership of capital. This broader approach requires, regretfully, that I touch quite lightly on some important and complex issues.

As a guide to those wanting to delve more deeply into various aspects of this subject, I have included in the bibliography to this paper reference to an excellent and extensive bibliography on ESOPs prepared by the Economic Development Agency (EDA) in the Department of Commerce, as well as references to selected works which I have found particularly useful.

My purpose in this paper is to give an overview of Kelso's theory of universal capitalism and of the early efforts at putting certain aspects of it into practice. I will also seek to place this issue in the context of other related developments regarding the ownership of equity capital. Finally, I will attempt to sort out some of the principal issues involved and speculate on how they may be resolved.

I will not attempt to deal with the issue of direct employee participation in management. Under the rubric of "co-determination" this has become a major issue in Europe; however, given the collective bargaining tradition here, neither labor nor management in the United States finds that approach appealing. As one national labor union official told me, "You can't sit on both sides of the table at once."

Richard J. Smith

I. THEORETICAL UNDERPINNINGS OF UNIVERSAL CAPITALISM

Kelsoism - A Man and His Vision

Louis O. Kelso, a San Francisco lawyer, is a man with a vision combined with the knowledge of the practical world of finance and with the energy that have permitted him to pursue it with vigor and considerable effect. In a ground-breaking 1958 book, written with the noted philosopher and educator Mortimer J. Adler, he argued that capitalism as currently practiced leads inevitably to ever increasing, and socially intolerable, concentrations of wealth. 1/ This results from financing procedures which assure that it is the owners of existing capital who become the owners of newly created capital.

Kelso sees attempts to deal with the inequities thus created by redistributing income through jobs programs, progressive taxation, and transfer payments as ineffective, inflationary measures which lead society away from free enterprise towards increasing government intervention and eventual socialism. 2/

Kelso buttresses or obscures, depending on your point of view, his case by developing an analytical framework he calls, "Two-factor Theory." In a book by that title, Kelso and his co-author expand on the argument that productivity increases are attributable basically to capital and are falsely credited to increased labor productivity. 3/

Kelso's thesis, which is referred to frequently in his books and articles, is that 90% of income is created by capital, but that labor gets 70% of that income as a result of political considerations, rather than the 10% that would accrue to it in an unregulated free enterprise situation. In his view, the strains and imbalances that this creates can only be corrected by providing an opportunity for every family to build a capital estate from which it derives a significant portion of its income.

In Two-Factor Theory, the authors contrast what they describe as the two possible distributive principles, one based on private property and one based on need.

> Unlike the private property principle, the need principle has no intrinsic limiations, either physical or logical. Private property is objective and specific; need, subjective and universal. Under the rule of private property, a claimant is entitled only to the equivalent of his production; this is a built-in check that automatically proportions demand to what is available. Private property enforces productive responsibility; it establishes orderly, dependable relationships between men, and between men and their environment. The need principle,

> by contrast, abolishes personal productive responsibility, severs dependable property relationships, and provides no mechanism to relate the size of the product to the demands of claimants. 4/

Kelso deserves to have the essential elements of his argument set out in his own words. In a second book written with Adler his theory of capitalism is summarized as follows:

> Briefly summarized, that theory involves the following propositions:
>
> (1) both labor (the human factor) and capital (the non-human factor) are <u>producers of wealth in the same sense</u>;
>
> (2) the productiveness of labor, except for temporary interruptions, has been declining since the dawn of civilization, and the productiveness of capital has been--both relatively and absolutely--increasing, as has the amount of capital employed in production;
>
> (3) technological change is the physical process by which the burden of producing wealth is gradually shifted from labor to capital;
>
> (4) political and economic freedom in an industrial society depend not merely on each household's being entitled to <u>consume</u> economic goods but upon each household's <u>being</u> entitled to <u>produce</u> economic goods; and
>
> (5) as labor progressively produces less, and capital progressively produces more, of the gross national product, a growing proportion of all households must participate in production through their ownership of capital and a diminishing number must depend upon the earnings of their labor. 5/

<u>The Critical Economists</u>

The response to Kelso from the economics profession, and indeed there has been very little response, has been generally disdainful. It is epitomized by Nobel Laureate Paul Samuelson's reference to Kelsoism as, "an amateurish and cranky fad." 6/ The economists tend to reject Kelso's two-factor analysis and go no further in their analysis of his ideas. To economists a factor is worth what it can get and they would view it as obvious that labor will command a higher price when there is less of it relative to capital. Thus, they are uncomfortable with Kelso's assertion that capital creates 90 percent of the income while labor gets 70 percent of it.

Economists also are troubled by Kelso's lack of attention to the remarkable increases in productivity that labor achieves through training and education. In testimony before the Joint Economic Committee, Professor Hans Brem of the University of Indiana expressed concern on this point, noting that since World War II, "We have more than trebled the number of people who have some kind of higher education, and we have raised labor productivity accordingly." 7/

Kelso responds that economists are so set in their ways that they cannot recognize a truly new insight. As he put it in response to a question on a television talk show regarding the opposition of leading economists such as Samuelson and Friedman, "Well, what do you think the flat world fellows thought of a guy who said that the world is shaped like a ball?" 8/ He says government actions raise labor's return.

In my view, the validity of the two-factor theory is a side issue. In attributing virtually all production to capital, Kelso can be accused of making an error that is the mirror image of the one made by Karl Marx in saying labor does it all. On the other hand, economists may be showing undue rigidity in dealing harshly with an analysis intended to make a point to a non-technical, general audience and not couched in the jargon of the economic profession. In any case, that issue is not the central one. Kelso's main point relates to the need to deal with capitalism's tendency to concentrate the ownership of capital, and this is an important insight quite independent of his two-factor theory.

Stuart Speiser, a New York lawyer who has chronicled the Kelso movement, and has described himself as an enthusiastic supporter of universal capitalism, has cited two-factory theory as Kelso's one mistake. 9/ He argues that it has slowed down serious consideration of universal capitalism, which he believes may be "the most important idea ever originated by an American." 10/

The Economic Precursors of Kelso

On the issue of broadening capital ownership as an antidote to the over-concentration of wealth, Kelso has, in fact, impeccable economic antecedents. The distinguished German economist Johann Heinrich Von Thunen, a contemporary of Karl Marx, developed a theory of the natural wage which held that each working unit must have access to interest from investment to supplement an amount necessary for subsistence. 11/ Although Von Thunen is most famous for his work in econometrics, marginal productivity theory, and location theory, he considered his wage theory his greatest accomplishment. At his request, a formula expressing his wage theory is engraved on his tombstone. 12/

It is also interesting to note that, like Kelso, Von Thunen was a practical man, and he carried out his ideas on his own estates. He set aside a portion of his profits for his employees, which was reinvested in the estate, and in subsequent years the worker would be paid interest on his investment, and finally receive his built up equity at retirement. The plan functioned successfully through several generations. 13/

Significantly, John Maynard Keynes, who is the father of the deficit spending, full employment policies which are anathema to Kelso, can also be cited in support of universl capitalism. In a 1940 book, Keynes warned of the inflationary implications of escalating wage rates and argued that as an alternative to higher wages the worker should be given, "a share in the claims on the future which would belong otherwise to the entrepreneurs." 14/

A Contemporary Supportive Analysis

More recently, a 1964 analysis by the widely respected British Economist J. E. Meade came to conclusions strikingly similar to those reached by Kelso. 15/ In a thin volume of less than 90 pages, Meade addresses in crisp, lucid prose the efficiency and distributional effects of the wage rate. He demonstrates that the most efficient wage rate will generally have unacceptable distributional effects, with most income going to a handful of owners of capital and land. He adds, "The problem is already a very real one in the highly industrialized developed countries in many of which there is a really fantastic inequality in the ownership of property." 16/ He goes on to note that in the United Kingdom in 1959, 99% of the pre-tax personal income from property went to 10% of the population and shows that this imbalance has been increasing steadily since 1911-13, when the top 10% received 92% of the property income. 17/

Meade examines the various alternatives for ameliorating this progressive and ultimately intolerable concentration of wealth and income: the Socialist State; the Trade Union State; the Welfare State; and a Property-Owning Democracy. His analysis leads him to clearly favor the final alternative, which he describes in glowing terms as follows:

> Let us suppose that by a wave of some magic wand--the nature of which we will examine later--the ownership of property could be equally distributed over all the citizens in the community. What a wonderful culture could now result from our future automated economy! Imagine a world in which no citizen owns an excessively large or an unduly small proportion of the total of private property. Each citizen will now be receiving a large part of his income from property. For we are assuming that for society as a whole the proportion of income which accrues from earnings has been greatly reduced by automation. 18/

While suggesting a number of modifications of traditional techniques for the progressive taxation of income and wealth as helpful, Meade comes closest to Kelso when he says, "Arrangements which encourage the accumulation of property by those with little property are certainly as important as those which discourage further accumulation or encourage dispersal of their fortunes by large property owners." 19/ Among his suggestions for accomplishing this are "employee share schemes whereby workers can gain a property interest in business firms." 20/

II. THE SECOND INCOME PLAN

Kelso has developed and proposed a systematic and comprehensive approach to making his vision a reality. The best overall presentation of that approach is in Two-Factor Theory, which outlines what is termed a "Second Income Plan". 21/ As a preliminary step, the authors say that the United States needs a Full Production Act, "... to be enacted by Congress, acknowledging the economic responsibility of business, labor unions and government to enable all Americans to participate fully in the economy and to produce affluence--through their labor, to the extent that labor is necessary under prevailing technology, and through capital ownership, to the extent that goods and services comprising affluence are the product of capital". 22/

The full scope of the plan is then set out as follows:

> The objective of the Second Income Plan, as we stated earlier, is the building of the second economy--an economy that, in the United States, must have several times the per capita productive power of the existing one. The means of accomplishing that physical objective (changes in the invisible structure of industry and business) must be so designed that the Second Economy will be owned primarily by the 90% of families and individuals who do not own viable holdings of productive capital today. These new capital-owning families can then engage in the production of wealth both through their employment (to the extent required by the current state of technology) and through their capital ownership. Our proposed tools relate to the following areas of the invisible sector:
>
> (1) Estate planning and the pattern of testamentary and intervivos gifts as they are effected by national and state tax policy.
>
> (2) The conduct of the corporation and the design of corporate strategy.
>
> (3) Financing capital ownership for corporate employees.
>
> (4) Financing capital ownership for non-corporate employees. 23/

With regard to estate and gift taxation, the following approach is suggested:

> Specifically, we would suggest modification of the tax laws to permit the wealthy, in various ways, to leave their wealth to individuals selected by them, tax free, as they now can to exempt foundations, providing that safeguards are imposed to prevent particular recipients from acquiring excessively large holdings in that manner. For example, tax-exempt gifts by individuals to employee deferred benefit trusts should be permitted. Similarly, tax-exempt gifts to individuals, whether related by blood or marriage or not, should be permitted, with a steeply graduated tax to apply if the capital estate of the recipient, after receipt of the gift, exceeds some legislatively defined viable capital holding. 24/

The authors estimate that this single measure would create a million new viable capital estates per year.

On the question of corporate behavior, the corporate income tax combined with the practice of retaining earnings are cited as principal barriers to the spread of capital ownership and the associated generation of adequate financing for the creation of new capital.

> Clearly, the elimination of the corporate income tax, thus shifting the revenue-raising burden of government to the ultimate taxpayers--the individual citizens--where it belongs, combined with the forcing of corporations to pay their net earnings to those who own the corporate capital--the stockholders--will enormously increase the financeability of newly issued corporate equities by the nonaffluent. 25/

The two approaches to financing capital ownership are described as follows:

> The Second Income Plan provides the corporation with two alternate sources for financing its new capital formation. The first is a form of employee deferred-compensation plan which we call the Second Income Plan Trust. It enables corporate employees to purchase newly issued corporate equities on pre-tax corporate earnings. The second is the Financed Capitalist Plan for enabling noncorporate employees to purchase newly issued corporate equities, and to pay for them out of the pre-tax earnings of the corporate equities so purchased. 26/

What is referred to as a Second Income Plan Trust later came to be known as an Employee Stock Ownership Plan (ESOP).

In a 1977 article, long time Kelso associate and supporter, Washington lawyer Norman Kurland, presented a variation of the Second Income Plan based on ESOPs, CSOPs, and ISOPs, which together would accomplish the transition to the era of universal capitalism:

> "Under a comprehensive national plan for stimulating and redistributing future growth opportunities directly among Americans who have no capital, three basic ownership diffusing mechanisms would be employed to link capital to individuals: employee stock ownership plans (ESOP), to cover employees of viable enterprises; consumer stock ownership plans (CSOP), to cover all regular customers of regulated public utilities and mass transit systems; and individual stock ownership plans (ISOP), to provide people who do not work for viable corporations in the competitive sector of the economy with the means to gain a diversified holding of newly issued stock reflecting growth of the competitive corporate sector. Each of these tools is designed to reduce drastically the cost of new capital formation and to overcome present tax and credit barriers to a more equitable sharing of future ownership opportunities."27/

An important element in Kurland's ideal plan, as in Kelso's, would be the provision of discounting facilities by the Federal Reserve System to lower the interest rates on loans in connection with the financing of universal capitalism to levels consistent with "pure credit," freed of costs associated with risk and inflation. Kurland explains this aspect of the program as follows:

> Under a national planned ownership strategy, the Federal Reserve System, using its present powers to expand bank credit through the discounting of eligible paper, would reduce bank interest rates to 2% to 3% for banks making loans to IRS-qualified ESOPs, ISOPs and CSOPs to enable mature, well-managed corporations to sell newly issued equity to their workers and other Americans. All loans would be non-recourse to the individual and would be repayable with projected pre-tax profits. The low-interest rates and the use of pre-tax dollars for servicing the capital formation debt would, of course, lower the

> cost of capital expansion within the private sector, at least when compared to the use of after-tax dollars and today's high interest rates. Only when all wasted and non-productive human talent gained work opportunities in the growing private sector and all other resources became fully employed, would the Federal Reserve clamp down on the supply of low interest credit. Any further expansion would not increase production and would therefore be inflationary. A sound national ownership program would aim at a target of zero rate of inflation and a maximum rate of production. 28/

Thus, Kurland is proposing a two-tiered interest system, with lower rates applicable to new capital creation undertaken as part of a planned national strategy to broaden capital ownership.

III. THE CONGRESSIONAL CONNECTION

A Populist Convert With Clout

The likelihood of solid real world results in this area rose sharply one night in late November of 1973. It was then that Louis Kelso and Norman Kurland met in Washington with Senator Russell Long. On that occasion, Kelso persuaded the powerful Senate populist of the merits of his idea for creating new capitalists. The response of the Chairman of the Senate Finance Committee was reportedly direct and to the point: "Okay, what's your plan? What can I do to get this thing moving?" 29/

At Kurland's suggestion, Long went to work immediately in support of an ESOP provision in pending legislation to reorganize a number of bankrupt railroads, which had been proposed the previous August by Senator Hatfield in a "dear colleagues" letter. (Other early Congressional supporters of the ESOP concept included Senators Fannin, Hansen, and Dominick, who unsuccessfully sought legislation on ESOPs in March of 1973, the first time a bill dealing with them had been introduced). 30/ Senator Long's support was decisive and within a month the Regional Rail Reorganization Act of 1973 set up a consolidated Rail Corporation (Conrail) to acquire the assets of a number of bankrupt railroads in the Northeast and Midwest, including Penn Central, and called for the use of ESOPs to the extent found practicable. Although falling short of a legislative requirement to set up ESOPs, which supporters would have preferred, this was the first time that ESOPs were recognized and defined by legislation.

The Act described ESOP as a technique of corporate finance that uses an employee trust qualified under the applicable IRS regulation 491(a), which is designed to build beneficial equity ownership of shares into employees substantially in proportion to their relative incomes, without requiring any cash outlay, any reduction in pay or other employee benefits, or the surrender of any other rights. 31/

A Growing Legislative Commitment

Senator Long has maintained his interest in the ESOP concept and has worked for its inclusion in a number of subsequent laws:

Employee Retirement Income Security Act of 1974 (ERISA)

This law was passed to set standards for private pension plans and prevent abuses. The reference to ESOPs was for the purpose of exempting them from prohibitious against loan and stock sale and from the requirement for diversification of plan assets. Thus, ESOPs were generally permitted to continue their existing method of operations. However, the law does require that transactions between the ESOP and the company be primarily for the benefit of the employees, and this has introduced a note of uncertainty since by design such transactions can also have important benefits for the company.

Trade Act of 1974

This included a provision which gives preferences for government guaranteed loans to companies injured by foreign competition to companies which establish ESOPs.

Tax Reduction Act of 1975

This contained a direct tax incentive for setting up a particular kind of ESOP. The Act increased the investment tax credit from 7% to 10%, and provided that the credit could be increased to 11% if the company contributes the additional 1% to an employee stock ownership trust. These trusts, which have come to be known as TRASOPs (Tax Reduction Act Stock Ownership Plans), incorporate some important features which do not apply to ESOPs generally, e.g., there must be immediate employee vesting and pass-through voting rights to employees.

Tax Reform Act of 1976

This Act extended the applicability of the TRASOP provision through 1980 and added a provision that the credit could be increased by a further ½%, if that was matched by a ½% contribution by the employees, with a total of 2% going into a TRASOP.

The growing Congressional concern with ESOPs and broadening stock ownership culminated in the following recommendation in the 1976 Joint Economic Report:

> To provide a realistic opportunity for more U.S. citizens to become owners of capital, and to provide an expanded source of equity financing for corporations, it should be made national policy to pursue the goal of broadened capital ownership. 32/

This is an idea with broad political appeal, and, while there remain differences of view on how best to reach that goal, there are no apparent Congressional centers of opposition to the concept of broadened stock ownership. An article in Barron's went to the heart of Kelso's political appeal:

> The Kelso doctrine has won enthusiastic endorsement from both liberals and conservatives in and out of Congress, albeit for different reasons. It is the only economic doctrine introduced in generations that could become a plank in either the Democratic or Republican platform. On one hand, the idea of letting workers share directly in the growth of profits appeals especially to liberals. On the other hand, the concept that business, not government, should be the arbiter of its fortunes is attractive to American conservatives. 33/

Concerned that an Executive Branch that did not generally share its enthusiasm for ESOPs might seek to frustrate its support for them, the Congress took the unusual step of specifying its intent in a law and cautioning the rule-makers not to block it. This important statement, aimed primarily at the IRS, was contained in the Tax Reform Act of 1976:

> The Congress, in a series of laws (the Regional Rail Reorganization Act of 1973, the Employee Retirement Income Security Act of 1974, the Trade Act of 1974, and the Tax Reduction Act of 1975) and this Act has made clear its interest in encouraging employee stock ownership plans as a bold and innovative method of strengthening the free enterprise system which will solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees. The Congress is deeply concerned that the objectives sought by this series of laws will be made unattainable by regulations and rulings which treat employee stock ownership plans as conventional retirement plans, which reduce the freedom of employee trusts and employers to take the necessary steps to implement the plans, and which otherwise block the establishment and success of these plans. 34/

More legislation on ESOPs and other measures for broadening capital ownership appears to be a certainty. The next legislative steps will be critical in terms of the way in which we proceed with efforts to broaden stock ownership. On the one hand, Senator Javits has been concerned that we are giving undue attention to ESOPs possibly to the detriment of other employee benefit plans, and he sees a need for a greater role for organized labor. In a bill sponsored jointly with the late Senator Hubert Humphrey, he concentrates on correcting perceived shortcomings and potential abuses of ESOPs. The major elements of the proposed Javits-Humphrey Employee Stock Ownership Fund Act of 1976, which would amend the National Labor Relations Act, are as follows: 35/

- Permit jointly managed labor-management employee trusts, established through collective bargaining.
- Require diversification of 70% of such ESOP funds, with no more than 30% to be held in company stock.
- Preclude the establishment of ESOPs under the NLRA unless the employer already has in effect a pension benefit plan qualified under ERISA.
- Provide for 100% vesting after 3 years of employee participation.

Representative William Frenzel, Democrat from Minnesota, on the other hand, has introduced a bill designed to further encourage the formation of ESOPs in a number of ways, including additional tax incentives. The principal provisions of his proposed accelerated Capital Formation Act of 1975 (H.R. 462) are:

1. Remove the present statutory limitation of 25% of covered compensation as the maximum amount an employer can contribute to a qualified employee stock ownership plan when such payments are used to enable the plan to repay stock acquisition debts incurred in connection with meeting the employer's capital requirements.
2. Provide a tax deduction to corporations for the amount of dividends they distribute either directly as taxable second incomes on stock held in an employee's account or which are used to repay stock acquisition indebtedness of the employee's trust.
3. Provide for advance IRS opinions on valuations of stock or other assets acquired by an ESOP where the parties to a financing transaction, which utilized an ESOP, would be subject to serious risk of penalties if the IRS, on a subsequent audit, disagreed with the valuation or other key features of the financing plan.
4. Exempt payments to an ESOP made for financing purposes from treatment as a conventional employee benefit for purposes of any wage, salary, deferred compensation, or other employee benefit controls or guidelines that might be established under executive order, regulations, future economic stabilization laws at the federal or state level. 36/

The Financed Capitalist Plan

A major new bill which is designed to test the viability of Kelso's "financed capitalist" approach will be introduced in this session by Senator Mike Gravel from Alaska. In a series of weekend meetings that have drawn in top economists and financial experts, a working draft has been prepared under the title, "The Financed Capitalist Plan--A Concept by Senator Mike Gravel". The 20-page document lays out a detailed plan for creating new capitalists, described in its essence as follows:

> I propose a new approach to capital expansion which would diffuse ownership of new capital to those who have not previously reaped the benefits of capital ownership. In simple outline the plan would guarantee private loans to purchase corporate stock, with the new capital being used by the corporation to pay for the expansion of plant and equipment. The stock would be held as security for the loan, and dividends used for repayment. After the loan is fully or partially retired, the investor would receive dividend income. The plan provides investment capital for industry while developing an alternate source of income for those who historically have depended on their labor income alone. The plan would not transfer existing wealth from the rich to the poor, but rather allow the poor to obtain a share of the new wealth generated by our capital expansion. 37/

Senator Gravel specifically recognizes the revolutionary nature of his proposal and says that, "The plan should be tested on a limited scale to determine its effect on individuals, corporations, government, and the economy as a whole." 38/ The current draft calls for $800 million in private, federally guaranteed loans in each of five consecutive years, with loans available to participants in amounts of $20,000 per family unit. 39/

Key features of the Gravel draft plan include the following:

- Participants would be chosen at random from four target groups: the blind and disabled, low income working poor, middle income taxpayers, and Social Security recipients.

- A new class of stock, referred to as Full Return Stock, would be created which would distribute all per share earnings, beyond a reserve for contingencies, quarterly.

- The loan would be guaranteed by a new independent federal corporation, the Capital Development Insurance Corporation (CDIC) and would be non-recourse to the participant borrower.

- An interest rate of 4% would be assured either through direct Treasury subsidies or, alternatively, by providing for the notes acquired to be discounted by the Federal Reserve Bank.

Senator Gravel calls for careful further study of his plan, and elements of it may well be modified before it is introduced in the Senate. This important legislative initiative is already at the stage, however, where it would enter the Congressional process more carefully and thoroughly thought through than most bills.

The job of selecting individuals to be particiants in a program of this kind is a daunting prospect, but at the same time it opens up some very appealing possibilities. For example, it could be used to provide income stability to non-affluent farm families to help them deal with the ups and downs of markets for agricultural products. It might also be used to cushion the impact of a scaling down of pension benefits for career military personnel. There are many attractive alternatives in this regard which should be examined.

IV. ESOPS AND TRASOPS

ESOP Technique Finds Specialized Uses

From a dozen or so in 1970, the number of Employee Stock Ownership Plans (ESOPs) has increased to an estimated 2000 currently. 40/ These have been quite heavily concentrated, however, in relatively small, closely held companies. They have often been used in special circumstances such as the divesting of a division from a conglomerate or the withdrawal of a founder and principal owner from a company.

One of the most potentially significant uses of ESOPs has been in the area of economic development as a technique for preventing the closure of companies and loss of jobs. The landmark case in this area is South Bend Lathe (SBL), a machine tool manufacturer in South Bend, Indiana. In 1975 the Chicago conglomerate, Amsted Industries, Inc., decided to close the South Bend plant. Since this was an economically distressed area, the city was able to obtain a $5 million EDA grant to establish a revolving fund which made a loan to support the establishment of an ESOP by South Bend employees who purchased the plant. Thus, some 500 jobs at SBL were saved, plus some 200 jobs at SBL's suppliers. SBL has since shown a profit for 30 consecutive months and appears to be thriving. 41/

A number of already successful firms have found ESOPs helpful. Among the largest of the companies to establish ESOPs has been E-Systems, Inc., of Dallas, Texas, which has about 10,000 employees. E-Systems Vice President Harry Thurman testified before the Congress to the remarkable improvements which they attribute to the 1973 establishment of an ESOP:

> Employee turnover has declined 50% since 1973 and is below the national average for our type of company. Our absenteeism has declined and is now 25% below the national average.
>
> Since the ESOP was established, interest and participation in the company suggestion program has improved in that suggestions submitted have increased 140% with a marked increase in suggestions regarding cost and waste reduction and efficiency improvements. 42/

In the course of making contacts for this study, I discovered that plans are now well advanced for the most dramatic and newsworthy use of ESOP to date. In a development with far reaching implications, an ESOP package has been put together to save the last of the American flag passenger liners. With ESOP investment counselor Norman Kurland, the National Maritime Union (NMU) has prepared a proposal to keep the Monterey and the Mariposa operating in the Hawaiian tour trade. The two ships have used up their eligibility for operating subsidies and in the normal course of events would follow many other such American ships into mothballs, razor blades, or the hands of foreign owners who would operate them more economically.

As it was explained to me, the NMU would agree to reduce manning costs by 60% in conjunction with the establishment of an ESOP through which the crews would share in the profits which would then be generated. No further operating subsidies would be required. The deal would require, however, low cost (3%) federal financing for all or part of the $10 million purchase price, which is now being sought through the Economic Development Agency (EDA) of the Department of Commerce. NMU President Shannon Wall described the proposal to me as the last chance for saving some 600 jobs.

NMU Treasurer Gene Spector told me that the numbers look right, and he is hopeful the proposal can be brought to fruition. He said it would require a re-structuring of work and manning practices, but, if successful, could set a pattern that could save many thousands of jobs for American seamen.

The NMU proposal is an important precedent in many respects, not least of which is the direct and active early involvement of organized labor in an ESOP. Labor's reaction to ESOPs thus far has been mixed. One national labor union official told me that ESOPs, at best, were, "a conspiracy between companies and the government to [expletive deleted] the taxpayer." At worst, labor fears that ESOPs will be substituted for more reliable benefits, such as pensions, or that they will be used to weaken unions. On the other hand, local unions at plants that have been saved and re-vitalized by ESOPs tend to be much more positive in their view of them.

Overall, the experience with ESOPs, while limited, has been quite favorable. My direct contacts and observations of firms having ESOPs were entirely consistent with the results of a survey of 68 ESOP companies by the University of Michigan Institute for Social Research. The Michigan study found good industrial relations, higher than average productivity and profitability, and general employee and management satisfaction with the ESOP. 43/ The study concluded that whether the plan was adopted for financial or moral reasons, "...the data of this report indicate that employee ownership may contribute to the economic viability of a firm and to the economic well being of members as well as to the quality of working life within the firm." 44/

The TRASOP Muddle

The TRASOP variation, which is tied to the investment tax credit, needs to be looked at separately. The attraction here is to companies with high capital expenditures and relatively few employees. The oil companies would be a prime example, and, in fact, most of them have set up TRASOPs. At the other end of the scale, a large retailer like Sears Roebuck would find the per employee amounts to be too small to bother with, i.e., on the order of less than $10 per employee.

Although some 200 of them have been set up, I found little enthusiasm for TRASOPs even among the companies that have the most to gain. Certain of the special provisions, such as the immediate vesting requirement have proved to be quite burdensome, involving, for example, the requirement to chase after short-term employees with checks for trivial amounts. Also, many of these companies have long-standing plans through which employees can obtain company stock, frequently at a discount or with proportional contributions from the company. They consider these established plans to be successful and well understood, and are reluctant to muddy the waters with this new scheme. This is especially true since there is considerable uncertainty as to whether the TRASOP provision will be continued beyond 1980.

I was told by an official of one of the major oil companies that they set up a TRASOP because they felt that they had no choice but to pass on this 100% tax subsidized benefit to their employees even though they were skeptical about it. He said that the administrative requirements were extremely onerous, particularly with regard to the requirement to get a ½% contribution from the employees in order to take full advantage of the investment tax credit under the Tax Reform Act of 1976. They have a well functioning and appreciated plan for employee stock purchases, with company contributions, which they believe far better serves their needs.

The pressures on a large company to set up a TRASOP, however reluctantly, can best be illustrated by reference to the situation involving American Telephone and Telegraph (AT&T). AT&T was among the all but a handful of companies that had not set up a TRASOP by the end of 1975. In October of that year, Senator Long made a speech at Louisiana State University which contained a message aimed directly at AT&T:

> This great company is entitled at this very moment to claim $50 million tax-free from the U.S. Treasury in order to buy stock for its employees and to help finance expansion, to buy new equipment, or whatever they might need. Now if I were a union organizer, I would have something to say about a company that would turn down $50 million out of the U.S. Treasury rather than let their workers have it. 45/

Senator Long had made AT&T an offer they couldn't refuse, and they have subsequently set up a TRASOP. I suspect that many of the other companies that went on to set them up also got the message in that speech.

A number of the large, capital intensive firms pointed out to me that they had no interest in using an employee trust as a corporate financing technique. They depend heavily on retained earnings for new capital investment. Moreoever, they would be concerned about the impact on their widely traded stock were they seen to be, "borrowing from our employees." This is part of the reason why they have been so carefully examining the teeth of the TRASOP gift horse.

A Caveat on the Wonders of ESOP Financing

Actually, the corporate financing advantages of an ESOP of any kind are not quite as wonderous as they might at first appear. True, the company contributions to the ESOP for repaying the loan used to purchase company stock are untaxed, and in a certain sense this is equivalent to paying back principal as well as interest on a loan in pre-tax dollars. But the hooker is that in addition to paying back the loan, the company has to "give away" stock of the equivalent market value. The essence of the transaction can be better understood if one considers that a company would be in exactly the same financial situation if it took out a standard loan from a bank and then made comparable contributions of its stock to an employee trust as it paid back the loan. In either case, the tax saving involved relates to the contribution to the trust, not to the repayment of the loan. 46/

Thus, it does require a certain set of circumstances for ESOP financing to be seen as advantageous. These circumstances, which now exist mainly in smaller, more closely held firms, include lack of retained earnings and accompanying cash flow stringency, need to make a market for an untraded stock, and desire of an owner to capitalize equity most effectively from a tax viewpoint. It is significant in this regard that many ESOPs have not been employed as a corporate financing technique. This was true of more than half of the ESOP companies I contacted, which was consistent with the reported results of a survey by Hewitt Associates:

> One of the most interesting questions concerning ESOP experience is whether companies are actually using their plan as a corporate finance technique. Five of the 10 companies in the survey reported that they have used their ESOP as a technique of corporate finance. 47/

The Hewitt study is one of the best available overall analyses of ESOPs, and, in particular, contains an excellent, detailed analysis of the financial implications of ESOP as compared to other financing alternatives. 48/

What Is This ESOP Animal?

A good part of the confusion that one encounters on this subject stems from the fact that the ESOP, like the elephant in the story of the three blind men is perceived quite differently depending on the direction from which it is approached. These differences are just as marked as those between the snake, the tree trunk, and the wall, that were separately perceived by the three blind men.

As an employee benefit scheme, it is often viewed suspiciously because of the lack of diversification that makes it vulnerable to changes in the fortunes of the company. In particular, its use as a pension fund is condemned on the basis that most firms decline or go out of business entirely over the 30-40 year working life of the average employee. Those that see it from this angle believe an ESOP has to be judged strictly on its merits in comparison to other employee benefit plans, such as pensions, profit sharing, and stock bonus plans.

Those interested in economic development in depressed areas see it as a way of saving jobs. Indeed, ESOPs have already shown their worth in that regard in companies which are effectively managed.

From a company's point of view, it can be seen under certain circumstances as an advantageous technique for financing new capital creation. The owner of a closely held company may look at it as a way of making a market for part or all of his equity in a way that minimizes both his taxes and his loss of control over the company.

The general taxpayer may think he is observing a slick corporate tax gimmick. Believers in Louis O. Kelso's universal capitalism are certain that an ESOP really is an essential element in the coming capitalist revolution.

As with the elephant, they all may be on to a piece of truth. But their different perceptions certainly make communication among them an awkward thing. A statement that ESOPs make lousy pension plans is likely to call forth the rejoinder that they make it possible for the common man to use the credit of corporations to build a viable capital estate, while in the process arresting America's drift towards socialism.

V. OTHER SHARE-THE-WEALTH APPROACHES

Profit Sharing

Programs aimed at broadening employee participation in industry profits are not new in America. For example, as the Profit Sharing Council points out, profit sharing is an old and widespread tradition:

> Half a century has passed since Congress enacted the first legislation dealing with profit sharing plans and trusts. From a mere handful of plans in existence at the birth of tax-exempt profit sharing, the number of qualified plans has grown to well over 100,000. No one knows the number of nonqualified cash plans that have come into being since the first recorded plan was established in 1794, but informed estimates indicate that the number in existence today nearly equals the number of qualified plans. 49/

The Council's 1977 survey of its member firms revealed a number of interesting characteristics about these plans: 50/

- The average contribution amounted to 9.69% of participant's pay.
- Smaller companies tend to make discretionary determinations on contributions while large companies tend to use profit-related formulas.
- The large majority (78% of those surveyed) of companies with deferred profit sharing plans, which are by far the most prevalent, do not offer an employee pension plan.

Pensions

In a 1976 book, Peter Drucker describes what he terms the growth of "pension fund socialism" in America:

> Through their pension funds, employees of American business today own at least 25% of its equity capital, which is more than enough for control. The pension funds of the self-employed, of the public employees, and of school and college teachers own at least another 10%, giving the workers of America ownership of more than one-third of the equity capital of American business. Within another ten years, the pension funds will inevitably increase their holdings, and by 1985 (probably sooner), they will own at least 50--if not 60--percent of equity capital. 51/

Drucker credits Charles Wilson, former Chief Executive of General Motors, with creating the first modern corporate pension fund in 1950. His innovation was a broadly diversified pension fund investment policy. Some one-stock pension funds such as Sears-Roebuck's, established in 1916, had been fabulously successful, making millionaires out of janitors. Drucker, however, agrees with the response Wilson gave at the time:

> More than half the leading retailers of 1916 had disappeared by 1950, thirty-five years later--a good many of them even before the depression--and the surviving companies, including such well-known names as Montgomery Ward, J. C. Penney, or the A&P, had done so poorly on average that employees dependent for their pensions on funds invested in these companies would, in 1950, have had to retire with little or no retirement income. 52/

Drucker concluded that, "investing the worker's main savings in the business that employs him may be 'industrial democracy', but it is financial irresponsibility." 53/

As noted in Robert Hamrin's analysis, the growth of pension funds is not an unmixed blessing. 54/ They are generally managed by asset managers with a conservative approach to equity markets that dictates a concentration on the stock of large substantial companies, thus diminishing capital available for newer, growing businesses. They move large blocs of stock, often on the same side of the market, which increases the risks to smaller investors. (Hamrin records, in that regard, that individuals were replaced by pension funds as the largest buyers in the market in the 1950's. As a result of 18 years as net sellers, individuals reduced their share of outstanding stock from 87% to 65% by the end of 1975). 58/ While recognizing that pension funds have been a major source of funds for capital formation, he explains, "By the late 1980's, however, it is likely that pension funds will have become pure transfer mechanisms, perhaps even dissaving because of the demographic trends which will lead to more benefit payments and less receipts." 56/

More philosophically, it can be argued that ownership through a pension fund of equity capital doesn't give the individual a sense of participation in the capitalist system. In fact, all he does own is a promise of a fixed future payment. This is an important asset, but it is different from an individual capital estate which carries with it significant rights of ownership as well as some risks. He never gets his hands on a share of the actual assets that are collectively owned and managed by the pension fund. It may be indicative that Drucker chose to describe the phenomenon as "pension fund socialism" rather than "pension fund capitalism"--particularly in view of the close involvement of government regulators in the activities of fund managers through legislation such as ERISA.

Stock Options and Related Plans

Many of the largest American companies have established preferential arrangements by which employees may acquire their stock. The scope of this development can be seen in a 1956 brochure published by the New York Stock Exchange covering plans set up in the 9 year period beginning in 1947, which notes, "Approximately 40% of all domestic companies have adopted stock purchase or stock option plans within the nine-year period. There are, of course, additional plans which started before 1947." 57/

Most stock plans offer the employee a clear incentive to acquire the stock. IBM, for example, offers a 15% reduction below current market price, the maximum allowed for plans approved by the IRS. Many others, such as Exxon, offer company contributions of stock to supplement purchases by employees who are regular participants in the plan.

VI. SORTING OUT SOME ISSUES

Productivity

Clearly, one key issue is whether employee ownership plans have any positive impact on productivity and employee motivation. Consultants and motivational researchers tend to downgrade this factor. In a study done for Conrail by a consortium of consultants, it was said that, "Research has shown that for employees in the middle income brackets, the minimum effective incentive ratio, excluding consideration of inflation and taxes, is somewhere between 20% and 35%. This means, in effect, that the payment of annual dividends below 20% of the employee's current earnings cannot reasonably be expected to increase productivity." 58/ The study concluded that for several reasons, including lack of motivational impact, Conrail should not institute an ESOP. 59/

It is difficult to demonstrate that morale and productivity increases have been caused by establishment of an ESOP, but it was impossible for me not to be impressed by the enthusiasm of those who have not been involved in these ventures. For example, the Virginia representative of Library Bureau, a Herkimer New York company that formed an ESOP in the course of splitting off from Sperry Rand in 1976, told me that his customers have been remarking on his improved service and asking what happened. He said he senses his own improved motivation and knows that the improvement in his productivity is due to the new status of the company. The chief executive of Library Bureau told me that the absentee rate at the company had dropped from 8% to 2% since the establishment of the ESOP.

Professor Hans Brems, in discussing differences between the European wage earner's investment funds (WEIF) and ESOPs, stressed the difference between one company productivity and productivity for the economy as a whole. 60/ He granted that with a one-stock ESOP fund productivity may well be raised in tangible ways on the plant floor. He added, however, that the more diversified non-job related WEIFs are more conducive to labor mobility, and this mobility in turn is an important factor in productivity for the economy as a whole.

The Big Picture

As with productivity, it is necessary generally to consider what impact various courses of action would have on the economy as a whole, not just the effect on individual firms. As we have seen, for example, the widespread development of pension funds, which is highly desirable from the point of view of the individual worker, may be having an effect on equity markets and the economy's ability to raise venture capital that would be a source of serious concern if present trends continue.

The Kelso approach to universal capitalism raises some sensitive questions. In that regard, one must consider its potential for having an inflationary impact. Kelso's claim that his proposals would be consistently deflationary depends on his assumptions that: (1) the new investments generated would lead promptly to increased outputs of goods and services; and (2) that wage demands would moderate as workers developed a second income from property holdings. It is not obvious that either assumption would hold, in the aggregate, particularly as the economy approaches full employment, and production bottlenecks begin to develop. Hamrin expresses considerable concern on this point:

> Widespread adoption of leveraged ESOPs, especially if accompanied by high economic growth rates, would contribute to inflation. .... The greatly expanded use of bank credit to finance new capital through ESOPs would result in a large increase in the money supply that would be fed into a demand for goods and services immediately. This process of sending more money after the productive capacity is an engine of inflation. Such use of bank credit on a small scale would do no harm, but on a massive scale, inflation would be aggravated. 61/

The impact of a widespread Kelso approach on equity and bond markets raises uncertainties that need to be examined. What would be the effect of a recession on a financial system structured along Kelso lines? It is not that universal capitalism would necessarily have seriously adverse impacts in any of these areas. It may be, for example, that tying credit expansion to productive new investment may be significantly less inflationary than the kind of deficit spending credit creation associated with traditional transfer payment policies. The effect on equity markets may be salutary and stabilizing. The problem is that we don't know and are not doing what is necessary to find out.

The clear need is for a major effort to study, including the use of extensive econometric analysis, what some of these effects might be. This is an urgent requirement that should be pursued before we get too far down any particular road to broadened stock ownership. It is a requirement that will not be fully met until the economics profession as a whole overcomes its distaste for what it views as Kelso's penchant for overstatement, if not hucksterism, and takes a sustained hard look at the implications of the policies he is recommending.

The aggregate numbers involved are easy to manipulate to support your particular point of view. Opponents of Kelso frequently point out that if all dividends in 1975 were evenly distributed to the non-government work force of 91 million, it would amount to $360 for each of them. Kelso's thesis, however, requires that corporate income tax be eliminated and all earnings paid out as dividends. This would increase the 1975 figure to $1,283 per worker. 62/ Also, Kelso is talking about a development that would occur over a period of decades and be the result of sharing the income on newly created capital, which, given the dynamics of the situation he is postulating, would be massive. Since it is not unreasonable to talk in terms of 4-5 trillion dollars in new capital being created in the United States over the next decade or so, one could on that basis project capital estates on the order of $100,000 being created out of that pot for 50 million household units. 63/

The Next Round

Most people, certainly most politicians, would agree in principle that broadened stock ownership is a good thing. The debate on what to do next will center largely on the question of the best means of accomplishing that objective.

(It is perhaps worth noting, however, that even the goal is not fully agreed. One Executive Branch official, while quite sensibly disavowing any intent to confront Senator Long on the issue, argued to me that stock was a much less desired form of compensation than money and that it was, therefore, inefficient to use it as such both for the employer and the employee. In particular, it was foolishness to encourage the use of this second rate form of compensation through tax subsidies. He took the position that if workers want stock, we should let them buy stock. He said, "let them buy stock" with much the same intonation that Marie Antoinette must have used when she said, "let them eat cake".)

For those that agree on the goal of broadened stock ownership, the question of what we should do next depends importantly on whether you are a convinced capitalist revolutionary or not. If you believe with Louis Kelso that we must fundamentally change the procedures for financing new capital creation, that suggests one set of alternatives. If not, then other alternatives become appealing.

