

KANSAS CITY SOUTHERN

Form 10-Q

July 27, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

- ☐ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended June 30, 2007
- ☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission File Number 1-4717

KANSAS CITY SOUTHERN
(Exact name of Registrant as specified in its charter)

Delaware
*(State or other jurisdiction of
incorporation or organization)*

**427 West 12th Street,
Kansas City, Missouri**
(Address of principal executive offices)

44-0663509
*(I.R.S. Employer
Identification No.)*

64105
(Zip Code)

816.983.1303
(Registrant's telephone number, including area code)

None
(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☐ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐

Edgar Filing: KANSAS CITY SOUTHERN - Form 10-Q

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at July 19, 2007
Common Stock, \$0.01 per share par value	76,845,816 Shares

Kansas City Southern

Form 10-Q
June 30, 2007

Index

	Page
<u>PART I FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	3
<u>Introductory Comments</u>	3
<u>Consolidated Statements of Income Three and six months ended June 30, 2007 and 2006</u>	4
<u>Consolidated Balance Sheets June 30, 2007 and December 31, 2006</u>	5
<u>Consolidated Statements of Cash Flows Six months ended June 30, 2007 and 2006</u>	6
<u>Notes to Consolidated Financial Statements</u>	7
<u>Report of Independent Registered Public Accounting Firm</u>	24
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	25
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	36
<u>Item 4. Controls and Procedures</u>	36
<u>Item 4T. Controls and Procedures</u>	37
<u>PART II OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	37
<u>Item 1A. Risk Factors</u>	37
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	37
<u>Item 3. Defaults upon Senior Securities</u>	37
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	37
<u>Item 5. Other Information</u>	38
<u>Item 6. Exhibits</u>	39
<u>SIGNATURES</u>	40

Kansas City Southern

Form 10-Q
June 30, 2007

PART I FINANCIAL INFORMATION

Item 1. *Financial Statements.*

Introductory Comments.

The Consolidated Financial Statements included herein have been prepared by Kansas City Southern, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). For the purposes of this report, unless the context otherwise requires, all references herein to KCS and the Company shall mean Kansas City Southern and its subsidiaries. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) have been condensed, or omitted pursuant to such rules and regulations. The Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. These Consolidated Financial Statements should be read in conjunction with the consolidated financial statements and the related notes, as well as Management's Discussion and Analysis of Financial Condition and Results of Operations, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Form 10-Q. Results for the three and six months ended June 30, 2007, are not necessarily indicative of the results expected for the full year ending December 31, 2007.

Kansas City Southern**Consolidated Statements of Income**

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(In millions, except share and per share amounts)			
	(Unaudited)			
Revenues	\$ 427.1	\$ 413.1	\$ 838.4	\$ 801.5
Operating expenses:				
Compensation and benefits	98.5	97.6	198.4	192.6
Purchased services	43.1	52.4	89.8	107.3
Fuel	65.7	63.1	128.2	121.4
Equipment costs	48.5	39.3	93.4	84.0
Depreciation and amortization	40.8	36.8	78.9	75.2
Casualties and insurance	17.5	15.5	36.9	28.1
Materials and other costs	29.9	30.9	57.3	54.1
Total operating expenses	344.0	335.6	682.9	662.7
Operating income	83.1	77.5	155.5	138.8
Equity in net earnings of unconsolidated affiliates	2.8	2.0	3.9	2.5
Interest expense	(41.6)	(40.6)	(81.0)	(81.2)
Debt retirement costs	(6.9)	(2.2)	(6.9)	(2.2)
Foreign exchange gain (loss)	3.4	(7.0)	0.3	(11.2)
Other income	3.3	2.9	3.9	5.8
Income before income taxes and minority interest	44.1	32.6	75.7	52.5
Income tax expense	13.8	8.5	23.1	15.5
Income before minority interest	30.3	24.1	52.6	37.0
Minority interest	0.1		0.2	
Net income	30.2	24.1	52.4	37.0
Preferred stock dividends	4.9	4.9	10.1	9.8
Net income available to common shareholders	\$ 25.3	\$ 19.2	\$ 42.3	\$ 27.2
Earnings per share:				
Basic earnings per share	\$ 0.33	\$ 0.26	\$ 0.56	\$ 0.37
Diluted earnings per share	\$ 0.30	\$ 0.24	\$ 0.52	\$ 0.36

Edgar Filing: KANSAS CITY SOUTHERN - Form 10-Q

Average shares outstanding (*in thousands*):

Basic	75,892	74,464	75,737	73,661
Potential dilutive common shares	14,840	18,088	14,813	16,355
Diluted	90,732	92,552	90,550	90,016

See accompanying notes to consolidated financial statements.

Kansas City Southern
Consolidated Balance Sheets

	June 30, 2007	December 31, 2006
	(In millions, except share amounts) (Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 66.3	\$ 79.0
Accounts receivable, net	298.4	334.3
Restricted funds	67.4	26.5
Inventories	80.3	72.5
Other current assets	59.7	93.7
Total current assets	572.1	606.0
Investments	64.2	64.9
Property and equipment, net of accumulated depreciation of \$844.9 and \$897.0 at June 30, 2007 and December 31, 2006, respectively	2,603.9	2,452.2
Concession assets, net	1,273.5	1,303.3
Deferred tax asset	119.0	128.7
Other assets	79.4	82.2
Total assets	\$ 4,712.1	\$ 4,637.3
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Debt due within one year	\$ 10.7	\$ 41.9
Accounts and wages payable	126.1	189.9
Current liability related to Grupo KCSM acquisition	52.3	50.9
Accrued liabilities	351.0	354.7
Total current liabilities	540.1	637.4
Other liabilities:		
Long-term debt	1,636.9	1,631.8
Long-term liability related to Grupo KCSM acquisition	33.3	32.4
Deferred income taxes	415.1	417.3
Other noncurrent liabilities and deferred credits	254.2	235.7
Total other liabilities	2,339.5	2,317.2
Minority interest	204.7	100.3
Commitments and contingencies		
Stockholders' equity:		

Edgar Filing: KANSAS CITY SOUTHERN - Form 10-Q

\$25 par, 4% noncumulative preferred stock, 840,000 shares authorized, 649,736 shares issued, 242,170 shares outstanding	6.1	6.1
Series C redeemable cumulative convertible perpetual preferred stock, \$1 par, 4.25%, 400,000 shares authorized, issued and outstanding	0.4	0.4
Series D cumulative convertible perpetual preferred stock, \$1 par, 5.125%, 210,000 shares authorized, issued and outstanding	0.2	0.2
\$.01 par, common stock, 400,000,000 shares authorized; 92,863,585 shares issued at June 30, 2007 and December 31, 2006, respectively; 76,860,894 and 75,920,333 shares outstanding at June 30, 2007 and December 31, 2006, respectively	0.7	0.7
Paid in capital	541.9	523.0
Retained earnings	1,077.2	1,050.7
Accumulated other comprehensive income	1.3	1.3
Total stockholders' equity	1,627.8	1,582.4
Total liabilities and stockholders' equity	\$ 4,712.1	\$ 4,637.3

See accompanying notes to consolidated financial statements.