For the advocates of Kelsoism, the path has been laid out. The requirement is to proceed to take measures that will encourage the payment of all dividends and encourage equity financing of new investment through ESOPs and a financed capitalist program. The non-believer would be more tempted to look at the full range of techniques including profit sharing plans, stock option and stock bonus plans, individual retirement plans (IRA and Keogh accounts), pension plans, ESOPs and possibly some variation of a financed capitalist plan, as complementary methods for broadening the ownership of equity capital.

Those not convinced that ESOPs are the key to capitalist salvation are also more bothered by their lack of diversification, particularly to the extent that they are substituted for pension funds, which provide a more assured benefit for the employee. This concern is heightened by the impact of the Pension Reform Act of 1974 (ERISA). In the process of dealing with pension abuses, ERISA has increased the paperwork burden and expense of pension funds that were already becoming extremely burdensome for many firms. I was told by an official of the Pension Benefit Guaranty Corporation, which was set up under the Act, that some 20,000 firms have terminated their pension plans since the passage of the Act in 1974. These tend to be smaller firms, for which ESOPs already have the greatest attraction.

VII. CONCLUSIONS AND RECOMMENDATIONS

Concerned about a persistent imbalance in which one-half of America's wealth is owned by six percent of its people, 64/ the United States Congress has made a commitment to broadened stock ownership and will enact significant and far-reaching further legislation on this subject in the years immediately ahead. It is equally clear that not nearly enough thought and analysis has been devoted to this subject to provide a sound basis for a public policy development of this magnitude. In particular, the policy proposals of Louis O. Kelso, which have been instrumental in bringing this issue to a head and which have been reflected in a series of laws, have not been subjected to the kind of systematic, searching examination by economists that they require.

The need now is to proceed with a national debate which will assure that all aspects of this issue are fully illuminated. The Joint Economic Committee hearings in 1975 on ESOPs were a good beginning, but only a beginning. The issue must be looked at as a whole so that we can develop a sense of how the parts fit together and how the total program affects the economy in its entirety, not just individual firms and groups of employees. Consideration must be given to the potential and the limitations of the full range of techniques that can lead to broadened capital ownership, e.g., profit sharing, pension plans, individual retirement accounts, stock bonus and option plans, ESOPs, and a financed capitalist plan. Particular attention should be paid to how these techniques interact and how incentives for one may impact on others.

Early experience with ESOPs have shown that they can have an important favorable impact, at least over a particular range of companies. Further, they have been remarkably successful for certain specialized purposes, such as the saving of jobs through the rescue of divisions spun off by conglomerates, which would have otherwise closed. It remains to be seen whether they can achieve wider usage through further modifications in the conditions under which they are formed and operated.

TRASOPs have not worked well and need to be re-thought. As currently structured, they represent a straight transfer from the general tax fund to a select group of relatively high paid employees of capital intensive corporations, under conditions that create a considerable administrative burden for the companies concerned. They had the merit of being one immediately available means for getting some broadening of stock ownership for at least some part of the investment tax credit, the bulk of which represents, in effect, a gift to existing owners of capital. Senator Long, at the time it was debated in the Senate, told his critics that if they didn't like TRASOPs they should come up with some better idea for achieving the objective of broadened stock ownership. The time has come to do so.

In general, I would recommend that we continue in a measured and careful way with experiments designed to further test elements of Kelso's universal capitalism at the same time that we proceed with the debate and study of the concept of broadened stock ownership, which I would anticipate would continue over a number of years. ESOPs significantly differ from certain other employee deferred benefit schemes only in their use as a corporate financing device, and further legislative incentives should concentrate on that aspect. Congressman's Frenzel's bill is well designed to do this through further tax benefits tied to financing operations and an important procedural provision calling for advance IRS rulings on stock evaluations for ESOP purposes.

The approach aimed at precluding ESOP abuses seems to me to be premature. Required diversification, for example, could undercut the special character and potential of an ESOP as a financer of new equity capital, before its usefulness in this regard had been fully tested. A requirement for an ERISA approved pension fund in conjunction with an ESOP could also be counter-productive. Thousands of smaller firms have simply found they cannot sustain pension funds in the face of ERISA's requirements, and these companies would then also be precluded from establishing ESOPs. ESOPs may have real weaknesses as pension funds, but they are certainly better than nothing, if that is the alternative.

Senator Gravel's soon-to-surface legislation on a financed capitalist plan represents a major breakthrough in this area. It would effectively complement the ESOP approach and constitute a more controllable and clear-cut test of the viability of Kelso's Second-Income Plan. It deserves the most careful and serious consideration of the Congress and the country.

America's success in creating viable capital estates for many who would otherwise have little prospect of achieving them, would have important implications that would extend beyond our own society. If we can deal effectively with some of the inequities and imbalances in our system through such a fundamentally capitalistic approach, this will send a powerful message to others who are weighing the merits of collectivist and free enterprise solutions to the problems of their societies. Thus, we have a broad interest in making this creative response to income inequities work.

FOOTNOTES

1/ Louis O. Kelso and Mortimer J. Adler. The Capitalist Manifesto (New York, 1958), passim

2/ Ibid., pp. 121-137

3/ Louis O. Kelso and Patricia Hetter. Two Factor Theory (New York, 1967), passim

4/ Ibid., p. 17

5/ Louis O. Kelso and Mortimer J. Adler. The New Capitalist (New York, 1961), p. 4

6/ Paul A. Samuelson. San Juan Star (April 27, 1972), as quoted in Stuart M. Speiser. A Piece of the Action (New York, 1977), p. 93

7/ Hearings before the Joint Economic Committee, Congress of the United States. (December 11, 1975), part I, p. 523

8/ Wall Street Week, shown on the Public Broadcasting System and hosted by Louis Rukeyser (December 12, 1975), as quoted in "The New Capitalist" (San Francisco, July 1976), p. 5

9/ Speiser, Piece of the Action, op. cit., Chapter 5

10/ Ibid., p. 93

11/ J. J. Jehring. The Significance of Von Thuner's Theory of Wages for Profit Sharing and a Free Economy (Evanston, 1960), passim

12/ Ibid.

13/ Ibid.

14/ John Maynard Keynes. How to Pay for the War (London, 1940), as quoted, Speiser, op. cit., p. 327

15/ J. E. Meade. Efficiency, Equality and the Ownership of Property (London, 1964), passim

16/ Ibid., p. 27

17/ Ibid.

18/ Ibid., p. 40

19/ Ibid., p. 59

20/ Ibid.

21/ Kelso and Hetter. op. cit., passim

22/ Ibid., p. 67

23/ Ibid., p. 68

24/ Ibid., p. 71

25/ Ibid., pp. 78-79

26/ Ibid., p. 79

27/ Norman G. Kurland, "Beyond ESOP: Steps Toward Tax Justice", The Tax Executive (April 1950), pp. 386-402, as reprinted by WORLD INSTITUTE OF ECONOMIC JUSTICE, 2027 Massachusetts Avenue, NW, Washington, D.C.

28/ Ibid., pp. 389-390

29/ Speiser, Op. cit., p. 194

30/ "Moving to Broaden Stock Ownership", Pensions and Investments, January 3, 1977, as reprinted by Norman Kurland and Associates, Washington, D.C. This is a particularly useful article on the history of ESOPs and legislation effecting them.

31/ "ESOPS: An Analytical Report", Hewitt Associates (Dearfield, Illinois, 1976), pp. 8-13; includes a good summary and analysis of legislative provisions affecting ESOPs

32/ 1976 Joint Economic Report, Joint Economic Committee, Congress of the United States (Washington, March 1976), p. 100

33/ "Mighty Kelso, His Brainchild is Idea "Whose Time Has Come'", Come'", Barron's, July 21, 1975, p. 3

34/ Tax Reform Act of 1976, Public Law 94-455, 94th Congress, Sec. 803(h)

35/ Summarized from an analysis by Hamrin, JEC Staff Study, p. 62 (see footnote 46)

36/ ESOPS: An Analytical Report, op. cit., p. 56

37/ Senator Mike Gravel, The Financed Capitalist Plan, a working draft, p. 3

38/ Ibid.

39/ Ibid.

40/ It is difficult to know for sure, but the 2000 estimate was given to me by two of my best informed contacts, Jack Curtis of the Senate Finance Committee Staff, and Bert Metzger, President of the Profit Sharing Council in Chicago

41/ Janice Shott, "Employee Stock Ownership Plans", Council on Urban Economic Development (Washington, April, 1978). This gives a good presentation on the use of ESOPs in economic development and contains details on the SBL case.

42/ ESOP Hearings before the JEC, _op. cit._, December 12, 1975, part 2, p. 624

43/ Michael Conte and Arnold S. Tannenbaum. _Employee Ownership -- Report to the Economic Development Administration United States Department of Commerce_ (Ann Arbor, June 15, 1977) _passim_

44/ _Ibid._, p. 38

45/ Senator Russell Long, from a speech at Louisiana State University (October 1975), as quoted in Speiser, _op. cit._, p. 210

46/ Robert Hamrin, _Broadening the Ownership of New Capital: ESOPs and Other Alternatives_, a Staff Study prepared for the use of the Joint Economic Committee Congress of the United States (Washington, June 17, 1976), pp. 41-49.

47/ ESOPS: An Analytical Report, _op. cit._, p. 51

48/ _Ibid._, pp. 29-41

49/ _Guide to Modern Profit Sharing_, Profit Sharing Council of America (Chicago, March, 1973), p. iii

50/ _1977 Profit Sharing Survey (1976 Experience)_, Hewitt Associates in cooperation with the Profit Sharing Council of America (Chicago, 1977), _passim_

51/ Peter F. Drucker, _The Unseen Revolution_ (New York, 1976), p. 1

52/ _Ibid._, p. 9

53/ _Ibid._, p. 8

54/ Hamrin, _op. cit._, Chapter 1

55/ _Ibid._, p. 14

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56/ *Ibid.*, p. 16

57/ *Stock Ownership Plans for Employees*, New York Stock Exchange (New York, December 17, 1956), p. 1

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EXHIBIT IX

WE SHOULD AMEND THE ANTI-TRUST LAWS TO PROMOTE EMPLOYEE OWNERSHIP OF PRODUCTIVE CAPITAL

There is an area in the administration of our anti-trust laws that could, by a very simple amendment, cause most divestiture orders or consent decrees to contribute materially to the broadening of the capital ownership base of our economy, rather than to merely change the names of the concentrated owners, as happens under the present administration of these laws.

In 1958, Dr. Mortimer J. Adler and Louis O. Kelso published THE CAPITALIST MANIFESTO. In that book (see pp. 195 et seq.), Adler and Kelso mentioned the fact that, once one understands two-factor theory, it is clear that the most basic kind of monopoly power that can exist in an industrial society is the monopolization of the power to produce wealth, i.e., the accumulation by particular consumer units (families or individuals) of productive power through capital ownership in excess of what they can actually use, with a reasonable margin for safety, to support the lifestyle they desire to adopt. Our anti-monopoly laws are all designed to control or punish an individual company or collaborating group of companies that gets an excessive share of the market, because then the law of supply and demand will not work objectively and effectively to determine prices impartially. There is no explicit recognition under our anti-trust laws of the concentration of the power to produce wealth, which inevitably leads to the dependence of the many upon the few and all of the disenchanting ways in which that dependence expresses itself, and is dealt with.

It would seem that one of the most effective ways of speedily broadening the capital ownership base and, in the course of doing so, to expedite the enforcement of the anti-trust laws, would be amendments to the several anti-trust laws, of such nature that wherever divestitures are ordered or are voluntarily agreed to, the divested assets would be sold to the employees wherever feasible, even if feasibility required the seller to carry the credit on a long term, low interest basis as punishment for violating the anti-trust laws.

As we have repeatedly shown, the totality of conventional financing techniques are designed to make the rich ever richer, and are not designed to make the poor richer. All of the governmental and private programs inspired by the existence of poverty attack only the effects of poverty and never its cause. People are poor because they are not rich, i.e., they do not possess holdings of productive capital to add to the productiveness of their labor power if, indeed, there is a market for that labor power. This phenomenon is the result of various laws in the field of banking, securities and related fields. It is also a product of the laws relating to finance, banking, investment banking, and the practices of financial law firms, the financial accounting professions, etc. Since our Constitution purports to assure to all citizens equal protection of the laws, it is perfectly clear that, if people are morally expected to be economically self-sufficient and to produce what they want to consume, the laws do not equally protect the rich and the poor. The whole massive machinery of business finance is operated squarely in the teeth of the idea of equal opportunity of the poor to acquire capital as compared with the opportunities of the rich to acquire more capital. There is a great inequality in the laws which makes it easy for the rich to increase their economic productiveness through capital ownership, and makes it virtually impossible for the poor to increase their productiveness by acquiring capital ownership.

Kelso & Co., Incorporated has developed the financing techniques by which employees of corporations are given access to the logic of corporate finance traditionally used by business itself. This is the opportunity to buy stock in a tax sheltered Employee Stock Ownership Plan (ESOP) and to pay for it out of the pre-tax yield of the capital represented by the stock so purchased. These techniques enable the poor legitimately to become economically self-sufficient over a reasonable working lifetime. Carried to its ultimate, this technique would eliminate the need for welfare or for Social Security, would accelerate the rate of economic growth, and would reverse inflation and bring about benign, gentle and regulated deflation.

The point may be illustrated with two examples:

<u>Peabody Mines</u>

Kennecott Copper Company, under a divestiture decree, was ordered to sell Peabody Mines, the largest coal mines in the United States, with holdings in several foreign countries. Kelso & Co., Incorporated did a preliminary feasibility study showing that through ESOP financing, the more than 100,000 employees of Peabody Mines could buy that giant asset from Kennecott Copper Company, pay the same price which it would receive from other bidders, and set an enormous example of the broadening of capital ownership and the beginning of a major solution to the economic ills of our economy. Kennecott Copper bluntly refused to study a carefully prepared proposal to this effect, and sold the asset for somewhat over a billion dollars to a group of six or seven giant conglomerates, thus perpetuating the concentration which the government had sought to terminate by the antitrust suit.

<u>The Avis Case</u>

Kelso & Co., Incorporated did an elaborate feasibility study demonstrating that the 70,000 or so employees of Avis could, through a properly designed ESOP, purchase, at market price, the 47 percent of the stock of Avis held by Richard Joyce Smith as trustee under an order of the Federal District Court to dispose of the stock in a way that would not upset the market. We ascertained that the financing to accomplish this transaction was available. Nevertheless, Richard Joyce Smith arrogantly refused to be deterred from his dribbling of the stock into the market through periodic public sales until Dave Mahoney, Chairman of Norton-Simon, Inc., came along and offered him a price well above the market. BARRON'S MAGAZINE, in a most precipient article, described the transaction under a heading entitled "Avis Comes Full Circle", meaning that after spending millions of dollars in an anti-trust suit against ITT, Avis had passed from one giant conglomerate into another giant conglomerate, and the government's work was automatically undone. Avis, which has incessantly advertised that its personnel "Try Harder" would, had we succeeded, have finally put their employees in a position where they would in fact have a reason to try harder.

Louis O. Kelso
President and Chief Executive Officer
KELSO & CO., INCORPORATED

EXHIBIT X

Congressional Record

United States of America

PROCEEDINGS AND DEBATES OF THE 94th CONGRESS, FIRST SESSION

Vol. 121 WASHINGTON, TUESDAY, JANUARY 14, 1975 *No. 1*

House of Representatives

H.R.462

INTRODUCTION OF THE ACCELERATED CAPITAL FORMATION ACT OF 1975

The SPEAKER pro tempore. Under a previous order of the House, the gentleman from Minnesota (Mr. FRENZEL) is recognized for 30 minutes.

Mr. FRENZEL. Mr. Speaker, I rise today to introduce the Accelerated Capital Formation Act of 1975. This is a refined version of H.R. 8590 which I introduced in the 93d Congress.

During the last session a great deal of progress in advancing the financing method known as ESOP or the employee stock ownership plan was made. A provision for study of the ESOP plan in restructuring the Penn Central and other Northeast and Midwest railroads was included as a vital section of the Railroad Reorganization Act. In the Pension Reform Act, signed into law last Labor Day, the ESOP was given special recognition as a form of employee benefit that could also be used to attract outside financing to meet the capital requirements of an expanding enterprise. In the Trade Reform Act companies utilizing ESOP will be given special preferences in the $1 billion program of federally guaranteed loans to companies expanding or locating in areas adversely affected by foreign competition. There were at least three other major pieces of legislation being considered in the 93d Congress which, though they did not reach the floor, contained ESOP provisions: these were railroad improvement loans, energy development and the Pan Am Assistance Act.

Though a great deal of progress has been made in recent years many people have questioned just what an ESOP does. Essentially, under existing law, the ESOP makes accessible to all corporate employees the techniques of corporate finance. Without any actual cash outlay from corporate employees—as in conventional employee stock purchase programs—and without any deduction in take-home pay or fringe benefits an ESOP builds blocks of corporate shares into employee ownership while providing moneys necessary for capital requirements. It has been used to finance corporate expansion, acquire new assets, accomplish divestitures or spinoffs and finance mergers, et cetera.

A standard ESOP incorporates a deferred compensation trust—technically a qualified stock bonus trust alone or coupled with a money purchase pension trust—into the financing process itself. In one common technique the employees trust borrows funds to invest in the employer corporation. This then allows the affected employees, subject only to the trusts paying off the loan, to become beneficial owners of the companies' stock.

The employer corporation obligates itself to make annual payments into the trust in amounts sufficient to amortize the debt out of tax deductible dollars.

The tax deduction makes it possible for the corporation to build greater capital ownership into the employees than it could otherwise, and the costs of financing its growth is about the same as if it conveniently borrowed and repaid—as to principal—in after-tax dollars. After the employers stock has been paid for in this manner the trust can, if desired, be diversified by tax-free exchanges of stock for other securities, or by a public offering out of trust.

This ESOP method, simply stated, allows greater benefits to the corporation than common expansion and financing techniques and permits the employee to gain a larger share of the organization he serves than conventional profit-sharing methods.

The first known use of ESOP financing, pioneered by Louis Kelso, involved an employee buy-out of a chain of California newspapers that was threatened with takeover by a major chain in 1956. But only in the last few years has the business world at large become aware of this innovation. A number of investment banking firms are pioneering this approach and several major firms have begun to recommend ESOP's to their clients. Over 100 corporations have, largely in the last year, adopted ESOP's including two of our larger electronic manufacturers. Many smaller firms and several major unions have adopted ESOP's.

In order to facilitate the use of the ESOP technique, and thus effectively link daily employee performance with the growth and operation of a business, the bill modifies the Internal Revenue Code as follows:

First, the bill removes the present statutory limitation of 25 percent of covered compensation as the maximum amount an employer can contribute to a qualified employee stock ownership plan when such payments are used to enable the plan to repay stock acquisition debt incurred in connection with meeting the employer's capital requirements. This places the sole limitation on financing contributions on the enterprise's capacity to service the debt out of cash flow. This reform reduces the cost of capital growth and transfers in the ownership of corporate assets, while accelerating the rate at which employees as individuals and as a group can accumulate stock of their employer and other income-yielding assets as a new and noninflationary form of employee benefit. Although treated as a tax deduction, this change would have the same impact as an investment tax credit in terms of encouraging capital spending; however, the investment tax credit increases the concentration of corporate ownership while ESOP contributions correct this economic factor.

This also rechannels corporate profits that would otherwise have gone into the corporate income tax base into productivity increases of the private sector, thus generating lower prices for consumers, expanded private payrolls, and a broadening base of taxable personal incomes and personal estates among productive workers.

Second, the bill provides a tax deduction to corporations for the amount of dividends they distribute either directly as taxable second incomes on stock held in an employee's account or which are used to repay stock acquisition indebtedness of the employees' trust. This provision also converts taxable corporate income into either taxable dividend incomes for employees to supplement their paychecks or their retirement and social security incomes or a more rapid rate of accumulation by employees of individual capital estates for their retirement security.

Third, the bill provides that a qualified employee stock ownership plan and trust shall have the tax characteristics of a charitable organization for purposes of estate, gift, and income taxes. This would encourage affluent taxpayers to make gifts to qualified trusts in order to reconnect the ownership of capital with a broader base of private individuals, namely productive employees some of whom have contributed to the building of the donor's wealth. Allocations to participants of the trust would become an immediate source of taxable second incomes—to the extent dividends are passed through the trusts—and a retirement estate for the employee-beneficiaries and their heirs. On the other hand, Government would lose no tax revenues since such contributions made to charitable organizations are already exempt from taxation, and profits from donated income-producing property are frequently accumulated tax-free within such organizations.

Fourth, the bill establishes a cutoff on further contributions in behalf of any employee when the value of the assets that employee has acquired during his working lifetime through one or more ESOP's exceeds $500,000. Such a safeguard on excessive accumulations acquired through tax deductions would be especially important in highly capital-intensive industries and would help foster more widespread and equitable sharing of ownership among Americans generally.

Fifth, the bill adds to the options of ESOP participants when distributions are made when they retire, die, or are otherwise separated from service. Although profit sharing plans are permitted to make distributions in many forms, the Internal Revenue Service has ruled that distribution from an ESOP must be made exclusively in company stock.

Although enabling employees to accumulate sizable holdings of employer stock has obvious motivational value, when an employee leaves the company and can no longer directly influence the yield on the company stock accumulated in his ESOP account, it is desirable to provide the departing employee and the remaining employees, through their ESOP, to arrange an exchange for his accumulated assets with other income-yielding assets or cash of an equivalent value. This bill would provide ESOP's the same flexibility in making distributions that is now enjoyed by profit sharing plans.

Sixth, the bill permits a repurchase option for plans of enterprises that are wholly owned by their employees, so that stock of departing employees can remain exclusively held within the employee group.

Seventh, the bill exempts lump sum distributions of income-yielding estates derived from an ESOP from any form of taxation, provided the assets are held to produce a taxable second income for the taxpayer or his beneficiaries. However, if the assets are converted into spendable income and not reinvested within 60 days, the uninvested proceeds will be taxed as ordinary income, instead of partially at the lower capital gains rate permitted under present law.

Eighth, the bill enables affected parties to seek advance IRS opinions on valuations on stock or other assets acquired by an ESOP where the parties to a financing transaction which utilizes and ESOP would be subject to serious risks or penalties if the IRS, upon subsequent audit, disagreed with the valuations or other key features of the financing plan. This is similar to the "no action" procedures already instituted by the FTC and SEC.

Ninth, the bill exempts payments to an ESOP made for financing purposes from treatment as a conventional employee benefit for purposes of any wage, salary, deferred compensation, or other employee benefit controls or guidelines that might be established under executive order, regulations, or future economic stabilization laws at the Federal or State levels. Instead, it would be treated as any other form of capital spending that would have a counterinflationary effect. In effect, it offers labor a trade-off for wage increases where wage ceilings are established.

I hope that the members of this body will carefully consider the legislation. I am hopeful that further progress can be made in this session.

A copy of the bill follows:

H.R. —

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TITLE.—This Act may be cited as the "Accelerated Capital Formation Act of 1975".

SEC. 2. PURPOSE.—The purpose of this Act is to provide incentives for accelerated financing of the formation of U.S. corporate capital and to encourage voluntary means for broadly diffusing equity ownership among employees of U.S. enterprises both (a) with respect to existing capital by means consistent with the protection of private property and (b) with respect to newly formed capital by means which extend the logic of conventional business finance to corporate employees.

SEC. 3. AMENDMENT OF INTERNAL REVENUE CODE.—The Internal Revenue Code of 1954 is amended by adding the following new Section 416 at the end of Subpart B of Part I of Subchapter D of Chapter 1:

SEC. 416.—EMPLOYEE STOCK OWNERSHIP PLAN FINANCING.

(a) DEFINITIONS. (1) "Employee stock ownership plans" means a technique of corporate finance described in Section 4975(e)(7) that utilizes stock bonus plans, or stock bonus plans coupled with money purchase pension plans, which satisfy the requirements of Section 401(a) and are designed—

(A) to invest primarily in qualifying employer securities,

(B) to meet general financing requirements of a corporation, including capital growth and transfers in the ownership of corporate stock;

(C) to build into employees beneficial ownership of qualifying employer securities,

(D) to receive loans or other extensions of credit to acquire qualifying employer securities, with such loans and credit secured primarily by a commitment by the employer to make future payments to the plan in amounts sufficient to enable such loans and interest thereon to be repaid, and

(E) to limit the liability of the plan for repayment of any such loan to payments received from the employer and to qualifying employer securities, and dividends thereon, acquired with the proceeds of such loan, to the extent such loan is not yet repaid.

(2) For purposes of this section, the term "employer securities" means securities issued by the employer corporation, or by an affiliate of such employer.

(3) For purposes of this section, the term "qualifying employer securities" means common stock, or securities convertible into common stock, issued by the employer corporation, or by an affiliate of such employer.

(b) Special Deductions (1) In addition to the deductions provided under section 404(a), there shall be allowed as a deduction to an employer the amount of any dividend paid by such employer during the taxable year with respect to employer securities, provided—

(A) such employer securities were held on the record date for such dividend by an employee stock ownership plan; and

(B) the dividend received by such plan is distributed, not later than 60 days after the close of the plan year in which it is received, to the employees participating in the plan, in accordance with the plan provisions; or

(C) the dividend received by such plan is applied, not later than 60 days after the close of the taxable year, to the payment of acquisition indebtedness (including interest) incurred by the plan for the purchase of qualifying employer securities.

(2) Notwithstanding the limitations of section 404(a), there shall be allowed as a deduction to an employer the amount of any contributions paid on account of a taxable years (as described in section 404(a)(6)) to an employee stock ownership plan, provided such contributions are applied to the payment of acquisition indebtedness (including interest) incurred by the plan for the purchase of qualifying employer securities.

(3) For purposes of sections 170(b)(1), 642(c), 2055(a), and 2522, a contribution, bequest, or similar transfer of employer securities or other property to an employee stock ownership plan shall be deemed a charitable contribution to an organization described in section 170(b)(1)(A)(vi), provided—

(A) such contribution, bequest, or transfer is allocated, pursuant to the terms of such plan, to the employees participating under the plan in a manner consistent with section 401(a)(4);

(B) no part of such contribution, bequest or transfer is allocated under the plan for the benefit of the taxpayer (or decedent), or any person related to the taxpayer (or decedent) under the provisions of Section 267(b), or any other person who owns more than 25% in value of any class of outstanding employer securities under the provisions of Section 318(a), and

(C) such contribution, bequest or transfer is made only with the express approval of such employee stock ownership plan.

(c) *Treatment of Participants* (1) Qualifying employer securities acquired by an employee stock ownership plan through acquisition indebtedness incurred by the plan in connection with the financing of capital requirements of the employer corporation or its affiliates must be allocated to the accounts of the participating employees to the extent that contributions and dividends received by the plan are applied to the payment of such acquisition indebtedness (including interest), in accordance with the terms of the plan and in a manner consistent with Section 401(a)(4).

(2) Upon retirement, death or other separation from service, an employee participating under an employee stock ownership plan (or his beneficiary, in the event of death) will be entitled to a distribution of his non-forfeitable interest under the plan in employer securities or other investments allocated to his account, in accordance with the provisions of such plan. If the plan so provides, the employee (or beneficiary) may elect to receive all or a portion of the distribution from the plan in—

(A) employer securities, other than qualifying employer securities;

(B) cash;

(C) a diversified portfolio of securities;

(D) a non-transferable annuity contract; or

(E) any combination of the above.

(3) An employee stock ownership plan may provide for the required repurchase of qualifying employer securities from an individual receiving a distribution thereof if all other of such outstanding employer securities, whether or not acquired through the plan, are subject to repurchase from non-employee shareholders under similar circumstances.

(4) Upon receipt of a lump sum distribution, as described in Section 402(e)(4)(A), from an employee stock ownership plan, an individual may exclude from gross income that part of the distribution which consists of employer securities or other assets, if income producing, held or reinvested within 60 days in income producing assets of equivalent value, for the purpose of providing the individual with dividends or other forms of realized income from such assets. Upon subsequent sale or disposition of any employer securities or other assets distributed by an employee stock ownership plan to the extent that proceeds realized from such sale or disposition are not reinvested within 60 days in income producing assets, the total amount of such proceeds (or the fair market value of any such securities or assets that are transferred without adequate consideration) shall be treated as ordinary income to the individual.

(5) An employee receiving a distribution under paragraph (b)(1)(B) of this Section shall be subject to taxation under Section 402(a)(1), and the provisions of Section 116 shall not apply to such distribution.

(6) A contribution by an employer which is deductible under paragraph (b)(2) of this Section or a contribution described in paragraph (b)(3) of this Section, shall not be included in the meaning of annual addition under Section 415(c)(2).

(7) No contribution to an employee stock ownership plan may be allocated for the benefit of any participant if the value of the total accumulation of employer securities and other investments under the plan for the benefit of that participant equals or exceeds $500,000, less the amount of any such accumulation for that participant under any other employee stock ownership plans.

(d) *Special Provisions.* (1) The acquisition or holding of qualifying employer securities and the incurring of acquisition indebtedness by an employee stock ownership plan shall be deemed to satisfy the requirements of Section 404(a)(1) of the Employee Retirement Income Security Act of 1974 provided that—

(A) the requirements of Section 408(b)(3) and 408(e) of such Act are satisfied; and

(B) the same standards of prudence and fiduciary responsibility that corporate management must exercise with respect to its shareholders are satisfied.

(2) Upon application by an employee stock ownership plan, the Secretary of the Treasury or his delegate shall issue an advance opinion as to whether a proposed transaction involving that employee stock ownership plan will satisfy all the requirements described in paragraph (1) of this subsection, and any such opinion shall be binding upon the Secretary.

Sec. 4—*Effect of Economic Stabilization.*—Payments by an employer to an employee stock ownership plan as defined in Section 4l6(a)(1) of the Internal Revenue Code of 1954, for the purpose of enabling such plan to pay acquisition indebtedness incurred for the purchase of qualifying employer securities or other contributions to such plan shall not be treated as compensation, fringe benefits or deferred compensation payments for the purposes of any laws, executive orders or regulations designed to control, establish guidelines or otherwise stabilize employee compensation or benefits but shall be treated as the equivalent of debt service payments made in the normal course of financing the capital requirements of that employer.

EXHIBIT XI

LOUIS O. KELSO, INC.
LAWYERS AND COUNSELORS
111 PINE STREET
SAN FRANCISCO, CALIFORNIA 94111

TELEPHONE
(415) 788-7200

CABLE ADDRESS
LOKINC

January 17, 1975

The Honorable Gerald R. Ford
President of the United States
The White House
1600 Pennsylvania Avenue
Washington, D.C. 20500

Dear Mr. President:

I am dismayed at the inadequacy of the economic program as presented in your State of the Union Message. It incorporates the continued use of the Keynesian expedients that have papered-over our problems from the last depression to our new depression without correcting the structural defects that make our economy work so badly.

Up to now, it has been abundantly demonstrated that the chief Keynesian weapon against inflation is unemployment, and that the chief Keynesian weapons against unemployment are inflationary. Now that we have opened up a two-front war simultaneously on unemployment and inflation, using the same old Keynesian tools, we can hardly be headed for anything but the most colossal disaster in our economic history.

The alternative -- I am certain the only alternative -- is outlined in the statement I prepared for your Economic Summit Meeting on Inflation last September. A copy of that statement is enclosed herewith.

The program contemplated by my Summit statement, "A New Economic Policy to Meet the Needs of the American People and of the U.S. Economy," can effectively and within time limits short enough to permit restoration of confidence of the people in our economy, accomplish the following objectives:

-- Restoration and acceleration of economic growth to unprecedented levels through making possible financing of the enormous, self-liquidating new capital formation so desperately needed by the U.S. economy today, including making ourselves self-sufficient in energy, the building of hundreds of rapid transit systems, the total rehabilitation of our railroad system, the reawakening of our housing industry, the multiplication of our agricultural output by several magnitudes (since it is our best trade balance weapon), etc.;

LOUIS O. KELSO, INC.
LAWYERS AND COUNSELORS

The Honorable Gerald R. Ford
January 17, 1975
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-- Create legitimate (not boondoggle) full employment for two or three decades until we can get the American people in a position where a major portion of their incomes are derived from capital ownership;

-- Lay the foundation for arresting inflation and initiating the hardening of our money, for once the newly-formed capital has paid for itself, it will continue to throw off goods and services almost indefinitely;

-- Achieve these steps only through self-liquidating expenditures, rather than through welfare and tax cuts, which must be ever repeated and ever increased to close, year after year, the purchasing power gap;

-- Build market power -- adequate market power -- into the workers in the form of a second income from their privately-owned capital;

-- Finance these objectives without adding one cent to the Federal debt through the discount technique proposed in my Summit statement, which is nothing more nor less than a technique for monetizing self-liquidating newly-formed capital. Compare this with the present Administration program, which primarily monetizes welfare!

-- Permit the lowering of the interest rate on these selected basic types of self-liquidating new capital formation to 3% or less, assuring enormously greater economic power in the form of new productive industry.

I am also enclosing a copy of a bill for an act entitled the "Accelerated Capital Formation Act of 1975." This bill, which was introduced into the House this week by Congressman Frenzel from Minnesota contains very minor changes in the tax laws relating to Employee Stock Ownership Plan financing techniques that will radically enhance their attractiveness to corporations, to employees, to labor unions, and to voters. The provisions of this bill will accomplish all and more than would an increase in the investment credit which, for all its advantages in helping to stimulate business, never creates a single new stockholder. Rather, the investment credit merely exacerbates the concentration of ownership that is already our Number One problem.

LOUIS O. KELSO, INC.
LAWYERS AND COUNSELORS

The Honorable Gerald R. Ford
January 17, 1975
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Mr. President, I urge you to consider these points, and if you are persuaded of their soundness, as I am, to help bring about their substitution for the programs now under consideration.'

Irrespective of what welfare or emergency measures might have to be taken to prevent immediate suffering as the result of the failure of the economy, the program I have outlined alone is a long-term solution and its vigorous employment would minimize the welfare expedients needed in the short term.

I respectfully urge your attention to the foregoing.

Sincerely,

Louis O. Kelso

Louis O. Kelso

LOK:rah
Enclosures

cc: The Honorable L. William Seidman

KELSO & CO.
111 PINE STREET
SAN FRANCISCO, CALIFORNIA 94111

A NEW ECONOMIC POLICY TO MEET THE NEEDS OF THE AMERICAN PEOPLE AND OF THE U.S. ECONOMY

Proposals to the President of the United States At the Economic Summit Meeting on Inflation Convened in Washington, D. C. September 27-28, 1974

By
Louis O. Kelso, Economist

As we meet to consider and recommend solutions to inflation and related problems now besetting the American economy, it is clear that fast and effective solutions are needed to:

— Resume and accelerate economic growth. The American economy derives its strength from its ability to bring into existence powerful capital instruments — the real source of its productive power and affluence — and to match them with skilled and motivated workers. We should never forget that economic strength depends on the ability to produce an abundance of low-cost, high quality goods and services, and to build market power into consumers in the process. Rapid economic growth is essential if we are to achieve self-sufficiency in energy within less than a decade; if we are to rehabilitate our railroad systems; if we are to rehabilitate our cities; achieve vastly expanded production of food and fiber at much lower costs in order to meet our share of the export demand and to solve our balance of payments problems; build a hundred or more new towns and a hundred or more rapid transit systems; and expand the production of basic goods and services in general.

— Create several million new jobs in the private sector in the course of expanding its output of goods and services. Certainly no one can suggest that we should find make-work employment in the public sector if, in fact, the expanding private sector requires more jobs.

— Protect the quality of our environment as we grow, which will further increase the need for new capital formation and for financing it.

— Achieve higher incomes for our poor and our middle classes, but by means other than increases in wages and salaries, in order to avoid increasing the costs of goods and services.

— Reverse inflation and achieve a gradual and continuous hardening of our money.

WHAT CAN ACCOMPLISH THESE OBJECTIVES WHEN SO MANY OTHER PLANS HAVE FAILED?

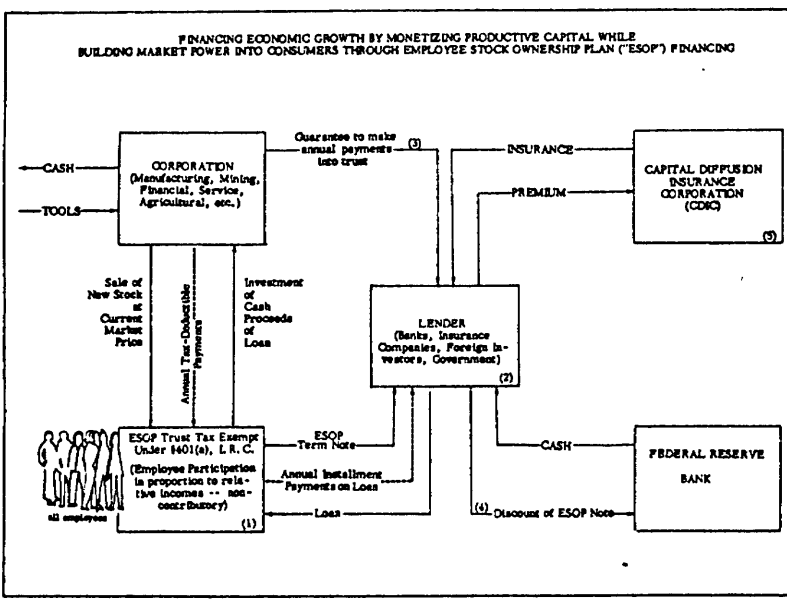
Modern inflation is of such nature that it can only be solved by radically increased investment in self-liquidating new capital formation. It is nothing short of a miraculous coincidence that we are facing a decade in which capital formation requirements exceed those of any past decade by several magnitudes.

Not only is it true that we can and must invest our way out of inflation, while solving the other problems noted above, but credit for doing so at low interest rates is *unlimited*. Expenditures during the coming decade of upwards of 4.5 trillion on basic private-sector new capital formation, if structured to radically broaden corporate equity ownership and to minimize making the rich any richer, will reverse inflation, build market power into most consumers, create two or three generations of intense full employment, and shrink to a fraction of their present size the various government agencies devoted to attacking the effects of poverty while leaving its causes untouched. This program is an attack on the *cause* of poverty, namely, the low economic productiveness of the individual who does not own significant income-producing capital. It will cause taxpayers' incomes to rise, the purchasing power of their money to grow, and their taxes to fall well below present levels.

WHAT ERROR IS RESPONSIBLE FOR OUR UNEMPLOYMENT, INFLATION, STAGNATED ECONOMIC GROWTH, AND INCOME DISTRIBUTION MISMATCH?

Present U.S. economic policy calls for solving the income distribution problems for all consumers through full employment, and to the extent that is not achievable, through welfare. At the same time, science, engineering, and management of business, industry and agriculture, strive ceaselessly to eliminate employment to minimize costs. Inflation flows relentlessly and unendingly from attempts of the Federal government to reconcile these unreconcilables, all of which take the form — recognizable or not — of the monetization of welfare. Money representing welfare is inflation in its essence.

THE BLUEPRINT FOR THE NEW ECONOMIC POLICY.



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— *EXPLANATORY NOTES.*

1. The Employee Stock Ownership Plan ("ESOP") Trust is a tax exempt entity organized to conform to Section 401(a) of the Internal Revenue Code. Not only are payments into it by the corporation deductible from corporate income tax within specified limits (maximum 25% of covered payroll), but the employees can accumulate capital ownership in the Trust until their retirement, free of annual income taxation.

2. In addition to banks, insurance companies, and foreign investors, all of which are currently eligible to make ESOP loans, consideration should be given to enlarging the power of savings and loan institutions to make such loans.

3. The corporate guarantee to make sufficient payments into the trust to enable the trust to meet its loan amortization requirements is, in effect, a pledge of the general obligation of the corporation *payable in pre-tax dollars*. In tax theory, this is a contribution to a qualified employee trust. In economic theory, it is merely a commitment on the part of the corporation to make a high payout of the wages (i.e., earnings) of the newly formed capital.

4. The direct discounting of the ESOP note with the Federal Reserve Bank should be strictly limited to basic financing of high priority, self-liquidating new capital formation, such as railroad rehabilitation, the building of new rapid transit systems, the expansion of agriculture, etc. It should never be used for consumer financing or mere purchase of existing assets. The interest rate should be limited to the administrative cost to the Federal Reserve Bank and the administrative cost to the lender, including a reasonable profit. We estimate this rate should not exceed 3% per annum to the ESOP borrower. No consideration of risk should be involved in the fixing of the interest rate, since the risk is covered in another way. (See Note 5 below.)

5. We recommend that Congress organize a capital financing counterpart of the FHA Insurance Fund designed for use primarily in the consumer housing field. Its name, suggested here, is Capital Diffusion Insurance Corporation. (For further discussion, see Kelso and Adler, *The New Capitalists*, Random House (1961); Kelso and Hetter *Two Factor Theory: The Economics of Reality*, Random House Vintage Books (1967); Testimony of Louis O. Kelso and Norman G. Kurland, Financial Markets Subcommittee of the Senate Finance Committee, September 24, 1973.)

This basic financing design, omitting the Capital Diffusion Insurance Corporation, and the arrangement for discounting ESOP notes directly with the Federal Reserve Bank (both of which we recommend Congress provide for with the control conditions herein outlined) has been successfully used by more than one hundred U.S. corporations under existing law. The newly-enacted Employee Retirement Income Security Act of 1974 greatly strengthens and enlarges the opportunities for the use of ESOP financing. (See in particular Sections 404(a)(2), 407(b), 407(d)(3)(A), 407(d)(6), 408(b)(3), 408(e), 2003(a), 4975(d)(3), 4975(d)(13), 4975(e)(7).)

WHY WOULD THE PLAN BRING ABOUT A CONTINUOUS HARDENING OF THE PURCHASING POWER OF MONEY?

The classical definition of inflation is too many dollars chasing too few goods. Since this plan is based upon the radical expansion of feasible and self-liquidating newly-formed capital, it involves bringing into existence productive facilities that will not only pay for themselves once within a reasonable number of years (normally 3 to 5), but these capital instruments, their productiveness preserved by depreciation practices which involve setting aside funds to restore and perpetuate their productive power before net income is computed, continue almost indefinitely to push goods and services into the markets without further capital costs. Furthermore, since the typical ESOP Trust covers all of the employees of each corporation employing it for financing purposes, employees are gradually put in a position where their increasing wage demands conflict with their accumulating capital ownership, and wage demands may be expected to flatten out. Since the typical ESOP Trust is designed so that, once stock is paid for, any dividends thereafter paid pass through the Trust into the employees' pockets, it becomes possible to raise employee incomes without raising corporate costs. Furthermore, the ESOP, by building significant capital ownership into employees over a working lifetime, will gradually replace fixed-benefit pension trusts and profit sharing arrangements that are invested only in secondhand equities. Since these do not finance growth of the sponsoring corporation, they are pure costs which can be gradually eliminated.

Finally, the rapid acceleration of the real growth of the U.S. economy, desperately needed and calling for large increases in employment, will render unnecessary the governmental costs of creating make-work jobs producing nothing of market value. The rolls of the unemployed will fall and in due course many government employees will be attracted by the advantages of working in industry under conditions providing opportunities for capital ownership, second incomes and economic security.

Second incomes from capital, paid to employees after their new capital holdings have paid for themselves, will enhance the market power of those with unsatisfied needs and wants. This "second income" is the wealth produced by capital — not monetized welfare such as is used today to close the purchasing power gap. The accelerated growth of the economy will make the poor richer without making the rich poorer, and will provide a larger income and property tax base for government. In the face of shrinking "need" or welfare demands, we can achieve every taxpayer's dream of a shrinking tax bite accompanied by increased purchasing power of the dollar.

CONVENTIONAL METHODS TO CLOSE THE PURCHASING POWER GAP OF THE POOR AND MIDDLE CLASS COMPARED TO THE PLAN BASED UPON ESOP FINANCING.

Conventional Economic Expedients	ESOP Financing Plan
Attacks only the effects of poverty.	Attacks the causes of poverty.
Increases dependence of the individual on the State.	Creates growing autonomy, increasing economic independence of the consumers who produce progressively more of their income through their privately-owned capital.
Progressively more inflationary.	Gradually deflationary through the hardening value of money. Living becomes easier because it is easier to produce goods and services and easier to buy and pay for them.
Demotivates economic activity through higher and higher taxes, redistribution and discouragement of craftsmanship.	By linking the worker's performance of his job with the acquisition of a viable capital estate, provides him the most powerful and satisfying motivating force in history.
Restrains economic growth.	Promotes accelerating economic growth.
Economy increasingly depends on taxation.	Economy increasingly depends on intelligent use of credit and the wise use of banking facilities to expand the private economy and enable all consumers to participate in production through capital ownership.
Numerous financial and institutional barriers to economic growth. "Where do we get the money?"	Institutional barriers to growth eliminated and only physical limits to growth remain.
Defy man's nature because they violate Machiavelli's Law: a man will forgive you for killing his father before he will forgive you for taking his patrimony.	The economy in which capital ownership is broadly owned conforms to the nature of man because it helps him to acquire a capital estate, protects his patrimony, and helps it to grow.
Concentrates economic and political power in the same hands and is eventually totalitarian.	Keeps the economic power out of the hands of the State and diffuses ownership broadly through all consumers. The State remains in the position of umpire and guide. The freedom of the individual can be protected by the individual, while political power from election to election is centralized in an administration. While government has enormous ability to make low-cost credit available for broadly-owned basic new capital formation, and has therefore enormous leadership capability within the society, economic power remains with the people.

KELSO & CO.
INCORPORATED
INVESTMENT BANKERS

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(415) 788-7454

October 1, 1974

Mr. William Seidman, and
Professor Paul McCracken
Old Executive Office Building
Washington, D.C. 20500

Dear Bill and Paul:

The Summit Conference on Inflation was a confidence-inspiring event for those involved and, I think, for this country as a whole. The administration gained in credibility perceptibly.

The very public nature of the sessions, however, minimized the possibility of considering new ideas of a scope commensurate with the size and seriousness of the underlying economic problems.

A dozen or more speakers noted that they had heard "nothing new." Among them was Dr. Gwen Bymers as the mini-summit meeting of the Banking and Finance Community on September 20th — where the Bangert & Company proposal was presented. But the fact is that Bangert & Company's proposal is both new and critically relevant: it involves taking direct steps that lie within the powers of a democratic society towards eliminating inflation, financing greatly improved economic growth and bringing about two or more decades of full employment. I do not, of course, criticize Professor Bymers for not grasping the significance of what she had heard in the limited time available. My invitation came on such short notice that I had no time to prepare an advance summary of my presentation — a copy of which I now enclose.

As you sift through the suggestions and begin to formulate a new economic policy however, I urge you carefully to consider making a recommendation to Congress for amending the Employment Act of 1946 to expand the U S economic goal to include a policy favoring the broadening of the ownership of capital. While this would be a new departure, (or at least one that is new since the Homestead Acts), it is one directed towards the solution of the chief *real* problem. It would proclaim a new goal while also giving the Administration and Congress time to consider the means of implementation. If the implementation is timed carefully, any temporary revenue losses will be far less than the cost of make-work jobs and other welfare expedients required to shore up a stagnant economy.

I am fully aware that conventional banking thought is quite oblivious to the power and importance of using pure credit to finance new capital formation. For example, Governor Henry C Wallich of the Federal Reserve Board, at the Conference for Corporation Executives on Wednesday, September 25, 1974, at the School of Advanced International Studies in Washington, D.C., stated:

> *"Conterproductive Proposals*
>
> "A variety of often ingenious suggestions were made during the pre-summit meetings that, upon closer analysis, have one feature in common: their application would require printing more money. Proposals to combat inflation burdened with this side effect do not carry conviction. ***This applies, for instance, to well meant suggestions to expand credit in order to expand productive investment in order to expand output*** More output indeed would tend to restrain inflation, but not if it has to be financed by an expansion of money and credit." (Emphasis added)

The prevalence of this *non sequitur* variety of thinking is part of the explanation as to how we got into our present mess. Governor Wallich is certainly correct when he says, "More output indeed would tend to restrain inflation," and he is dead wrong when he asserts that such is not true if the expanded output "has to be financed by an expansion of...credit." Newly-formed capital in well-managed businesses (and the Federal Reserve Board can lay down regulations concerning the quality of feasibility studies) pays for itself *not just once, but repeatedly in cycles*, rarely of more than half dozen years each, its productiveness restored by depreciation practices that are universally used. Such *Ex Cathedra* and unsupportable statements should not shut off the only line of thinking that can lead us out of the inflation woods. Neither Governor Wallich, nor any one else could explain the financing of the industrialization of Japan over the last half century without acknowledging that new capital formation can indeed be financed out of pure credit without inflation. Japan's inflation came long after Japan had risen to high-level industrial status, and is due to essentially the same causes as that in the United States: the attempt to solve the income distribution problem through labor, when the great bulk of its wealth is in fact produced by capital. Japan's further mistake lay in failing to develop techniques, such as we have developed, to radically broaden the equity ownership base.

You both have copies of *Two-Factor Theory: The Economics of Reality*, written by Patricia Hetter and myself in 1967. In the appendix to that book is a draft of just such a revision of the Employment Act of 1946 which you could quickly adapt to suit your own views.

The world is facing a crisis arising out of the ultimately hopeless attempt to distribute as pay for labor the income derived from the overwhelming input of capital. This economic policy is clearly not working, nor can it ever work, for technology modifies the input mix into the economy in only one direction.

You have the opportunity to set us on the course to sound and necessary change in your formulation of the Administration's new economic policy recommendations to Congress.

Please give this suggestion your most careful consideration. I will be at your service, of course, should you find that I can be of help.

With best regards,

Sincerely,

Louis O. Kelso

EXHIBIT XII

IDENTIFICATION OF KELSO & CO., INCORPORATED

Kelso & Co., Incorporated was formed in 1971 to provide a wide range of investment banking services other than public underwriting. It does not engage in any aspect of the stock brokerage business. Areas of emphasis in the firm's work are the designing of short and long range financing plans, private placement of debt and equity securities, both for new ventures and established businesses, and the acquisition and disposition of business assets.

Where appropriate, Kelso & Co., Incorporated emphasizes methods of financing expansion and accomplishing the acquisition, disposition and reorganization of businesses by means which effectively build capital ownership into the executives and employees of its clients. One means for implementing these techniques -- an area of specialization of Kelso & Co., Incorporated -- involves the use of Employee Stock Ownership Plan (ESOP) financing.

Louis Kelso, President and Chief Executive Officer of Kelso & Co., designed and implemented the first ESOP in 1956, some 18 years before his innovation was expressly recognized by Federal law. The complicated orchestration of the diversified disciplines required to design and implement an ESOP include economics, financial analysis, corporate finance, accounting, communications, employee business and economic education, law (including deferred compensation, general commercial and financial law, corporate, labor and securities regulation, both by the Securities and Exchange Commission and State regulatory bodies, and tax law), and employee and shareholder relations. The complete turnkey services provided by Kelso & Co. to clients frequently involve solutions to problems that are not achievable under conventional financing techniques. The experience and efforts of Mr. Kelso and his associates have resulted in substantial beneficial legislation regarding ESOPs, and the creation of a nationwide demand for the innovative forms of financing involved.

In the course of its work, Kelso & Co., Incorporated and its personnel have appraised and valued hundreds of companies, designed hundreds of financing transactions, provided sophisticated financial analysis, and solved intricate problems arising from the interplay of differing interests and objectives of directors, corporate management, shareholders, lending institutions, unions, employees and use of ESOP financing to solve estate planning problems.

Kelso & Co., Incorporated also provides consultation services to domestic and foreign governmental entities desirous of simultaneously accelerating economic development, freeing themselves from dependence on foreign capital, building broad purchasing power in potential consumers, reversing inflation, achieving low interest rates for self-liquidating basic new capital formation, and stabilizing business constituencies through creating widespread ownership of business equities.

The thesis upon which the need for a new form of investment banking service business with the characteristics, objectives and facilities of Kelso & Co., Incorporated was postulated in the following:

THE IMPLICATIONS OF TWO-FACTOR THEORY AND THE PRIVATE BUSINESS FINANCING TECHNIQUES STRUCTURED UPON THAT THEORY, NAMELY EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs), CONSUMER STOCK OWNERSHIP PLANS (CSOPs) AND GENERAL STOCK OWNERSHIP PLANS (GSOPs)

THE PREPONDERANCE OF OUR GOODS AND SERVICES ARE PRODUCED BY CAPITAL, YET FAMILIES OWNING SIGNIFICANT CAPITAL HOLDINGS ARE A MINUTE FRACTION OF THE POPULATION.

No one has refuted, or can refute, the basic argument of THE CAPITALIST MANIFESTO, THE NEW CAPITALISTS (by Louis O. Kelso and Mortimer J. Adler, Random House, 1958 and 1961, respectively) and TWO-FACTOR THEORY: THE ECONOMICS OF REALITY (by Louis O. Kelso and Patricia Hetter, Random House, 1968) that it is the productivity of capital which is rising and that the productivity (or productiveness) of labor is at best stationary, and more probably shrinking.

The serious qualitative studies of the distribution of ownership of productive capital show that at most five percent of the households in the United States own capital holdings capable of significantly adding to their incomes and providing sources of purchasing power for them.

Robert A. Lampman, THE SHARE OF TOP WEALTH-HOLDERS IN NATIONAL WEALTH, 1922-1956, National Bureau of Economic Research.

Jean Crockett and Irwin Friend, "Characteristics of Stock Ownership", PROCEEDINGS OF THE AMERICAN STATISTICAL ASSOCIATION, Business and Economic Statistics Section, 1964, pp. 146-168.

Herman P. Miller, RICH MAN, POOR MAN, Thomas Y. Crowell, New York, 1964.

Ferdinand Lundberg, THE RICH AND THE SUPER-RICH, Lyle Stuart, Inc., New York, 1968.

The studies by the Stock Exchange showing quantitatively the number of families who own equity stock are not in conflict with the qualitative studies.

McClaughry Associates, Inc., EXPANDED OWNERSHIP, the Sabre Foundation, Fond du Lac, Wisconsin, 1971. At pp. 101-198 is a comprehensive survey of the studies on "The Distribution of Wealth in the Twentieth Century", by Professor James D. Smith of the Pennsylvania State University. All of the studies surveyed confirm the general accuracy of the Lampman analysis.

STOCK OWNERSHIP: CHARACTERISTICS AND TRENDS, by Marshall E. Blume, Jean Crockett and Irwin Friend, Working Paper No. 12-74, published by the Rodney L. White Center for Financial Research, University of Pennsylvania, The Wharton School. This study confirms the findings of the earlier studies.

IF WE ARE TO PRESERVE PRIVATE PROPERTY IN THE OWNERSHIP OF CAPITAL, RADICAL CHANGES IN OUR TECHNIQUES OF FINANCING MUST BE MADE.

If the means of production are to be privately owned, it is elementary that every household must own either one or both of the input factors. But technology is rapidly shifting the input burden to capital instruments while diminishing the relative productiveness, and in fact obsoleting increasing numbers of the labor force. The strenuous efforts of the economy to conceal this reality through government-subsidized production of non-consumer-destined goods and services (mostly military) are wearing thin, particularly in the face of growing resentment of poverty.

While labor power is almost universally distributed throughout the households of the economy, capital ownership is very narrowly held. Since private property functions in a private enterprise economy much like wiring in an electronic circuit, namely, to connect input to out-take, it is clear that the institution of private property must progressively disintegrate where a few of the households own the great bulk of the input factor, yet all must participate in out-take -- the distribution of purchasing power.

THE ECONOMY LOOKS TO WALL STREET FOR FINANCIAL LEADERSHIP, BUT WALL STREET FAILS IN THIS RESPECT.

Against this background of increasing capital productiveness and the failure of our financing techniques aggressively and logically to build millions of new capital-owning households, those financial institutions popularly called "Wall Street", led, in the minds of the American people, by the New York Stock Exchange, have failed to come forward with effective new ideas. In general, member firms of the New York Stock Exchange are engaged in bringing together the owners of existing capital (financial savings) and businesses which need to finance new capital formation in the time-honored and empirically discredited method described by Merwin Waterman in INVESTMENT BANKING FUNCTION in 1958. It takes no sophistication to understand that these methods are designed to give the owners of existing capital a monopoly of access to the ownership of newly-formed capital. They are techniques for concentrating the ownership of capital, rather than for building new capital-owning households in our economy. They are techniques for aggrandizing the productive power of those who already produce vastly more than they can or wish to consume, and systematically depriving the underproductive or the non-productive of the means of becoming economically productive and to so gain more purchasing power.

Glaring examples of steps towards concentration are added to the financial scene daily. Well in excess of a hundred billion dollars of newly-formed capital are put into place annually in the U.S. economy without adding significantly to the number of viable capital estates.

It seems unlikely that this disastrous course towards the destruction of the private property economy can be interrupted unless leadership in investment banking and in the securities industry champions new financing techniques more suited to the facts of life in an advanced industrial economy.

THE CONVENTIONAL ECONOMISTS HAVE FAILED UTTERLY EITHER TO SEE THE PROBLEM OR TO PROPOSE SIGNIFICANT SOLUTIONS.

This can be demonstrated no more effectively than by referring to Simon Kuznets' definitive book CAPITAL IN THE AMERICAN ECONOMY: ITS FORMATION AND GROWTH, published in 1961 by the National Bureau of Economic Research. In this volume, Dr. Kuznets (pp. 394-399) answers the question of why financing is necessary in connection with new capital formation by saying that it is because businesses have a need for capital instruments before they have saved the funds to buy and pay for them.

However, Dr. Kuznets is totally oblivious to the fact that in a private property industrial economy, all households and individuals have a need to own equity capital before they have saved the funds to pay for it. Indeed, they need to own equity capital so that they can save the funds to pay for it. Yet it takes no argument to demonstrate that while we have devised elaborate means for financing the purchase of consumer goods (which produce no marketable wealth and thus do not assist buyers to pay for their cost), we have virtually no techniques for financing the purchase by individuals of newly-issued equity securities, although new capital formation which takes place under reasonably competent management does normally produce income in amounts sufficient to pay for stock representing it.

TECHNIQUES FOR SIMULTANEOUSLY PROVIDING THE MEANS OF FINANCING CORPORATE GROWTH AND THE MEANS OF FINANCING FAMILIES AND INDIVIDUALS TO BECOME OWNERS OF VIABLE CAPITAL ESTATES ARE URGENTLY NEEDED. THEIR EMPLOYMENT ON A BROAD SCALE WOULD VASTLY INCREASE THE BUSINESS OF THE REGISTERED SECURITIES EXCHANGES AND THEIR MEMBERS.

The techniques outlined in the second half of TWO-FACTOR THEORY: THE ECONOMICS OF REALITY are responsive to this need and are receiving increasing attention and approval by businessmen, investment bankers, commercial bankers and political leaders. They are being successfully used in hundreds of corporations. They unquestionably can be supplemented and refined by members of the financial community. This study and refinement, and the development of action programs to begin large scale employment of such new techniques in the business community, must be initiated by aggressive leadership from within the financial and business communities and from within labor.

Less than 5 percent of new capital formation taking place in the American economy over the past ten years was financed by the issuance of equity securities. If 50 percent or 75 percent of such corporate growth had been financed through the issuance of equity securities in such manner as to make millions of new capital-owning families, the business of the New York Stock Exchange and the other registered exchanges, and of their members, would be vastly increased. A second means of engaging in production and a second source of income would be possessed by these millions, and the general health of our political economy would be immensely improved.

Senator BAUCUS. Our next witness will be the Honorable Thomas Judge, Governor of the State of Montana. By way of introduction, I would like to say, Governor Judge has been one of the most progressive, forward-thinking, imaginative, intelligent governors that our State has been blessed to have. We have had some good governors, too.

Governor Judge, I will appreciate hearing your testimony. Thank you for making the trip back once again to help Washington, D.C. see what should be done to help the West.

Governor, we are delighted to have you here.

STATEMENT OF THOMAS L. JUDGE, GOVERNOR, STATE OF MONTANA

Governor JUDGE. Thank you very much, Senator Baucus, for your very generous introduction.

I very much appreciate the opportunity to appear before you at the Senate Committee on Finance. Clearly, we would not be here before you today, reporting still more progress toward saving the Milwaukee Road and the brighter outlook for ultimate success were it not for your early personal interest in our efforts. The bankruptcy of the Milwaukee poses an urgent and critical problem for my State, and we long will be grateful for your leadership and assistance.

The survival and revitalization of an independent Milwaukee Road serving the Northern Tier States is essential to the economic future of our region and my State of Montana, in particular. If the Milwaukee western lines are allowed to wither, Montana will lose jobs, shipping capacity, local tax revenues, and will enter an era of rail deregulation without the protection of competition. Additionally, the development of increasingly important western coal reserves will be significantly impaired unless the Milwaukee survives. Rapidly expanding trade with other Pacific rim nations through North Pacific coast ports will be hampered to the detriment of our entire region and the national balance of payments.

In Montana alone, the Milwaukee currently employs about 800 persons with an annual payroll of $15 million. Many of these employees are second, third, and fourth generation Milwaukee workers, with family traditions of dedicated service to this railroad, its customers, and the region it serves. They and their colleagues throughout the West are an ideal employee group to undertake at least partial ownership of a new railroad. Their commitments alone have encouraged all of us about the prospects of succeeding in our efforts to save the Milwaukee.

The railroad serves over 150 stations in 23 counties, as well as 31 public warehouses and grain dealer facilities having short-term storage capacity of approximately 4,300,000 bushels, which could be without rail service unless the western lines are preserved. The export of agricultural products, particularly grain, is an increasingly important factor in our balance of payments.

Montana and its sister States across the northern tier are among the leading grain producing States in the Nation. Our grain is moving in larger and larger quantities west for export to the Orient and beyond through Pacific coast ports. In fact, 70 percent of Montana's average annual grain harvest of 100,000 bushels is exported to Pacific rim nations.

In fact, Mr. Chairman, you will recall the first merchant vessel of the People's Republic of China to call at a U.S. port loaded Iowa corn in Seattle in April of this year. Not only is the survival of the Milwaukee important to the continued development of this trade, but grain export growth helps bolster the prospects for a revitalized Milwaukee line west.

Certainly, you recognize the hardship that elimination of the Milwaukee would pose for agriculture. At the present time, even with the Milwaukee still offering some semblance of service, there simply is not enough rail capacity in Montana to move the vast quantities of grain currently stored in elevators throughout the State.

Elevator operators will buy no more grain until present holdings can be moved and those that will make purchases will do so at a substantial discount and for future delivery with the selling farmer required to provide interim storage. As many as 25 percent of the elevator's in Montana are facing bankruptcy caused by the fact that grain purchases are financed on credit with interest accruing until the grain can be moved to markets and sold. Obviously, an already unacceptable situation would become tragic in the absence of the Milwaukee.

Another industry with still more potential and of even greater national interest as the energy situation worsens is the development of western coal. As chairman of the Western State Energy Policy Commission, I can assure you that the Governors of Western States with energy resources are committed to developing those resources to assist in solving this Nation's energy problems.

As you know, the largest coal fields in the Nation are in Montana. And the Milwaukee western lines are ideally located to serve this booming industry. In fact, the Milwaukee traverses more than one-third of the Nation's known reserves of low-sulphur coal, that are so much in demand because of the dictates of the Clean Air Act.

The Nation expects Montana to encourage the development of these coal reserves in order to enable us to achieve energy independence. We are prepared to do our part, but as with grain, rail service is currently inadequate to move coal already being mined. I understand that the Western Energy Co., to cite just one example among several, was unable to meet the requirements of one of its contracts last year because of the inability of the railroads to move the required volume of coal from Montana mines.

This alone cost the State of Montana $1 million in coal severance taxes, $500,000 in mine employees' payroll, and represented a loss to rail carriers of $8 million in freight revenues.

With rail service already limiting the removal of coal currently being mined in Montana, one can only conclude that achieving energy independence will depend upon more and better rail service. The loss of a major transcontinental rail carrier, when considered in this context, seems unconscionable. And I would hasten to add that the growth potential in this industry, with its comparatively large transportation costs, also bodes well for a prosperous new Milwaukee.

Montana, as you are aware, is the Big Sky Country. This phrase accurately suggests the vastness of western spaces and the tremendous distances involved in transportation. Trucks simply do not represent a viable alternative to rail for the movement of enormous quantities of bulk cargo like grain, coal, and forest products over the required distances.

Rail is virtually the only feasible means of moving these goods and we must retain an independent Milwaukee line west in order to meet current transportation needs let alone future demands.

Trade through to the north Pacific coast is already booming. Additionally, my fellow western governors and I have decided to create a Western States International Trade Commission to expand regional exports to the Pacific rim. I have already mentioned grain exports and that only relatively recently has the export of western coal been considered increasingly likely in the not too distant future. These ports are also handling a growing share of the overland common point cargo being shipped between the Orient and the midwestern and eastern United States. The bulk of OCP traffic is containerized.

The port of Seattle is now moving more containerized cargo than any other West Coast port and ranks second nationally only to the port of New York and New Jersey in the total number of containers handled. The Milwaukee has played a key role in the growth of this traffic through the port of Seattle. Over the past 3 years, the Milwaukee has handled an average of approximately 46 percent of all of Seattle OCP traffic.

With the Panama Canal becoming less competitive each year, continued growth in this trade can be expected. But the port of Seattle has indicated that the one major constraint on its future growth is the availability and quality of critical rail service. And growth in OCP traffic through the Port of Seattle and its sister ports on Puget Sound and the Columbia River, like grain and coal, not only depends upon the railroad, but really improves the outlook for a successful reorganization of the western lines.

I suppose one could suggest that, although rail service is clearly important, it does not really matter who provides it and that the Milwaukee's major or minor competitors will be able to fill the void. In fact, Mr. Chairman, that is hardly the case, as I have already suggested in terms of the current capacity of existing carriers.

But there is a more fundamental problem with this suggestion. The elimination of the Milwaukee western lines as an independent carrier will leave only one major transcontinental carrier in the northern tier. Rail competition is crucial in several aspects including cost, quantity and quality of service. As an example, the Burlington Northern attempted to raise grain freight rates about 15 percent 2 years ago but was forced to rescind the increase because the Milwaukee declined to follow suit. And I would be remiss were I not to remind the committee that the existence of the Milwaukee to provide competition was the premise on which the ICC and ultimately the Supreme Court permitted the merger which created the Burlington Northern.

Our fears about a noncompetitive climate are only heightened by the prospect of deregulation which would withdraw public oversight and leave us truly at the mercy of a single carrier.

Mr. Chairman, I recognize that, to some extent, I have been preaching to the converted here today. Nevertheless, I think it is critical to our efforts that we continue to highlight the very real importance of this railroad to the economy of Montana and the entire northern tier. As you know, we have not been sitting on our hands out home expecting others to realize our plight and come to our rescue. I am pleased to acknowledge at this point the major contribution that the organization known as SORE—Save Our Railroad Employment—has made toward highlighting the issues at stake here and catalyzing efforts to save the Milwaukee. I also am proud to mention that the State of Montana has been supportive of SORE's efforts all along. In fact, SORE and Montana jointly retained counsel to represent our mutual interests in the Federal court in Chicago.

As you know, last month we successfully opposed the petition of the Milwaukee trustee to discontinue all service west of Miles City. And we are committed to continuing those efforts.

Through legal counsel, we will participate in the many hearings, appeals and studies that will undoubtedly occur in both the Federal courts to appoint a new trustee that will fairly consider the interest of the northern tier States.

Now that SORE and the State have been joined by other affected States, the labor organizations and the major shippers along the Western lines, we are ever more hopeful about the ultimate outcome of our efforts.

Last Saturday, we achieved a major breakthrough in terms of coordinating the activities of the many groups seeking to preserve the Milwaukee lines west. Senator Baucus, you and I developed a proposal which the shippers endorsed to create Milwaukee Lines West Corp., a nonprofit corporation to undertake this coordination function and launch in earnest the many complex efforts which must be undertaken to reorganize the western lines into a new employee and shipper-owned railroad.

Although Senator Long is not here today, for the record I would like him to know of my optimism about the participation of my fellow northern tier Governors in this effort and, as an indication of our sincerity, the Old West Regional Commission has been authorized by us to expend a minimum of $200,000 for organizing and supporting this organization.

I expect the Pacific Regional Commission, which will meet this coming week, will also authorize $200,000 for this new organization.

As you are aware of the strength of the private sector commitment and I am delighted to report that the public sector also is dedicated to this effort and that we are prepared to enthusiastically join in nurturing this new organization.

We expect to create the new railroad company in the near future and shelter it until it can stand on its own. And the kind of private-public relationship we have forged really indicates that we mean business.

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I hope our efforts to date meet your expectations of us and begin to fulfill your charge to the interested parties to get off the dime ourselves before expecting more of the Congress. Mr. Chairman, the loss of the Milwaukee would be so harmful and the potential so great for not only saving it but also making it into a profitable, model railroad owned by its employees, shippers and other interested parties that we have no alternative but to do everything we can. The meeting last Saturday I think demonstrates that not only do we understand our situation and accept your charge but that we are doing something about solving our problems ourselves.

I can only hope that our efforts to date rise to meet your expectations and that we can look forward to your continuing interest and assistance.

Thank you for your courtesy.

Senator BAUCUS. Thank you very much, Governor. That is a most comprehensive and thorough statement, very comprehensively outlining the need for continued rail transportation in the West.

You very cogently and convincingly explained why, with the increased development of coal and grain transportation to markets in the Far East and elsewhere we need to keep the Milwaukee Railroad going.

The second point I would like to underline is your statement that the competition is very important. The example of the Burlington Northern attempting to raise its rates by 15 percent and the Milwaukee not following suit, certainly was a good example of the importance of competition and the effect of competition in our State.

It is an important point. I hope more people are aware of such examples when we look at not only the Milwaukee Railroad but rail deregulation.

I want to commend you for your efforts in convincing your fellow Governors and the Old West Regional Commission and Pacific Northwest Regional Commission to help provide money.

We all know it is helpful and important to talk about ways to reorganize the Milwaukee It is important and necessary, in fact, to discuss techniques like ESOP's and CSOP's, and the profitability of the railroad. But we are not going to get anywhere, as a practical matter, particularly in this case where the present management of the Milwaukee is not terribly well-disposed towards keeping the Milwaukee operating, unless we come up with some interim organization and some interim financing to keep it moving.

Your statement here today that the Old West Regional Commission will pledge $200,000, and, I understand, the Pacific Northwest Regional Commission will also provide $200,000, is to be very welcome.

A lot of people talk about doing something. You went out and did it. You talked to the Governors, and I want to personally thank you for all that you have done.

As you know, shippers are attempting to raise additional funds. Paul Schmechel of the Montana Power Co. will report on the efforts to date and will comment on raising money from shippers.

But you have come up with the first significant step in the right direction in coming up with $400,000 pledged from the two regional commissions, and I want to thank you, publicly, for providing a tremendous service.

Thank you very much.

Governor, I wonder if you could tell us where else we might obtain help for this effort. Are there other funds that any of the States that are served by the Milwaukee might contribute? Are you finding cooperation among all the States that are served by the Milwaukee, or are there some States where we need to explain why it is important that they should come on board as well?

Governor JUDGE. The Old West Regional Commission, Senator, is five States—Montana, North and South Dakota, Wyoming, and Nebraska—-and the support for the Milwaukee has been very enthusiastic by all of the Governors, even those Governors from States that the Milwaukee Railroad does not serve.

I have spoken to my fellow Governors in the Pacific Regional Conference and, as I mentioned, they will meet next week. I visited with them at the Western Governors Conference last week in Sun Valley. The attitude of those Governors' would do everything that they possibly could if it was possible to save the Milwaukee.

So I would say that the Governors in the Pacific Regional Commission—you have the States of Idaho, Washington, and Oregon, and so, Senator, there are eight States that I could say are very enthusiastically and strongly supporting financially the Milwaukee Railroad.

I have been very impressed by the fact that just since Saturday the private sector has come up with something like $175,000. They have not even seen the proposal for the new organization yet. Paul Schmechel will comment on that in his testimony.

I will hope that the employees—I would certainly expect that they would come forward, too, with financial contributions from their unions.

Senator BAUCUS. The regional commissions and Governors must believe that the Milwaukee is a profitable enterprise or that it can be made profitable. Otherwise, they would not have contributed money.

Could you amplify a little bit on this? What discussions have you had with the Governors and representatives of the regional commissions along these lines? For the record, because I think there is still a myth the Milwaukee cannot be operated profitably, the Booz-Allen report commission the trust showed that each of eight alternative route configurations studied, would return operating income in the long run. The Milwaukee Railroad, including a couple of versions of the Pacific Coast extension could be run profitably, assuming roadbed rehabilitation and certain maintenance and new equipment.

I wonder if you could amplify on what I just stated. Some people feel that perhaps the Milwaukee Road is a losing proposition. Based on your knowledge and discussions with Governors and others, what is your assessment of the profitability?

Governor JUDGE. Speaking for myself, I sincerely believe that the Milwaukee Road can be made a profitable organization with support that I have seen and commitments from the private sector and employee participation with the growth of coal development, the growth of grain shipments. I just am convinced that the Milwaukee, under new management, a new reorganization, a new railroad, could be definitely profitable.

In terms of my other Governors and my colleagues, I do not know whether they know that it could be profitable. I can say that they realize how vital it is to continue exploring every other possibility to keep the Milwaukee Railroad operating.

And if that means financial equipment from the regional commissions, they are more than glad to do so.

Senator BAUCUS. Thank you very much, Governor. That is a strong statement from the regional commissions and States. If they are going to put up money because they want to keep the Milwaukee going, I think that that is an excellent indication that States, and regional commissions, believe solidly in the Milwaukee's future and keeping rail competition and service in the northern tier States.

I want to thank you again very much.

Governor JUDGE. Thank you very much, Senator.

Senator BAUCUS. Our next witness will be Mr. Paul Schmechel, president, Montana Power Co.

Mr. Schmechel has taken a very active interest in talking to various shippers that utilize the Milwaukee Railroad and has been speaking with them to see what commitments they will make.

Mr. Schmechel, I want to thank you as well as the Governor. You have been in the forefront trying to help put the Milwaukee back together. I want to thank you very much for your efforts.

STATEMENT OF PAUL M. SCHMECHEL, PRESIDENT, MONTANA POWER CO.

Mr. SCHMECHEL. Thank you very much, Mr. Chairman, members of your staff, ladies and gentlemen. My name is Paul Schmechel. I am president of the Montana Power Co. and I am here today representing shippers along the Milwaukee Road.

My fellow shippers and I are grateful for the opportunity today to participate in congressional deliberations concerning the future of the Milwaukee. It is my great pleasure, Mr. Chairman to bring good news to you about our efforts out West to generate serious shipper support for retaining and rehabilitating the western section of the Milwaukee Road.

I will keep my remarks short, in order to allow time for any questions at the end.

As you are very well aware, Mr. Chairman, a meeting was held in Butte last Saturday and the Governor alluded to that, as you did, and we appreciated very much the efforts that you put into that meeting in getting it together.

Its purpose was twofold. First, to determine the depth of shipper commitment to a new railroad entity and, second, to develop an interim, private-public structure to help nurture the new entity.

I am very pleased to report significant progress toward reaching both of those goals.

Since that Saturday meeting, at which several major shippers pledged their support for this effort and they agreed to develop similar commitments from other shippers, $165,000 has been raised from the business community to support efforts to salvage the Milwaukee's western line.

That was accomplished purely over the telephone. If we had had the opportunity, if time had allowed where we could meet personally with more of the shippers, we could have raised a great deal more in that period of time.

But we are confident that this is just the beginning and that, together with the public sector and the employees, we will be able to sustain the many complex activities which now must be undertaken in earnest toward preservation of the Milwaukee western system.

The rough structure of an organization to coordinate those efforts also was outlined subject to further refinement, a nonprofit organization governed by a board consisting of the representatives of the Governors of the northern tier States of the shippers and employees already now has been incorporated.

The Milwaukee Lines West Corporation shortly will be in a position to coordinate, to direct efforts, to reorganize the railroad and represent our mutual interests in the courts, before Federal agencies and here in the congress.

While we all recognize that we have embarked on an extremely difficult effort and we recognize the outcome is hardly assured, we are determined to give it our very best shot. We believe, Mr. Chairman, that this is the kind of real and substantive commitment from the grass roots that you and your associates on this committee had been looking for.

We have been able to develop this commitment for several reasons beyond our own direct and basic need for rail service.

First, we are troubled with the outlook for our regional economy unless there is competition in the rail industry. As you understand, abandonment of the Milwaukee Transcontinental Lines would leave us with only one rail carrier and the possible advent of deregulation and the withdrawal of public oversight almost certainly suggests still more strongly the need to maintain at least some semblance of competition across the northern tier.

Second, we are optimistic about the future of the Milwaukee's western lines, if track and equipment rehabilitation is accomplished promptly; if able management is installed—and that is an underscored statement—and if adequate working capital can be obtained.

The Milwaukee, as you know, traverses a significant share of this Nation's coal reserves, as Governor Judge has described. My own company understands this all too clearly. We have some of those reserves in our possession.

The ability of those of us in Montana to develop those reserves as we are now increasingly expecting to do, directly depends on our ability to transport the coal from those reserves.

I will state very clearly, Mr. Chairman, that we need the Milwaukee to accomplish this effort. The increased traffic that the development of western coal will generate, significantly improves the financial prospects for the new railroad entities. Significantly, trade with the Orient is coming through our vast Pacific Northwest, a very booming industry.

The Port of Seattle, which also is supportive of the effort to save the Milwaukee, has indicated that the growth of its container trade is now constrained only by the unavailability of rail service.

The export of American grain, so critically important to our balance of payments and to our regional economy also would be adversely affected if the Milwaukee were allowed to die.

In short, Mr. Chairman, we believe that the Milwaukee's western lines not only should be reorganized in our regions in the Nation's interests, but also that the new railroad can be successful in a relatively short period of time.

In conclusion, Mr. Chairman, I am very pleased to join with Governor Judge and other representatives of the public sector out West in advising you of the progress that we have made at this point. I am confident that we are meeting the charge that you gave us, and Senator Long gave us a few weeks ago, to step forward in a meaningful way ourselves before asking for your continued support.

Now that we have successfully launched our efforts and are reaching out to include the employees and other public and private interests in our efforts, we hope we can count on you and your colleagues to back us up.

Again, Mr. Chairman, thank you for this opportunity and for all of your encouragement.

Senator BAUCUS. Thank you very much, Mr. Schmechel.

You have come up with $165,000; the Governor of Montana approximately $400,000. That is a good start.

Could you give me some sense, though, of what the potential commitment may be from shippers? You have been working for several days. I am sure, since you are the president of a major utility, it has not been every waking hour of each of those days, but can you give me a sense of how much you think potentially can be raised from the shippers?

Mr. SCHMECHEL. The objective for the shippers for the initial effort is $300,000.

The total requirement is predicted to be $1.3 million over the next 6 months, and about $900,000 of that total will be required for consultants, for legal, for market studies, for elements of that type, and $400,000 will be required for administrative needs.

To put the able management that I described into place and have them begin to get the new organization underway and start building towards the profitable Milwaukee Lines West Corporation.

Senator BAUCUS. Do you think that the shippers will contribute a total of $300,000?

Mr. SCHMECHEL. We have no difficulty in assuming that.

Senator BAUCUS. Should this organization shoot for more?

Mr. SCHMECHEL. It is conceivable that we could develop even more than that. The budget that we have established for the $1.3 million over the next 6 months would include the regional commissions at a level of $400,000, as Governor Judge has already described; then the rail employee organizations, $300,000; the Milwaukee shippers, as I mentioned, $300,000; and Federal technical assistance grants, $300,000.

Senator BAUCUS. How soon do you think that can be raised, the balance up to $300,000 or $400,000 or whatever seems to be possible?

Mr. SCHMECHEL. I think we can get this put together in the next couple of weeks. I believe we will have commitments to that extent, perhaps by even the end of June.

Senator BAUCUS. I take it that you think, and you so stated, that the Milwaukee Railroad can be turned into a viable operation. Could you expand on that, please?

Mr. SCHMECHEL. I would like to do that, Mr. Chairman.

The Milwaukee Road is one of six transcontinental railroads. The transcontinental roads, except for the Milwaukee, have all been very successful railroads in the United States. The railroads that have had the greatest difficulty are the core railroads, the regional type railroads.

Senator BAUCUS. Why is that?

Mr. SCHMECHEL. The failure of the Milwaukee to be a successful railroad is just the fact that they have not been aggressive, and I recognize that wishful thinking does not make a successful railroad, nor does apathy. And I might describe what I mean by that.

We are a very large shipper of coal. Much of our coal is shipped on the Milwaukee Road. We have been dealing with the Milwaukee Road since 1968. We have increased the tonnage that we move across the Milwaukee each year.

Not once in the history of our activity has the Milwaukee Road, or a representative of that railroad, called on our offices to solicit business. Every time that we have had any dealings with the Milwaukee Road, we have had to go to their offices and it is an unusual way to do business.

Senator BAUCUS. I take it that other railroads have contacted you?

Mr. SCHMECHEL. Yes, Mr. Chairman. We are regularly called upon by the Burlington Northern, the Chicago and Northwestern Railroad calls on our offices at least monthly, about every 3 weeks. I might point out that the Chicago and Northwestern Railroad does not extend in Montana. Notwithstanding that, they call on us that frequently, because they are interested in coupling traffic through their lines. Either they would like to originate the traffic even though it cannot be delivered in Montana or, alternately, if they can originate the traffic from Montana in the case of our mining operations, they would like to be the delivering carriers.

They are very aggressive and very anxious to generate traffic in and out of Montana.

Senator BAUCUS. What you are saying is that various railroads, except the Milwaukee, have been aggressive to secure the business of your company. But, for some reason or other the Milwaukee has been less aggressive. Since 1968 has the Milwaukee been trying to seek business?

Mr. SCHMECHEL. I think it has been a grossly neglected part of their business.

Senator BAUCUS. Is the experience that you have had with Milwaukee, in your judgment, representative, or is it an isolated case?

Mr. SCHMECHEL. I have talked to many shippers, Mr. Chairman, and I have found the same experience with those shippers. Once in a while, I think you will find the isolated case where the Milwaukee Road has been aggressive and called on the shipper, but those are the isolated cases.

Senator BAUCUS. You said that Chicago-Northwestern was one of the railroads that contacted you. Is that correct?

Mr. SCHMECHEL. Other railroads have contacted Chicago-Northwestern.

Senator BAUCUS. That is an employee-owned railroad, is it not?

Mr. SCHMECHEL. Yes.

Senator BAUCUS. I suppose that that is a good example of why we need an ESOP here.

If an employee stock ownership plan is put together with some kind of customer stock ownership plan, a shipper stock ownership plan, several questions come to mind. Does that kind of organization make sense, from your viewpoint, as a customer or shipper? Would it create tension within the organization or would it create incentives?

On balance, where does it come out? As a shipper of a large quantity of coal, how much of what we were talking about this afternoon makes sense to you?

Mr. SCHMECHEL. Mr. Chairman, I think that when shippers and employees own a railroad—let me speak purely from the standpoint of the shippers first.

When you own a business, you are more inclined to use that business than you are to transfer that activity to someone else's business.

When they own it, they are going to be far more enthusiastic about using that service.

From the standpoint of the employees, let me give you the experience of the independent truckers. Nobody is more aggressive in developing markets than the independent truckers. If the Milwaukee Road operated as independent truckers operated, we would have them lined up at the mine entrance every morning trying to get a piece of our business.

Senator BAUCUS. You might have some blockades, too.

Mr. SCHMECHEL. The same thing would apply in the case of an employee-owned railroad. They would all be very much interested in the success of that enterprise.

Senator BAUCUS. Assuming that a new organization proceeds along these lines, what do you think the potential commitment on the part of shippers would be towards the purchase of a new railroad or railroad stock?

You already suggested that shippers can certainly come up with at least $300,000, maybe $400,000 during this interim period. Could you give me some estimate as to what the ultimate commitment might be?

Mr. SCHMECHEL. That would be a little difficult for me to express here, Mr. Chairman. What we have done to date has been on the basis of telephone calls, and when we get a formal organization fleshed out and then we can meet with the purpose of explaining that organization, I think I could do a much better and more accurate job of answering that question.

From the contacts we have made by phone alone, we found a great deal of enthusiasm on the part of the shippers to keep the Milwaukee Railroad a viable, operating transportation system and they have committed, at least in concept, to the shipper ownership program.