Kansas City Southern**Consolidated Statements of Cash Flows**

	Six Months Ended June 30,	
	2007	2006
	(In millions)	
	(Unaudited)	
Operating activities:		
Net income	\$ 52.4	\$ 37.0
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	78.9	75.2
Deferred income taxes	22.9	15.6
KCSM employees' statutory profit sharing	4.6	5.6
Equity in undistributed earnings of unconsolidated affiliates	(3.9)	(2.5)
Minority interest	0.2	
Stock based compensation	5.3	2.6
Changes in working capital items:		
Accounts receivable	35.9	15.4
Inventories	(8.3)	(13.8)
Other current assets	33.4	4.1
Accounts payable and accrued liabilities	(65.4)	(69.0)
Other, net	4.1	(14.3)
Net cash provided by operating activities	160.1	55.9
Investing activities:		
Capital expenditures	(132.7)	(103.4)
Proceeds from disposal of property	7.7	
Contribution from NS for MSLLC (net of change in restricted contribution)	63.4	40.0
Property investments in MSLLC	(48.4)	
Other, net	(5.3)	8.5
Net cash used for investing activities	(115.3)	(54.9)
Financing activities:		
Proceeds from issuance of long-term debt	326.2	405.2
Repayment of long-term debt	(351.8)	(406.6)
Debt issuance costs	(18.9)	(9.5)
Proceeds from stock plans	0.6	5.2
Dividends paid	(13.6)	(4.2)
Net cash used for financing activities	(57.5)	(9.9)
Cash and cash equivalents:		
Net decrease during each period	(12.7)	(8.9)
At beginning of year	79.0	31.1

At end of period	\$	66.3	\$	22.2
------------------	----	------	----	------

See accompanying notes to consolidated financial statements.

Kansas City Southern

Notes to Consolidated Financial Statements

1. Accounting Policies and Interim Financial Statements.

In the opinion of the management of KCS, the accompanying unaudited consolidated financial statements contain all adjustments necessary, which are of a normal and recurring nature, to present fairly the financial position of the Company as of June 30, 2007, and December 31, 2006, the results of operations for the three and six months ended June 30, 2007 and 2006, and cash flows for the six months ended June 30, 2007 and 2006. Certain information and footnote disclosure normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted. These consolidated financial statements should be read in conjunction with the financial statements and accompanying notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. The results of operations for the three and six months ended June 30, 2007, are not necessarily indicative of the results to be expected for the full year ending December 31, 2007. Certain prior year amounts have been reclassified to conform to the current year presentation.

2. Share-Based Compensation.

Effective January 2006, Statement of Financial Accounting Standards No. 123R (Revised) Share-Based Payments (SFAS 123R) was adopted on a modified prospective basis requiring the Company to measure the cost of equity classified share-based compensation awards at grant date fair value in exchange for employee services rendered. All stock options and nonvested stock awards are granted at their market value on the date of grant. Their fair value is determined on the date of grant and recorded as compensation expense over the attribution period, which is generally the vesting period. Stock options and the Employee Stock Purchase Plan (ESPP) awards are valued at their fair value as determined using the Black-Scholes pricing model.

Stock Option Plan. The Kansas City Southern 1991 Amended and Restated Stock Option and Performance Award Plan (as amended and restated effective May 5, 2005) (the Plan) provides for the granting of options to purchase up to 16.0 million shares of the Company's common stock by officers and other designated employees. Options have been granted under the Plan at 100% of the average market price of the Company's stock on the date of grant and generally have a five year cliff vesting period and are exercisable over the ten year contractual term, except that options outstanding with limited rights (LRs) or limited stock appreciation rights (LSARs) become immediately exercisable upon certain defined circumstances constituting a change in control of the Company. The Plan includes provisions for stock appreciation rights, LRs and LSARs. All outstanding options include LSARs, except for options granted to non-employee Directors prior to 1999. The grant date fair value, less estimated forfeitures, is recorded to expense on a straight-line basis over the vesting period.

The fair value of each stock option award is estimated on the date of grant using the Black-Scholes option pricing model. The weighted-average assumptions used to value options issued during the respective periods are as follows:

	Six Months Ended June 30,	
	2007	2006
Expected dividend yield	0%	0%
Expected volatility	34.43%	38.00%
Risk-free interest rate	4.68%	5.00%

Edgar Filing: KANSAS CITY SOUTHERN - Form 10-Q

Expected term (<i>years</i>)	7.5	6.8
Weighted-average grant date fair value of stock options granted	\$ 16.24	\$ 12.64

The Company has not paid dividends to common stockholders since January of 2000 and currently does not expect to pay dividends to common stockholders in the future. The expected volatility is based on the

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

historical volatility of the Company's stock price over a term equal to the estimated life of the options. The risk-free interest rate is determined based on the U.S. Treasury rates approximating the expected life of the options granted, which represents the period of time the awards are expected to be outstanding and is based on the historical experience of similar awards.