Senator BAUCUS. When Mr. Kelso and Mr. Kurland were here—they were prior witnesses—they generally testified as to the technical problems and steps that would have to be taken to put together this kind of organization. I asked them to provide me and the new Milwaukee organization a list of names of people who, in their judgment, could put all of this together. Some kind of administrator-director with organizational skills, political sensitivity, understanding of the legislative process, a deep understanding of the railroads and transportation systems in the country is needed. I do not know that, at this moment, you could provide some names, but if you could provide me and the new organization the names of several people that come to mind, it would be very helpful.

In my judgment, we are going to need someone to organize this new entity.

Mr. SCHMECHEL. If I could do that, Mr. Chairman, in a letter, I think it would be more appropriate. It would give me a chance to review the list of names that are potential candidates for those different positions.[1]

Senator BAUCUS. We know the Milwaukee is not a modern railroad. It has a miserable roadbed; it is like a roller coaster. It needs mammoth infusion of capital, roadbed rehabilitation and equipment, et cetera.

I am wondering, while you are here this afternoon, if you could very briefly advise the committee as to what kinds of new modern managerial techniques come to mind that would help the Milwaukee. What kinds of technologies are you aware of that have not been utilized by the Milwaukee to date that could be utilized by the new Milwaukee? Does anything come to mind from a modern manager's viewpoint that might be translated and utilized by the new Milwaukee Railroad?

Mr. SCHMECHEL. I would not like to comment on the financial management and some of those elements of it, but I would like to touch on just one aspect of it, and that is marketing. They simply have got to get after the marketing activity.

I have spent a good part of my working lifetime in the coal business and I have yet to find a single coal customer who has come into our offices to buy the coal. We have always had to go out, and it has been a hardsell business.

It has been successful only because of very aggressive marketing activity.

Senator BAUCUS. I want to thank you, Mr. Schmechel, you have been very helpful. I wish you good luck in the rest of your efforts.

Mr. SCHMECHEL. Thank you very much, Mr. Chairman.

Senator BAUCUS. Our final witnesses will be a panel—I hope they are all here. They include Mr. Dick Walsh, Director, Office of Economic Analysis, Department of Transportation; Mr. Paul Dempsey, Director, Office of Special Adjustment Assistance, Economic Development Administration; Department of Commerce; and Mr. James Newkirk, Director of Special Projects, Federal Railway Association, Department of Transportation.

My understanding is that Mr. Walsh and Mr. Dempsey both have statements to make. Mr. Newkirk does not have a statement, but is available to answer any questions that might arise.

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[1] At presstime the information was not received by the committee.

Why do you not proceed?

STATEMENT OF DICK WALSH, DIRECTOR, OFFICE OF ECONOMIC ANALYSIS, DEPARTMENT OF TRANSPORTATION, ACCOMPANIED BY JAMES NEWKIRK, DIRECTOR OF SPECIAL PROJECTS, FEDERAL RAILWAY ASSOCIATION, DEPARTMENT OF TRANSPORTATION

Mr. WALSH. Mr. Chairman, my name is Dick Walsh, Director of the Office of Economic Analysis, Office of the Secretary of Transportation. I am accompanied here today by James Newkirk who heads up the Special Projects Staff in the Federal Railway Administration.

My office is responsible for the analysis of the proposal known as Save Our Railroad Employment, or SORE. As you know, this proposal incorporates a plan to operate the western portion of the Milwaukee Road as a separate carrier apart from that portion of the Milwaukee which the former trustee has said that he wants to continue to operate.

Several members of the Congress have asked that the Department conduct a 30-day study of this proposal and its financial viability. I am here today to report on the status of our work.

First, let me explain why my office is managing this task rather than the Federal Railroad Administration.

As you know, the viability of the SORE proposal is a key issue for developing plans for coping with the Milwaukee bankruptcy. It deserves immediate attention.

We, in the Department of Transportation, including the Deputy Secretary, the Federal Railroad Administrator and the Assistant Secretary for Policy and International Affairs, have thought that it is very important to have an analysis carried out by people who are at least one step removed from FRA's day-to-day efforts to facilitate necessary restructuring of rail service in the Midwest and elsewhere.

My office follows these efforts closely and keeps informed on them, but we are not directly involved in the day-to-day activities.

Accordingly, inasmuch as mine is the office in OST that is responsible for any substantive economic analysis of rail matters, I received the assignment. To that end, we have contracted for a financial analysis of SORE's viability. Through a sole source procurement, we have obtained the services of the Consulting Center, a small consulting firm with headquarters in Sudbury, Mass. and a branch office in Alexandria, Va. It is the only firm that we know of that we can confidently expect to do an objective and rigorous high-quality analysis in the very short time available.

Under the terms of our contract, we expect to have a final report by July 6. We expect the analysis to cost somewhat under $10,000.

The Alexandria office of the Consulting Center is headed by Russell Murphy, executive vice president of the firm. Both Mr. Murphy and his staff have been actively engaged in the financial analysis of troubled railroads for the past several years. A former employee of DOT where he was closely involved with the analysis of Penn Central's difficulties, Mr. Murphy was successively director of financial analysis and then vice president for finance of the United States Railway Association.

Most members of his group have comparable experience. Thus, all of them are familiar in the most intimate detail with the problems and challenges of analyzing financially marginal rail operations.

We are confident that Mr. Murphy and his team will do the job right. My own staff will be working closely with him and directing their efforts.

The analysis is progressing on schedule and should be ready on time. However, at this juncture, I have nothing to offer you in terms of any substantive results. Because of the importance and sensitivity of the issue, I think it would be entirely inappropriate for me, or the Department, to speculate on the outcome of the analysis when only part of the required work has been done.

Mr. Chairman, that completes my prepared statement. If there are any questions you would like to ask, I would be happy to try to answer them.

Senator BAUCUS. Why do we not proceed with Mr. Dempsey. Why do you not go ahead, Mr. Dempsey?

STATEMENT OF PAUL DEMPSEY, DIRECTOR, OFFICE OF SPECIAL ADJUSTMENT ASSISTANCE, ECONOMIC DEVELOPMENT ADMINISTRATION, DEPARTMENT OF COMMERCE

Mr. DEMPSEY. My name is Paul Dempsey, Director of the Office of Special Adjustment Assistance in the Economic Development Administration of the Department of Commerce. I am pleased to be able to testify at these hearings on possible ways of maintaining service of the western portion of the Milwaukee Railroad.

The Economic Development Administration is very concerned about the direct job losses and economic disruption that could occur in a number of western communities as a result of curtailed operations of the Milwaukee Road. EDA has participated in, the efforts that are being made to develop viable alternatives for keeping the western lines operational.

It has been our experience in addressing economic dislocations that attempts to restore the economic base of communities affected by dislocation and efforts to generate reemployment opportunities for the workers are difficult, costly and oftentimes only marginally effective.

It is far less costly, and potentially much more effective, to avert a dislocation than to try to pick up the pieces afterwards.

One method the EDA has used to avert economic dislocation has been through the financing of employee acquisition of the firm. During the past few years, EDA has financed six employee stock ownership trusts ranging in size from the 500 employee South Bend Lathe Co. to the 2,000 employee Okonite Co.

Each of these investments was successful in averting the threatened dislocation. All of these firms are now prospering.

I should add, however, following our funding of the South Bend Lathe ESOP, we were literally inundated with requests to finance additional ESOP's. A very large number of these requests were from firms that clearly were not financially viable under any form of enterprise ownership.

EDA has commissioned a study, undertaken by the University of Michigan's Institute of Social Research, that tentatively indicates that employee-owned firms tend to be slightly more productive than firms with other forms of enterprise ownership. But we do not believe that employee ownership in and of itself can turn a financially failing firm into a successful operation.

In evaluating business assistance proposals such as those proposed by the Milwaukee Railroad, EDA considers a number of factors. These include basic program eligibility criteria; the likelihood of long term viability based on financial market and management data; the job creation and retention potential; the cost-effectiveness of the EDA investment relative to competing proposals for accomplishing the same purposes; and the availability of funds.

EDA participation in any proposal for maintaining operation of the western portion of the Milwaukee Road would have to be weighed against these factors.

Particularly pertinent in this instance is the availability of funds. The SORE proposal identifies Federal funding requirements of $170 million for acquisition and operation of the Milwaukee Road lines west of St. Paul, Minn.

EDA's anticipated economic adjustment budget for fiscal year 1980 is slightly less than $40 million. Approximately one-half of this amount will be earmarked for Department of Defense, base closures.

Thus, EDA has very limited financial resources to address a problem of this magnitude. However, EDA supports efforts to thoroughly examine alternatives to keeping the western portion of the Milwaukee Railroad operating and in spite of our very limited financial resources, we would be willing to work closely with the Department of Transportation, the Federal Railroad Administration, the Farmers Home Administration, the States, unions, and shippers, to try to develop a financially viable solution to this problem.

That concludes my remarks.

Senator BAUCUS. Thank you very much, Mr. Dempsey.

Do you have a statement, Mr. Newkirk?

Mr. NEWKIRK. No, sir, I do not. I am prepared to answer any questions.

Senator BAUCUS. Thank you very much.

Mr. Dempsey, you were here when Ms. Singletary from Farmers Home Administration was here?

Mr. DEMPSEY. I was not here.

Senator BAUCUS. Very generally, she was very supportive of the ESOP concept. She said the Farmers Home Administration stood ready, consistent with Farmers Home regulations and procedure, to help an organization such as the new Milwaukee organization to fund an ESOP plan.

I am curious as to whether you could work jointly with Farmers Home Administration, FRA and other agencies in trying to jointly come up with enough money?

It might take $50, $60, $70 million. I do not know how much it would take.

In your experience, is that a feasible approach? Can you work jointly with other agencies in putting together funds for an ESOP fairly quickly?

Mr. DEMPSEY. We have never worked jointly with other Federal agencies in the financing for the ESOP's that we have funded but we frequently work with the Farmers Home Administration in financing development projects of all types.

Senator BAUCUS. What is the maximum amount that EDA could commit to the Milwaukee ESOP or CSOP?

Mr. DEMPSEY. Well, as I indicated in my statement, the program budget—the economic adjustment program budget—anticipated for next year would be slightly less than $40 million. Approximately 50 percent of these funds will be used to respond to military base closures. We have very limited program funds in our economic adjustment budget.

We have a much larger business assistance program. Not as large as the B&I program in the Farmers Home Administration, but it is significantly larger than the economic adjustment program.

The major problem here is that in order to be eligible for that assistance, the area has to be designated by EDA and many portions of the area covered by the western lines are not designated.

Senator BAUCUS. I did not hear whether you said that EDA has had direct experience. Has EDA?

Mr. DEMPSEY. We have financed six ESOP's.

Senator BAUCUS. Six.

What is the one that most closely resembles the Milwaukee Railroad?

Mr. DEMPSEY. Most of these, I would say, are medium-sized manufacturing firms located in an urban area.

Senator BAUCUS. Manufacturing firms?

Mr. DEMPSEY. Yes.

In each and every case, they were manufacturing firms. I think financing an ESOP for the Milwaukee Road would be somewhat unique for us.

Senator BAUCUS. I take it, though, that your studies show that the productivity of an ESOP-managed company is slightly higher and slightly better?

Mr. DEMPSEY. Yes. The productivity of workers in employee-owned firms is slightly higher than those for comparable firms, with other forms of enterprise ownership.

Senator BAUCUS. How much better?

Mr. DEMPSEY. That was a tentative conclusion based on a 1-year study done by the Institute of Social Research at the University of Michigan. We are considering doing a followup study that would be over a 3-year period and we would be able to come up with answers to the sort of question you just asked.

Senator BAUCUS. Does EDA have technical personnel that would help this new organization put together an application with EDA for funding?

Mr. DEMPSEY. Yes. We can work with the grant applicant.

Senator BAUCUS. How long would it take to put all of this together? What is the timeframe?

Let us say that today the new organization wants to apply to EDA for a commitment to help fund an ESOP, say jointly, with Farmers Home? How long would it take to process?

Mr. DEMPSEY. From what I have seen of the proposals, you are talking about EDA working jointly with the Farmers Home Administration and perhaps the Federal Railroad Administration and other parts of the Department of Transportation.

It would be very difficult to give a timeframe for putting together an application with that number of participants.

Senator BAUCUS. Can you give me any time estimate? The Milwaukee is losing money. It is losing money more quickly every month.

I am curious, if you could give me some sense of how long this might take?

Mr. DEMPSEY. We would, given our resources, be one of the smaller participants financially. I could tell you how long it would take if we are the sole participant in a grant package, but I really would not be able to give you even a ball park figure on how long it would take to put together something of this magnitude, involving as many parties as apparently would need to be involved.

Senator BAUCUS. I have a series of five questions here that I am going to submit to you and ask you to answer them for the record.

Mr. DEMPSEY. We would be happy to do so.

Senator BAUCUS. They are a bit technical. It probably would be better if you had more time to answer them.

Mr. DEMPSEY. I would be happy to do so.

Senator BAUCUS. Thank you.

[The information to be furnished follows:]

U.S. DEPARTMENT OF COMMERCE,
THE ASSISTANT SECRETARY FOR ECONOMIC DEVELOPMENT,
Washington, D.C., July 11, 1979.

HON. MAX BAUCUS,
Chairman, Subcommittee on Oversight of the Internal Revenue Service, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR SENATOR BAUCUS: The Department of Commerce was pleased to have been able to appear before the Subcommittee on Oversight of the Internal Revenue Service to discuss ways of possibly averting the abandonment of the western lines of the Milwaukee Railroad. As we indicated in our testimony, the Department of Commerce is very concerned about the economic ramifications of abandoning the western portion of the Milwaukee Road. We are supportive of efforts to develop a viable solution to this problem, and we would be willing to participate, within the limits of our authority and resources, in the implementation of a program if an economically viable solution were developed. We would, of course, wish to work closely with the Department of Transportation in any such effort.

If maintenance of the Milwaukee Road were deemed not to be economically advisable, EDA would stand ready to work with firms and communities impacted by the dislocation.

Enclosed are answers to the six questions forwarded under cover of your letter of June 26. We will be happy to provide additional information as necessary.

Sincerely,

ROBERT T. HALL,
Assistant Secretary for Economic Development.

Enclosure.

Question 1. Although it is true that the Federal Railroad Administration has the primary responsibility for railroad transportation matters, the Department of Commerce has primary responsibility for port developments, and this may have some considerable bearing on the Milwaukee situation. Particularly, what impacts would abandonment of the Milwaukee Road have on port development and operations in the Far West and Midwest? (The Department should respond in writing with specific reference to the ports of Tacoma, Seattle, and Portland in the Far West, and Great Lakes ports in the Midwest.)

Answer. A. *Far West ports.*—The Milwaukee Road is one of three primary transcontinental railroads serving the port communities of the Pacific Northwest. The other rail services are the Burlington Northern and Union Pacific. Of the three, the Milwaukee Road is the prime mover of grain exports. Additionally, the grain storage infrastructure is more developed along the Milwaukee Road. An inventory of rail service to northwest ports is presented below.

TRANSCONTINENTAL SERVICE

Port	Milwaukee Road	Total rail service
Tacoma	1	3
Seattle	1	3
Portland	1	4
Vancouver	1	3
Kalama	1	3
Longview	1	3
Grays Harbor	1	3
Port Townsend	1	1
Port Angeles	1	1
Everett	1	2

As indicated above, the potential shutdown would have a severe impact on northwest ports, in terms of both service and cost, through the elimination of competitive service. It is quite evident that the most dependent ports, such as Port Angeles and Port Townsend, and their respective communities would be drastically affected.

B. *Great Lakes ports.*—The Milwaukee Road (CMSTP&P) has trackage from Louisville and Kansas City on the south to the west coast of Lake Michigan on the east, by Lake Superior on the north and the Pacific Ocean on the west. Its major ports are Chicago, Milwaukee, and Green Bay, which serve 22 states as the westernmost ports of the Great Lakes.

The Milwaukee Road has approximately 480 freight connections and junction points to 88 other transportation companies, barge, rail and drayage. It is said that half of the gross national product of manufactured goods is produced in the ten states immediately adjacent to the Great Lakes. The Milwaukee Road is west and south of that area.

The Milwaukee Road owns and operates 22,872 cars of which approximately 4500 are hoppers. These are used to handle basic commodities from farm products to coal. In 1978 CMSTP&P's gross freight revenue figure was $425.6 million. Percentage by commodity and carloads are as follows:

	Percent of total	Carloads
Farm products	14.3	118,142
Lumber and lumber products	14.3	126,683
Transportation equipment	12.0	51,186
Food products	11.9	49,694
Pulp and paper	8.6	69,916
Coal	8.1	111,258
Chemicals	6.4	44,359

The economic impact on the states adjacent to the Milwaukee Road's tracks rights would be very difficult to measure, although it probably would be substantial.

Question 2. The Department of Commerce has explicit responsibilities in maintaining and expanding export opportunities to the Far East. Two particular commodities that play an extremely large role in future economic opportunities for the Northern Tier are the exports of grain, coal, and lumber to the Far East. In light of these factors, what is the Department's position about the impact that the abandonment of the Milwaukee would have on export opportunities over the affected states?

Answer. It is difficult to project the impact that abandonment of the Milwaukee Road would have on exports of grain, coal, and lumber from the Northern Tier States. The Burlington Northern runs parallel to the Milwaukee Road through much of the Northern Tier. Arrangements might be able to be made with both the Burlington Northern and the Union Pacific to service much of the area currently being served by the Milwaukee Road. However, given the volume of freight carried by the Milwaukee Road (the 1978 figures are 118,142 carloads of farm products, 126,683 carloads of lumber and lumber products, and 111,258 carloads of coal), a signficiant amount of economic disruption along the area serviced by the Milwaukee would have to be anticipated.

Question 3. The Department of Commerce in general, and the Economic Development Administration in particular, have responsibility for dealing with economic dislocations and displacements. Assuming that the abandonment of the Milwaukee will cause significant economic dislocation not only among the employees of the Milwaukee Road, but more importantly, among the industries and their employees that rely on the Milwaukee as a shipper, what steps does the Department of Commerce anticipate taking in insuring that these dislocations are minimized?

Answer. The Economic Development Administration (EDA) would work with the States and individual communities whose economies would be particularly disrupted as a result of the abandonment of the western portion of the Milwaukee Road. Assistance is available under the Agency's Economic Adjustment Program (Title IX) to enable these communities to prepare a comprehensive plan to minimize the affects of the dislocation on the area economy. In addition, a limited amount of adjustment assistance is available to carry out the specific adjustment activities identified in the plan. These activities could include, for example, the construction of public facilities or provision of business financing to facilitate the expansion of an existing employer, or the location of a new employer. The Maritime Administration (MarAD) in its role as Federal advisor on port development is available to work with the affected communities, railroads and other Federal agencies to rectify this situation. In its program of cooperative port planning, MarAD has joined with northwest ports, as in other regional areas, to identify future waterborne cargo movements and the respective marine terminal requirements. Its first cooperative assessment of these Pacific Northwest ports was completed in 1975. MarAD expects to update this long range cooperative plan during fiscal year 1980. Certainly, the existence of a competitive rail service as important as the Milwaukee Road is a critical issue in any future development of the ports of regions and, thus, the mission of MarAD.

Question 4. The Department of Commerce has a statutory responsibility to minimize the impact of energy developments. The State of Montana has perhaps the most progressive energy impact program of its own. One facet of that program, for instance, provides substantial funds generated from severance tax revenues to minimize the adverse impacts that occur from coal development and "boom towns." On the other hand, many Western states that have substantial coal developments do not have adequate energy impact programs, and it seems safe to assume that in the event the Milwaukee Road is closed, greater coal development will occur in other states where inadequate protections are available for adverse energy impacts. In light of the above, and considering the existence of the Department of Commerce's Energy Impact Mitigation Program, what steps is the Department of Commerce taking with respect to the Milwaukee Road to insure that coal development impact situations are minimized?

Answer. Under present law, EDA has the authority, but very few resources, to provide assistance to areas for the purposes of minimizing the impacts of energy developments. However, there is an Administration-endorsed proposal, now pending before the Senate Environment and Public Works Committee, that would enable EDA to provide a substantial amount of mitigation assistance. Should this Inland Energy Impact Assistance Program become law in its present form, states such as Montana that have their own energy impact programs would not be penalized; rather, these states would be given credit for their efforts under the state allocation formula. You can be assured that, if this program becomes law, EDA would work closely with the State of Montana in any area where it could provide assistance.

Question 5. Two regional commissions (i.e., the Old West Regional Commission and the Pacific Northwest Regional Commission) are actively pursuing a positive role in exploring opportunities for ways to save the Milwaukee Road. As a Senator representing a state that would be severely adversely affected if the Milwaukee Road were abandoned, I want to state that I am particularly pleased by the roles of those two Commissions. How does the Department of Commerce plan to support the initiatives undertaken by its two regional commissions that are working to help maintain and improve the Milwaukee Road?

Answer. As is evidenced by the responses to the other questions, EDA, MarAD, and the Industry and Trade Administration would cooperate fully, within the limits of their authorities and resources, to support an economically viable initiative which might be undertaken to help maintain and improve the Milwaukee Road. We would, of course, be guided in our efforts by the judgements and determinations of the U.S. Department of Transportation.

Question 6. Please provide a detailed description of assistance, both technical and financial, that the Department of Commerce, including the Economic Development Administration, could provide to an employee and shipper organization attempting to purchase and operate portions of the Milwaukee Road property. Please also describe any assistance that could be provided jointly with other agencies including the Farmers Home Administration, the Department of Transportation, and the Federal Railroad Administration.

Answer. EDA's Private Sector Investment programs provide a wide range of financial assistance to almost any type of industrial or commercial venture. The nature of the applicant does not present any problems for EDA, so long as the venture being financed would generate sufficient profits to repay all debt, and the project is located in a geographic area eligible for assistance.

EDA is receptive to innovative financing techniques involving, for instance, ownership of certain assets by a tax exempt entity such as an LDC, with operation of the project by a profit making entity; SBA, FmHA or other Federal Agency financing of a portion of a project with complementary EDA financing of the remainder; and partial financing by way of employee stock ownership plans.

EDA's business financing tools include direct loans, guaranteed loans, guarantee leases and interest subsidies. Proceeds of EDA (direct or guaranteed) loans can be used for either working capital, fixed assets, or both. Since any reasonable EDA involvement in this project would necessitate business development financing in excess of $10 million, the only practical EDA tool would be that of a guaranteed loan.

Any EDA project of this magnitude will involve many technical details tailored to the specifics of any effort that might be agreed to by all the parties. EDA's major concerns would be the financial viability of the project including its overall repayment ability, adequate equity to give the project financial strength, and EDA's ability to justify the size of the investment in relationship to the number of jobs to be created or saved in the EDA designated redevelopment area(s).

Senator BAUCUS. Mr. Walsh, I appreciate your report on the study that you have sole sourced to the agency that you mentioned for $10,000. Would you tell me about the status of the study that DOT is conducting on Milwaukee's western lines mandated by last year's Local Rail Services Act.

Mr. WALSH. Senator Baucus, Mr. Newkirk will answer that question.

Mr. NEWKIRK. Senator, the special projects staff in the Office of the Administrator was given the responsibility for conducting that study. Last Friday we were to have received what was supposed to be a preliminary draft report. It was incomplete and lacking in conclusion, and the consultants have gone back to finish the work they were supposed to have finished last week.

We met with them again yesterday. They are making substantially better progress and we expect that study to be completed and delivered to us in final form on the 5th of July; as soon as we have reviewed it, we will hasten to get copies up here to the Hill.

Senator BAUCUS. Thank you very much.

What about the FRA analysis of the Booz-Allen report prepared for the bankruptcy trustee?

Mr. NEWKIRK. The Office of Federal Assistance is in the process of reviewing it. Their initial views, I believe, are that the gross assumptions in terms of economic growth, the present level of service on the line, the amount of rehabilitation that would be required to make it competitive, we believe are very reasonable.

We have not had adequate time to fully examine the traffic projections upon which the financial results are predicated.

Senator BAUCUS. Could you tell us what is FRA's general impression of employee stock ownership plans? We have heard Mr. Dempsey give the results of their studies.

Does FRA have a general belief as to the relative productivity of companies that are employee owned?

Mr. NEWKIRK. I think that our opinion could be best characterized as one of we would support any kind of railroad ownership or operation that would improve capital and labor productivity, which are the two critical problem areas facing the industry.

Senator BAUCUS. FRA does not have a view now, whether as a general rule, ESOP's have historically been more productive?

Mr. NEWKIRK. No, sir. We have not. We have done no research on that subject.

Senator BAUCUS. What about your office, Mr. Walsh? Have you looked into this?

Mr. WALSH. Senator Baucus, historically the Department of Transportation has been very sympathetically disposed to the concept of ESOP's. In the absence of practical experience in railroading, or in other parts of regulated transportation, we have only with that general disposition, I am sorry to say.

Senator BAUCUS. Congressman Staggers, Mr. Walsh, in the Interstate and Foreign Commerce Committee report that accompanied H.R. 341, asked the Department to do an analysis of employee and shipper ownership of the Milwaukee. Recently, the Department received a letter from myself and Senator Magnuson making the same request.

I am wondering how the Department intends to respond to our request?

Mr. WALSH. Senator Baucus, you will certainly get a response promptly. I should point out that the study that I have just described regarding the SORE proposal and another study that my office is doing regarding labor protection costs and impacts on employees under a number of different Milwaukee Railroad scenarios, as well as the Western Lines study, will all bear very importantly on that question of the feasibility of an ESOP.

All of those studies will be done within the next 2 to 2½ weeks, and I think they will tell us very much as to whether it is practical to go ahead with the fully planned study.

Senator BAUCUS. Does the Department have the money to proceed?

Mr. WALSH. I cannot answer that categorically. I know that my office is virtually out of money for fiscal year 1979, but there is considerable flexibility within the Department for purposes of transferring funds.

If you are interested, I can get you an answer.[1]

Senator BAUCUS. If you could, please.

As I understand you, you do not know yet whether you will be able to proceed with the study. Is that correct?

Mr. WALSH. That is correct.

The letter that you referred to was not addressed to my office for action. I cannot give you an answer.

Senator BAUCUS. When do you think you will be able to tell us whether or not——

Mr. WALSH. I assume you will get an answer to that, Senator.[1]

Senator BAUCUS. I read in the Washington Post Tuesday that the Urban Mass Transit Administration has provided $500,000 for a

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[1] At presstime the information was not received by the committee.

study on the feasibility of electric trolleys in Georgetown. How much would a study for the Milwaukee Railroad cost in your judgment?

Mr. WALSH. I really do not know.

Senator BAUCUS. Could you provide that?

Mr. WALSH. We can, indeed.[1]

Senator BAUCUS. It seems to me it is important to study the possibility of continuing the rail service in the West as it is new rail service——

Mr. WALSH. You make a very telling point.

Senator BAUCUS [continuing]. In Georgetown.

You heard Governor Judge and Mr. Schmechel today describe an organization that is now being formed to help shippers and employees in their effort to obtain and put together a feasible, profitable, Milwaukee Railroad.

Besides the comprehensive study on shipper and employee ownership we have discussed what other kinds of financial help or technical assistance should be provided by the Department of Transportation?

Mr. WALSH. Mr. Newkirk may be able to address that, because most of the rail financing authority in the Department is under FRA.

Mr. NEWKIRK. I would be pleased to. I would like to break it into two parts.

The first, technical advice as to how one should proceed with a market research study and a viability study to determine the feasibility of making such an investment, and we would be happy to make available all the work we have done on the northwest study and any other market-type studies we have undertaken in the past several years.

Senator BAUCUS. Besides studies, what kind of technical help or financial help can the FRA provide?

Mr. NEWKIRK. I think that there is already a very appropriate mechanism in place. The branch line assistance program under title VIII whereby moneys are made available to the individual States for the purposes of constructing State rail plans. Because the several States affected by the lines in the West now are coordinating their activities, it is very likely that then planning money can be used jointly by the States to perhaps assist in funding some of the necessary planning that must be undertaken.

Furthermore, the financial assistance program under title V of the 4-R Act, the 505 preference share program and the 511 loan guarantee program might be available to implement the transfer and rehabilitation of some of the properties if the application meets the requirements of the statute and of the FRA regulations.

Senator BAUCUS. With the rising cost of diesel fuel, has FRA begun to update any studies that compare the efficiency of rail transportation, with truck transportation? Obviously diesel fuel costs for railroads go up as they do for trucks. Diesel fuel is now costing at least 80 to 85 cents a gallon at the pump in my State of Montana.

I heard today that a railroad has decided to purchase diesel fuel at $1.15 a gallon, about 2 million gallons worth, I am curious if you

[1] At presstime the information was not received by the committee.

have begun to update any studies on the relative efficiency of transportation systems based upon rising fuel costs.

Mr. NEWKIRK. The Office of Policy and Program Development together with the Office of Research and Development, both within FRA, are looking at the fuel efficiency of the two modes of transportation under different conditions, for example, long-haul, heavy-commodity-type movements versus short-haul pickup and delivery movements.

There was some work done in that area recently and I will try to obtain a copy of that for the committee.

Senator BAUCUS. You have been with the FRA for some time. This is not a new question. You must have some sense of the relative efficiencies. You must have some studies that show relative fuel efficiencies for grain, for coal, for automobile parts, and certain other products.

Mr. NEWKIRK. It can be best broken out in the short-haul pickup and delivery function, the long-haul delivery between regions over distances greater than 100 miles or so.

I think that it has been shown that in most circumstances—not all—the motor carrier is more fuel efficient for the short-haul pickup and delivery of most commodities, not necessarily the very heavy bulk commodities, and the railroad long haul is more fuel efficient over greater distances.

Senator BAUCUS. As you know, under title V of the Railroad Revitalization and Regulatory Reform Act of 1976, there are provisions for financial assistance to railroads.

Under section 505, FRA has already provided approximately $34 million to Milwaukee. An additional $21.5 million, approximately, in loan guarantees for rehabilitation of freight cars and locomotives have been provided under section 511.

My question is, how much additional money might be available to the Milwaukee under sections 505 and 511? What is possible?

Mr. NEWKIRK. I do not have that money at my fingertips. It would be the unobligated portions of appropriate 505 and 511 funds for the balance of this fiscal year, plus next year's appropriation.

Senator BAUCUS. If you could provide the precise amounts for the record it would be helpful. Could you do that, please?

Mr. NEWKIRK. I would be pleased to.[1]

Senator BAUCUS. Right now, just tell me roughly what the unobligated balances would be?

Mr. NEWKIRK. My guess is the unobligated balance in the 505 program is somewhere in the neighborhood of probably $30 or $40 million. I am not very certain of that number. The 511 number would be substantially higher.

Senator BAUCUS. My understanding is there might be $210 million authorized.

Mr. NEWKIRK. The 505 loan guarantee program, yes, sir.

Senator BAUCUS. I see.

Various FRA officials have suggested that financial aid under the 4-R Act would not be available for Milwaukee tracks west of Minneapolis because of low density of traffic. For example, on October 6, a memo from John Sullivan to the Secretary of Transportation, Mr. Adams, states:

[1] At presstime the information was not received by the committee.

Our position regarding financial assistance to the Milwaukee for rehabilitation of this line is, while the line may be technically eligible under the law, the priorities established in our regulations for the administration of section 505 programs are such that, unless the moneys available under section 505 are increased enormously, we cannot fund this line.

There is a memo dated October 5 from yourself to Mr. Gallimore which states:

I strongly recommend that our position at these meetings be one of support for the approach Mr. Hillman is taking toward the reorganizing of the Milwaukee. I furthermore recommend that we publicly declare our views. The Federal financial assistance under the present title V programs is unwarranted and undesirable.

The question is, What kind of analysis did the FRA do of the Milwaukee line before these decisions were made?

Mr. NEWKIRK. Those decisions were made based on the criteria we used in establishing the regulations for the title V programs. The criteria basically were economic in nature. We recognized a very limited source of financial assistance and a very large need.

As you know, we report the capital need of the industry to be between $13 and $16 billion not including ConRail. Amounts authorized in the 505 and 511 programs, as you know, are a fraction of the percentage of the need.

We felt that the Federal Government could do the most good for the industry and the shipping public if we concentrated those scarce, new financial assistance resources on those portions of the system that indeed had substantial need, but were also more heavily used by the shipping public.

So we established a set of regulations that prioritized the manner in which we would view applications.

First and foremost was the density test, which was the measure of the level of years of a piece of railroad track. We felt that that would represent the best expenditure of public dollars by generating the most benefit, if you would.

Senator BAUCUS. What density figures did you use? What dates?

Mr. NEWKIRK. A compilation of 1971 through 1975 which we developed into the line designations standing required by the 4-R Act, and furthermore, at the time an application is submitted, revised density figures must be included in the application.

Senator BAUCUS. Essentially your density figures were historical. As I understand your answer, you did not do any studies as to future transportation needs for grain or coal, particularly in the West. Is that correct?

Mr. NEWKIRK. That is correct, sir. The title V program, as laid forth in the 4-R Act was regarded as an interim financial assistance program, while the capital needs study was being conducted, following which we were to recommend to the Congress a long-term financial assistance program where the use of traffic projections would be more appropriate.

Senator BAUCUS. Do you not think it makes more sense to study future needs and possible and probable markets and revenue of railroads rather than looking at historical figures? As I understand, you used data roughly from the early 1970's, and updated it at the time of the application.

Does it not make more sense to look forward rather than backward?

Mr. NEWKIRK. I would certainly agree that it would. That is what our capital needs study does, in fact, do.

In the circumstances, what we were faced with when the title V program was passed was substantially more need for this interim program financing than there were dollars available.

Senator BAUCUS. Does FRA conduct studies to show what the adverse economic impact would be if a railroad was abandoned, as the Milwaukee Railroad would have been if the trustee's petition had been granted? Do you have any studies to show what the consequences are?

Mr. NEWKIRK. We have not undertaken what I would call economic impact studies at this time.

Senator BAUCUS. The answer to that is no, is that right?

Mr. NEWKIRK. That is correct.

Senator BAUCUS. I have a letter here sent by yourself to trustee Stanley Hillman. I would like to read one paragraph.

It begins:

> I was, however, able to obtain a copy of what I consider to be one of the most interesting of the studies done by the research program. I am enclosing it for your information. The report discusses self-improvement programs. Because this is a draft report, it has not yet been released by the Department.
>
> I would ask you to hold it closely, particularly because the section discussing rail labor has not yet been approved by the Federal Railroad Administration.

My question is, at the time that you gave this document to Mr. Hillman, had it been released to the public?

Mr. NEWKIRK. No, it had not, for the reasons stated.

Senator BAUCUS. What is that?

Mr. NEWKIRK. The consultant drafted the report used what I would have to consider bad judgment in using inflammatory language in certain sections of the document.

Senator BAUCUS. Is it standard procedure to give advance copies of reports or studies done by an outside contractor to the trustee?

Mr. NEWKIRK. That would depend on the circumstances.

Senator BAUCUS. That raises, in my judgment, certain questions.

Mr. NEWKIRK. Let me explain that study to you. That study focused on the elements of management organization within a railroad firm and how railroad management can better be organized on a structural basis to deal with railroading in 1980 as opposed to 1920.

There is a school of thought that believes that railroad management structure and organization has not kept pace with the technological and competitive change that the industry has faced over the years. We undertook that study with the cooperation of several different railroads. I do not recall the number, but nearly a dozen, and the consultant worked for about 9 months with those carriers, and with ourselves, to develop a framework for restructuring management organization for our railroad.

That report, at the time that it went to Mr. Hillman, was in the hands of approximately a dozen different railroads who participated in the development study.

Senator BAUCUS. When was that report available to the public?

Mr. NEWKIRK. I believe it may be available to the public now, sir. I know the final draft went to the printer some time in April.

Senator BAUCUS. I cannot understand why it is not available to the public at any time, even when it is a draft copy sent to the railroad. What is the national security issue here?

Mr. NEWKIRK. The normal procedure in the Federal Railroad Administration—I cannot speak for other organizational elements of the Government—conducts contract researches, we have a right to review draft reports and recommend certain kinds of changes which would not impact the substantive conclusions of the report prior to the release of an official Government document.

That is standard procedure, at least in the Federal Railroad Administration.

Senator BAUCUS. This was a report or study conducted by an outside contractor. Is that correct?

Mr. NEWKIRK. Contracted for by the FRA. We did not conduct the study.

Senator BAUCUS. But you provided the funds to the subcontractor who did this study.

Mr. NEWKIRK. That is correct.

Senator BAUCUS. Essentially, it is contracted work.

Mr. NEWKIRK. That is correct.

Senator BAUCUS. Who did the study? Can you name the contractor?

Mr. NEWKIRK. Levy Associates, a consulting firm; and Greenwich Associates.

Senator BAUCUS. When they do the study, they do a draft report to the FRA. Is that correct?

Mr. NEWKIRK. That is correct, but through all the development of the report there are a series of progress meetings in which the progress of the report is discussed between the consultant and the FRA.

Senator BAUCUS. What was the nature of the study, please, again?

Mr. NEWKIRK. It was the study of how railroad management could better be organized to deal with the competitive productivity environment it now works in.

Senator BAUCUS. Why would that not be available to the public at any time?

Mr. NEWKIRK. I suppose it could be under the Freedom of Information Act. I am not an attorney; I cannot address that.

It is customary not to release a report to the public through press releases and sending them to NTIS until the final report has been approved by the Federal Railroad Administration.

Senator BAUCUS. What you are saying is that it is customary to privately negotiate with and talk to the railroads—and exchange drafts back and forth to the exclusion of the general public knowledge until some agreement is reached—before the FRA releases the final study? Is that what you are saying?

Mr. NEWKIRK. Let me clarify that a bit. When the FRA or, I believe, any executive branch organization indulges in contract research of this nature, an individual is appointed from the originating office whose responsibilities are technical oversight of the contract research.

Before the work is begun, a very detailed statement of work is created that tells the contractor precisely the steps that he is to follow in developing his report so the Government can presume that no areas that should be investigated are omitted.

That is the kind of review that I am talking about.

Senator BAUCUS. I can only say, based on what I hear, that it raises certain questions about whether the regulators are too close to the regulated industry. As you know, members of the public believe that agencies tend over a period of time, to become too close to the industries they are regulating.

I can only say candidly, based upon what I hear and what you are saying, that there certainly does seem to be a problem with the FRA.

I cannot speak with absolute judgment as to the situation. I do not know enough about it yet. I suggest you would be doing the public a better service the more that you deal at arm's length.

Mr. NEWKIRK. I would like to clarify what appears to be a misconception. I am not talking about any kind of negotiation with the railroad. Rather, I am talking about how the Government goes about supervising contract research. The contract research firm, in this instance, was not a railroad. It was an independent business consultant who was working independently but yet had to meet certain criteria for the contents of the final report he was to deliver to the Government, by which I mean he had to cover areas A, B, C, and D, and as that report is developed, it is the Government's responsibility that A, B, C, D, and E are, in fact, adequately covered and reported on by the consultant.

I am not talking about any relationship with the railroad here, sir.

Senator BAUCUS. Earlier today I asked Governor Judge, Mr. Kelso, and Mr. Kurland, and others here, whether they could help us by providing the names of people whom they either know might run across who could help put together an interim organization and begin to develop a managerial team.

I would appreciate it if any of you three here today, sometime within the next week could provide me with the names of anybody who comes to mind, or some advice as to where we might look.

We obviously are looking for some vehicle or organization that can devote full time and full attention to the filing of proper papers and developing all of the applications and talent needed. I am afraid that the chances that the Milwaukee will not succeed are probably greater without with such an organization.

You can all be very helpful if you could do that.

Before we conclude this afternoon, do any of you have any other suggestions that we might pursue at this point? You have lots of experience with rail matters. You have seen railroads come and go. I am curious whether at this point you could help us with some observations or feelings?

Mr. NEWKIRK. I think, Senator, that the most important chore facing the new organization is a very extensive and credible market research effort to determine what levels of traffic can, in fact, be produced to be transported by the new firm. There are many issues that may overlap that particular issue at stake.

For example, the coal slurry trunkline, speed limits, weight limitations, diesel fuel, and many other issues that had to be considered when one makes an overall assessment of the future viability of what should be, in fact, a new railroad company.

Senator BAUCUS. It would be helpful if you would provide me with the names of all the shippers to the degree that you can that utilize the Milwaukee Railroad, or would potentially utilize the Milwaukee Railroad.

Mr. NEWKIRK. I think we could do that, sir.

Senator BAUCUS. If you could provide us with the names, addresses, and the telephone numbers of the central offices, it would be helpful.

Mr. NEWKIRK. We will be glad to do that.[1]

Senator BAUCUS. Thank you.

As I mentioned earlier, we need a group of people to put this together, and there is also a need for a study of some kind. We have had lots of studies, I know, but some kind of a study put together by FRA or DOT, which would explain how this new organization should proceed.

Since the Department of Transportation has technical wherewithal and experience and knowledge it could be very helpful.

Can you suggest to me how we can begin to put an ESOP/SSPO study together? Would an organization apply for a study, or would you on your own to put something together?

What is your suggestion?

Mr. WALSH. Senator, I am going to turn it back to Mr. Newkirk again. The Department of Transportation does not have grant authority, unlike most Federal partners. That is, we cannot, out of general research funds, simply give money to a private organization to do their thing.

In many cases, I wish we could. There may be some way under the general financing authorities that FRA administers that might be possible.

Senator BAUCUS. It would be helpful if each of the agencies, together and collectively, could for the record state what kinds of measures you can undertake to generally help in providing technical aid? What kind of financial assistance is potentially available? What other general services, as a public agency, you can provide? It is not necessary that you commit yourself to agreeing to an application of any kind that might be forthcoming. Just the kind of services available and that you are standing ready to help.

The hearing record will close July 9. Any responses to questions I have and any other materials you wish placed in the record must be submitted by July 9, or earlier if possible.

Finally, let me state that I am going to be placing in the record statements and letters from various people around the country commenting on the Milwaukee Railroad. This has created quite a bit of interest in the Northern Tier States and other parts of the country as well.

I will include these items in the record as an appendix to the hearing record, for your information.

[The material referred to follows:]

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[1] At presstime the information was not received by the committee.

[From the Congressional Record—June 7, 1979]

ADDITIONAL DOCUMENTS OF INTEREST

Over the past few weeks a number of documents have been produced relative to the Milwaukee Road's position that I believe are of keen public interest. To assist the public in gaining access to these documents, I am including them in the RECORD today.

HOUSE COMMITTEE REPORT ON MILWAUKEE

The first document I want to present is the House Commerce Committe report that accompanied the 45-day resolution which was reported out on May 30. The first four paragraphs of that report—particularly the fourth paragraph, which begins with the phrase "In order to best determine the viability * * *"—are particularly timely. I urge the Department of Transportation to move quickly on the studies mentioned in the report. The Department has the authority and the funds necessary to undertake such studies. Thus, I respectfully urge Secretary Adams to begin them immediately and not wait for further congressional action.

The report follows:

REPORT

The Committee on Interstate and Foreign Commerce, to whom was referred the joint resolution (H.J. Res. 341) to require continuation of rail service by the Chicago, Milwaukee, St. Paul, and Pacific Railroad for a period of 45 days, having considered the same, report favorably thereon with an amendment and recommend that the joint resolution as amended do pass.

The amendment is as follows:

Strike out all after the resolving clause and insert in lieu thereof the following:

That (a) Congress hereby finds that—

(1) the proposed embargo of the freight operations of the Chicago, Milwaukee, Saint Paul, and Pacific Railroad Company (hereinafter the "Milwaukee Railroad") in the States of Washington, Montana, Idaho, North Dakota, South Dakota, Illinois, Iowa, Missouri, Michigan and Indiana, which the trustee of the railroad has asked the bankruptcy court to authorize and to direct, would have crippling repercussion on the economies of these States;

(2) the threatened embargo of freight service extends o... seven thousand miles of the track, or approximately 75 per centum of the Milwaukee Railroad's rail system;

(3) the proposed embargo would result in the loss of many thousands of jobs of railroads workers and other workers whose employment is dependent upon uninterrupted rail serivce;

(4) coal shipments from the great coal deposits underlying Montana, Wyoming, North Dakota, and South Dakota are totally dependent upon continuing rail services;

(5) the agricultural producing and marketing activities in this tier of States is equally dependent upon continued service;

(6) cessation of essential transportation services by the Milwaukee Railroad would endanger the public welfare;

(7) cessation of such services is imminent; and

(8) there is no other practicable means of obtaining funds to meet payroll and other expenses necessary to provide such services.

(b) Upon the basis set forth in subsection (a), the Congress declares that emergency measures must to taken to avoid the substantial damage to the economy of the region and of the Nation which the proposed embargo would otherwise cause.

SEC. 2. For a period of forty-five days following the date of enactment of this resolution, the Milwaukee Railroad (1) shall maintain its entire railroad system, as it existed on May 1, 1979; (2) shall continue no less than the level of service provided by it as of that date; and (3) shall not take any action to abandon or discontinue service over any part thereof unless it is authorized to do so by the Interstate Commerce Commission, and no affected State (or local or regional transportation authority) opposes such action by the Commission.

SEC. 3. (a) The Secretary of Transportatioan, under the authority of the Emergency Rail Services Act of 1970, shall immediately guarantee trustee certificates of the Milwaukee Railroad in the amount specified in section 4 of this joint resolution. Such guarantee shall be made without regard to the findings and conditions set forth in subsections (a) and (b) of section 3 of such Act, and the certificates guaranteed under this joint resolution shall not have the status and priority set forth in subsection (c) of section 3 of such Act.

(b) Certificates guaranteed under this joint resolution shall not have priority in bankruptcy over the claim of any creditor of the Milwaukee Railroad as of the date of enactment of this joint resolution.

SEC. 4. The Secretary of Transportation shall guarantee trustee certificates of the Milwaukee Railroad pursuant to this joint resolution in an amount equal to the difference between (1) the total expenses incurred by such railroad in and attributable to the maintenance and continuation of service as required by section 2 of this joint resolution, and (2) the direct revenues from the handling, routing, and moving of traffic in connection with such service, together with any other source of revenues available to such railroad.

SEC. 5. The Secretary of Energy shall immediately conduct an assessment of present and potential coal hauling needs in the area served by the Milwaukee Railroad and report his findings to Congress within 30 days after the date of enactment of this joint resolution.

PURPOSE AND SUMMARY

The report resolution requires that for a period of 45 days following enactment of the resolution, the Milwaukee Railroad shall maintain its entire railroad system as it existed on May 1, 1979. During this 45-day moratorium, alternatives to the proposed embargo and subsequent directed service will be evaluated by both governmental and private sector interests.

BACKGROUND AND NEED

The Chicago, Milwaukee, St. Paul, and Pacific Railroad, the Nation's seventh largest railroad entered bankruptcy for the third time in this century on December 19, 1977. On April 23, 1979, the court-appointed trustee Stanley E. G. Hillman of the Milwaukee Railroad petitioned the bankruptcy judge to embargo approxiamtely 7,000 miles of its 9,400 mile system and to furlough an estimated 5,000 employees. A series of hearings have been held on the proposed embargo by the bankruptcy judge beginning on May 4, 1979, and a decision on the proposal is imminent.

The Milwaukee Railroad is one of two railroads that serve one of the world's largest coal formations—the Fort Union formation—which underlies part of Montana, Wyoming, North Dakota, and South Dakota. Both coal and agricultrual shipments in this area are totally dependent upon railroad transportation. This region will provide an increasingly greater amount of coal as the country implements its coal conversion program.

Were the proposed embargo to be implemented at this time, severe and irreversible economic dislocations would occur in those areas served by the Milwaukee Railroad. The embargo threatens transportation services for shippers and employees in the northern tier States and would leave substantial geographical areas, especially in Washington, Montana, North Dakota, and South Dakota, without rail competition for the carriage of goods or without any rail services at all. The committee believes such a disruption of commerce and employment should not be made until an objective analysis of alternative scenarios for northern tier freight transportation is completed by the Department of Transportation, the Interstate Commerce Commission, the affected States, the Milwaukee employees, other railroads that serve the northern tier, the shippers, and the creditors of the Milwaukee Railroad and is available for public comment.

All proposals, including employee and shipper stock ownership plans, must be fully explored and evaluated, before an embargo is implemented, for the alternative is the use of Interstate Commerce Commission directed service (49 U.S.C. 11125). The committee believes a directed service order of this unprecedented magnitude is the costliest and, in the long run, least effective resolution of the problem. The Commission's recent decision to direct other carriers to provide service over certain of the proposed embargoed lines will entail $30 million in Federal payments to those carriers for the statutory maximum period of 240 days, after which service will cease if the lines in question are not purchased. Because a directed service order cannot substantially impair the ability of the directed carrier to serve its own shippers adequately or meet its common carrier obligations, the proposed ICC order, whereby 95 percent of the Milwaukee's present shippers would be served, may not provide even an adequate short-term remedy. Those carriers that might be directed to provide service are experiencing such serious locomotive and equipment shortages that their ability to meet their own common carrier obligations might be impaired. Finally, while a directed service order provides that the directed carrier must hire the employees of the other carrier, it is anticipated that less than half of the Milwaukee Railroad's employees would be employed by the directed carrier.

During the moratorium on cessation of service required by House Joint Resolution 341, it is essential that alternative plans for continuing essential transportation services be developed. The Department of Transportation should analyze and make appropriate adjustments to studies of the operations of the Milwaukee Railroad that have been made to date, including the Booz, Allen & Hamilton, Inc., report, which was authorized by the trustee and which was only recently made available to the public. Interstate Commerce Commission filings, internal company data and other sources will be of significant aid in completing the Department of Transportation analysis.

In order to best determine the viability of employee and shipper stock ownership proposals, the Department should consult with representatives of and employees of the Milwaukee, with its past and present management, with the financial experts of the railroad itself, the Federal Railroad Administration, other agencies, Members of Congress and other advisers. Variations on existing proposals should be evaluated to develop the most desirable design for an ESOP or SSOP with an estimate of the overall effects of employee and shipper ownership on employee relations, relations with regulatory commissions, profitability, ability to finance growth, ability to restore and rehabilitate the railroad's physical plant and equipment and other material effects. A necessary component of this analysis is a comprehensive market study for potential shipper revenues, including expanding export markets for grain and coal. The committee expects the Department to complete such an analysis before the end of the 45-day period, thereby providing sufficient time for implementation of appropriate recommendations or proposals.

OVERSIGHT FINDINGS

Pursuant to clause 2(l)(3)(A) of rule XI of the Rules of the House of Representatives, the committee has made general oversight findings and recommendations set forth in this report.

Pursuant to clause 2(l)(4) of rule XI of the Rules of the House of Representatives, no oversight findings have been submitted to the Committee on Government Operations.

INFLATIONARY IMPACT STATEMENT

Pursuant to clause 2(l)(4) of rule XI of the Rules of the House of Representatives, the committee makes the following statement with regard to the inflationary impact of the reported bill:

The committee believes that the enactment of this legislation will have no inflationary impact on prices and costs in the operation of the national economy.

COST ESTIMATE

In compliance with clause 7(a) of rule XIII of the Rules of the House of Representatives, the following statement is made regarding the cost of this legislation:

In accordance with clause 2(l)(3)(C) of rule XI of the Rules of the House of Representatives, the committee includes the following cost estimate submitted by the Congressional Budget Office relative to the provisions of House Joint Resolution 341:

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS,
Washington, D.C., May 25, 1979.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce, U.S. House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Pursuant to section 403 of the Congressional Budget Act of 1974, the Congressional Budget Office has reviewed House Joint Resolution 341, to require continuation of rail service by the Chicago, Milwaukee, St. Paul, and Pacific Railroad for a period of 45 days. This resolution was ordered reported by the House Committee on Interstate and Foreign Commerce on May 24, 1979.

The resolution directs the Secretary of Transportation to use authority available under the Emergency Rail Services Act of 1970 (ERSA) to guarantee loans made to the Milwaukee Railroad for a 45-day continuation of that railroad's current operations. An estimated $15 to $20 million would be required for this purpose. The resolution does not authorize new budget authority or loan authority.

The resolution requires the Secretary of Transportation to make the guarantees without application of certain findings and conditions required by current law. It would reduce the priority status accorded by law to ERSA guarantees, placing the Milwaukee guarantees (which are actually loan notes purchased by the Federal Financing Bank) in positions subordinate to claims of other creditors of the railroad. This lessens the probability that the Government will receive all the required interest and premium payments. However, it is difficult at this time to estimate how much repayment the government will receive. Loan terms will probably require repayment to begin in fiscal year 1980.

Should the committee so desire, we would be pleased to provide further information.

Sincerely,

ALICE M. RIVLIN,
Director.

SECTION-BY-SECTION ANALYSIS OF HOUSE RESOLUTION 341

Section 1

Subsection (a) of section 1 of the reported resolution states certain congressional findings with respect to the crippling impact on the economies of certain States served by the Milwaukee Railroad if the imminent threatened cessation of essential rail services over approximately 75 percent of the Milwaukee's system is permitted to occur.

Subsection (b) of section 1 states a congressional declaration that emergency measures must be taken to avoid the substantial damage to the economy of the region and of the Nation which such cessation would cause.

Section 2

Section 2 of the reported resolution requires that, for a period of 45 days following enactment of the resolution, the Milwaukee Railroad shall maintain its entire railroad system, as it existed on May 1, 1979, shall continue to provide no less than the level of service provided by it as of that date, and shall not take action to abandon or discontinue service unless authorized to do so by the Interstate Commerce Commission and no affected State (or local or regional transportation authority) opposes such action by the Commission. This section does not preclude filing of an abandonment or discontinuance application with the Commission in accordance with existing law nor excuse less than full compliance with all Federal safety laws and regulations.

Section 3

Subsection (a) of section 3 of the reported resolution requires the Secretary of Transportation, under the authority of the Emergency Rail Services Act of 1970, to immediately guarantee trustee certificates issued by the Milwaukee Railroad without regard to certain findings and conditions set forth in such act. Subsection (a) also provides that such certificates shall not have the status of expenses of administration or receive the highest lien on the railroad's property and priority in payment under the Bankruptcy Act.

Subsection (b) of section 3 provides that certificates so guaranteed by the Secretary shall not have priority in bankruptcy over the claim of any creditor of the railroad as of the date of enactment of the resolution, thereby protecting the rights of existing creditors.

Section 4

Section 4 of the reported resolution requires the Secretary of Transportation to guarantee trustee certificates of the Milwaukee Railroad under this resolution in an amount equal to the difference between (1) total expenses incurred by the railroad in and attributable to the required maintenance and continuation of rail service and (2) direct revenues from the handling, routing, and moving of traffic in connection with such service, together with any other source of revenues available to the railroad.

Section 5

Section 5 of the reported resolution requires the Secretary of Energy to immediately conduct an assessment of present and potential coal hauling needs in the areas served by the Milwaukee Railroad and report his findings to the Congress within 30 days after the date of enactment of this resolution.

COMMITTEE CONSIDERATION

The Committee on Interstate and Foreign Commerce ordered House Resolution 341 reported to the full House by a vote of 34-15. The Subcommittee on Transportation and Commerce held hearings concerning the Milwaukee Railroad and legislative proposals on May 9, 1979.

JUDGE MCMILLAN'S JUNE 1 DECISION

The decision follows:

[U.S. DISTRICT COURT, NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION, NO. 77 B 8999]

IN THE MATTER OF CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, DEBTOR.

DECISION ON TRUSTEE'S PETITION FOR DIRECTION WITH RESPECT TO PARTIAL EMBARGO OF FREIGHT OPERATIONS

On April 23, 1979, the Trustee of the above railroad (hereinafter referred to as the Milwaukee Road) petitioned the court to direct an embargo on certain of his freight operations effective May 8, 1979 at 12:01 a.m. Hearings were commenced on May 4, 1979 and continued before Special Master Milton H. Gray on May 15 through May 18, 1979. Master Gray filed his recommendations on May 25, 1979 and objections to the recommendations were filed by various parties on May 29, 1979. In the meantime the Master had considered scores of exhibits, testimony of all interested parties which totalled 1350 pages of transcript, and many written sworn statements which were admitted subject to cross examination. Obviously the court is greatly indebted to the Special Master and to all interested parties for the expeditious handling of this matter.

We have carefully examined the report of the Special Master and the several objections filed thereto. Many parties, including the indenture trustees, have not filed objections, but we assume the indenture trustees object to the Master's recommendations because they have filed a petition for a complete embargo. In any event, we have familiarized ourself with the record and find and conclude that the findings of fact contained on pp. 10 through 25 of the Master's report are supported by substantial evidence, to the extent not modified hereafter in this Decision.

However, we reluctantly disagree with his conclusions of law, in substance, for the reason that we cannot find any statutory or other authority for our entering the order requested by the Trustee. We say this "reluctantly" because we believe that the Master and the attorneys for the Trustee have conscientiously attempted to find a solution or the difficult problems of the Milwaukee Road, and the Trustee's proposal is one which we believe would promote the public interest. However, every avenue which has been explored leads, in our opinion, to a road block, erected primarily by the Federal government.

The Trustee's petition and his attorneys' arguments are based primarily upon 49 U.S.C. § 11125. This statute, enacted in substantially its present form on January 2, 1974 and amended in technical details on October 17, 1978, is entitled "Directed rail transportation." It provides in substance that the Interstate Commerce Commission may direct another carrier to handle the traffic available to the affected carrier for a maximum period of 240 days, with reimbursement to the direct carrier for certain additional expenses incurred by it. The purpose of this statute is presumably to substitute service by one carrier for another under certain conditions, the additional cost being borne by the United States government. Thus the affected carrier, the Milwaukee Road in this instance, would be temporarily relieved of its duties as a common carrier and the public interest would be served by its competitors.

The statute, however, imposes certain conditions precedent upon the Commission's discretion to direct service, as follows:

(a) When a rail carrier providing transportation subject to the jurisdiction of the Interstate Commerce Commission under subchapter I of chapter 105 of this title *cannot* transport the traffic offered to it because—

(1) its cash position makes its continuing operation *impossible;*

(2) transportation has been discontinued under *court order;* or

(3) it has *discontinued* transportation without obtaining a required certificate under section 10903 of this title;

the Commission *may* direct the handling, routing, and movement of the traffic available to that carrier and its distribution over the railroad lines of that carrier by another carrier to promote service in the interest of the public and of commerce. (Emphasis supplied to key words.)

In applying the foregoing statute, it must be noted at the outset that its requirements are apparently intended to be quite strict, as the emphasized words illustrate. The effect of the statute is to abrogate much of the Interstate Commerce Commission's primary jurisdiction to supervise abandonment or transfer of rail services. Hence Congress altered the procedures of the traditional administrative agency for only three narrowly defined, almost insoluble, crises. Each of these crises also seems to contemplate a complete, unavoidable, and not a partial, cessation of operations. Finally, the language of the statute is oriented toward action by the I.C.C., not by the reorganization court.

The first criterion for determining whether or not § 11125 applies, therefore, is whether the Milwaukee Road cannot transport its traffic because its cash position makes its continuing operation "impossible." The Trustee alleged this in his petition filed April 23, 1979 but the Master did not so find. He did find, at the bottom of p. 32 of his report, that "additional borrowing . . . would not be proper at this time; as a result, the Trustee is without cash to operate the entire Milwaukee." We do not find support in the record for any finding that the Trustee's cash position makes a continuing operation of the Road "impossible," Even if we did, § 11125 authorizes action by the I.C.C., not by this court.

We did find in a decision entered May 10, 1979 that the Trustee was in dire need of operating capital, since his bank balance had been reduced to about $300,000 and he was incurring losses of about $500,000 per day as of May 4, 1979. At that point his cash position was as a practical matter "impossible," since he had payrolls and accounts payable for operating expenses which exceeded his available cash. Therefore, for this and for other reasons, we authorized the issuance of a seventh Trustee's Certificate for priority borrowing of $15 million, since "denying this borrowing, would have the same effect as ordering a prompt cessation of rail operations." (Decision of May 10, 1979, Conclusions par. 1, p. 10.)

The Trustee has not shown in the record on his instant petition for a partial embargo that the $15 million has been exhausted, or that his losses are continuing at the rate of approximately $500,000 per day, or that he is not able to obtain additional working capital. As a matter of fact, at this moment, he has a petition under consideration by Master Gray for an additional Trustee's certificate to borrow $20 million. In that hearing his witnesses have testified that $4.3 million of the previous priority borrowing has not yet been used and that his losses are now averaging about $10 million a month.[1] Possibly somewhere within the time frame of continued operations are also additional receipts from sales of operating and nonoperating real estate, grants from states, shippers, and the Federal government, and dividends from the wholly-owned Milwaukee Land Company. In short, we find that the "impossibility" contemplated by § 11125(a)(1) has not yet been encountered by the Trustee.

The second alternative provided in § 11125 is when "transportation has been discontinued under court order." The Trustee apparently believes that this language confers implied authority upon this court to enter an order for a partial embargo, but we do not agree. His case has been brought into this court by a petition filed under § 77 of the Federal Bankruptcy Act. Under § 77, this court is not only limited by the provisions of that statute but is also subject to review of most substantive decisions by the I.C.C. Section 77(o) of that Act (11 U.S.C. § 205(o)), provides that this court may authorize abandonment or sale of the debtor's properties upon certain conditions and after certain procedures have been followed, "but only with the approval and authorization of the Commission when required by chapter 1 of Title 49. . . ."

The latter section is currently contained at 49 U.S.C. § 10903 which provides in pertinent part that:

(a) A rail carrier providing transportation subject to the jurisdiction of the Interstate Commerce Commission under subchapter I of chapter 105 of this title May—

(1) abandon any part of its railroad lines; or

(2) discontinue the operation of all rail transportation over any part of its railroad lines;

only if the Commission finds that the present or future public convenience and necessity require or permit the abandonment or discontinuance. In making the finding, the Commission shall consider whether the abandonment or discontinuance will have a serious, adverse impact on rural and community development. . . .

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[1] Emergency Motion of Indenture Trustees to Amend Order No. 166 etc. and Trustee's Response thereto, filed and heard in this matter on May 31, 1979.

We find it impossible to believe that Congress intended to bypass the time-honored and elaborate administrative procedures of §§ 10903, 10904 and 10905 by enacting the bare bones "court order" provision of § 11125(a)(2).

The Trustee strenuously contends that he is not "abandoning" any part of the railroad and that his petition is therefore not subject to § 10903. However, his evidence establishes that, once directed service is ordered on any portion of its line, the debtor is unlikely to be able to retrieve and reactivate that portion successfully. Furthermore, the Trustee concedes that he cannot reorganize the Milwaukee Road if it contains the portions sought to be embargoed. Therefore, in our opinion, the requested embargo for a substantial portion of the Road for a lengthy period of time does constitute a *de factor* abandonment. This cannot be ordered by this court except through the process of I.C.C. review mandated by § 10903.

If a partial temporary embargo is ordered, it also constitutes a form of a reorganization, the plans for which are likewise subject to approval by the I.C.C. after a statutory review procedure. The Trustee's evidence, supported in the main by a report of the management consulting firm of Booz, Allen & Hamilton (Trustee's Ex. 65), clearly indicates to us that a reorganization of the entire railroad is highly impractical if not impossible, and the Master agrees (Report pp. 19, 22).[2] The principal impediment to complete reorganization is the existence of the main line which would be subjected to an embargo, primarily that portion west of Miles City, Montana and between Kansas City and Chicago. If the Trustee is unable to reorganize these portions of the railroad and seeks an embargo followed by directed service of competing lines, he is in effect proposing at least a partial reorganization plan. For this additional reason, the "court order" alternative for discontinuing transportation under § 11125 is not available in this case.

It could be argued that § 11125 by implication amends and supersedes § 77(o) and § 10903 which were on the statute books long before the provisions of § 11125 now being discussed. However, it is well-recognized that statutes should be construed compatibly and that amendments or repeals by implication are disfavored. In *Radzanower* v. *Touche Ross & Ross & Co.*, 426 U.S. 148 (1976) the Supreme Court restated its earlier holdings that it is "a cardinal principle of statutory construction that repeals by implication are not favored." 426 U.S. at 154. Equally important, the Court emphasized that, in the absence of a "clear intention otherwise," a statute dealing with a narrow, precise, and specific subject is not submerged by a later-enacted statute of a more generalized nature. 426 U.S. at 153. Since Congress did not refer in any way to the Bankruptcy Act or its appendages in enacting § 11125, and since there are situations where a court order could cause discontinuance of transportation in cases where the railroad has not filed a petition under § 77, we can only conclude that the "court order" subsection of § 11125 does not refer to a court order of this court sitting in federal reorganization cases.

The Interstate Commerce Commission and its counsel have consistently taken the position that this court has no jurisdiction to order a partial embargo. Certainly that Commission and its counsel should be well-acquainted with the intricacies of the Interstate Commerce Act and § 77 of the Bankruptcy Act. In fact, the I.C.C. had taken this position earlier, giving Congress a clear opportunity to amend the statute if it intended a contrary interpretation. See *Lehigh and New England Railway Co.*, 540 F.2d 71, 81, f.n.28 (3d Cir. 1976) *cert, denied*, 429 U.S. 1061 (1977). Despite its disagreement with the Trustee's legal position, however, the Commission stands ready to direct service upon 36 hours' advance notice if we decide otherwise.

In short, we conclude that subsection (a)(2) of § 11125 does not afford this court independent authority to order a partial temporary embargo and that the provisions of the Bankruptcy Act and 49 U.S.C. § 10903 control any order which we could enter on this subject.

The third subsection, requiring "discontinued transportation" is obviously inapplicable on any of the facts in this record. The Milwaukee Road is still operating its trains from Kansas City to Chicago and west of Miles City, Montana, albeit painfully and at a loss. If we have no authority to enter a "court order" under subsection (a)(2), we also for the same reasons have no authority to order a discontinuance under subsection (a)(3). The Trustee does not contend otherwise.

Either in recognition of the foregoing problems with § 11125 or in an effort to find an alternative ground for relief, the Trustee and the Master turn to the proposition that continued operation of the entire Milwaukee Road would result in an unconstitutional erosion of the rights of creditors, particularly secured creditors. The Master concludes that an order for a partial embargo would tend to promote the objectives

[2] This does not necessarily preclude additional priority borrowing if a viable portion of the railroad is reorganizable and such funds are necessary to maintain the railroad's operations pending that reorganization.

of § 77 because it would result in a more reorganizable entity. This of course assumes, by implication at least, that the embargoed portions would be abandoned under any reorganization plan, to protect creditors from further erosion and to produce a plan of reorganization which will be feasible and in the interest of creditors as well as the public. However, the concept of an unconstitutional erosion of creditors' interests has not gone to the point of permitting a reorganization court to exercise equitable powers in derogation of the I.C.C.'s jurisdiction.

In *New Haven Inclusion Cases,* 399 U.S. 392 (1970) the court approved the imposition of losses upon creditors by permitting priority borrowing by the railroad when reorganization was a possibility. Our own Court of Appeals *In the Matter of Chicago, Rock Island and Pacific R. Co.,* 545 F. 2d 1087 (7th Cir. 1976) held that priority borrowing was within the discretion of the court if reorganization was not "clearly impossible." Although the Master found that reorganization of the entire railroad as a continuum was apparently impossible, he also found that a partial reorganization accompanied by partial abandonment or other disposition of unprofitable sectors was not impossible. Neither the United States Supreme Court nor the Seventh Circuit Court of Appeals nor any other court that we know of has ruled that the impossiblity of complete reorganization justifies an order for partial embargo, and as a matter of fact the courts have uniformly found that the reorganization of a railroad is one piece of cloth. Priority borrowing for a limited purpose or even for a viable segment of the railroad may be permissible under certain circumstances, but it does not follow that the remainder can be abandoned by court order.

Perhaps the most pertinent decision on the constitutional issue is Judge Friendly's opinion for the Special Court *In the Matter of Revaluation Proceedings Under §§ 303(c) and 306 of the Regional Rail Reorganization Act,* 439 F.Supp. 1351 (1977). In that case the court gave precedence to the requirements of the Interstate Commerce Act and § 77 in the matter of abandonment. It ruled that these statutory procedures must be followed even if the process results in a serious erosion of the railroad's property. It is the very nature of reorganization proceedings that creditors' rights be subordinated to those of the general public and subjected to financial losses, even though the reorganization process may take several months or years to reach fruition. Only if a railroad is faced with imminent "cashlessness" is a railroad justified in abandoning its service, according to the decision of the Special Court. When faced with a complete or substantial impossibility of continued operation because of a lack of working capital, the court ruled that a railroad cannot be required to do what it is unable to do, and that the only alternative is abandonment, a cessation of operations. See also *In re Penn Central Transportation Co.,* 384 F.Supp. 895, 919 f.n 31 (Special Court 1974).

Similarly, in *In re Central Railroad of New Jersey,* 485 F.2d 208 (3d Cir. 1973) *(en banc) cert. denied sub nom. Timpany* v. *New Jersey,* 414 U.S. 1131 (1974), the court stated that termination of passenger service could not be ordered in a § 77 reorganization proceeding without following the I.C.C. notice and hearing route. *Accord, In re Erie, Lackawanna Railway Co.,* 517 F.2d 893 (6th Cir. 1975). Although none of these cases involved § 11125, they are instructive in applying that statute as well as for rejecting the concept of an unconstitutional erosion of creditors' rights.

It is perhaps unfortunate that the I.C.C. modified its regulation Part 1006 which until February 6, 1978 permitted embargo by a common carrier where "compelling circumstances beyond the control of the carrier" required it. By limiting this provision to motor carriers after February 6, 1978, the Commission once again indicated its opinion that an embargo or partial embargo by a railroad should not be permitted except pursuant to the provisions of § 10903, although the foregoing regulation was not specifically directed toward the construction or scope of § 11125. In any event, as is pointed out in the objections of the State of Montana to the Master's report, his reliance and that of the Trustee on 49 C.F.R. § 1006, now § 1059, is misplaced.

In finding that the Milwaukee Road is not "cashless" on the record in this case, and that its continued operation is not "impossible," we are painfully aware that the Trustee will be confronted by these conditions in the foreseeable future. They can be temporarily avoided by the pending petiton for a certificate to borrow $20 million on a priority basis (the decision on which has not yet been reached), but they can be avoided even longer by the United States Congress as evidenced by Senate Resolution 81 (and House Resolution 341). We have been advised by the distinguished senators from Montana, Senators Melcher and Baucus, that passage of this ameliorative legislation is imminent.

While we as well as the Senators are aware of the unpredictability of the fate of emergency legislation of this sort, we must advert to the fact that continued operation of the Milwaukee Road for any length of time is almost entirely dependent upon financial relief from Congress. The findings of fact by Master Gray which we have approved make this crystal clear, particularly when the long-term operating deficits and substantial amounts of deferred maintenance are taken note of. Without summarizing these in this opinion, we call attention particularly to the findings on pp. 12 through 17 of the Master's report, most of which findings are incontrovertible on the record.

Congressional action is the only foreseeable alternative. We were advised in the hearing by representatives of the Interstate Commerce Commission that a petition for abandonment, if filed by the Trustee under § 10903, would necessarily consume several months before it could be acted upon, even then subject to appeal. The alternatives offered by § 11125 in its present form are certainly not in the public interest nor are they in the interest of the creditors. We have little doubt, however, that the Trustee will find continuing operation impossible or will be forced to discontinue transportation without obtaining a certificate under § 10903 in the foreseeable future, absent a release from the strictures of § 11125 or substantial and continued infusion of funds by the United States government.

For the reasons stated hereinabove, the objections of the State of Montana and others to the conclusions of law of the Special Master are sustained, and the Petition of the Trustee for Direction with Respect to Partial Embargo of Freight Operations is denied. The court directs the Clerk to enter a judgment pursuant to F.R.C.P. 58 denying said petition appealable pursuant to 11 U.S.C. § 47(a).

Enter:

THOMAS R. MCMILLEN,
Judge, U.S. District Court.

SPECIAL MASTER'S DECISION ON THE MILWAUKEE CASE

Mr. BAUCUS. One week before Judge McMillen refused the trustee's abandonment proposal, Milton Gray, the court appointed special master in the case, reported his findings of fact and conclusions of law. Although Judge McMillen did not accept all of these findings and conclusions, I think they are an important part of the history of this case.

The material follows:

IN THE MATTER OF CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY, DEBTOR

[In the U.S. District Court for the Northern District of Illinois, Eastern Division, In Proceedings for the Reorganization of a Railroad No. 77 B 8999]

REPORT OF SPECIAL MASTER MILTON H. GRAY, INCLUDING FINDINGS OF FACT, CONCLUSIONS OF LAW, AND RECOMMENDATIONS, TO TRUSTEE'S PETITION FOR DIRECTION WITH RESPECT TO PARTIAL EMBARGO OF FREIGHT OPERATIONS

To the Honorable Thomas R. McMillen, District Judge:

I. *The Proceedings*

On April 23, 1979, Stanley E. G. Hillman, Trustee of the Chicago, Milwaukee, St. Paul and Pacific Railroad Company (the Milwaukee), filed a petition requesting that the Court direct him to embargo the Milwaukee's freight operations over more than 70 percent of its track effective May 8, 1979, and approve the borrowing of $15,000,000, as requested in a petition of April 16, 1979, to maintain the remaining operations of the Milwaukee. This petition was set for hearing on May 4, 1979, the Trustee was directed to file written testimony by April 30, 1979, and other parties were instructed to file answers and comments by May 3, 1979.

In response to the Court's direction, the Trustee filed statements by himself, his assistant, and Milwaukee Vice Presidents of Finance, Operations, Planning and Management Services. Statements and memoranda were also filed by more than fifteen other interested parties, including, *inter alia,* the Continental Illinois National Bank and Trust Company of Chicago as Indenture Trustee (the Continental Bank), the First National Bank of Chicago as Indenture Trustee (the First National), Harris Trust and Savings Bank as Indenture Trustee (Harris Bank), Girard Bank as Indenture Trustee (Girard Bank), the Milwaukee, the Interstate Commerce Commission (ICC), the Railway Labor Executives' Association (RLEA), the Railway Employes' Department (RED), and several states which would be affected by the requested embargo.

In his testimony on May 4, the Trustee revised the request contained in his original petition. The revisions postponed the requested date for initiation of the embargo to May 31, 1979, extended the requested embargo to include certain lines to Kansas City, and eliminated from the embargo a line to Miles City, Montana.

The postponement of the requested embargo date was in response to the urging of the ICC and connecting rail carriers so as to permit the development of a plan for directed service by such carriers over embargoed territory in accordance with 49 U.S.C. 11125.

The hearing on the petition commenced on May 4, 1979. Bacause of the postponement of the effective date of the requested embargo, and because of the extreme nature of the cash crisis which was facing the Milwaukee, the May 4 hearing focused upon the propriety of borrowing $15,000,000 to continue operation of the Milwaukee through May 31, 1979. The factual statements on behalf of the Trustee, together with supporting figures and tables, were sworn to and admitted into evidence, with certain modifications and supplementary materials, as Trustee's Exhibits 1 through 62. The Trustee's witnesses were then cross examined with respect to the $15,000,000 borrowing. None of the other parties sought to introduce any sworn direct testimony on this issue, and the hearing with respect to it was concluded with final argument of counsel. The Court resolved the borrowing issue by authorizing the requested borrowing pursuant to Orders No. 166 and 166A and the findings of fact and conclusions of law appended thereto.

At the conclusion of the May 4, 1979 hearing, the Trustee indicated that in view of the use of the $15,000,000 of borrowing to keep the Milwaukee operating over its entire line through May 31, 1979, he would need authority to borrow an additional $20,000,000 at the end of May for the purpose of operating the unembargoed portion of the Milwaukee beyond that date. A hearing on this request was scheduled for May 29, 1979 and the Trustee was directed to provide for the statutory notice of that hearing.

The hearings with respect to the requested embargo were continued until May 15, 1979, and interested parties were directed to file any additional or supplementary written material prior to that date. Pursuant to that direction, additional written statements and memoranda were filed by the Trustee, the Girard Bank, the ICC, the RLEA, several states and other interested parties.

On May 10, 1979, Judge Thomas R. McMillen appointed the undersigned as Special Master to "consider and report promptly, stating findings of fact and conclusions of law, upon the issues raised by the Trustee's petition for direction with respect to partial embargo of freight operations, financing remaining operations, and related relief, as set forth in this Court's Orders No. 158 and 169 . . . On the same basis, the Special Master shall separately consider and report concerning the Trustee's application to FRA for financial assistance as set forth in Order No. 167." (Order No. 170). Thereafter, the undersigned took and subscribed the prescribed oath.

The Special Master did not participate in the May 4, 1979 hearing but prior to the May 15 hearing reviewed the May 4 transcripts and all filings made in respect to the issues pertinent to his appointment.

The Special Master sat with the Court during the hearing on May 15. Thereafter, he sat singly as Special Master during the continuation of the hearings on May 16, 17 and 18. All hearings were conducted in the customary judicial manner in the Ceremonial Courtroom in the Dirksen Federal Building, and all proceedings were recorded by the official court reporter. Testimony was taken under oath and full opportunity was given to all parties for direct and cross examinations. Proofs were closed late in the evening of May 18 and all counsel were given the opportunity of making closing statements. In view of the time pressures and the impending hearing of May 29, the Special Master announced that it was his intention to have his Report filed by May 25, that copies would be available in the Chambers of Judge McMillen, that it would be the responsibility of parties and counsel to secure copies of it, and that all objections to the Report should be in written form and filed by 10:00 a.m. on May 29. This schedule appeared satisfactory to all parties and counsel present.

During the hearings on May 15 through May 18, the supplementary and additional factual statements of the Trustee's assistant, the Vice Presidents of Management Services and Planning, and the President and Chief Executive Officer, were sworn to and admitted into evidence. In addition, the Trustee introduced the testimony of Charles W. Hoppe, Vice President of Booz-Allen & Hamilton, Inc. (Booz-Allen). Booz-Allen had conducted strategic studies of the Milwaukee's operations to assist the Trustee in evaluating the potential for its reorganization. The results of those studies were introduced into evidence as Trustee's Exhibit 65.

In all, in excess of 30 witnesses submitted direct sworn testimony and were tendered for cross examination, and several other interested groups and parties submitted written statements of position. In total, the record with respect to the embargo question contains in excess of 1,350 pages of hearing transcript, and many hundreds of pages of written testimony, memoranda, figures and tables.

II. *The Positions of the Parties*

The Trustee's position is that the Court is faced essentially with two alternatives, directing embargo as requested or permitting additional borrowings of $65,000,000 to $75,000,000 which would be necessary to operate the entire Milwaukee system through December 31, 1979. The Trustees suggested that the second alternative may result in an unconstitutional impairment of the creditors' security and preclusion of the possibility of the successful reorganization of any portion of the Milwaukee. He asserted that continued operation of the entire system through 1979 will result only in worsening an already serious situation. He stated that, "The railroad would continue to deteriorate both physically and economically; its market would continue to erode; the likelihood of successfully revitalizing a smaller railroad would be reduced; and the total indebtedness incurred during this proceeding could approach $200 million dollars." (Trustee Ex. 1, p. 12). In short, the Trustee concluded that the Court has no reasonable alternative but to direct the requested embargo. Such an embargo would maintain the possibility of reorganizing the Milwaukee at a minimum risk while preserving 5,000 jobs and the Milwaukee's most effective service to shippers.

The States of Illinois, Iowa, Michigan, Minnesota, Montana, North Dakota, South Dakota, Wahsington, and Wisconsin expressed their views with respect to the requested embargo. Minnesota, North Dakota, South Dakota, and Wisconsin generally supported the Trustee's proposal on the grounds that it is necessary in view of the financial condition of the Milwaukee, will preserve the potential for reorganization of a portion of the Milwaukee, and will lead to better service on the portion of its lines which will remain in operation. Montana and Washington opposed the requested embargo and expressed particular concern with the cessation of service on the line between Miles City, Montana and Seattle, Tacoma, and Portland. They contended that the elimination of such service would have a serious adverse effect upon the economic interests of their states, and that continued operation of those lines would provide the Milwaukee with increased opportunities for the hauling of coal, grain and containerized cargo. The State of Illinois opposed the requested embargo, expressing general concern for the protection of shipper, environmental and public interests. The State of Iowa urged the complete liquidation of the Milwaukee as soon as possible, but requested that the Milwaukee's entire line be operated in the interim. Michigan expressed concern with the Milwaukee's line through Upper Michigan to Ontonagon, a line not included in the requested embargo.

The DLEA and the RED opposed the requested embargo because of its effect upon the Milwaukee's employees. The RLEA submitted statements of general chairmen of the various railway brotherhoods which represent the Milwaukee's employees, indicating that there will be substantial loss of employment on the Milwaukee as a result of the requested embargo, that this loss of employment will include many employees of advanced age and substantial seniority, and that many of those furloughed may have difficulty finding comparable employment or may be required to move long distance to find such employment. The Trustee had estimated that about half of the Milwaukee's approximately 10,000 employees would be furloughed as a result of the proposed embargo (Trustee Ex. 61, pp. 2-3). The labor representatives' testimony appears generally to support that estimate.

The Association To Save Our Railroad Employment (SORE) also opposed the requested embargo and seeks to acquire and operate the Milwaukee's lines west of Minneapolis as a new employee-owned company (SORE St., p. 2). It argued that the embargo would result in the dispersion of the Milwaukee's employees and the destruction of its revenue base and competitive position on the western lines (SORE St., p. 4), thereby jeopardizing the success of SORE's proposed new company.

The representatives of the Milwaukee and creditors generally have urged the immediate termination of all the Milwaukee's operations and the prompt liquidation of its assets. The position of the creditors is essentially that there is no possibility of the successful reorganization of any portion of the Milwaukee and that further operations by it through additional priority borrowing would unconstitutionally erode their security. On May 3, 1979, the Continental Bank filed a motion for an order directing the Trustee to embargo immediately all freight operations on the Milwaukee and to commence the liquidation of its properties. This motion was denied by the Court after the May 4, 1979 hearing (Orders No. 166 and 166A). On May 10, 1979, the Continental Bank, together with the First National Bank, Harris Bank and Girard Bank, filed a joint motion to direct an embargo of all freight operations and begin liquidation of the Milwaukee as of May 31, 1979. This motion has not been set for hearing by the Court.

The ICC opposed the requested embargo, essentially on legal grounds. It viewed such an embargo as a potential invasion of its authority under Section 77(o) of the Bankruptcy Act and 49 U.S.C. 10903 to hear and determine requests for abandonment or discontinuance[1] of rail transportation over all or any portion of a rail carrier's lines. The ICC has not questioned, or presented any evidence with respect to, the factual assertions relied upon by the Trustee to support the requested embargo or his decision as to the portion of the line to be embargoed. Nor has the ICC suggested any specific possible alternatives to the Trustee's request which may exist. Instead, it has confined itself to the assertion of its primary jurisdiction in the area of rail abandonments and discontinuances, and has requested that the Court require continued operation of the Milwaukee through December 31, 1979 while it exercises that jurisdiction.

III. *Findings of Fact*

The ICC presented the testimony of Richard J. Schiefelbein, Deputy Director for Rail Services Planning, with respect to the Commission's plans and preparations for providing directed service to shippers if the requested embargo is permitted. 49 U.S.C. 11125 provides that the ICC may direct other carriers, initially for a period of 60 days and thereafter for a period up to 180 additional days, to handle traffic available to a rail carrier which cannot transport that traffic because its cash position makes its continuing operation impossible or because transportation has been discontinued pursuant to a court order. The ICC stated it had been engaged in contingency planning for directed service since the inception of these proceedings in late 1977 (Schiefelbein St., p. 3). Those preparations were accelerated in early 1979 as a result of the Commission's awareness of the seriousness of the Milwaukee's cash situation, and have proceeded at a rapid pace since the Trustee informed the ICC of his plans on April 10, 1979 (Schiefelbein St., pp. 3-5). On May 11, 1979, the full Commission entered an order authorizing directed service for a 60 day period in the event that the requested embargo goes into effect (T. 97).[2] Prior to expiration of the 60 day period, the Commission will hold hearings for the purpose of considering continued directed service for an additional 180 days (T. 98). Under the order, the Commission would direct various carriers to service traffic originating and terminating on areas of the Milwaukee which are adjacent to the directed carrier's own line (T. 97, Scheifelbein St., p. 8). The level of service to be directed by the Commission would protect 99.4 percent of the traffic in the embargoed territory and would involve rail operations over 72 percent of the Milwaukee's track in that territory (T. 113). The cost of this service to the Government under the provisions of 49 U.S.C. 11125, is estimated to be in the area of $30,000,000 for a full 240 day period (T. 179). The Commission will be prepared to implement its directed service plan as of May 31, 1979 (T. 107, 125, 246). Section 11125(b)(4) requires that the directed carrier "hire the employees of the other carrier, to the extent that they previously provided that transportation for the other carrier, and assume the existing employment obligations . . . of the other carrier". The Commission is in accord with the Trustee's estimate that directed service will provide employment for approximately 2,000 of the 5,000 employees who would be furloughed by the MIlwaukee as a result of the requested embargo (T. 128-129, 598-599, Trustee Ex. 61, p. 3).