The following table summarizes activity under the stock option plan:

Six Months Ended June 30, 2007	Shares	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Contractual Term In years	Aggregate Intrinsic Value (In millions)
Options outstanding at December 31, 2006	2,940,332	\$ 8.98		
Granted	22,500	34.11		
Exercised	(81,479)	6.58		
Forfeited or expired	(18,672)	21.43		
Options outstanding at June 30, 2007	2,862,681	\$ 9.16	4.15	\$ 81.2
Vested and expected to vest at June 30, 2007	2,851,094	\$ 9.12	4.13	\$ 81.0
Exercisable at June 30, 2007	2,420,848	\$ 7.84	3.71	\$ 71.9

Compensation expense of \$0.1 million and \$0.3 million was recognized for stock option awards for the three months ended June 30, 2007 and 2006, and \$0.3 million and \$0.7 million for the six months ended June 30, 2007 and 2006, respectively. The total income tax benefit recognized in the income statement for stock options was \$0.1 million for the three months ended June 30, 2006, and \$0.1 million and \$0.3 million for the six months ended June 30, 2007 and 2006, respectively.

Additional information regarding stock option exercises appears in the table below (in millions):

	Six Months Ended June 30,	
	2007	2006
Aggregate grant-date fair value of stock options vested	\$ 0.1	\$ 0.2
Intrinsic value of stock options exercised	2.5	4.2
Cash received from option exercises	0.5	3.5

Excess tax benefit realized from option exercises

As of June 30, 2007, \$1.3 million of unrecognized compensation cost relating to nonvested stock options is expected to be recognized over a weighted-average period of 1.58 years. At June 30, 2007, there were 1,899,133 shares available for future grants under the Plan.

Nonvested Stock. The Plan provides for the granting of nonvested stock awards to officers and other designated employees. The grant date fair value is based on the average market price of the stock on the date of the grant. These awards are subject to forfeiture if employment terminates during the vesting period, which is generally a five year cliff vesting for employees and one year for directors. The grant date fair value of nonvested shares, less estimated forfeitures, is recorded to compensation expense on a straight-line basis over the vesting period.

Kansas City Southern**Notes to Consolidated Financial Statements (Continued)**

A summary of nonvested stock activity is as follows:

Six Months Ended June 30, 2007	Number of Shares	Weighted- Average Grant Date Fair Value	Aggregate Intrinsic Value (In millions)
Nonvested stock at December 31, 2006	613,573	\$ 23.74	
Granted	424,769	32.03	
Vested	(62,948)	25.78	
Forfeited	(45,046)	26.62	
Nonvested stock at June 30, 2007	930,348	\$ 27.25	\$ 34.9

Compensation cost on nonvested stock was \$1.7 million and \$0.8 million for the three months ended June 30, 2007 and 2006, and \$3.3 million and \$1.7 million for the six months ended June 30, 2007 and 2006, respectively. The total income tax benefit recognized in the income statement for nonvested stock awards was \$0.6 million and \$0.3 million for the three months ended June 30, 2007 and 2006, and \$1.2 million and \$0.6 million for the six months ended June 30, 2007 and 2006, respectively.

As of June 30, 2007, \$19.8 million of unrecognized compensation costs related to nonvested stock is expected to be recognized over a weighted-average period of 1.72 years. The fair value (at vest date) of shares vested during the six months ended June 30, 2007, was \$1.6 million.

Performance Based Awards. In January 2007, the Company granted performance based nonvested stock awards which are subject to continued employment through January 2010. In addition to the three year service condition, the number of nonvested shares to be received depends on the attainment of performance goals based on the following annual measures: operating ratio, earnings before interest, tax, depreciation and amortization (EBITDA) and return on capital employed. Over the three year performance period, participants in the aggregate can earn up to a maximum of 858,000 shares which have a weighted-average grant date fair value of \$29.82 per share.