It has been clearly established that the Milwaukee is in the grips of a dire cash crisis, and is suffering a cash drain of approximately $500,000 per working day (T. 548); and that continued full operation of the Milwaukee through December 31, 1979 would result in losses of approximately $157,000,000 (T. 534) and would necessitate additional borrowing of $65,000,000 to $75,000,000 (T. 545). There is no available source for the additional borrowings other than first priority loans (Trustee Ex. 1, p. 6).

In determining whether such borrowings would be consistent with the purposes of Section 77 of the Bankruptcy Act, consideration must be given to the effect that the borrowings would have on the possibility of reorganization, and on the creditors. The facts of record establish that the borrowing of $65,000,000 to $75,000,000 to maintain operations over the entire line of the Milwaukee through December 31, 1979 would substantially reduce the possibility of successfully reorganizing any portion of the Milwaukee and of preserving its estate for the benefit of creditors.

The Milwaukee's rail operations have resulted in rapidly accelerating losses during recent years. In the three years of operations which preceded the filing of the instant proceeding in late 1977, the Milwaukee suffered rail losses totaling $100,000,000 on an ICC accounting basis, including losses of $28,000,000 in 1975, $23,000,000 in 1976, and $49,000,000 in 1977 (Trustee Ex. 1, p. 3, May 4 T. 107, T. 555). In 1978, the Milwaukee suffered a loss of $82,000,000 on the same basis, and the loss for the first quarter of 1979 totaled $45,000,000 (Trustee Ex. 6, pp. 1-2). The

[1] For convenient reference, the term "abandonment" will be used to indicate abandonment and/or discontinuance in the remainder of this Report unless the context otherwise indicates.

[2] References in this form are to the transcript of the hearings held on May 15 through 18. References to the transcript of the May 4 hearing will so indicate.

potential loss in the last three quarters of 1979 is estimated at $112,000,000, which would make the total 1979 loss $157,000,000 and the total loss during reorganization $239,000,000 (Trustee Ex. 6, p. 2, T. 534, T. 555–556). The estimated 1979 loss is approximately 700 percent of the 1976 loss.

The cash position of the Milwaukee has also rapidly deteriorated to the critical stage. As of May 4, 1979, the Milwaukee's books showed a cash balance of $300,000 (May 4 T. 11, 119). As of that date, the Milwaukee had between $4,000,000 and $5,000,000 in past due invoices, and a payroll obligation for the last half of April approaching $8,000,000 (May 4 T. 119). The Milwaukee's average cash deficit, excluding borrowing, approaches $500,000 per working day (Trustee Ex. 10; May 4 T. 118–121; T. 548, and the cash deficit at the end of 1979, assuming no additional borrowing, is estimated at $81,614,000 (Trustee Ex. 10).

These losses and cash deficits have prevented and are continuing to prevent normal maintenance of the Milwaukee's physical plant and equipment. The absence of this maintenance has resulted in substantial deterioration of plant and equipment, and a consequent deterioration in service. The amount of deferred maintenance reported to the ICC by the Milwaukee in 1978 was $578,431,000, and the present maintenance level has caused an increase in this figure since it was reported (Trustee Ex. 12, p. 2; T. 556). The Milwaukee has a fleet of 504 road locomotives, and 450 of these units must be in constant operation to meet its service requirements (Trustee Ex. 12, p. 3; T. 54). On April 12, 1979, the Milwaukee had 386 operational road locomotives, and it is estimated that at the present rate of maintenance expenditures, only 322 units would be operable by the end of 1979 (Trustee Ex. 12, p. 5). To have as many as 400 operational units by the end of 1979, the Milwaukee would have to increase its maintenance-of-equipment budget for the remainder of 1979 from $52,600,000 to $64,600,000 (Trustee Ex. 12, p. 4)

The lack of maintenance on the Milwaukee's tracks has resulted in the restriction of speeds along much of its right-of-way. For example, in mid-April, 1979, the Milwaukee had 162 miles of 10 m.p.h. track between Chicago and Tacoma, 131 miles of such track between Savanna, Illinois and Kansas City, and 71 miles of such track between Chicago and Louisville (Trustee Ex. 12, p. 6; T. 662–63). Many other reduced speed areas will develop throughout the Milwaukee system during 1979 (Trustee Ex. 14). These conditions have placed the Milwaukee in a seriously adverse competitive position in certain areas. For example, its current transcontinental transit time is almost three times that of the Union Pacific and Burlington Northern schedules (Power Sup. St., p. 2). The Burlington Northern schedules service from Minneapolis to Seattle in 48 hours 40 minutes, while the Milwaukee's transit time is 137 hours (Trustee Ex. 12, p. 11; T. 503). The Milwaukee's current level of maintenance-of-way expenditures is $5,750,000 less than that necessary just to keep all the railroad in service for the remainder of 1979 (Trustee Ex. 12, p. 6). While this level of expenditure would keep the Milwaukee track serviceable, it would not prevent continued deterioration resulting in additional slow areas (Trustee Ex. 12, p. 7).

The seriousness of the deterioration of service on the Milwaukee is underlined by the statements of the interested parties. As previously noted, four states support the requested embargo despite the fact that the embargo would affect certain lines in each of these states. In addition, the State of Iowa seeks the complete liquidation of the Milwaukee, concluding that "the railroad transportation services provided by the Milwaukee must be placed in the hands of other carriers more capable of serving the public interest" (Kassel St., p. 6). The Port of Seattle, which opposes the requested embargo, noted that while rail carriers commonly advertise 4th morning service from Seattle to Chicago, the Milwaukee is providing 11 to 12 day service (Ct. Ex. 15, p. 5). The Montana International Trade Commission, which also opposes the embargo, notes that one Montana shipper has recently diverted shipment producing $1,500,000 of revenue annually from the Milwaukee to the Burlington Northern because of the "problems plaguing the Milwaukee, such as derailments." (Ct. Ex. 17, p. 3).

The deterioration in the Milwaukee's physical facilities and the resulting decline in its ability to provide service are exemplified by the decline in the amount of traffic it handles. In 1977, a year in which it lost $49,000,000 (May 4 T. 107), the Milwaukee handled 866,000 carloads. In 1978, carloads dropped to 806,000, and 1979 carloads are estimated at 725,000. The 1978 figure represents a decline of 6.9 percent from 1977, and the 1979 projection a decline of 16.3 percent (Trustee Ex. 6, p. 3).

The results of the Booz-Allen study (Trustee Ex. 65) further confirm the serious and worsening nature of the Milwaukee's condition. Booz-Allen was retained by the Trustee to evaluate the long-term potential viability of the entire railroad and of various smaller configurations of its line. In making this evaluation, it was asked to consider the operations, facility, equipment and capital investment requirements for each configuration, as well as the traffic potential and emloyee impact of each (Trustee Ex. 65, p. I-3). Ultimately Booz-Allen studied eight possible configurations for the Milwaukee. These included operation of the entire system minus low density lines as to which abandonment proceedings are either pending or likely witnin the near term, as well as the "Miles City Sub Core", which essentially consists of the portion of the Milwaukee which the Trustee proposes to continue to operate (Trustee Ex. 65, pp. III-3-4).

The study included a market analysis which was based, in part, upon a customer survey. The survey involved interviews with 72 selected customers. These customers were representative of a wide range of industries traditionally served by rail, and together account for 63 percent of the Milwaukee's present traffic (Trustee Ex. 65, pp. IV-1, 2; T. 919).

The results of these interviews confirm the Trustee's view of the present condition of the Milwaukee, and the causes of that condition. The shippers rated the Milwaukee below industry standards in equipment supply, service reliability and transit time by substantial majorities, while also indicating that the competence of Milwaukee personnel and its assistance to customers equaled or exceeded industry standards. The customers rated the Milwaukee below industry standards in equipment supply by an 84 percent margin, in service reliability by an 81 percent margin, and in transit time by a 66 percent margin. They rated the Milwaukee equal to or above industry standards in customer assistance by a 75 percent margin, and in personnel competence by a 53 percent margin (Trustee Ex. 65, Chart IV-4). Significantly, 82 percent of the shippers rated either equipment supply or service reliability as the most important factor in choosing between competing railroads (Trustee Ex. 65, Chart IV-3). These statistics clearly support the conclusion that in the absence of major increases in expenditures for the improvement of facilities and equipment, continued operation of the Milwaukee will simply result in continued erosion of its traffic base.

For each of the eight alternative configurations, the Booz-Allen study estimated the present and future traffic and market potential, plant condition and rehabilitation costs, and current and prospective operating costs, the estimates resulted in conclusions as to the potential net railway operating income (NROI),[3] and the investment commitments for rehabilitation of plant and acquisition of equipment necessary to achieve that NROI, for each configuration. These conclusions are summarized in Table 34 of Trustee Ex. 25. They indicate that with respect to the Milwaukee's entire system, exclusive of low density lines, an investment of $1,082,000,000 would be required to obtain an annual optimum NROI of $8,000,000. With respect to the "Miles City Sub Core", an investment of $189,000,000 would be required to obtain the same $8,000,000 NROI. To estimate the downside risk inherent in these investments, the Booz-Allen results, as summarized in Table 34, indicate the NROI which would be achieved in the two configurations if Milwaukee traffic did not rise above 1977 levels. With respect to the entire line such a traffic level would produce a $55,000,000 annual net railway operating loss, while the "Miles City Sub Core" would produce an $18,000,000 annual loss.

These facts establish that there is little likelihood that the entire Milwaukee system can be reorganized (T. 197). They further establish that the continued operation of that system through 1979, with the concommitant increase in priority debt of $65,000,000 to $75,000,000, would seriously jeopardize the possibility, which now appears to exist, of successfully reorganizing the most viable portion of that system (T. 503, 521).

The investment required to reorganize the entire system is enormous, the optimum return minimal, and the downside risk substantial (Trustee Ex. 65, p. VI-24). Optimum NROI would not be achieved for a lengthy period due to the massive rehabilitation required, and during this period negative cash flow would continue (Trustee Ex. 65, p. VI-22). Even assuming the optimum NROI could be obtained, the Milwaukee would continue to be a losing proposition after debt service. Moreover, the railroad might drown in its own interim losses during the prolonged period necessary to rehabilitate the system and achieve optimum NROI (Trustee Ex. 65, p. VI-23).

The possibility of reorganizing the Milwaukee on the basis of the "Miles City Sub Core", or some other variation of a markedly reduced Milwaukee system, appears to exist at the present time (T. 197). The "Miles City Sub Core", in comparison to the entire Milwaukee system, requires only a small fraction of the investment commitment, has virtually the same upside potential and only a third of the downside risk (Trustee Ex. 65, p. VI-24). The necessary rehabilitation could be achieved with relatively small cash losses for a shorter period (Trustee Ex. p. VI-22; Trustee Ex. 1,

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[3] NROI does not include debt service (Trustee Ex. I, p. 10).

p. 10). Operation of the "Miles City Sub Core" will concentrate the Milwaukee's activities in the Midwest, where it has historically been a more effective competitor, as well as in other areas where it is not at a competitive disadvantage to the Burlington Northern and Union Pacific (Trustee Ex. 1, p. 10; T. 66). It may permit partial financing of rehabilitation through the sale of assets in other areas (Trustee Ex. 1, p. 11), completion of the current 4R Act-funded track rehabilitation, further development of the currently successful sprint train experiment, and improvement of service through concertration of cars and locomotives (Trustee Ex. 1, p. 14). In view of these and other factors, the operation of a markedly reduced system centered in the Midwest would made substantial marketing opportunities immediately available to the Milwaukee and might ultimately lead to a viable railroad operation with NROI in excess of that predicted by Booz-Allen (Trustee Ex. 1, pp. 11, 12).

The viability of such a reduced system is, however, by no means assured. The prospect of an additional investment of $189,000,000 to achieve an NROI of $8,000,000 is not encouraging in view of the Milwaukee current $420,000,000 debt (T. 775). Moreover, even that level of NROI is by no means guaranteed (Trustee Ex. 1 p. 10). The NROI estimates are based on an optimistic view of the Milwaukee's ability to achieve substantial traffic gains (Trustee Ex. 65, pp. VI-6, 7), and are the result of a process which includes many estimates and judgmental assumptions (Trustee Ex. 65, p. VI-21). Booz-Allen concludes that, "it will be difficult to achieve all of the operating improvements while at the same time reorganizing the railroad, rehabilitating the plant, and recapturing the traffic" (Trustee Ex. 65, p. VI-25).

The foregoing facts lead inevitably to the conclusion that additional priority borrowing of $65,000,000 to $75,000,000 to continue operation of the entire Milwaukee system would seriously jeopardize the possibility of reorganizing the Milwaukee on any basis. The reorganization of the entire Milwaukee system appears impossible on the basis of the present record, and the reorganization of a markedly reduced system possible, but problematic. Permitting the borrowing necessary to continue operation of the Milwaukee's entire system would simply permit its already serious economic and physical condition to continue to deteriorate, resulting in worsening service to the public, and contained erosion of its market.

The additional priority borrowing necessary to continue operation of the Milwaukee through 1979 would also be detrimental to its creditors. Since the borrowing would be primarily or entirely on a first priority basis, it would reduce the assets available for payment of the creditors by its full amount, while making no positive contribution either to the railroad's current profitability or to its long term chances of success. As has been noted, such a course would simply permit the continuation of the serious economic and physical deterioration of the Milwaukee. The facts are that the current debt of the Milwaukee exceeds $420,000,000, exclusive of certain debts which the railroad cwes to its subsidiaries and of the $65,000,000 to $75,000,000 necessary to continue operation of the entire system (T. 775, 801). These sums do not take into account other costs which would be incurred if liquidation took place. Such costs would include: (1) labor protection claims which could run into the hundreds of millions of dollars (Trustee Ex. 1, p. 18; Trustee Ex. 62; T. 811); (2) possible damages with respect to the abrogation of leases and other contracts (T. 800); (3) state and local taxes accruing during the liquidation period (T. 800–801); and (4) potential administrative costs (T. 801).

There is not real suggestion on the record that the entire Milwaukee can ever be reorganized; and the proceeds of the borrowing necessary to continue operation of the entire system would immediately flow out of the Milwaukee as cash operating losses, leaving only unsatisfied debts in their wake. Permitting extensively priority borrowing under these circumstances would only postpone the inevitable crisis, while making it much more difficult to deal with that crisis when it occurs. It increases the likelihood that the outcome of that crisis would be disastrous for the creditors, as well as all others concerned, including employees.

Creditors can and should be required to incur losses during and interim period where such losses are necessary to prevent elimination of essential rail operations and to achieve a feasible alternative to such an elimination. In this instance, however, priority borrowing to continue operations of the entire Milwaukee system through 1979 is neither necessary to prevent the elimination of essential rail services nor would it contribute to the achievement of a feasible alternative. As has been concluded, the continued operation of the entire Milwaukee system would not promote, but would jeopardize, the only apparently feasible alternative for reorganizing the Milwaukee. Moreover, the ICC intends to direct other carriers to service traffic originating and terminating on the portions of the Milwaukee's system which are included within the requested embargo. Under the ICC's directed service order, 99.4 percent of the traffic in the embargoed territory would be protected for up to 240 days, and no essential rail system would be eliminated. Under such circumstances, neither of the factors might justify the imposition of losses upon creditors is present.

The eight month period during which the Commission has the power to direct service would provide time for a determination of the ultimate direction of the Milwaukee (Trustee Ex. 1, p. 14). During this period, the ICC, the United States Department of Transportation, the various state governments, the representatives of the Milwaukee's employees, and Congress could determine the nature and extent of assistance which might be made available to support the reorganization of the Milwaukee (Trustee Ex. 1, pp. 15, 16, 19). The period of directed service would also permit the Trustee's staff to determine the possibility of improving the results of a substantially reduced system, and to negotiate sales of portions of the Milwaukee lines to other carriers in a manner which will maximize job opportunities for Milwaukee employees (Trustee Ex. 1, pp. 16, 17; T. 451, 504). Undoubtedly, much must be done in a short period if the Milwaukee is to survive. The requested embargo may well serve to focus attention on the need for prompt action, while avoiding a continued drain of resources which must be preserved if the efforts of the interested parties are to bear fruit. In this connection, it should be noted that the Milwaukee has been in reorganization for almost 1½ years, during which the Trustee has made his view of the Milwaukee's needs and problems known to federal and state officials, as well as the public (Trustee Ex. 1, p. 6). During this period, little of benefit to the Milwaukee has been forthcoming.

IV. *Objectors' Factual Contentions*

The previous discussion indicates that directing the requested embargo would be in the long term interest of all concerned since it is necessary to preserve the possibility that the Milwaukee can be reorganized in the public interest. Several of the parties have, however, raised objections to the requested embargo based upon their particular interests. These concerns do not justify sacrificing or jeopardizing the possibility of a successful reorganization of the Milwaukee.

A most compelling objection to the requested embargo is made by the representatives of the Milwaukee's employees. the prospect of immediate loss of employment for approximately 3,000 employees, and the consequent disruption of their lives and their communities, is disheartening from any point of view. There is, of course, hope that some of these employees may return to work if portions of the Milwaukee are sold to other carriers or if public funds are made available in amounts and upon terms which would permit expansion of the portion of the Milwaukee system to be operated by the Trustee (Trustee Ex. 1, pp. 17, 19). Some employees will find work with other railroads (T. 429). The Court is now faced with the hard choice of directing the requested embargo, with its attendant consequences, or jeopardizing the jobs of all 10,000 Milwaukee employees and the public benefits which will be derived if the Milwaukee can be reorganized in a manner which will permit it to become an effective competitor providing adequate service to the shipping public. Only the former alternative is desirable.

SORE opposes the requested embargo because in its view the embargo will endanger the viability of its proposal to operate the Milwaukee's line from Minneapolis, Minnesota, to the West Coast as an independent company. SORE has submitted two written statements, a written copy of its proposal, and the written testimony and affidavits of J. Fred Simpson, a SORE employee who formerly was employed by the Milwaukee as a General Attorney and as an Assistant Vice President (Ct. Ex. 32-36). The Trustee questions whether the SORE proposal is feasible at all (Power Supp. St., pp. 1-10). That proposal is based on a preliminary study (Ct. Ex. 34, p. 9) and the assumptions upon which it relies are more optimistic that the data underlying the Booz-Allen conclusions. The SORE proposal is inconsistent with the Trustee's plan since both would involve operation over the Milwaukee's line between Minneapolis and Miles City, Montana, and both appear to rely to some extent on use of the same equipment (Power Supp. St., p. 5). The States of Minnesota, North Dakota and South Dakota, which would be served under either plan support the Trustee. The determination of the viability of the SORE proposal, or a choice between that proposal and the Trustee's long term plans, is, however, neither required nor appropriate at this stage. SORE's point that the embargo will result in the dispersion of some of the Milwaukee's employees, and will adversely affect its revenue based and competitive position on the lines west of Miles City, may well have some validity (Smith St. pp. 3-4; T. 44-46), although SORE acknowledges that, even in the absence of an embargo, the Milwaukee's competitive position on those lines in rapidly deteriorating (Ct. Ex. 34, pp. 22-23, 25). The potential detrimental effect of the embargo upon SORE's preliminary proposal cannot outweigh the real and immediate need to preserve the possibility of reorganizing the Milwaukee.

The State of Montana and various groups representing interests within that State have vigorously opposed the requested embargo on the ground that elimination of service between Miles City, Montana and the West Coast would adversely affect Montana's economic interests. Those giving factual presentations on behalf of Montana included: (1) Montana's two United States Senators, the Honorable John Melcher and the Honor ble Max Baucus; (2) the Montana Department of Agriculture; (3) the Montana International Trade Commission; (4) the Grain Terminal Association; and (5) the Western Energy Company. Senators Melcher and Baucus reported upon efforts being made in Congress to provide federal assistance to the Milwaukee. It is apparent that these Senators are making every effort to secure such assistance and that such assistance, if forthcoming, would represent a major contribution to the Milwaukee's reorganization. It is also apparent, however, that such assistance in the form of grants or subordinated loans is neither imminent nor assured, and can't be relied upon in dealing with the Milwaukee's immediate crisis. No bill to provide a grant or a subordinated loan to the Milwaukee has yet been approved by a full Committee of either the House or the Senate (T. 79-80), and a letter from the Honorable Harley O. Staggers, Chairman of the House Commerce Committee, presented in open Court by Senator Melcher, indicates that the Commerce Committee will be considering the problems of the Milwaukee "in the next several months" (T. 70-71).

The other Montana representatives discussed the problems which would result if service provided by the Milwaukee ceases. Under the requested embargo, however, the Milwaukee would continue service east from Miles City, and directed service would protect all other significant Montana traffic (White Supp. St., pp. 3-4). While the Montana representatives emphasized the need to preserve the Milwaukee as a competitor with the other railroads operating in Montana, their testimony indicates that the Milwaukee is not currently providing effective competition in that State. For example, although the 14 grain elevators operated by the Grain Terminal Association in Montana which are served by the Milwaukee could tender 4,000 cars of freight per year to the Milwaukee, more than half of all such grain shipments are trucked becuase the Milwaukee does not provide "a viable service of transportation" (Ct. Ex. 11, pp. 1-2; T. 286). Only 10 to 15% of the grain movement from Montana is currently handled by the Milwaukee (T. 232, 298, 963-64). The Milwaukee is currently providing transportation for only one coal producer in Montana, and the tonnage involved is less then 4 percent of the total coal tonnage shipped from Montana by rail (Ct. Ex. 16, pp. 3-4; T. 363). This coal movement is eastward over lines the Milwaukee would continue to operate under the requested embargo (T. 368).

The State of Washington objected to the requested embargo on grounds similar to those raised by Montana. As in the case of Montana, directed service in Washington would protect all important Washington traffic (White Supp. St., pp. 1-3). Moreover, the Milwaukee's current ability to compete effectively in Washington is also questionable, Milwaukee transit times to and from Wshington are triple those of its competitors, and "the deteriorating condition of the carrier over the last 2-3 years" "makes it unlikely that the Milwaukee Road could expect to attract its historical share of traffic." (Ct. Ex. 15, pp. 5-6; T. 349).

V. *Conclusion of Law*

The principal legal issue posed by the Trustee's petition is whether an order directing the requested embargo would exceed the Court's jurisdiction and invade the province of the ICC Section 77(o) of the Bankruptcy Act provides that the bankruptcy court may authorize abandonment of portions of a debtor railroad's lines. The Section further provides, however, that, in the event the abandonment is of the type which requires ICC approval under 49 U.S.C. 10903, it may not be carried out without such approval. Several of the opponents of the petition argue that the requested embargo is, in fact, the type of abandonment which requires ICC approval, and cannot be authorized since no such approval has been obtained.

The Trustee contends that the requested embargo is not an abandonment at all, but is, instead, the type of emergency embargo which a railroad may unilaterally declare pursuant to 49 C.F.R. 1006.1 (renumbered 49 C.F.R. 10591; Fed Reg, Vol 43, No 3, pp 972-973) Section 1006.1 embargoes involve temporary suspensions of service in instances where compelling circumstances beyond the railroad's control render it unable to provide rail service to or from any territory. They differ from abandonments covered by 49 U.S.C. 10903, since abandonments involve a voluntary cessation of services which the railroad intends to be permanent.

The Trustee argues that the requested embargo is neither voluntary nor permanent. He asserted that the need for the embargo arises from the inability of the Court to authorize additional priority borrowing to continue operation of the entire system, and the Milwaukee's resulting lack of cash to fund further operations. The Trustee believes that authorizing the additional priority borrowing necessary to maintain operation of the entire system would constitute an unconstitutional erosion of creditor security.

In arguing that the embargo is not a permanent abandonment, the Trustee indicates that substantial change may take place during the directed service period. Funds may become available to restore embargoed service through state and/or federal rehabilitation programs or through direct Congressional assistance. To the extent this does not happen, he will attempt to arrange sales of portions of the embargoed territory as operating lines. If lines cannot be sold on an operating basis, he will file abandonment petitions with the ICC.

The parties which oppose the requested embargo argue that it is neither involuntary nor temporary. They contend that the Court may constitutionally permit additional borrowing to maintain operation of the entire Milwaukee system pending the submission of abandonment petitions to the ICC and the resolution of those petitions by that body. They further argue that it is apparent that the requested embargo would be indefinite as to all lines and permanent as to many.

In the opinion of the Special Master, authorizing the additional borrowing necessary to continue operation of the entire Milwaukee system would not be proper at this time; as a result, the Trustee is without cash to operate the entire Milwaukee; and he may, therefore, put the requested embargo into effect without the prior approval of the ICC. These conclusions are not premised on a finding that the additional borrowing would necessarily constitute and unconstitutional erosion of creditors' security or that the proposed embargo is of the type which the ICC contemplated would be covered by 49 C.F.R. 1006.1. Instead, they are based on a finding that the embargo is essential if the purposes of Section 77 of the Bankruptcy Act are to be served rather than frustrated, and that granting it is authorized by the relevant statutory language and precedent.

The Court has discretionary authority to allow or disallow priority borrowing to continue losing operations of a debtor railroad. *New Haven Inclusion Cases*, 399 U.S. 392, 490-91 (1970); *Matter Of Chicago, R.I. & P.R. Co., 545 F. 2d 1087, 1090 (7th Cir. 1976).* In exercising this discretion, the Court must act consistently with the purposes of Section 77 both to preserve an ongoing railroad in the public interest and to conserve the debtor's assets for the benefit of creditors. To allow the borrowing necessary to maintain operation of the Milwaukee's entire system through 1979 would be inconsistent with both these purposes. It would preclude or seriously jeopardize the possibility of a successful reorganization while at the same time raise the possibility of unconstitutional erosion of creditor security. These circumstances dictate that the Court should exercise its discretion by refusing to allow such borrowing.

The foregoing conclusions are based entirely upon the unique factual circumstances which are set forth above. The Trustee's efforts to improve the Milwaukee's performance during the last 1½ years have been to no avail. The Milwaukee's annual losses will have increased 700 percent since 1976 if the railroad is operated through 1979, the losses for each recent year are nearly double the preceding year, the Milwaukee has virtually no cash, reorganization of the entire Milwaukee system does not appear possible, and continued operation of the entire system through 1979 would preclude or seriously jeopardize the possibility of reorganizing any portion of the Milwaukee. Borrowing to finance operations of the entire system through 1979 would raise the possibility of unconstitutionally impairing the security of the Milwaukee's creditors, while exacerbating the deterioration of the Milwaukee, postponing the inevitable crisis, and rendering that crisis unmanageable when it ultimately occurs. Authorizing the requested embargo will preserve the possibility of a successful reorganization without interrupting essential service to the public or preventing prompt resort to the ICC while service continues.

The purposes of Section 77 of the Bankruptcy Act are the preservation of an ongoing railroad in the public interest and the conservation of the debtor's assets for the benefit of creditors. The statutory objective is "that the reorganized company should, if at all possible, emerge as a 'living, not a dying . . . enterprise.' " *New Haven Inclusion Cases, supra*, 399 U.S. at 431. "With these goals in view, the statute bestowed a 'broad and general' authority upon both the court and the trustees." *Id.*, at 420-421.

One of the broad powers conferred upon the Court is the power to allow the Trustee to incur priority debt to maintain losing railroad operations during a reasonable period in which a feasible plan for continued operation of the railroad is sought. *Id.*, at 490-492. The extent to which priority borrowing will be allowed is, however, within the discretion of the reorganization court, and will not be disturbed on appeal in the absence of an abuse of that discretion. *Id.*, at 490-491; *Matter of Chicago, R. I. & P. R. Co., supra*, 545 F. 2d at 1090.

In exercising its discretion as to whether to allow priority borrowing, the likelihood of successful reorganization and the possibility of injurious consequences to creditors must be considered. Where the borrowing would not contribute to a feasible reorganization plan, would not have a beneficial effect upon the railroad's operations, and is not necessary to maintain essential transportation service, it is inconsistent with the objectives of Section 77 and should not be allowed. Thus, in *Matter of Chicago, R. I. & P.R. Co., supra*, 545 F.2d at 1091, the Court approved priority borrowing only upon specific findings that reorganization was not clearly impossible, the borrowing was essential to continued operation of the railroad, and would have a direct beneficial effect on its profitability. In *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 124 (1974), the Court stated that where a railroad is not reorganizable on an income basis within a reasonable time, "compelled continued rail operations . . . may accelerate erosion . . . through accrual of . . . claims having priority", and ". . . raise the distinct possibility that [creditors] would suffer an 'erosion taking' without . . . compensation. . . ." In *New Haven Inclusion Cases, supra*, 399 U.S. at 492, the Court stated that the rights of the creditors would not prevent priority borrowing where, absent such borrowing, "rail operations vital to the Nation [would] be jettisoned despite the availability of a feasible alternative." In *Matter of Valuation Proceedings Under Secs. 303(c) and 306 of the Regional Rail Reorganization Act*, 439 F. Supp. 1351, 1366-67 (Special Ct. 1977), Judge Friendly indicated that priority borrowing might constitute an unconstitutional taking if the creditors seek liquidation, the railroad is not reorganizable on an income basis, and the borrowing is simply to permit continued losing railroad operations while alternative arrangements are worked out.

In arguing that the Court may properly allow the borrowing necessary to operate the entire Milwaukee system, the opponents of the requested embargo place principal reliance upon the major losses imposed upon creditors during the New Haven and Penn Central reorganizations. In *New Haven Inclusion Cases*, the Supreme Court did approve the imposition of losses upon the creditors. It did so, however, primarily on the basis that the creditors there, unlike the Milwaukee's creditors, had not sought liquidation, but had consented to the continuation of the railroad in the hope of reaping gains from its inclusion in the Penn Central system. *New Haven Inclusion Cases, supra*, 399 U.S. at 492-493; *Matter of Valuation Proceedings, supra*, 439 F. Supp. at 1366. Moreover, as noted, the language in the *New Haven* case supports imposition of losses only where necessary to preserve essential rail services pending implementation of a feasible reorganization. It is true that the Penn Central sustained $851,000,000 in losses in reorganization from mid-1970 through 1973, but these losses took place prior to the reorganization court's finding in 1974 that the Penn Central was not reorganizable within a reasonable time. *Regional Rail Reorganization Act Cases, supra*, 419 U.S. at 124. Moreover, the Milwaukee is not the Penn Central in a number of respects. The incursion of losses totalling $851,000,000 by the Milwaukee during reorganization would more than dissipate the Milwaukee's assets, leaving nothing for creditors. Subsequent to 1973, the Penn Central remained alive only as a result of the infusion of several hundred million dollars in government funds between 1973 and April 1, 1976, and on that date it was conveyed to a federally created corporation. *Matter of Valuation Proceedings, supra*, 439 F. Supp. at 1376-1377. No one has suggested that such a solution is possible or desirable in the case of the Milwaukee.

Neither the New Haven nor the Penn Central reorganization proceedings provides any support for the conclusion that the Court is without discretion to refuse to permit priority borrowing to support continued rail operations where such operations would frustrate the purpose of Section 77 by precluding or seriously jeopardizing, the possibility of reorganization on an income basis.

The availability of directed service pursuant to 49 U.S.C. 11125 to protect 99.4% of the Milwaukee's traffic in the embargoed territory for up to 240 days also distinguishes this case from the New Haven and Penn Central situations. In those cases, the Courts were faced with the alternatives of permitting the cessation of shipping services vital to the national interest or of requiring lengthy continued operation of the carriers during which substantial physical and economic erosion of their estates would take place. The Courts necessarily chose the second alternative, and, in both cases, the result was that the railroads could not be reorganized on an income basis in accordance with the objectives of Section 77. In this case, the availability of directed service eliminates the necessity of compelling the debtor to continue its entire operation to insure maintenance of transportation vital to the Nation. That necessity undoubtedly contributed heavily to the result in the New Haven and Penn Central situations. Its absence here permits a third alternative which, unlike the other two, is in keeping with the purposes and objectives of Section 77. This alternative is to utilize directed service to conserve resources essential to the possibility of a successful reorganization, while service to the public continues and a reorganization plan is developed.

Permitting the requested embargo under the circumstances of this case would not be contrary to the requirements of Section 77(o) of the Bankruptcy Act, and would not infringe upon the ICC's jurisdiction under 49 U.S.C. 10903. Section 77(o) prohibits reorganization courts from authorizing only those abandonments which require ICC approval under Section 10903, and the Trustee's requested embargo is not such an abandonment. In view of the impropriety of authorizing the borrowing necessary to maintain operation of the entire system, the Trustee simply does not have sufficient cash resources to operate that system beyond early June. It follows that the Trustee, as a result of conditions beyond his control, not only may, but must, promptly cease operation of a portion of that system.

Judge Friendly, expressing the opinion of the Special Court under the Regional Rail Reorganization Act, has twice stated that cashlessness justifies a cessation of rail operations pursuant to an order of a reorganization court because such a cessation would not constitute, an abandonment under 49 U.S.C. 10903. Initially in *In Re Penn Central Transportation Company*, 384 F. Supp. 895, 919 fn. 31 (Special Ct. 1974), Judge Friendly stated that the Special Court assumed that the requirement that an economically distressed railroad continue losing operations pending the filing of an abandonment petition with the ICC did not apply:

". . . if, after all reasonable efforts, a reorganization trustee was faced with an imminent depletion of cash that would make it impossible for him to pay current bills for wages, supplies, interline balances, and similar expenses, and still leave an amount sufficient to permit an orderly liquidation."

In Matter of Valuation Proceedings, supra, 439 F.Supp. at 1375-77, 1379 fn. 49, Judge Friendly elaborated on these comments. He stated that "a carrier *does not 'abandon'* what it is simply unable to do." *Id.*, at 1376 (emphasis added). He went on to conclude that Section 10903 could be disregarded "when cessation of operations [was] required by 'cashlessness' or other circumstances beyond a trustee's control," and such a cessation was authorized by a reorganization court. *Id.*, at 1379 fn. 49.

The opponents of the requested embargo argue that a result in accord with Judge Friendly's views would be contrary to *Palmer v. Massachusetts*, 308 U.S. 79 (1939) and its progeny—*In Re Erie Lackawanna Railway Co.*, 517 F.2d 893 (6th Cir. 1975) and *In Re Central Railroad Company of New Jersey*, 485 F.2d 208 (3rd Cir. 1973). These cases involve attempts to abandon passenger service through an order of a reorganization court without the approval of a state administrative agency having jurisdiction of the abandonment. They hold that such an abandonment is unlawful because it would impair the balance between national and state authority and dispense with the benefits to be derived from resort to the expertise of the appropriate administrative agency.

Several significant factors render the *Palmer* line of cases inapposite here. None of the cases involved the cashlessness situation which Judge Friendly discussed, and none contemplated a period during which service to the public would be maintained while resort to the appropriate administrative agency took place. Since a cessation of operations pursuant to a court order necessitated by cashlessness is not an abandonment within the purview of 49 U.S.C. 10903, there is no administrative agency with jurisdiction over the cessation. Since service to shippers in the embargoed territory may be directed for up to the next eight months, essential public services will be continued rather than abandoned. Finally, because the Court has the power to require the Trustee to resort promptly to the ICC while service to the public continues, there is no danger that the benefits to be derived from the Commission's expertise will be lost.

VI. *Recommendations*

In light of the record in this case, it appears to the Special Master that approving the Trustee's requested embargo serves the public interest far better than any other available alternative. The ICC has requested the Court to ". . . require [the Trustee] to apply to the Commission for authority to discontinue operations over the lines embraced within the proposed embargo notice", and thereby to require ". . . . the estate of the Milwaukee to continue providing services for a reasonable period of time during which not only the Commission but all other affected public agencies would have an opportunity to come up with a solution in the public interest" (ICC Br., p. 6). Approving the Trustee's request would meet these objectives and would also have many other benefits not otherwise obtainable.

(a) It would avoid unnecessarily depleting essential resources of the Milwaukee during the period in which time consuming ICC hearings would take place, and thereby enhance the possibility that a successful reorganization can be achieved.

(b) It would preserve the ICC's opportunity to apply its expertise to the solution of the Milwaukee's difficulties while 99.4 percent of all traffic on the embargoed territory is protected by directed service.

(c) It would diminish the possibility of an unconstitutional erosion of creditor security.

(d) It would maintain sufficient resources in the estate to enable the Court and the parties to avoid the chaos which could otherwise ensue if a successful solution to the Milwaukee's problems is not promptly forthcoming.

(e) It would diminish the threat of an ultimate cessation of operation of the Milwaukee, and a consequent termination of all of its employees.

(f) It would maximize the possibility that the purposes of the Bankruptcy Act can be achieved in this proceeding.

It is therefore respectfully recommended to the Court by the Special Master that the embargo requested by the Trustee be directed by the Court to commence at 12:01 a.m. on June 1, 1979.

It is also respectively recommended to the Court by the Special Master that the requested conditions of the ICC be included in such Order, namely:

1. That the Trustee be required to make available sufficient locomotives, cars, cabooses, worktrains and wrecker trains to directed carriers to permit them to perform directed service without unduly hampering their ability to serve their own shippers.

2. That the Trustee be required to file an appropriate application for authorization to discontinue and/or abandoned service within the embargoed territory, and that until such application is acted upon, the Trustee be prohibited from in any manner altering track and facilities within the embargoed territory without prior ICC approval.

3. The Court retain jurisdiction to enter such other and further orders which may be necessary to facilitate directed service.

The Court may also wish to give consideration to the following additional conditions:

1. That where appropriate the Trustee be required to act promptly to develop and submit to the ICC applications for the sale or lease to other carriers of portions of the embargoed territory as operating lines.

2. That the Trustee be required to act promptly to develop a plan of reorganization to submit to the ICC.

3. That the Trustee be required, and the ICC be requested, to file montly reports with the Court as to the progress of discontinuance and/or abandonment applications, sale or lease applications, reorganization plans, the status of directed service, and the effect of the embargo on employees of the Milwaukee.

Respectfully submitted,

MILTON H. GRAY,
Special Master.

Dated: May 24, 1979.

SHIPPERS INTEREST IN SAVING THE MILWAUKEE ROAD

Mr. BAUCUS. Over the past few weeks I have observed some skepticism over the possiblity that affected shippers would not contribute in any way to saving the Milwaukee Road. I do not know how much these shippers might contribute, but I do know that they tell me that they would consider contributing if they knew how much was asked of them.

To show the interest of these shippers, I am enclosing a selection of telegrams that bear directly on this point.

The telegrams follow:

"Senator MAX BAUCUS: The Louisiana Land and Exploration Company and the Burlington Northern Railroad is planning a coal development in the Bull Mountain area of Montana to develop a coal mine with the potential of up to 2 million tons perannum.

"In this regard we are interested in pursuing a plan for continued operation of the Milwaukee Railroad including such arrangements as employee ownership of the railroad.

"Additional information on our development can be supplied upon your request.

"FRED J. KNABE,
"Manager Marketing."

BUTTE, MONT.,
May 17, 1979.

Hon. RUSSELL B. LONG,
U.S. Senate,
Washington, D.C.:

Re: Milwaukee Railroad Western Energy Company and Montana Power Company believe that a workable plan involving employee and shipper ownership of the Milwaukee Railroad can be developed. We are interested in pursuing such a plan. We believe that the plan will result in the continued operation of the Milwaukee Railroad, which is essential to the economy of our area and for transportation of coal to serve the energy objectives of this nation.

W. P. SCHMECHEL,
President of Western Energy Co.

MADISON, WIS.

Hon. RUSSELL B. LONG,
U.S. Senate,
Washington, D.C.:

Wisconsin Power and Light Company, a large user of the Milwaukee Road, is interested in exploring possibilities of employee/shipper ownership of that railroad. It is our understanding your office will communicate our message and that of other Milwaukee Road Shippers to the Federal court so that body can consider this development as it prepares to rule on an embargo.

JAMES R. UNDERKOFLER,
President, CEO Wisconsin Power and Light Co.

BELLEVUE, WASH.

Senator RUSSELL B. LONG,
Washington, D.C.:

We believe that a plan for continued operation of the Milwaukee Road with employees and shippers should be pursued. Loss of the Milwaukee western facilities could result in significant effects on regional energy transport.

JOHN W. ELLIS,
President, Puget Sound Power and Light.

HURON, S. DAK.

Senator RUSSELL B. LONG,
U.S. Senate,
Washington, D.C.:

We urge that Congress explore ways in which to provide short term grants and long term low interest loans to help keep in operation the vital transportation service provided to this Nation by the Milwaukee Railroad.

We are interested in having pursued all plans possible for continuing operation of the Milwaukee Railroad including ownership of the line by employees of the railroad.

Continued service by the Milwaukee Railroad is important to the citizens and economy of the entire Nation as well as the State of South Dakota.

A. S. SCHMIDT,
President, Northwestern Public Service Co.

BISMARCK, N. DAK.

Hon. RUSSELL B. LONG:

It is very important for Montana-Dakota Utilities Co., and our customers in a 4-State area that the Milwaukee Railroad continue operation. We are interested in an employee-shipper ownership plan if that will keep the railroad going.

DAVID M. HESKETT,
Chairman of the Board and Chief Executive Officer.

RAPID CITY, S. DAK.

Senator RUSSELL B. LONG,
Senate Building,
Washington, D.C.:

We strongly support the concept of pursuing a plan whereby employee and shipper ownership could be developed to continue the Chicago Milwaukee rail service particularly as it effects deliveries within the State of South Dakota. It is our understanding that this plan is under consideration and it bears your most serious consideration.

LARRY M. OWEN, *Vice President, Administration,*
Black Hills Power and Light Company.

GREAT FALLS, MONT.

Senator RUSSELL LONG,
Senate Office Building,
Washington, D.C.:

If the present Milwaukee Railroad management cannot or will not continue to operate their lines west to the coast I would strongly urge that the Senate support the alternate plan for a purchase and operation of the lines by the employee shipper group. If the Milwaukee western operation is abandoned Montana will be without rail competition and many important grain shipping points will be without rail service.