The Company expenses the grant date fair value of the awards which are probable of being earned based on forecasted annual performance goals over the three year performance period. Compensation expense on performance based awards was \$0.7 million and \$1.3 million for the three and six months ended June 30, 2007, respectively. Total income tax benefit recognized in the income statement for performance based awards was \$0.3 million and \$0.5 million for the three and six months in the period ended June 30, 2007.

As of June 30, 2007, \$3.7 million of unrecognized compensation cost related to performance based awards is expected to be recognized over a weighted-average period of 1.18 years. The unrecognized compensation cost includes only the amount determined to be probable of being earned based upon the attainment of the annual performance goals.

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

3. Earnings Per Share Data.

Basic earnings per common share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Restricted stock granted to employees and officers is included in weighted average shares for purposes of computing basic earnings per common share as it is earned. Diluted earnings per share reflect the potential dilution that could occur if convertible securities were converted into common stock or stock options were exercised. The following reconciles the weighted average shares used for the basic earnings per share computation to the shares used for the diluted earnings per share computation (*in thousands*):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Basic shares	75,892	74,464	75,737	73,661
Effect of dilution	14,840	18,088	14,813	16,355
Diluted shares	90,732	92,552	90,550	90,016

Potentially dilutive shares excluded from the calculation:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Stock options where the exercise price is greater than the average market price of common shares				
Convertible debt instruments which are anti-dilutive				1,836
Convertible preferred stock which is anti-dilutive	7,000	7,000	7,000	7,000

The following reconciles net income available to common stockholders for purposes of basic earnings per share to net income available to common stockholders for purposes of diluted earnings per share (*in millions*):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	25.3	19.2	42.3	27.2

Net income available to common stockholders for purposes of computing basic earnings per share				
Effect of dividends on conversion of convertible preferred stock	2.1	2.1	4.4	4.2
Effect of interest expense on conversion of \$47.0 million escrow note		0.4		
Effect of interest expense on conversion of note payable to TMM for VAT/Put settlement		0.2		0.5
Net income available to common stockholders for purposes of computing diluted earnings per share	27.4	21.9	46.7	31.9

4. Derivative Instruments.

The Company does not engage in the trading of derivative financial instruments except where the Company's objective is to manage fuel price risk and foreign currency fluctuations. In general, the Company enters into derivative transactions in limited situations based on management's assessment of current market conditions and perceived risks. However, management intends to respond to evolving business and market conditions and in doing so, may enter into such transactions more frequently as deemed appropriate.

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

Fuel Derivative Transactions. As of June 30, 2007, the Company did not have any outstanding fuel swap agreements. Fuel hedging transactions, consisting of fuel swaps, resulted in a decrease in fuel expense of \$0.4 million and \$0.3 million for the three and six months ended June 30, 2007, and a decrease in fuel expense of \$0.3 million and \$0.6 million for the three and six months ended June 30, 2006, respectively.

Foreign Exchange Contracts. The purpose of the foreign exchange contracts of Kansas City Southern de México, S.A. de C.V., a wholly-owned subsidiary of the Company (KCSM), is to limit exposure arising from exchange rate fluctuations in its Mexican peso-denominated financial assets and liabilities. Management determines the nature and quantity of any hedging transactions based upon net asset exposure and market conditions. As of June 30, 2007, KCSM did not have any outstanding call option contracts. As of June 30, 2006, KCSM had two Mexican peso call options outstanding in the notional amounts of \$1.7 million and \$1.2 million, based on the average exchange rate of 14.50 and 13.00 Mexican pesos per U.S. dollar, respectively. These options expired on May 30, 2007 and September 6, 2006, respectively.

Foreign Currency Balance. At June 30, 2007 and at December 31, 2006, KCSM had financial assets and liabilities denominated in Mexican pesos of Ps.2,352.2 million and Ps.2,304.0 million, and Ps.829.1 million and Ps.651.4 million, respectively. At June 30, 2007 and at December 31, 2006, the exchange rate was Ps.10.78 and Ps.10.82, per U.S. dollar, respectively.

5. Comprehensive Income.

Other comprehensive income refers to revenues, expenses, gains and losses that under U.S. GAAP are included in comprehensive income, a component of stockholders' equity within the consolidated balance sheets, rather than net income. Under existing accounting standards, other comprehensive income for KCS reflects the amortization of interest rate swaps and amortization of prior service credit.

KCS' total comprehensive income was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net income	\$ 30.2	\$ 24.1	\$ 52.4	\$ 37.0
Other comprehensive income:				
Amortization of interest rate swaps		0.1		0.2
Amortization of prior service credit	(0.1)			
Total comprehensive income	\$ 30.1	\$ 24.2	\$ 52.4	\$ 37.2

6. Commitments and Contingencies.

Litigation. The Company is a party to various legal proceedings and administrative actions, all of which are of an ordinary, routine nature and incidental to its operations. Included in these proceedings are various tort claims brought by current and former employees for job related injuries and by third parties for injuries related to railroad operations. KCS aggressively defends these matters and has established liability reserves which management believes are adequate to cover expected costs. Although it is not possible to predict the outcome of any legal proceeding, in the opinion of the Company's management, other than those proceedings described in detail below, such proceedings and actions should not, individually or in the aggregate, have a material effect on the Company's financial position. However, a material adverse outcome in one or more of these proceedings could have a material impact on the operating results of a particular period.

Environmental Liabilities. The Company's U.S. operations are subject to extensive federal, state and local environmental laws and regulations. The major U.S. environmental laws to which the Company is subject include, among others, the Federal Comprehensive Environmental Response, Compensation and Liability Act

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

(CERCLA, also known as the Superfund law), the Toxic Substances Control Act, the Federal Water Pollution Control Act, and the Hazardous Materials Transportation Act. CERCLA can impose joint and several liabilities for cleanup and investigation costs, without regard to fault or legality of the original conduct, on current and predecessor owners and operators of a site, as well as those who generate, or arrange for the disposal of hazardous substances. The Company does not believe that compliance with the requirements imposed by the environmental legislation will impair its competitive capability or result in any material additional capital expenditures, operating or maintenance costs. The Company is, however, subject to environmental remediation costs as described below.

The Mexican operations are subject to Mexican federal and state laws and regulations relating to the protection of the environment through the establishment of standards for water discharge, water supply, emissions, noise pollution, hazardous substances and transportation and handling of hazardous and solid waste. The Mexican government may bring administrative and criminal proceedings and impose economic sanctions against companies that violate environmental laws, and temporarily or even permanently close non-complying facilities.

The risk of incurring environmental liability is inherent in the railroad industry. As part of serving the petroleum and chemicals industry, the Company transports hazardous materials and has a professional team available to respond and handle environmental issues that might occur in the transport of such materials. Additionally, the Company is a partner in the Responsible Care® program and, as a result, has initiated certain additional environmental, health and safety programs. The Company performs ongoing reviews and evaluations of the various environmental programs and issues within the Company's operations, and, as necessary, takes actions intended to limit the Company's exposure to potential liability.

The Company owns property that is, or has been, used for industrial purposes. Use of these properties may subject the Company to potentially material liabilities relating to the investigation and cleanup of contaminants, claims alleging personal injury, or property damage as the result of exposures to, or release of, hazardous substances. Although the Company is responsible for investigating and remediating contamination at several locations, based on currently available information, the Company does not expect any related liabilities, individually or collectively, to have a material impact on its results of operations, financial position or cash flows. Should the Company become subject to more stringent cleanup requirements at these sites, discover additional contamination, or become subject to related personal or property damage claims, the Company could incur material costs in connection with these sites.