WALTER V. HICKS,
Manager, Great Falls Shipping Association.

GREAT FALLS, MONT.

Senator RUSSELL LONG,
U.S. Senate,
Washington, D.C.:

We are interested in an employee-shipper owned railroad from Minneapolis to Portland, Oregon, to take over the Milwaukee tracks.

DUANE A. OLSON,
Montana Traffic Manager.

RAYTOWN, MO.

Senator LONG,
Washington, D.C.:

Ninety days for the Milwaukee road employee ownership.

T. D. CARTER.

KREMLIN, MONT.

Senator RUSSELL LONG:

We need the Milwaukee Railroad in Montana and very interested in employee owned and shipper owned rail line in Montana.

BOB KOUYNIK,
Manager, Farmers Union GTA Elevator.

TOWNSEND, MONT.,
May 22, 1979.

Sen. RUSSELL LONG,
U.S. Senate, Washington, D.C.:

We the Broadwater County Farm Bureau in Townsend, Montana urge you to support the effort by the employers and the shippers to purchase the Milwaukee Railroad.

PEGGY FLYNN, *Secretary.*

INVERNESS, MONT.,
May 18, 1979.

Sen. RUSSELL LONG,
Senate Office Building, Washington, D.C.:

We need the Milwaukee Railroad in Montana and are very interested in an employee owned and shipper owned rail line in Montana.

JIM SCHAEFER, *Farmers Union GTA.*

HUNTLEY, MONT.,
May 18, 1979.

Sen. RUSSELL LONG,
Senate Office Building, Washington, D.C.:

We need the Milwaukee Railroad in Montana and are very interested in an employee-owned and shipper-owned rail line in Montana.

FARMERS UNION GTA ELEVATOR.

GUILFORD, MONT.,
May 18, 1979.

Sen. RUSSELL LONG,
Washington, D.C.:

We need the Milwaukee Railroad in Montana and are very interested in an employee owned and shipper owned rail line in Montana.

KENNEDY D. THUNE, *Manager, GTA Elevator.*

FAIRFIELD, MONT.,
May 18, 1979.

Senator RUSSELL LONG,
U.S. Senate,
Washington, D.C.:

We need the Milwaukee railroad in Montana and are very interested in an employee owned and shipper owned rail line in Montana.

A. H. BERG, *Manager.*

CHESTER, MONT.,
May 18, 1979.

Senator RUSSELL LONG:

We need the Milwaukee railroad in Montana and are very interested in an employee owned and shipper owned rail line in Montana.

GTA ELEVATOR.

POWDERVILLE, MONT.,
May 19, 1979.

Senator RUSSELL LONG,
U.S. Senate,
Washington, D.C.:

We support shippers and employees as owners of the Milwaukee Railroad.

PETE AND MARY HILL, *Shippers.*

FAIRFIELD, MONT.,
May 24, 1979.

Senator RUSSELL LONG,
Washington, D.C.:

Northwest area wife ask your support JSR81. Detrimental to Montana agriculture economy to lose Milwaukee.

JO BRUNNER, *Northwest Area Spokeswoman.*

HINGHAM, MONT.,
May 21, 1979.

Senator RUSSELL LONG:

We need the Milwaukee Railroad in Montana and are very interested in an employee owned and shipper owned rail line in Montana Grain Terminal Assn., Hingham, Mont.

CARL YOUNCE.

FORSYTH, MONT.,
May 21, 1979.

Senator RUSSELL LONG:

We support the efforts of employees and shippers to purchase the Milwaukee Railroad.

GEORGE T. ASAY, *Shipper.*

LEWISTOWN, MONT.,
May 18, 1979.

Senator RUSSELL LONG,
Senate Office Building,
Washington, D.C.:

We need the Milwaukee Railroad in Montana and are very much interested in an employee owned and a shipper owned rail line in Montana.

HENRY MCDUNN, *Manager, GTA Terminal.*

WINIFRED, MONT.,
May 18, 1979.

Senator RUSSELL LONG:

We need the Milwaukee Railroad in Montana and we are very interested in an employee owned and shipper owned rail line in Montana.

PAUL SIELSTAD, *Manager, GTA Elevator.*

THREE FORKS, MONT.,
May 18, 1979.

Senator RUSSELL LONG,
Capitol One, D.C.:

We need the Milwaukee Railroad in Montana are very interested in an employee owned and a shipper owned rail line in Montana Farmers Union, GTA Three Forks, Montana.

FARMERS UNION GTA ELEVATOR.

RUDYARD, MONT.,
May 18, 1979.

Senator RUSSELL LONG,
Capitol One, D.C.:

We need the Milwaukee Railroad in Montana and are very interested in an employee owned and shipper owned rail line in Montana.

FARMERS UNION GRAIN TERMINAL ASSOCIATION.

CUT BANK, MONT.,
May 18, 1979.

Senator RUSSELL LONG:

We need the Milwaukee Railroad in Montana and are very interested in an employee owned and shipper owned rail line in Montana.

NORMAN O. JOHNSON.

MOORE, MONT.,
May 18, 1979.

Senator RUSSELL LONG:

We need the Milwaukee Railroad in Montana very interested in an employee owned and shipper owned rail line in Montana respectfully.

RAY KING.

BIG SANDY, MONT.,
May 18, 1979.

Senator RUSSELL LONG,
Washington, D.C.:

We need a Milwaukee Railroad in Montana and are very interested in an employee owned and shipper owned line in Montana.

TOM WORSLEY.

SHELBY, MONT.,
May 18, 1979.

Senator RUSSELL LONG,
Capitol One, Washington, D.C.:

We need the Milwaukee Railroad in Montana and are very interested in an employee owned and shippers owned rail line in Montana.

J. HULTIN, *Farmers Union Grain Terminal Association.*

GERALDINE, MONT.,
May 18, 1979.

Senator RUSSELL LONG,
Washington, D.C.:

We need the Milwaukee Railroad in Montana and are very interested in an employee owned and shippers owned rail line in Montana.

FARMERS UNION GTA.

BILLINGS, MONT.,
May 18, 1979.

Senator RUSSELL LONG:

We need the Milwaukee Railroad in Montana and are very interested in an employee owned and shippers owned rail line in Montana.

FARMERS UNION GTA LINE ELEVATOR.

The ANACONDA Company 555 Seventeenth Street
Denver, Colorado 80217
Telephone 303 575-4323

Ralph F. Cox
President

June 2', 1979

The Honorable Max S. Baucus
United States Senate
5327 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Baucus:

We at Anaconda are most appreciative of your continuing leadership in efforts to preserve freight operations on the existing lines of the Chicago, Milwaukee, St. Paul and Pacific Railroad Company. As you know, the proposed embargo of "the Milwaukee's" freight operations would negatively impact the economy of all of the states presently served by the line. We, of course, have a special interest in Montana, and we feel that it is not only important to preserve the services but also the jobs and the competition that occurs because of "the Milwaukee's" presence.

We are pleased, therefore, to commit to a $50,000 contribution to the "New Milwaukee Fund," in the hope that the new interim organization will be able to lay the groundwork for the establishment of continued railroad service to Montana and the other states with Milwaukee Railroad trackage.

Although we will not be as heavily affected as many other shippers, we want to do our part and to join with you in this vital effort. We cannot, at this time, make a long term commitment until details are known about proposals to continue the railroad's operations. We do, however, want to make sure every feasible opportunity is studied carefully and our participation is for this express purpose.

We understand that the hearings will be held before your Subcommittee on Oversight of the Internal Revenue Service of the Senate Finance Committee on Thursday to discuss the future of the Milwaukee Railroad. We will have a representative at the hearing, ready to assist if need be in what we hope proves to be a highly successful effort.

Sincerely yours,

Ralph F. Cox

Ralph F. Cox

RFC/cls

Bill: Milwaukee file.

LAW OFFICES OF
WICKWIRE, LEWIS, GOLDMARK
& SCHORR

WILLIAM H BLOCK
THOMAS J. BREWER
DAVID C CROSBY
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500 MAYNARD BUILDING
SEATTLE, WASHINGTON 98104

(206) 622-9603

June 15, 1979

The Honorable Max Baucus
United States Senate
1107 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Milwaukee Railroad Reorganization: Lines West

Dear Senator Baucus:

Thank you for inviting us to join you in Butte today. Steve Browning of your office has asked us to outline the activities that we believe are now required to salvage the Milwaukee's western lines. The discussion that follows represents our thoughts in that regard.

Although Judge McMillen refused to grant Trustee Hillman's petition for an order embargoing service on the Milwaukee's western lines, the future of those lines remains precarious at best. Before resigning, the Trustee initiated an appeal of the Court's decision that will be briefed during the coming summer and argued early next fall. Moreover, the creditors presently have appeals pending challenging the propriety of the $15 million borrowing application that was approved by the Court during the month of May. The creditors, almost surely to be joined by the shareholders, are also planning a new appeal should the Court grant permission for the Trustee to borrow any additional funds to maintain operations during the summer. Further, a renewed embargo petition should be expected at any time "cashlessness" can be more firmly established by the railroad. Although short-term congressional relief seems possible in the event such a petition were granted or Judge McMillen's current order denying an embargo reversed, recess and floor schedules for the remainder of the year could fatally delay legislative action.

Additionally, we have been advised by Bill Brodsky that some portions of the Milwaukee's western lines require rehabilitation that must be completed by the end of October, if service is to be provided this coming winter.

The tasks that we believe are necessary to accomplish any successful reorganization of the Milwaukee's western lines must therefore be begun, and completed, during a very short period of time.

These efforts can be collected under four basic headings: (1) litigation, (2) corporate organization, (3) representation before government agencies, and (4) legislative activity.

1. Litigation. Efforts must be maintained in the Reorganization Court in Chicago, and on appeal to the United States Court of Appeals for the Seventh Circuit, to respond to the Trustee's appeal of the order denying the embargo of Lines West, the creditors' motions and appeals challenging additional borrowing, and also to combat efforts to dispose of assets critical to the future viability of the western lines. Additionally, the resignation of Trustee Hillman raises issues that should be pursued in the Reorganization Court context.

Further, the recent decision of the Trustee to seek formal abandonment of all of the lines west of Miles City will create a wholly new litigation proceeding -- before the ICC -- in which representation of western interests will be necessary. You should also know that we have recently been informed by counsel for the Trustee that a preliminary reorganization plan is in preparation which will apparently be filed as soon as it is ready, probably by mid-summer. This event will trigger additional proceedings before the ICC as to the propriety of the proposed plan.

2. Corporate Organization. If the Milwaukee's western lines are to be reorganized as a viable operation, a new railroad corporate entity should be created shortly. Capitalization must comply with federal and state securities laws. The Employee Stock Ownership Plan (ESOP) needs to be developed. Negotiations should be continued with the Trustee and undertaken with the creditors and shareholders as to the terms of purchase.

3. Liaison With Government Agencies. The new corporate entity, in addition to complying with SEC and state securities registration requirements, must also initiate and vigorously pursue an application for a certificate of public convenience and necessity before the ICC. Further, the basic feasibility studies already being conducted under the auspices of the Department of Transportation (DOT) must be given thorough attention. Additionally, loans for rehabilitation and to cover initial operating losses must be obtained from DOT. Loans to initiate the ESOP must be guaranteed by the Economic Development Administration and/or the Farmers Home Administration. Preliminary contracts with each of these agencies indicate that although favorable disposition of these myriad requests is possible, skillful representation and much hard work will be required. Finally, it should be noted that any replacement for Trustee Hillman selected by the Court must be approved by the Interstate Commerce Commission. In our view, it would be desirable for Montana's interests in this regard to be effectively represented to the Commission.

4. Legislation. The emergency relief resolution which the Senate has already passed must remain positioned for quick enactment. Consideration should also be given to broadening the resolution's scope to accomplish other objectives, if necessary. Careful attention must be given to the Senate and House floor and recess schedules. Additionally, the appropriations process should be monitored for opportunities to direct federal spending, if required.

In our view, it is essential that the efforts outlined above be undertaken and pursued as expeditiously and vigorously as possible. It should be evident that the successful reorganization of the Milwaukee's western lines is a complex undertaking requiring simultaneous and urgent action on a number of fronts. And although some institutional framework for coordinating these efforts seems desirable, the creation of an organization should not delay or impair critical substantive efforts.

Very truly yours,

WICKWIRE, LEWIS, GOLDMARK
& SCHORR

Yale Lewis

O. Yale Lewis, Jr.

Participants in Milwaukee Road Shippers Meeting, Butte, Mont.

SATURDAY, JUNE 16, 1979

A. S. Kane, Knife River Coal Mining, 1915 N. Karancy Drive, Bismarck, ND 58501—(701) 223-1771.
Joseph Maichel, Montana Dakota Utilities, Bismarck, ND 58501—(701) 224-3424.
Jim Murphy, Western Energy Co., Butte, Montana 59701—(406) 723-5421.
D. Kissner, 917 W. Silver, Butte, Montana 59701—(406) 792-0321.
George D. McCarthy, Old West Regional Comm., 1730 K Street N.W. 20006—(202) 634-3907.
Newell B. Anderson, Office of Commerce, Helena, Montana 59601—(406) 449-3923.
Ray Dore, 422 Albert Street Helena, Montana 59601—(406) 449-3111.
Terry Whiteside, Dept. of Agriculture, Helena, Montana 59601—(406) 449-3124.
Gordon McOmber, Dept. of Agriculture, Helena, Montana 59601—(406) 449-3144.
Chris Johansen, MCFRA, Great Falls, Montana 59401.
John Craig, Dept. of Highways, Helena, Montana 59601—(406) 449-3984.
Tom Templeton, MGGA, Great Falls, Montana 59401—(406) 761-4596.
Martin A. White, 40 E. Broadway, Butte, Montana 59701—(406) 723-5421.
Steve Browning, 1107 DSOB 20510—(202) 224-2651.
Dan Rovig, Anaconda Company, Box 688, Butte, Montana 59701—(406) 723-4311.
Steve Foster, Anaconda Company, Box 688, Butte, Montana 59701—(406) 723-4311.
Jack Burke, 40 E. Broadway, Butte, Montana 59701—(406) 723-5421.
Gerry Johnson, 500 Maynard Bldg., Seattle, Washington 98104—(206) 622-9603.
Yale Lewis, 500 Maynard Bldg., Seattle, Washington 98104—(206) 622-9603.

[From the Wall Street Journal, July 6, 1979]

Milwaukee Road Plans Abandonment Request for Lines in Far West

(By a Wall Street Journal Staff Reporter)

CHICAGO.—The Milwaukee Road said it plans to file a formal application to abandon the road's lines west of Miles City, Mont., and a map showing that the entire system is subject to abandonment over the next three years with the Interstate Commerce Commission.

The filings are in conformance with ICC regulations for the abandonment of rail lines.

Officially known as the Chicago-Milwaukee, St. Paul & Pacific Railroad, the Milwaukee has been in bankruptcy proceedings since December 1977.

In filing the applications with the federal agency, the road emphasized that the actions don't signal a stoppage of service in the immediate future. "We are beginning the formal process of presenting to the ICC our case that, west of Miles City, the Milwaukee is neither economically self-sustainable nor commercially necessary," an attorney for the road said.

Two weeks ago, federal Judge Thomas R. McMillen ordered the Milwaukee's trustee to begin the necessary paper work to get ICC approval to close down the entire system.

[From the Huron, (S. Dak.) Daily Plainsman, June 21, 1979]

An Employee Solution

A former Huronian, now president of an investment corporation in La Jolla, Calif., who has been retained to represent an employee group seeking control of the Milwaukee railroad, makes a convicing argument for an employee takeover of that ailing rail line.

Adrian Parmeter, who once worked in the Northwestern switch yards here, has the job of convincing congressmen that the Milwaukee Road can be operated successfully under new management, and that employees and shippers can generate enough equity capital to buy the line. He has some interesting points.

One is that the Milwaukee has assets worth more than twice its liabilities and that these assets include prime timberland that could easily be converted to cash. Another is that the railroad has overstated its losses, and that its operating losses are not as high as claimed. And finally that the traffic to support the main line to the West Coast is already in place in quantity to provide for a profitable main line operation.

Parmeter claims there are three groups that would like to see the Milwaukee line liquidated. They are the creditors. Basically Chicago banks who hold long-term notes a 3½ percent interest; large stockholders who might realize gains of as much as 1600 percent if the line were liquidated; and competing railroads who might pick up choice segments of the rail lines and who would just as soon see a competitor removed from the scene.

Those who would like to keep the Milwaukee intact include long-time employees, shippers who want to maintain a competitive main line railway to the West Coast and political leaders of states such as South Dakota where service might be adversely affected by any change.

The employee group is attempting to broaden its base of support. An organization called Milwaukee Lines West Corporation has been formed. The group is seeking labor, business and government representatives from each of the affected states. That group will be attempting to generate both political and financial support for employee ownership.

The group hopes to be able to move quickly enough to take over the ownership and operation of the line yet this year if given the opportunity.

Meanwhile the U.S. Department of Transportation has retained a private consultant to examine the employee proposal. And the Senate and House Transportation Committees have already exerted some pressure on the case. As the ranking Republican member of the Senate Surface Transportation subcommittee, South Dakota's Sen. Larry Pressler should be in a position of influence.

South Dakotans who have witnessed the successful employee operation of the Chicago & Northwestern line should support the same sort of an arrangement for the Milwaukee if the employee group can prove its ability. The entire state has a stake in the ultimate disposition of that railroad.

Senator Baucus. Finally, let me thank you very much. You have been patient all afternoon. I want to thank you for your help. Thank you.

[Whereupon, at 4:40 p.m., the subcommittee recessed, to reconvene at the call of the Chair.]

EMPLOYEE STOCK OWNERSHIP PLANS FOR RAILROADS

FRIDAY, JULY 20, 1979

U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT OF THE
INTERNAL REVENUE SERVICE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 3:05 p.m. in room 2221, Dirksen Senate Office Building, Hon. Max Baucus, chairman of the committee, presiding.

Present: Senator Baucus.

[The press release announcing this hearing follows:]

[Press Release, July 16, 1979]

COMMITTEE ON FINANCE, U.S. SENATE,
SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE.

FINANCE SUBCOMMITTEE ON OVERSIGHT OF THE INTERNAL REVENUE SERVICE SETS ADDITIONAL HEARINGS ON THE AVAILABILITY OF EMPLOYEE STOCK OWNERSHIP PLANS (ESOP'S) AND SHIPPER STOCK OWNERSHIP PLANS (SSOP'S) FOR THE CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD CO. (MILWAUKEE ROAD), AND THE POSSIBILITY OF PROVIDING FOR INTERNAL REVENUE SUPERVISION OF THESE PROGRAMS

Senator Max Baucus (D.-Mont.), Chairman of the Subcommittee on Oversight of the Internal Revenue Service of the Senate Committee on Finance, announced today that the Subcommittee will hold a second hearing on July 20, 1979, on the applicability of the Internal Revenue Code provisions regarding employee stock ownership plans to the Milwaukee Road and the possibility of revising these provisions to promote adoption of these plans by railroad employees and shippers and for Internal Revenue Service Administration of them.

The hearing will be held in Room 2221 Dirksen Senate Office Building and will begin at 3 p.m.

In announcing the hearings, Senator Baucus stated that at the earlier hearing the Subcommittee had received testimony from shippers who depended upon the services of the Milwaukee Road, Federal agency officials who would supervise the adoption of an ESOP and an SSOP by the Milwaukee Road and assist in their funding, and experts in the field of broadening stock ownership. This hearing will be directed at receiving testimony from representatives of the employees of the Milwaukee Road. In addition, testimony may be received regarding certain Department of Transportation (DOT) studies on the future viability of the Milwaukee Road.

Legislative Reorganization Act.—Senator Baucus stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress, "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on lettersize paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Committee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

Written Testimony.—Senator Baucus stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies *by July 23, 1979,* to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

Senator BAUCUS. The Subcommittee on Oversight of the Internal Revenue Service will be in order.

This is the second in a series of hearings to examine the feasibility of an employee and shipper stock ownership plan for the Milwaukee Road.

At our first hearing on June 21, we heard from technical experts, from representatives of Milwaukee shippers and the regional commissions, and from representatives of Federal agencies which may be in a position to assist in the employee and shipper ownership effort.

We have two additional witnesses today. Mr. Jim Snyder, legislative director of the Rail Labor Executive Organization, will discuss the efforts rail labor is making to advance this effort.

Mr. Mike Fitzgerald, a director of Milwaukee Lines West, will discuss that organization and its plans.

The Department of Transportation will soon submit to the Congress several studies of the Milwaukee Road and its operations. This subcommittee intends to schedule another hearing in the very near future to discuss these studies and their relevancy to employee and shipper stock ownership plans.

Before turning to our first witness, I would like to give a few of my own personal observations on the progress made in various quarters on saving the Milwaukee Road.

For some time now, I, along with a number of my western colleagues have expressed concern about the need to save the Milwaukee Pacific coast extension. My interest in this, understandably, is that Milwaukee western lines serve the State of Montana.

From a national perspective the fact that these lines traverse the world's largest known coal deposits suggests that some pause should be given before Federal courts and Government agencies permit abandonment.

The only way that we can achieve the President's goal of shifting from oil to coal as an energy source is to develop a strong, viable transportation system.

Several months ago, the Milwaukee Road trustee proposed the abandonment—or in his words, embargo—of the Pacific coast extension west of Miles City. Although Judge McMillen's decision in late May refused this embargo, it is clear that the Milwaukee management continues to pursue the same course.

I can attest that the representatives from States served by the proposed core are becoming increasingly restive because a long delay over the determination of what to do with the western lines may ultimately cause the demise of the core.

Accordingly, proposals that would permit an expedited abandonment of the western lines and a rapid reorganization of the core have been advanced.

I know of no one—except perhaps for scrap iron dealers and perhaps other competitive transportation carriers—who would like to see the entire road continue, providing, of course, that it can operate on a profitable basis without continuing financial support from Government.

As I have made clear before, given current economic constraints in the Nation and an emerging political will to balance the Federal budget, I do not think that Congress will support a Federal bailout of the Milwaukee. In other words, I do not see a western "ConRail." Such a solution would cost too much and would not be acceptable, in my judgment, to Congress.

I would hope that the witnesses would address the current political situation wherein we have three groups: namely, core supporters, western lines supporters, and whole railroad supporters.

I draw this distinction primarily because our first witness represents virtually all the nonsupervisory employees of the Milwaukee Road—both in the core area and on the western lines. Our second witness will be talking primarily—but not exclusively, I hope—about the progress toward a western lines solution.

Personally, I do not think their interests necessarily conflict. Indeed, it seems to me possible that the core and the western lines could be reorganized independently and then an ultimate solution worked out for a combination of the two.

I would hope that the witnesses would assist me in seeing how the various interests can be made to coincide.

I have one final thought to express before turning over the discussion to Mr. Snyder.

I am continually struck by the metaphors used by the trustee and the current management of the Milwaukee. When referring to the railroad, their descriptions frequently include that of a "sick patient," or an "invalid." Only yesterday, I heard the railroad referred to as "a patient in an iron lung, waiting to have the plug pulled."

I agree that the Milwaukee is sick. However, I do not think the iron lung analogy is quite accurate.

I do not view the Milwaukee as a patient in an iron lung—with scrap dealers calculating the value of selling the lung.

Rather, the Milwaukee Railroad is more like an alcoholic suffering from a 20-year binge. All of us know that an alcoholic on a bender refuses all sustenance except what comes from a bottle.

According to the witnesses who have testified before me earlier, the management of the Milwaukee Road has refused to provide the nutrition needed to keep the railroad fit. It has declined both physically and financially.

But all of us have known alcoholics who have finally seen the light and changed their lives.

I look forward to a Milwaukee Road that swears off the booze and moves aggressively to restore the vitality needed to continue essential services.

But enough of unhealthy metaphors; let's get down to facts.

I would like to call now on Mr. Jim Snyder to provide an update on rail labor efforts to improve the chances of continued Milwaukee Road service.

Mr. Snyder, I cannot tell you how appreciative I am of the efforts you have undertaken in dedicating yourself to keep a strong rail transportation system in our country. It is a delight to have you before us this afternoon and you may proceed in any manner that you wish. You may read your statement or summarize it or whatever you want to do. It is good to see you.

STATEMENT OF JIM SNYDER, NATIONAL LEGISLATIVE DIRECTOR, UNITED TRANSPORTATION UNION

Mr. SNYDER. Thank you, Mr. Chairman.

On behalf of all railroad labor on the Milwaukee Railroad, I want to express to you our sincere appreciation for this opportunity to work with you and your very capable staff and the other Senators' staff, who are very much interested in the very important project.

I am delighted to have with me this afternoon on my left, Mr. Tom McGuire, who serves as alternate vice president from the western territory and general chairman on the Milwaukee Railroad, Lines East, for the United Transportation Union.

On my right I am delighted to have Mr. Jim Kennedy, national legislative counsel for the BRAC organization and also on my right, Mr. William G. Mahoney, the counsel for the Railway Labor Executive Association.

With your permission, the statement is not too long, and in as much as we have had meetings right up to yesterday afternoon late, a meeting with the House and Senate staff members regarding this issue, I guess I had better read this because I think that it will be more appropriate.

The RLEA is an association of 31 standard and international labor organizations, representing virtually all of the organized work force employed by class 1 railroads in this country. The RLEA's primary function is to promote the common interest and welfare of the hundreds of thousands of railroad workers and their families and it is with this purpose that we appear here today.

I have listed the names of these 21 associated railway labor organizations, as required by the rules of the Senate.

A large part of this work force represented by these organizations is and for generations has been employed by the Milwaukee Railroad, approximately 12,000 in number as of December 1977. These are men who are dedicated to railroad service. Many of them are second and third generation, they and their fathers and grandfathers either have spent or will spend their entire working lives in railroading.

We have been involved in a major effort to help this railroad survive, ever since its troubles began a few years ago. Our efforts were intensified at some point in mid 1978 when it became apparent that the creditors of the bankrupt estate were determined to dismember it.

As the chairman knows from his own intensive efforts to save this railroad, we are committed to do everything possible to maintain it as an intact transcontinental transportation system. We have now come to a point where either the employees and shippers join forces to acquire the entire property or a substantial part of it or they will lose all or most of it.

I am happy to report that all of the forces working in this direction have now joined in a coalition to finance a study to determine the feasibility of a takeover through means of an employee-shippers' stock ownership plan. The States, the shippers, and the railway labor organizations are in the process of raising $1,300,000 for the express purpose of financing a complete review of the feasibility, cost, and financing of the acquisition program and the manner in which it can most effectively be done.

As we see it, this will include a critical review of the Booz-Allen and Hamilton planning report and the Ford, Bacon Davis liquidation analysis and in addition, will require a resurvey of the market potential in the light of shipper commitments; as well as other factors which were not included in the Booz-Allen and Ford, Bacon Davis surveys.

In our view, the coalition study should extend to include among other things, the impact of a complete overhaul of management procedures and policies, particularly in operations and sales but in other departments as well, of employee participation and of all other elements which may contribute to the rehabilitation of the railroad in the event that we are successful in developing our program.

Our coalition study will, as we see it, address all problems connected with the takeover program, including the development of the EXOP-SSOP structure which, standing by itself, Louis Kelso said would take at least 6 months to complete. We expect that this can be done within a shorter time frame.

Also included will be the development of the acquisition program in all of its detail and of the legislative program to provide the foundation for the entire takeover operation, should it be proven to be feasible.

Working with the shippers and with the States we have begun to identify the key personnel who will take charge of this coalition survey. A substantial part of the $1,300,000 fund has been either raised or pledged and we are confident we shall raise the entire amount necessary to do this job.

Railway labor's share will match the contributions of the shippers.

Senate Joint Resolution 81, which you introduced, provides the key to the success of this venture. Its counterpart, House Joint Resolution 341 is now pending before the Rules Committee. Technical and clarifying amendments have been prepared for it and we are hopeful that the bill will be cleared by the Rules Committee in time for it to be considered by the House before the August recess.

There are other measures which, as the chairman knows, are being pressed as a substitute for House Joint Resolution 341. In various ways these competing bills would expedite the dismemberment of the railroad and unless adapted to the indispensable moratorium policies expressed in Senate Joint Resolution 81, would defeat our efforts to save this railroad for the employees, the shippers and the western economy.

The notion, implicit in these competing bills, that a substantial part of western freight service will be satisfactorily maintained by other railroads is rebutted by the fact that the Governors, the Senators, and the Representatives of the nine affected States, the shippers throughout the West, and the labor organizations are going to such great lengths to save the railroad. In fact, these groups are betting $1,300,000 that they can do this.

They, more than any other party in this entire picture, are in the best position to determine whether the continuation of this railroad is essential to the well-being of the Western part of the United States.

Any suggestion that continued operation of the railroad through the moratorium period will erode the estate to the detriment of the creditors is, we think, pure nonsense.

This is an asset-rich estate. Its liquidation value, as reported by Ford, Bacon, and Davis in its liquidation analysis, in excess of $800,000,000. Claims of creditors, excluding the Federal Government, are in the neighborhood of $300,000,000.

There thus appears to be an ample cushion of safety to assure the creditors that continued operation of this railroad will not endanger their precious dollars.

There is, of course, a cash-flow problem, which for the next month or two may be eased by the most recent ERSA loan. But should the railroad run out of cash, within the next 30 to 60 days, as the trustee's counsel says it will, the Federal court will certainly entertain a renewed motion to embargo freight over 75 percent of the system as recommended by the Federal master last month. At that point, the Interstate Commerce Commission will direct service at a substantial cost to the Federal Government and our opportunities to complete our coalition survey will be forever lost. The Milwaukee Railroad will be doomed at this point.

It is thus essential that we proceed on the coalition course which we have outlined earlier. These bills, Senate Joint Resolution 81, and House Joint Resolution 341, are essential to our million dollar effort to set the stage for the purchase of this entire railroad or a substantial part of it through the employee-shipper stock ownership plan.

The cash flow provided by section 3 of Senate Joint Resolution 81 in the form of guaranteed trustee certificates will cost the Federal Government less than the cost of directed service under the Interstate Commerce Act.

The failure of this railroad, we believe, is a management failure. Without exception, our people have told us that competitive railroad service on the Milwaukee Road can be restored if there is a complete housecleaning of management personnel and its ancient and outmoded ways of doing business with a complete turnaround in maintenance and rehabilitation. We are betting that our study will demonstrate that they are right.

The fact is that this inadequate and ineffective management downgraded service on the Milwaukee Road. It deferred maintenance until the track conditions became intolerable. Slow orders of 10 miles per hour or less on lines west have all but eliminated service on that part of this railroad. The conditions on lines east are, of course, somewhat, but not much better.

If you were to drive along a highway paralleling lines east, you would see a Milwaukee train engine appear to be lunging down its track because of the condition of the road bed.

We are told that management is following the same policies and practices that the industry has had without change for the past 100 years.

The Milwaukee Road's so-called market centers, designed to handle coal and wood products, are no more than clerical gatherings. You will recall shipper testimony in the earlier hearings before this subcommittee last month, on the complete absence of anything resembling an aggressive sales policy on the Milwaukee. One major shipper testified that at no time during the period of his relationship with his company had he ever seen a representative of the Milwaukee sales department.

There have been no contacts of any kind by the sales staff. We are told that personnel in the sales department cannot identify their customers. There is great weakness in all critical aspects of Milwaukee management such operations, purchasing, marketing, and sales.

A marginal railroad with a marginal management using ancient and outmoded management tools and techniques is a sure loser. We say change all of this, particularly in view of the market potential of the booming development of the Northwest and we will have a winner.

There are great opportunities to bring this railroad into the 21st century. It has been suggested that if our takeover program is successful, the task force concept which has been so successful wherever used can and should be applied to the area of management techniques on the Milwaukee Road. It will, of course, be available for improving Milwaukee service in all respects through experiments and demonstration.

I should perhaps explain at this point that the labor management task force concept combines the talents of labor, management, and in some cases Government and shippers in an attempt to improve railroad service, attract new railroad business and establish job security. Applying this concept to the Milwaukee Road could lead to a number of innovative cost saving and new business type alternatives.

Work could be done on branch line problems where shippers, with SSOP interests in the railroad, would commit themselves to provide a given number of boxcars to insure that rail labor and management, in providing rail service, would know annual tonnage and annual requirements.

Rail labor could, where cost savings were needed, introduce innovative concepts in serving branch lines of this type and again, with ESOP interests in the railroad, would have incentives to coordinate the use of equipment on branch lines in order to reduce shipper costs.

Similarly management, in providing a type of service on a branch line, would be in a better position to know cost and equipment requirements on a weekly, monthly or annual basis. Rail service could be tailored to meet revenue generated under this new coordinated ownership system.

Under the program, as we see it, the participating shippers would commit themselves to the use of the Milwaukee Road. They would not be free to choose alternative services. They would committed to providing a given number of boxcars.

As the task force has demonstrated, there are any number of innovations that can be introduced in the intermodal field, short, fast dedicated piggyback service can introduce more innovations with respect to crew size and fuel efficiencies.

The task force concept can be put to use in exploiting the opportunities to move grain by rail, about which much testimony was heard a few weeks ago in the hearings before this subcommittee. Experiments with short, fast trains that run around to a number of local grain elevators and grain suppliers would be attractive from a cost standpoint and from a shipper's standpoint.

Another area which must be investigated is the possibility of moving North Slope Alaskan crude oil by rail tank car on the Milwaukee Road.

Most oil movements with the United States are moved by ship or pipelines. Some petroleum products are moved by rail but at the present time all rail movement of crude oil is on a spot, rather than a unit train basis.

The current lack of unit train movements of crude oil is not necessarily indicative of the inappropriateness of this form of transportation for transporting large quantities of oil. Until recently, very little thought had been given to using unit trains for crude oil movements. Part of the lack of attention due to the fact that oil companies prefer to move oil by means of transportation which they control.

It is the total control over oil from the well to the gasoline station which gives them pricing, profit and competition advantages over independent and less integrated oil companies. Furthermore, it is only recently that special equipment has been developed and put into use which is designed to maximize the efficiency of railroad tank car transportation of bulk liquid commodities.

The United States lacks an effective transportation system for moving crude oil from the west coast inland. This deficiency is currently most evident in the surplus of North Slope Alaska crude oil on the west coast. Because there are no land transportation systems to move this surplus crude, it must be taken by tankers through the Panama Canal to gulf and east coast ports, as well as to Puerto Rico and the U.S. Virgin Islands.

While much attention has been given to the possibility of constructing one or more pipelines to carry this surplus, years of delay have created serious doubt that any one of these pipelines will ever become a reality. Even more questionable than whether a pipeline will be built is the issue of whether there will be enough surplus Alaska oil to justify the type of major capital investment which crude oil pipelines entail.

In our view, the market possibilities of moving North Slope crude oil along the right-of-way of the Milwaukee Road should be explored and will be explored by the coalition study group. With a North Slope surplus likely to continue for a long time in the future and with the doubt which attends the construction of the pipelines, crude oil movement by the Milwaukee unit train tank cars becomes all the more interesting and possible. The huge coal deposits in central Indiana and Illinois served by the Milwaukee offer strong market opportunities for future development.

The task force concept as applied in the Chicago area could be spread to include the entire Milwaukee Railroad. The application of the car-flow measurement system, developed by the task forces in Chicago, would be particularly useful to the regeneration of vitality on the Milwaukee Railroad. The application of the car-flow measurement system, developed by the task forces in Chicago, would be particularly useful to the regeneration of vitality on the Milwaukee Road. This procedure would give the railroad access to facts on car movements which it has never had.

The incentives, motivating both employees and shippers, that would result from an employee-shipper stock ownership program could lead to these various types of service innovations through the task force concept that over a period of time could turn this railroad around.

In conclusion I should like to again emphasize the absolute necessity of moving the companion to Senate Joint Resolution 81 through the House of Representatives. If and only if these bills are enacted into law, will we have the opportunity to preserve this railroad.

I wish to thank the Chairman for the time allotted to me in presenting these views on behalf of the Railway Labor Executives' Association.

Thank you, Mr. Chairman. We will be available for any questions that you may wish to ask.

[The appendix to Mr. Snyder's statement follows:]

APPENDIX

(1) American Railway Supervisors Association.
(2) Americam Train Dispatchers Association.
(3) Brotherhood of Locomotive Engineers.
(4) Brotherhood of Maintenance of Way Employes.
(5) Brotherhood of Railroad Signalmen.
(6) Brotherhood Railway Carmen of the United States and Canada.
(7) Brotherhood Railway, Airline and Steamship Clerks, Freight Handlers, Express and Station Employes.
(8) Hotel & Restaurant Employes & Bartenders Int'l. Union.
(9) Int'l. Assn. of Machinist and Aerospace Workers.
(10) Int'l. Brotherhood of Boilermakers and Blacksmiths.
(11) Int'l. Brotherhood of Electrical Workers.
(12) Int'l. Brotherhood of Firemen & Oilers.
(13) Int'l. Longshoremen's Association.
(14) Int'l. Org. of Masters, Mates & Pilots of America.
(15) Int'l. Marine Engineers' Beneficial Association.
(16) Railroad Yardmasters of America.
(17) Sheet Metal Workers' Int'l. Association.
(18) Seafarers Int'l Union of North America.
(19) Transport Workers Union of America.
(20) United Transportation Union.
(21) Railway Employes' Department AFL-CIO.

Senator BAUCUS. Thank you very much. I appreciate all the work that you have done.

As you know, the regional commissions have conditioned their support on the contributions of both the shippers and labor organizations.

Can you, as of this date, say if the RLEA has committed $300,000 to the new Milwaukee organization?

Mr. SNYDER. As of this date, as of yesterday, I have not checked with my executive secretary over here. We have had a majority of the Railway Labor Executive Association. Some of these are not affected by the Milwaukee, although they have voted an approval of such a plan as we have outlined here and we do have commitments from the majority of them and the commitments that we have, as far as the dollars are concerned, is around $175,000 at this point.

Now, it is my understanding that a meeting at which I was not present, Jim Kennedy—Mr. Kennedy over here was present at that meeting—it is my understanding that the groups affected by this would turn the fees in all and the money that they would contribute, their pro rata share attorneys' fees would come from that pro rata share where, in our case, we have committed our own attorneys and we were paying for our own attorneys. This would not come out of our committee funds, so we are pretty well in the ballpark, I think, of the commitment, when you put it on that basis.

Is that the understanding, Jim?

Mr. MAHONEY. That is accurate, yes.

Senator BAUCUS. As I understand it, Mr. Kennedy, BRAC has contributed a certain amount, an inkind contribution, not a monetary contribution. Is that correct?

Mr. KENNEDY. No. That is not correct.

Our contribution is to be in cash and on a pro rata share based upon the same procedures that we use for the RLEA quotas in breaking down our share. So that is with us and the UTU as a significant part.

Senator BAUCUS. The various labor organizations will together come up with a total of $300,000? Is that correct?

Mr. KENNEDY. That was the understanding, yes, that we would come up with a significant part of that. As to whether or not it was going to be exactly $300,000, our commitment was to try to raise the $300,000.

I think Jim Snyder has answered. As of this date, from the organizations that have answered, we have raised $175,000 of that.

Mr. SNYDER. We are still in the process of continuing to try to raise additional funds.

Senator BAUCUS. Do you have any idea of what the chances are of raising the additional $125,000 would be, and how quickly it would be available?

Mr. KENNEDY. I think, if I may, because Jim mentioned the meeting that I was at, I think that what he pointed out to you, as far as attorneys' fees, the portion of attorneys' fees that would be handled by the organizations, that would be handled by the organization themselves, that is not represented in that $175,000 figure.

Senator BAUCUS. That is correct. I understand that.

Mr. KENNEDY. It is in addition to that.

Therefore, what Jim is referring to, perhaps the total budget of $1,300,000 is a little high if we are going to handle a portion of the attorneys' fees directly and not through our total $1,300,000 budget, but in addition.

Senator BAUCUS. Jim, you have been talking to all the groups in your organization. Could you give me a little sense of the likelihood that you will be able to raise roughly $300,000? Is there any sense of how much and how quickly that would be raised?

Mr. SNYDER. To be quite honest with you, I do not think we will come up with a round figure of $300,000. Just like any other group here, we have a group that has been voting on this issue. Unless there are some changes made, some of them have voted against it.

We do have a majority that is in favor of it, and we do have at this time the commitment of the $175,000.

I doubt that with the structure that we have in the Railway Labor Executive Association that we could come up with round figures of $300,000 at this point.

What I understand is the understanding with the other groups involved—actually, this would not be necessary inasmuch as they have taken their attorneys' fees out of their pro rata share of the $300,000. They are taking the attorneys' fees where, in our case, we are paying our own attorneys and so it all balances out by the same thing.

Senator BAUCUS. In addition to national contributions, can you describe in more detail how you will be joining in saving the Milwaukee? What other efforts will you all be making?

You mentioned attorneys' fees. I am wondering the degree to which you will actively be participating on the board of the new Milwaukee West organization, for example?

I am curious as to efforts you will be making in addition to the financial contribution.

Mr. SNYDER. Bill, do you want to comment on the structure of that board?

We definitely will have labor members serving on the board as well as the shippers. I think the last makeup I saw there would be a representative from the Governors of each State involved, three from labor and three from the shippers. I believe that is the last recommendation that has been presented to us.

Right now, we are in the process of trying to get the money together.

Senator BAUCUS. I do not mean to push you, but is there any way you can tell us about how quickly you will be nominating a director or two? I do not know how many have been allocated to labor.

Mr. SNYDER. We hope to in a very short period of time. The time element is involved.

Senator BAUCUS. There is not much time involved.

Mr. SNYDER. No, sir, there is not. We hope to in a short period of time.

Senator BAUCUS. What is your view as to the scale of the employee stock ownership plan? Should it cover the entire Milwaukee system, lines west, a core system, or a portion of it?

Mr. SNYDER. Right now, I think that is the purpose of this study, to see what would be feasible and possible, realizing that some of those lines, perhaps, could not survive the employee ownership plan.

But our goal is for the entire system. As was pointed out here, the entire system. I would think that to study, in making a study, Mr. Chairman, would be in two parts, maybe three parts, that the entire system, scaled down system in the neighborhood of 7,000 or 8,000 miles, in that area, so maybe some branch lines here and there that could be abandoned and would not be a burden on developing the setup.

Senator BAUCUS. There is no doubt in anyone's mind that the preferable solution is to find a mechanism or means of saving the entire railroad.

My question really goes to what happens if—due to circumstances beyond our control, whatever they may be—a portion of the railroad moves in one direction whereas another portion of the railroad seems to be moving in another direction.

That is, a trustee may say that certain portions should be abandoned, and the courts may move in that direction.

Under those circumstances, even though the preference is to save the entire railroad would you see an employee stock ownership plan formed for only one portion as opposed to the entire system? Is that potentially viable?

Mr. SNYDER. Really, we have not gotten into that in that phase of it, in case a turn of events should develop in that direction.

I know in our position in rail labor—we have discussed this many times—we absolutely share the same views as you do on this—we are opposed to just a core system of 2,400 miles and we are also committed, I think, the membership on the Milwaukee Railroad, to try to save as much of the railroad as possible.

If these things develop like this, we are hoping—and through some of our legislation—that we can have some alternatives in there that maybe would be workable.

Bill, would you like to address yourself to some of the legislation that you are working on?

Senator BAUCUS. I only asked the question because the last trustee wanted to abandon a portion, and we may be faced with that problem.

Mr. MAHONEY. It is our hope, Mr. Chairman, that the legislation will be such as to permit this overall group to make a determination as to whether or not the entire railroad is a feasible single operation, prior to the time that the trustee can take any action to cut it up, and it has been the commitment of railroad labor to have the ESOP plan apply to the entire railroad, if possible, and we would hope that the study that comes out of this would say that it is a feasible thing to do—if it is.

The legislation now pending, we have supported it and it would permit that study to make that determination one way or the other prior to any action being taken by the trustee or the court.

If it eventuates that the study shows that the ESOP plan or some other similar alternative would not be the feasible thing as to the railroad operation, it is my understanding, at least, that the rail unions would have to take a quick look and make a decision.

Senator BAUCUS. Is it your view that the core portion can be reorganized without including the western lines?

Mr. MAHONEY. It is the position of the trustee that the only possible reorganization——

Senator BAUCUS. I know it is his. I am curious whether it is railroad labor's view?

Mr. MAHONEY. That is one of the reasons we want this study. We have had no independent—and I say that because for lack of any expertise in this field, I do not know how the Booze-Allen-Hamilton study really stacks up.

They say that it would be easier to reorganize this small subcore than it would be to reorganize larger portions.

In any event, although I think the study does say that the most profit potential is with the entire system, although the startup costs for the entire system are extremely high, I have no independent opinion about the subcore being reorganized.

Mr. SNYDER. Mr. Chairman, can I go back to the financing again? If time permits here, and if we have the time, I must point out here that everything has been moving so fast to try to get some type of constructive legislation through before the August recess, that to our legislative representatives here in Washington, our recommendations went to the presidents of the various organizations that are listed here and recommended the money.

In all fairness to the presidents of these various organizations represented here today, they do not really have a complete, up-to-date evaluation of this because we are dealing with it day in and day out. Of course, we brief our various presidents from the various groups here, but I think that this could be given a very serious look and I am sure it will be and the September meeting, the regular meeting of the RLEA will be here in Washington in September.

Then as to how we make progress, where the resolution passes, giving us the time, that there is the possibility, then, when the full explanation and the alternatives are presented to the president that the various organizations themselves, that there is a possibility of completing $300,000 that could be forthcoming.

It may be that some of the organizations may wish to pursue a special assessment on the Milwaukee employees to accomplish this, if they are pretty well convinced that this corporation is getting started and that it looks like it might fly.

I was very much impressed with Senator Long. We had a meeting with Senator Long yesterday and just briefly, inasmuch as he is so interested in the ESOP plan, his staff, Mr. Jack Curtis and Mr. Don Bailey. We had, I think, a very productive meeting with Senator Long.

We briefly told him we were in the process of raising these funds. He seemed to be well pleased with that and he still seems to be very much interested if some plan were feasible where we just would not be throwing our employees' money away or the Federal Government's money away, that he is still very much interested.

Senator BAUCUS. I appreciate that very much, Jim. You obviously have done a terrific job in talking to various organizations within railway labor. They have already pledged $175,000. You have done a very good job.

The difficulty is that we just do not have much time.

Mr. SNYDER. I agree with you.

Senator BAUCUS. We need not only financial commitments by all parties that are involved, but we need unity in various groups working together.

Mr. SNYDER. I understand. You are like us. You are searching for answers.

Senator BAUCUS. There is so little time left. We are on a fragile, precarious edge of whether or not we are going to keep the Milwaukee Railroad alive.

I hope that not only rail labor, but the various States, regional commissions, shippers and other parties walk an extra mile. Otherwise our efforts, as meritorious as they have been in these last several months will have been in vain.

I want to thank you for all the effort that you have undertaken.

Mr. KENNEDY. I rethought the question you asked me a long time ago and really, I think I would like to change my answer or at least explain it a little bit. I apparently misunderstood.

Really, labor is going to make its proportionate share of the $1,300,000. We are talking about $175,000 in cash and then really, to get back to answer what you said about the balance that could be classified as in-kind services, the attorneys' fees, the costs of our representatives, and everybody else who will be involved in participating in this project.

So what we have said now is we raised $175,000, or roughly that, but that the balance of it could be determined, as you in your question called it, in-kind services from railway labor.

Senator BAUCUS. I do not know whether in-kind services meets the contingency requirements of the Old West Regional Commission or not. Hopefully, it will. If it does not, we can talk to Old West.

I am sure that we can find an answer to that.

Mr. Kennedy, in addition to your efforts and the Old West organization's efforts, are there any other groups trying to save the Milwaukee Railroad? Obviously, the trustee is not. Do you know of any other organizations trying to save the Milwaukee?

Mr. SNYDER. Yes. The SORE group. I understand there is another group trying to organize, the same group. I am not familiar with that.

I have had several meetings with the SORE group.

While we may have different approaches to it, I think that we are all pretty well in agreement that we all have one goal in mind—to save as much of the Milwaukee Railroad as possible, and the Montana Shippers Group—that is right, the Montana Shippers Group. I just received this morning in the mail so I did not have a chance to read it. I was fixing to go up and testify this morning on the coal slurry pipeline legislation, the complete report of a meeting that was held in Seattle on July 12.

The Western Line Group and shippers and employees, it is going to be worked in, as I understand it, in conjunction with what we are proposing here.

I have been meeting with the SORE group. This has pretty well been worked out, to work out a coordination here.

We are trying to get all the parties together, here.

I hope that many more of them do not form. Anyway, we are trying to get the parties together and really get the thing moving in a real constructive way.

Senator BAUCUS. As you know, we are waiting for studies from the Department of Transportation. Do you have any idea what those studies will show?

They are due fairly soon; I am just curious.

Mr. SNYDER. Mr. Chairman, my experience with the many studies as to rail safety and other studies conducted by the Department of Transportation, they have always been pretty negative, as far as we are concerned.

I do not know, if we are all wrong, or the Department of Transportation is wrong or all right or they are wrong and we are right.

I have been advised within the Safety Bureau by top people in the Safety Bureau that there have been some parts of a study—I do not think it is exactly a study; maybe an investigation of the overall track structure of the Milwaukee Railroad and I was told, as of yesterday, that this is not as bad as it has been reported.

The track roadbed—there are some spots, as I pointed out here, that are really bad. Mr. McGuire here, the general chairman over there, he might be able to elaborate on that.

Senator BAUCUS. So I can clarify a point in my mind, the financial contribution that the labor organizations will be making will go toward the work undertaken by the new Milwaukee West organization. Is that not correct?

Mr. SNYDER. Yes. It is in conjunction with that that just involved the lines west of what you are speaking.

Senator BAUCUS. The $175,000 and other money raised is a contribution to the Milwaukee West organization. Is that not correct?

Mr. KENNEDY. That is not my understanding. It is not a contribution to the Milwaukee Lines West. It is my understanding that it is a contribution to a group that would be formed to study the feasibility of the entire system.

Senator BAUCUS. That is right. I will rephrase the question; including the Lines West, not exclusively.

Mr. SNYDER. Yes. It would be included.

Senator BAUCUS. The fact of the matter is, due to circumstances beyond our control, it may be that Lines West is the system that is organized. I do not know if that is going to be the case. I hope the entire railroad is kept intact.

Mr. SNYDER. We are going to be working on this. We have our attorneys working on it. We have been meeting with Mr. Tom Allison, whom we think is going to be very helpful in setting up this corporation as acting director with assistance, hopefully, later on by other capable staff people who are on the Hill here that have expertise in the various areas where it is needed; of course, naturally some expertise from the shippers in those groups there in conducting the study.

Senator BAUCUS. Jim, I want to thank you very much. You have been very helpful.

Mr. Kennedy, Mr. Mahoney, Mr. McGuire, we appreciate your help, too.

Mr. SNYDER. Thank you for inviting us. We look forward to, we hope, successful efforts here.

Senator BAUCUS. I have one more question. You may supply the answer for the record, because there is a vote going on and I will have to dash over and vote.

On page 7 of your statement, you indicate that the net worth of the Milwaukee Road is approximately $500 million, $800 million of assets and $300 million of liabilities. Do you include in this computation the debt to the Federal Government and the costs of any labor protection provisions required by existing laws and contracts?

Do you know whether those are included in the debts?

Mr. SNYDER. It is my understanding that they are not.

Senator BAUCUS. None of it is debt to the Federal Government, as far as you are aware. Is that correct?

Mr. KENNEDY. None of what is debt?

Senator BAUCUS. Are obligations that the Milwaukee Road presently has to the Federal Government included in your computation of debt?

Mr. MCGUIRE. Not in this testimony, they are not included.

Senator BAUCUS. Do you know what the actual cost of labor protection provisions would be?

Mr. SNYDER. It depends. We discussed this very thoroughly yesterday at the joint meeting. It depends on what size system you have.

Senator BAUCUS. If possible, could you provide that information for the record?

Mr. KENNEDY. The larger the system that can solve this, the less the cost of labor protection.

Senator BAUCUS. I understand that.

Mr. KENNEDY. It is very difficult. You can play with hypothetical figures as to how many employees would be disemployed or moved, and so forth, and then try to calculate from that.

Senator BAUCUS. Assume that the trustees' petition for abandonment filed in Federal court were approved. Could you calculate the cost of labor protection?

Mr. SNYDER. We did. I think, earlier before the judge had a decision down on the number of employees that were adversely affected by directed service, how many employees would be without jobs by directed service.

Senator BAUCUS. Answer the question as best you can.

I have a vote that I have to get to immediately.

Mr. KENNEDY. Would you like us to submit that for the record?

Senator BAUCUS. If you would.[1]

Jim, I know how concerned you are about coal slurry legislation. I share that concern.

I hope we will show the Nation that the best way to haul coal is by train; specifically, in Montana by the Milwaukee and by the Burlington Northern.

I assume that you agree with that?

Mr. SNYDER. Sure.

Senator BAUCUS. Thank you very much.

The committee will recess for about 10 minutes.

[A brief recess was taken.]

Senator BAUCUS. The subcommittee will come to order.

Our next witness will be Mr. Mike Fitzgerald, director of the Montana International Trade Commission and treasurer of the new organization, the Milwaukee Lines West.

Mr. Fitzgerald, we welcome you to the committee this afternoon. I know you have been working very hard, trying to keep the Milwaukee Railroad alive.

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[1] At presstime the information was not received by the committee.

I want to personally thank you for your efforts. I look forward to any additional information you can provide to the committee and any help that you can give to us.

Mr. FITZGERALD. Thank you, Mr. Chairman.

I would like to introduce James Wickwire who is with me today, who is counselor for our corporation and it may be prudent to have him along, if you want a detailed explanation of the legal activities and legislative activities we feel are going to be necessary and we are already engaged in.

He is better able to lay those out than I. I will proceed with my testimony.

STATEMENT OF MICHAEL FITZGERALD, DIRECTOR, MONTANA INTERNATIONAL TRADE COMMISSION, AND TREASURER, MILWAUKEE LINES WEST, ACCOMPANIED BY JAMES WICKWIRE

Mr. FITZGERALD. I should state at the outset, Mr. Chairman, that I am particularly pleased to be here today with the representatives of rail labor. We have found rail labor to be extremely cooperative and helpful in our efforts and are delighted to report that during the past few days we have developed some common strategies.

We are looking forward to participating in the new independent study of the feasibility of restructuring the entire railroad, not just the western lines. We feel privileged to have been included in this effort and are anxious to assess the viability of saving the entire Milwaukee Railroad.

We aleady are convinced that the western lines can be reorganized on a viable basis. Given the ongoing efforts of the railroad and the trustee to abandon lines west, we also are proceeding toward the acquisition and rehabilitation of lines west and the creation of a new employee and shipper owned railroad with rail labor to assess the viability of salvaging the entire system.

We simply must move forward quickly since formal abandonment proceedings before the ICC possibly will be completed at the end of the year. We will incorporate the results of the joint study in our plans several months down the road.

In fact, Mr. Chairman, much of our preliminary work will be easily adapted to the acquisiton of a larger system when and if its feasibility is established and more of the system becomes available for acquisition.

Since the trustee is seeking to abandon lines west and retain the core, we are hopeful of striking a fair deal for the acquisition of the Transcontinental line, gaining strength as an operating railroad and being in a better position to consider a larger system in the future.

Since your last hearing, Mr. Chairman, the board of Milwaukee Lines West has met twice. As you will recall, the Governors of the northern tier States are each entitled to name a director and to serve with directors appointed by Milwaukee employees and shippers.

The organization will be supported financially by the Old West and Pacific Northwest Regional Commissions and Milwaukee shippers and labor organizations.

In addition to Mr. Schmechel and myself, William Arnold of Tacoma, Wash., who runs the Milwaukee Employee Credit Union;

Lloyd M. Hansen of Spokane, Wash., Milwaukee Lines West UTU general chairman; C. K. Clover of Tacoma Lines West BLE general chairman; and P. H. Jacobson of Coeur d'Alene, Idaho, Lines West maintenance-of-way general chairman, also have joined the board.

John A. Wall of Helena, Mont., and president of the Montana Citizens Freight Rate Association is serving as vice president. Other appointments to the board are expected shortly.

I believe all the Governors' appointees will be appointed by the end of next week.

In addition, we have provided at our last meeting an additional membership appointment for another shipper and another employee representative and we anticipate that it will be a representative of the international unions.

Financial support for the organization also is being developed and received. Appended to my testimony for inclusion in the hearing record is a copy of the articles of incorporation and bylaws of Milwaukee Lines West which describe our structure and goals in greater detail.

Many of these efforts already have been commenced by Milwaukee Lines West board members, our regional and Washington counsel, and our many friends. Consistent with our new joint effort, we also shortly will be hiring staff to help organize the new railroad company, survey the system, develop increased local support and coordinate our activities here and in the field.

As you can see, Mr. Chairman, we are earnestly proceeding toward realization of our goal. I am pleased to have had this opportunity to present our progress to you and want to thank you for your ongoing support of our efforts. I hope we are meeting your, and Governor Judge's, expectations for this organization when you first jointly proposed its creation a mere 6 weeks ago.

Before closing, I wish to summarize that while our efforts initially and at the moment are concentrated on saving the Western Lines of the Milwaukee Railroad, our priority along with, I think, the Congress—and certainly the international labor unions—would be to save the entire railroad.

Clearly that is in everybody's best interests. We merely began on the Western Lines because the trustee declared the bankruptcy court initially supported efforts to disregard and to disengage the Western Lines. It was there that we concentrated our efforts, and have to date.

However, we welcome the opportunity to participate with international labor, the Congress, with the various Federal Government agencies to attempt to salvage and reorganize the entire Milwaukee Railroad, and are prepared to dedicate our efforts towards that, and we are pleased to be included in that effort.

With that I would close, and I think you will find in our articles of incorporation, if you have time to scrutinize them, that we did not exclude our activities legally to the Western Lines. We have merely concentrated our strategy on the Western Lines.

Now, as a result of our discussions with labor, we are expanding that effort.

Thank you.

[The articles of incorporation follow:]

ARTICLES OF INCORPORATION

OF

MILWAUKEE LINES WEST

FILED
JUN 21 1979
SECRETARY OF STATE
STATE OF WASHINGTON

The undersigned, in order to form a nonprofit corporation under Chapter 24.03 of the Revised Code of Washington, hereby signs and verifies the following Articles of Incorporation:

ARTICLE I

The name of the corporation is MILWAUKEE LINES WEST.

ARTICLE II

The duration of the corporation shall be until December 31, 1979.

ARTICLE III

The corporation is formed to undertake and coordinate federal, state, local and private efforts to provide for continued competitive railroad service in regions currently serviced by the Milwaukee Railroad, and to that end the corporation will:

1. Develop an organizational, financial, management and marketing plan for a shipper- and employee-owned railroad;

2. Advance and protect the interests of the corporation in proceedings before the state and federal courts, the Interstate Commerce Commission, and other state and federal agencies;

3. Negotiate with appropriate persons for acquisition of necessary railroad assets;

4. Work with the appropriate federal agencies including without limitation the Departments of Transportation, Commerce, Agriculture, Energy and Defense, the Interstate Commerce Commission and the Securities and Exchange Commission and with the Congress to develop a viable railroad organization;

5. Work with appropriate state and local officials to coordinate these efforts with state rail plans and to insure compliance with applicable state and federal laws;

6. Obtain adequate and appropriate participation and support from employees, labor unions, shippers and other appropriate private persons;

7. Take such other actions as are necessary to guarantee a viable, competitive rail service in the areas now serviced by the Milwaukee Road.

ARTICLE IV

The initial registered office of the corporation is 500 Maynard Building, Seattle, Washington 98104, and the initial registered agent at such address is O. Yale Lewis, Jr.

ARTICLE V

The number of directors constituting the initial Board of Directors shall be three, and the names and addresses of the persons who are to serve as initial directors are:

William Arnold	4410 20th Street East Tacoma, Washington
Michael Thomas Fitzgerald	1530 Big Horn Road Helena, Montana 59601
Paul Schmechel	1049 Porphyry Butte, Montana 59701

The number of directors constituting the permanent Board of Directors shall be set in the bylaws.

ARTICLE VI

The name and address of the incorporator is:

William Arnold	4410 20th Street East Tacoma, Washington

ARTICLE VII

The corporation shall have all powers which now or hereafter are conferred by law upon a nonprofit corporation organized under Chapter 24.03 of the Revised Code of Washington.

ARTICLE VIII

The corporation shall have no capital stock, and no part of the net earnings or assets of this corporation shall ever inure to the benefit of any director, trustee, or officer thereof or to the benefit of any private person. In the event of liquidation, dissolution or abandonment of the corporation, its assets remaining after payment of, or provision for payment of, all debts and liabilities of this corporation shall be distributed to the parties who have contributed to the corporation in the ratio of their contribution to the total contributions.

EXECUTED IN TRIPLICATE this 21st day of June, 1979.

William Arnold
Incorporator

STATE OF WASHINGTON)
) ss.
COUNTY OF PIERCE)

WILLIAM ARNOLD, being first duly sworn, on oath deposes and says:

I am the incorporator of the above-named corporation; I have read the foregoing Articles of Incorporation, know the contents thereof, and believe the same to be true.

William Arnold
William Arnold

SUBSCRIBED AND SWORN to before me this 21st day of June, 1979.

Barbara J. Bopray
NOTARY PUBLIC in and for the State of Washington, residing at Tacoma

BYLAWS

OF

MILWAUKEE LINES WEST

ARTICLE I

Board of Directors

I.1 Powers and Qualifications. The affairs of the corporation shall be managed by the Board of Directors, who shall be appointed as follows:

1. The governors of each of the following states may appoint one director:

   a. Idaho
   b. Iowa
   c. Minnesota
   d. Montana
   e. Nebraska
   f. North Dakota
   g. Oregon
   h. South Dakota
   i. Washington
   j. Wyoming

2. The Milwaukee shippers shall select three directors.

3. The Milwaukee employees shall select three directors.

I.2 Number. The number of directors of the corporation shall be not less than nine. The Board of Directors by amendment of these bylaws may increase or decrease the number of directors.

I.3 Executive Committee. The Board of Directors by resolution adopted by a majority of the directors in office may designate and appoint an executive committee which shall consist of as many directors and which shall have and exercise such authority of the Board of Directors in the management of the corporation as may be specified in said resolution; provided, that no such committee shall have the authority of the Board of Directors in reference to amending, altering or repealing the bylaws; electing, appointing or removing any member of any such committee or any director or officer of the corporation; amending the articles of incorporation; adopting a plan of merger or adopting a plan of consolidation with another corporation; authorizing the sale, lease, exchange or mortgage of all or substantially all of the property and assets of the corporation; authorizing the voluntary dissolution of the corporation or revoking proceedings therefor; adopting a plan for the distribution of the assets of the corporation; or amending, altering or repealing any resolution of the Board of Directors which by its terms provides that it shall not be amended, altered or repealed by such committee. The designation and appointment of any such committee and the delegation thereto of authority shall not operate to relieve the Board of Directors or any individual director of any responsibility imposed upon it or him by law.

I.4 Vacancies. The Board of Directors shall have the power to fill any vacancy occurring in the Board by reason of an increase in the number of directors by amendment of these bylaws. Any vacancy created by any resignation or by the inability of a director to perform his duties shall be filled by the organization or political division or subdivision originally responsible for his appointment.

I.5 No director with an interest in conflict with the reorganization and rehabilitation of the Milwaukee Western Lines shall be seated.

ARTICLE II

Meetings of Board of Directors

II.1 Monthly Meetings. The Board of Directors shall meet at least monthly at the time and place specified by the Chairman.

II.2 Special Meetings. Special meetings of the Board of Directors may be held at any place, at any time, whenever called by the president or secretary, or any two (2) or more Directors.

II.3 Notice of Meetings. Notice of the monthly meetings of the Board of Directors shall be given ten days in advance by the Secretary. Notice of the time and place of any special meetings of the Board of Directors shall be given by the secretary, or by the person or persons calling the meeting, by mail, telegram, or by personal communication over the telephone or otherwise, at least three (3) days prior to the date on which the meeting is to be held. Attendance of a director at any meeting shall constitute a waiver of notice of such meeting, except where the Director attends a meeting for the purpose of objecting to the transaction of any business because the meeting is not lawfully called or convened. Neither the business to be transacted nor the purpose of any meeting of the Board of Directors need be specified in the notice or any waiver of notice of such meeting.

II.4 Quorum. A majority of the Directors in office shall constitute a quorum for the transaction of business. The act of the majority of directors present at a meeting at which a quorum is present shall be the act of the Board of Directors. At any meeting of the Board of Directors at which a quorum is present, any business may be transacted, and the board may exercise all of its powers.

ARTICLE III

Actions by Written Consent

Any corporate action required or permitted by the articles of incorporation or bylaws, or by the laws of the State of Washington, to be taken at a meeting of the directors of the corporation, may be taken without a meeting if a consent in writing, setting forth the action so taken, shall be signed by all of the directors entitled to vote with respect to the subject matter thereof. Such consent shall have the same force and effect as a unanimous vote, and may be described as such.

ARTICLE IV

Waiver of Notice

Whenever any notice is required to be given to any Director of the corporation by the articles of incorporation or bylaws, or by the laws of the State of Washington, a waiver thereof in writing signed by the person or persons entitled to such notice, whether before or after the time stated therein, shall be equivalent to the giving of such notice.

ARTICLE V

Indemnification of Directors and Officers

Each director or officer now or hereafter serving the corporation and each person who at the request of or on behalf of the corporation is now serving or hereafter serves as a trustee, director or officer of any other corporation, whether for profit, or not for profit, and his respective heirs, executors, and personal representatives, shall be indemnified by the corporation against expenses actually and necessarily incurred by him in connection with the defense of any action, suit or proceeding in which he is made a party by reason of being or having been such trustee, director or officer, except in relation to matters as to which he shall be adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of duties; but such indemnification shall not be deemed exclusive of any other rights to which such person may be entitled under any bylaw, agreement, vote of Board of Directors, or otherwise.

ARTICLE VI

Officers

VI.1 Officers Enumerated. The officers of the corporation shall be a president, one or more vice presidents, a secretary, a treasurer, and such other officers and assistant officers as may be deemed necessary by the Board of Directors, each of whom shall be annually elected by the Board of Directors and shall serve until their successors are duly elected and qualified. Any two or more offices may be held by the same person, except the offices of president and secretary. In addition to the powers and duties specified below, the officers shall have such powers and perform such duties as the Board of Directors may prescribe.

VI.2 The President. The president must be a director of the corporation. He shall exercise the usual executive powers pertaining to the office of president. He shall preside at meetings of the Board of Directors.

VI.3 The Vice President. In the absence or disability of the president, the senior vice president present shall act as president.

VI.4 The Secretary. It shall be the duty of the secretary to keep records of the proceedings of the Board of Directors and of the membership, to administer the membership register, to sign all certificates of membership, when not signed by the president, and when requested by the president to do so, to sign and execute with the president all deeds, bonds, contracts, and other obligations, or instruments, in the name of the corporation, to keep the corporate seal, and to affix the same to certificates of membership and other proper documents.

VI.5 The Treasurer. The treasurer shall have the care and custody of and be responsible for all funds and investments of the corporation, and shall cause to be kept regular books of account. He shall cause to be deposited all funds and other valuable effects in the name of the corporation in such depositories as may be designated by the Board of Directors. In general, he shall perform all of the duties incident to the office of treasurer.

VIII.6 Vacancies. Vacancies in any office arising from any cause may be filled by the Board of Directors at any regular or special meeting.

VIII.7 Salaries. The salaries of all officers and agents of the corporation shall be fixed by the Board of Directors.

VI.8 Removal. Any officer elected or appointed may be removed by the Board of Directors whenever in its judgment the best interests of the corporation will be served thereby. The removal of an officer shall be without prejudice to the contract rights, if any, of the officer so removed; provided, that election or appointment of an officer or agent shall not of itself create contract rights.

ARTICLE VII

Administrative and Financial Provision

VII.1 Fiscal Year. The fiscal year of the corporation shall end on May 31.

VII.2 Loans Prohibited. No loans shall be made by the corporation to any officer or to any trustee.

VII.3 Books and Records. The corporation shall keep current and complete books and records of account and shall keep minutes of the proceedings of its Board of Directors and committees having any of the authority of the Board of Directors. All books and records of the corporation may be inspected by any active member, or his agent or attorney for any proper purposes at any reasonable time.

VII.4 Amendment of Bylaws. These bylaws may be altered, amended or repealed by the affirmative vote of a majority of the directors in office at any annual or special meeting of the board.

VII.5 Rules of Procedure. The rules of procedure at meetings of the membership and of the Board of Directors of the corporation shall be the rules contained in Roberts' Rules of Order on Parliamentary Procedure, as amended, so far as applicable and when not inconsistent with these bylaws, the articles of incorporation or with any resolution of the Board of Directors.

Senator BAUCUS. Thank you, very much, Mr. Fitzgerald.

I understand it that your hope is that the entire system will be reorganized. The organization Milwaukee West is attempting to save the railroad as a single entity. Is that correct?

Mr. FITZGERALD. That is our hope; that is our effort.

Senator BAUCUS. As I further understand it, if it for whatever reasons portions of the railroad are separated then you will be focusing your effort primarily on the Pacific coast extension.

Mr. FITZGERALD. That is correct.

Senator BAUCUS. What about the core system? Do you think the core system is necessary to the Pacific coast extension?

Mr. FITZGERALD. Our initial studies indicate the Western Lines is viable without the core. The core, in all probability, is not viable without the Western Lines.

Clearly, to make a final determination on that, further studies are needed, specifically a marketing study and a rehabilitation study to clarify the rehabilitation cost as well as a management survey to see what steps could be taken between shippers and employees to make just the daily managagement of that organization a little more lean and efficient.

Until we have a final determination on both, I do not think anyone is prepared absolutely to that question, but our preliminary investigations indicate that the Lines West are viable without the core, that the core is not viable without the Lines West.

Clearly, in our assessment, the core would be very, very important to the Lines West because it is existing. If it could be cleaned up, if it could be rehabilitated, that is the optimum.

We are prepared to try to push toward that end.

Senator BAUCUS. Then I take it that the employee stock ownership plan—perhaps, combined with the shipper stock ownership plan—for the entire system is feasible, or perhaps even necessary. Is that correct?

Mr. FITZGERALD. I think it is feasible. I think that would be the optimum.

Senator BAUCUS. The entire system?

Mr. FITZGERALD. The entire system under employee/shipper owned plan.

Senator BAUCUS. Can you outline for the benefit of the Committee what you see as the schedule of events down the road? You do not have to be entirely specific.

Could you briefly summarize what you foresee as necessary actions, or hopeful actions, anyway, of the Milwaukee West over the next several months?

Mr. FITZGERALD. Yes, Mr. Chairman, our corporation is in business for a 6-month period, scheduled to end on December 31, so we are anticipating concluding all of these activities within that time period and are proceeding simultaneously on all of them. I just went through the list.

The first, and one of the most essential things that needs to be accomplished is a marketing study. We are taking steps to achieve that.

The general administration of our organization, getting everything in place, is being actively pursued. We will immediately engage in the financial planning to financially construct a new railroad and develop financial plan thereof, to undertake a plan under a rehabilitation planning survey in the immediate future. We want to find experts who will advise us as to the exact cost and all the infrastructure needed to rehabilitate the system.

Railroad operations planning will be undergone simultaneously in the immediate future as well as the legal representation in the Bankruptcy Court on the ICC abandonment hearings and here in the Congress and for that part which is the most immediate and crucial, I am going to let James Wickwire outline that for you, since he is in charge of administering that.

We have most of these actions underway. If I might, I might refer this section to Mr. Wickwire.

Senator BAUCUS. I welcome you to the committee, Mr. Wickwire. You also have performed an invaluable service. I am glad you are able to help out.

Mr. WICKWIRE. It is good to be here, Mr. Chairman.

Briefly, so as not to take too much of the committee's time today, in the bankruptcy proceeding itself, as you recall, Judge MacMillan denied trustees' petition for the embargo. That ruling is now on appeal to the seventh circuit.

Of course, there will be activity there to determine whether the judge's ruling was a valid ruling at the time.

Additionally, the judge ruled on some ERSA borrowings, $20 million being the most recent one.

That decision of the court is also in appeal to the seventh circuit by the creditors, so there will be some activity at the appellate court level over the next few weeks to determine whether the judge's decisions on those two points is correct.

Senator BAUCUS. Have hearings been scheduled on those two points?

Mr. WICKWIRE. There has been a briefing schedule set. No hearings have been set before the court.

As you know, Mr. Chairman, the trustee recently filed a petition with the Interstate Commerce Commission for abandonment of Lines West of Miles City, and just yesterday in the Federal Register the ICC published a tentative schedule for those abandonment proceedings which are contemplated to be concluded, if that schedule is finally adopted, by January 10, 1980.

This would contemplate several hearings before the Commission, both here in Washington as well as out in the affected northern tier States.

I think most knowledgeable observers believe that that process will take longer than from now until January 10. It could, in fact, take as long as a year to conclude. In a sense, the heavy legal activity will shift to the Interstate Commerce Commission, at least insofar as the abandonment aspect of this entire proceeding is concerned.

Senator BAUCUS. Because of the effect of the judge's ruling, I take it—assuming that his ruling to deny the embargo petition is sustained?

Mr. WICKWIRE. Yes. The judge required as a condition of the most recent ERSA borrowing for the trustee to file his abandonment petitions with the ICC.

There are a couple of other proceedings before the Interstate Commerce Commission that are quite important to the future of any reorganized Milwaukee, particularly if it has a Lines West segment. That is the Burlington Northern inclusion case where there are a number of conditions that are quite important to the Milwaukee Railroad, conditions that were imposed as a part of the Burlington Northern merger earlier in the 1970's.

Many of those conditions have not been fulfilled. There are certain other conditions that need to be sought for the ICC to assist to bring about a viable Milwaukee Lines West or a viable entire railroad, if it should take that course.

Senator BAUCUS. ICC determinations?

Mr. WICKWIRE. Yes.

Senator BAUCUS. Are there any dates?

Mr. WICKWIRE. As far as I know, Mr. Chairman, no further action has been scheduled at this present time. I have a hunch that is because of the pendency of the abandonment proceeding and it will wait until that has run its course.

Should there be a reorganized western lines west of the Twin Cities, it will be necessary to file with the Interstate Commerce Commission an application for certificate of public convenience and necessity. It is anticipated that that application will be filed in the next few weeks by Milwaukee Lines West.

It is not necessary to have a new railroad in existence to file that application. It is possible for the corporation.

Senator BAUCUS. Will that certificate cover only Lines West, or will it cover the entire railroad?

Mr. WICKWIRE. Initially, Senator Baucus, until there has been a determination of the possible viability of the core along with Lines West, the studies that Mr. Snyder referred to in his testimony and Mr. Fitzgerald mentioned, we feel that it is imperative to move ahead on the western portion to take the preliminary steps necessary.

Senator BAUCUS. Why can they not file two certificates?

Mr. WICKWIRE. I think it is possible to amend those applications somewhere down the road. I think the same work would have to be done; the same data would have to be prepared.

Another important area of activity would be the applications that would be necessary for the Federal Railway Administration for rehabilitation funds to do the work necessary to bring that system back up to the standard that it had several years ago.

Those applications, while they will not be filed immediately, there is quite a bit of preliminary work that has to be done in order to prepare the plan.

One other thing that will have to be looked at, of course, if there is a new company, whether it is the core in the West or the West alone, there will have to be compliance with the SEC requirements, the issuance of new stock, and so on.

Senator BAUCUS. Would those be registration of stock? New issue registration?

Mr. WICKWIRE. Those types of requirements; yes.

None of us are sure of precisely what form the new company would take at this time, so it is not possible today to be very precise in terms of advising you about that.

Senator BAUCUS. What is the present financial state of the Milwaukee? How long can the present Milwaukee Railroad continue to operate based upon your knowledge of its cash position?

Mr. WICKWIRE. The latest information I have, Mr. Chairman, came out of the meeting yesterday that Mr. Snyder mentioned at which Mr. Roe, attorney for the trustee, was present, along with several members of the labor groups, several staff people from both sides of the Hill, and Mr. Roe advised us there that it was their present belief that the railroad could operate through August and possibly later.

We are looking at 45 days at the earliest, another 2 months after that.

Let me say that there would be additional emergency rail service funds available to the Milwaukee Railroad should the trustee apply for them that would be available to take the railroad beyond this period.

Senator BAUCUS. That is ERSA money?

Mr. WICKWIRE. Yes.

It is my understanding it is $30 million.

Senator BAUCUS. To what degree have States that may or may not be represented on the Board or represented through regional commissions participated in Milwaukee West activities?

Could you answer that question, please?

Mr. FITZGERALD. Mr. Chairman, it is my understanding—and I have not personally visited with each of the Governors but I have spoken to others who have, and they say every Governor is committed to put someone on the board and to have that accomplished by next week.

Beyond that, I think there are various levels of commitment as well as direct involvement along the lines based almost directly in proportion to the impact of the Milwaukee.

I think that a safe, conservative summary would be that all of those nine States that we are talking about in addition to a couple of others are committed to an organization to put someone on the

Board and to participate on that level. Of three, all of them will do more and some of them have activities well underway in that regard.

Senator BAUCUS. All nine States will have representatives on the Board by the end of next week?

Mr. FITZGERALD. By the end of next week. That is their goal.

Senator BAUCUS. They all indicated that that is their intention?

Mr. FITZGERALD. That is correct.

Senator BAUCUS. What about shippers? What is the shipper commitment thus far?

Mr. FITZGERALD. Shipper commitments—we have four slots, four positions on the Board for shippers and we have essentially one of those filled.

Mr. Schmechel, whom you know, and myself will, in the immediate future, and hopefully we can take care of that in the next week.

We have a summons from the Board to go request participation by specific shippers and it is merely getting our schedules coordinated to do that, and we are committed to, and I believe we will receive a positive response.

Senator BAUCUS. How quickly do you think you will get sufficient shipper representation? How quickly will you get all the shippers? Second, what authority do you have to get all four slots filled by shippers?

Mr. FITZGERALD. The first question I anticipate will have all the shippers signed up by the next Board meeting of the corporation, which is August 2. I anticipate that we will have the whole Board of Directors appointed by that time.

Your second question, our articles of incorporation have permitted us to proceed on several fronts without the whole Board giving their whole approval, but some of the things that we have been engaged in that I cannot imagine that the majority will overturn.

Senator BAUCUS. How many members on the Board do you presently have?

Mr. FITZGERALD. Six members.

Senator BAUCUS. Six.

Mr. FITZGERALD. Four labor representatives, Mr. Schmechel and myself plus Mr. Wall, who is not a Board member but who is an officer.

Mr. Arnold is the other labor representative.

Senator BAUCUS. Do you have any Board members who are employees?

Mr. FITZGERALD. Yes, sir. Four of those.

Let me read you their names here to clarify. The four employee representatives are Mr. Arnold, Tacoma, Wash. who runs the Milwaukee Employee Credit Union but has been a 20-year employee of the Milwaukee Railroad.

Mr. Lloyd Hansen, Spokane, Milwaukee Lines West UTU general chairman.

Mr. C. K. Clover, Tacoma, who is Lines West, Brotherhood of Locomotives, general chairman.

Mr. P. H. Jacobson, Coeur d'Alene, Idaho, Lines West, maintenance of way, general chairman.

Then we have one more slot, one more position on the board for a labor representative. We anticipate that will be done.

Senator BAUCUS. Do you anticipate that the Rail Labor Executive Association represented by Mr. Snyder would like a position on the board?

Mr. FITZGERALD. It is my understanding that they have agreed to give us a name for a representative on the board.

Mr. WICKWIRE. There undoubtedly will be discussions in the next few days that will lead to the appointment or selection of the additional labor people.

Mr. FITZGERALD. We have made that recommendation.

Senator BAUCUS. There is a position on the Board available?

Mr. FITZGERALD. Correct.

Senator BAUCUS. You do not see any problems or difficulties, then, in reaching agreement between the international rail unions that represent nonsupervisory employees and the Milwaukee West organization? Do you foresee any problems?

Mr. FITZGERALD. I do not anticipate any insurmountable difficulties with striking some agreement to proceed on a strategy to save the railroad.

Senator BAUCUS. As you know, the Department of Transportation is conducting some feasibility studies. Do you have any idea what those studies are going to show.

Mr. FITZGERALD. We have not had the benefit of those studies, Mr. Chairman. We have heard some rumors. It strictly depends on who we are talking to and who read the news to what they say.

Some people say that they are negative regarding what we are trying to do; some say they are positive. I think it would be pure speculation, certainly, on my part to guess what is in the studies. Others may have had better information in that regard than myself.

Senator BAUCUS. What if they are negative? Are you going to give up?

Mr. FITZGERALD. Heavens, no. I think irregardless of what the studies say, it will not effect our organizations commitment and hopefully it will not have too overwhelming an effect if they are negative on the part of the Federal Government and the agencies.

I think that it is safe to say that historically studies—any kind of studies—are left to some interpretation by the reader at best, as well as we are committed to once we get their studies back, whatever they show, then we are committed to try to start remedying the situation and the studies that are negative, to try to come to some middle ground on what we believe can be done and what those studies indicate.

If they come out positive, that simply adds to our case. Irregardless, we are proceeding further.

Senator BAUCUS. I am glad to hear you say that.

It is my feeling that with tremendous effort and imagination, the Milwaukee can be saved.

I think there is a bit of an assumption that the Milwaukee cannot be saved; therefore, there might be a tendency on the part of some of the agencies to concur with some kind of self-fulfilling prophecy.

The conclusions are very significantly biased and influenced by premises and assumptions they are based on.

I do not know what the studies are going to show, either. I have heard the same reports, some positive, some negative. I suspect that if the reports are negative, the agencies are not approaching the problem with as much new energy and new dedication as they might.

Of course, if they are positive, that would be great. I suspect they will not be because historically with respect to Milwaukee, they have not been.

Mr. FITZGERALD. That will be the basic case, that all of the activities that we are working on and attempting to accomplish are activities to change the circumstances and the actions that have resulted in the present circumstances of the railroad.

In that regard, in our opinion, if the studies validate some of our beliefs, so much the better. If they do not, then we will proceed under our own assumptions that we believe to be valid, particularly in light of the fact that, as you well know, Mr. Chairman, from your initiation and leadership of this original effort as well as other figures from Montana, I think it is not an overstatement to say that everyone, at least on our team involved, is committed to make a model railroad out of this.

So we are prepared to turn over stone and look at every new possibility that could make that railroad a more modern, a more efficient, more effective, more of a service institution and we are taking steps to accomplish that.

In that light, I think that makes invalid any negativeness that comes out of the studies.

Senator BAUCUS. I think there are other reasons, too. Obviously, with the energy crisis we are facing today,. we will be shipping more coal. Nobody denies that.

The President wants to convert more to coal. I do not know anybody who seriously advances solutions to our energy crisis who does not anticipate and, in fact, advocate a significant increase in the amount of coal that we mine and therefore ship.

There are additional reasons why I think the Milwaukee can be saved. Far Eastern markets are opening up for grain. Certainly the People's Republic of China is going to be buying more American products, no doubt about that. There is some question as to how quickly they will be buying more American products, but everybody agrees that sooner or later there will be significant advances in that direction.

Mr. FITZGERALD. Once we have validated evidence in the past testimony that has been delivered in court and at these hearings from trade experts, particularly from the port of Seattle and the port of Portland and other people affiliated with those activities of the growing and expanding markets there and the activity which is totally dependent upon rail transportation.

Senator BAUCUS. In addition to that, the social costs that will result if the Milwaukee does collapse, and effects of a lack of rail transportation in many parts of the country and certainly in the Pacific Northwest are not really calculated into any feasibility studies that the various Federal and non-Federal agencies might make.

Mr. FITZGERALD. The potential effect of deregulation, if that could come about, will alone transform the railroad business.

Senator BAUCUS. I want to thank you, Mr. Fitzgerald, and you, Mr. Wickwire. It has been very helpful.

I do not need to remind you that we do not have much time here. I am available to help you as much as I can.

Mr. FITZGERALD. Please permit me on behalf of the organization I represent that you and your staff are a part of us now of your leadership. Without the leadership of congressional representatives, this literally would not have been possible.

With it, we are actually satisfied that it can be done.

Senator BAUCUS. We just have to get a few more converts.

Thank you very much. That concludes the hearing.

[Thereupon, at 4:45 p.m. the subcommittee recessed, to reconvene at the call of the Chair.]

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