The Company records liabilities for remediation and restoration costs related to past activities when the obligation is probable and the costs can be reasonably estimated. Costs of ongoing compliance activities to current operations are expensed as incurred. The Company's recorded liabilities for these issues represent its best estimates (on an undiscounted basis) of remediation and restoration costs that may be required to comply with present laws and regulations. Although these costs cannot be predicted with certainty, management believes that the ultimate outcome of identified matters will not have a material adverse effect on the Company's consolidated results of operations, financial position or cash flows.

Environmental remediation expense was \$3.2 million and \$2.7 million for the six months ended June 30, 2007 and 2006, respectively, and was included in casualties and insurance expense on the consolidated statements of income. Additionally, as of June 30, 2007, KCS had a liability for environmental remediation of \$9.4 million. This amount was derived from a range of reasonable estimates based upon the studies and site surveys described above and in accordance with Statement of Financial Accounting Standards No. 5 Accounting for Contingencies (SFAS 5).

Casualty Claim Reserves. The Company's casualty and liability reserve for its U.S. business segment is based on actuarial studies performed on an undiscounted basis. The reserve is based on claims filed and an estimate of claims incurred but not yet reported. While the ultimate amount of claims incurred is dependent on

Kansas City Southern**Notes to Consolidated Financial Statements (Continued)**

various factors, it is management's opinion that the recorded liability is a reasonable estimate of aggregate future payments. Adjustments to the liability are reflected as operating expenses in the period in which the adjustments are known. Casualty claims in excess of self-insurance levels are insured up to certain coverage amounts, depending on the type of claim and year of occurrence. Activity in the reserve follows (*in millions*):

	Six Months Ended June 30,	
	2007	2006
Balance at beginning of year	\$ 117.4	\$ 103.9
Accruals, net (includes the impact of actuarial studies)	12.2	3.7
Payments	(43.5)	(9.4)
Balance at end of period	\$ 86.1	\$ 98.2

The casualty claim reserve balance as of June 30, 2007 is based on an updated study of casualty reserves for data through May 31, 2007 and a review of the last month's experience. The activity for the six months ended June 30, 2007 primarily relates to the net settlements and payments related to a large casualty claim, and the reserves for FELA, third-party, and occupational illness claims. The changes to the reserve in the current year compared to the prior year primarily reflect a large litigation settlement, the reversal of approximately \$4.4 million of loss reserves in the first quarter of 2006 and the current accruals related to the trend of loss experience since the date of the prior study.

Reflecting the uncertainty surrounding the outcome of casualty claims, it is reasonably possible that future costs to settle casualty claims may range from approximately \$82 million to \$96 million. However, management believes that the \$86.1 million recorded is the best estimate of the Company's future obligations for the settlement of casualty claims at June 30, 2007. The most sensitive assumptions for personal injury accruals are the expected average cost per claim and the projected frequency rates for the number of claims that will ultimately result in payment. A 10% increase or decrease in either the expected average cost per claim or the frequency rate for claims with payments would result in an approximate \$8.6 million increase or decrease in the Company's recorded personal injury reserves.

Antitrust Lawsuit. The Kansas City Southern Railway Company, a wholly-owned subsidiary of the Company (KCSR), has been included along with the other major U.S. railroads in a number of putative class actions alleging that the individual railroads conspired in violation of U.S. antitrust laws. The other railroads included are CSX Transportation, Inc., BNSF Railway Co., Union Pacific Railroad Co., and Norfolk Southern Railway Co. In some cases the Association of American Railroads has been named as a party. The allegation relates to fuel surcharge rates in connection with unregulated shipments in the United States. The first of these lawsuits was filed on or about May 14, 2007 in the United States District Court for the District of New Jersey. As of July 18, 2007, 19 additional, virtually identical, lawsuits have been filed in numerous federal courts. A motion is presently pending before the Judicial Panel on Multidistrict Litigation (JPML) to transfer all of these lawsuits to a single district court for coordinated pretrial proceedings. Because plaintiffs and defendants agree that multidistrict treatment of the lawsuits is appropriate, KCSR anticipates that the JPML motion will be granted. However, because the JPML has not yet ruled,

the transferee court has not yet been identified. Each of the lawsuits is at an early stage, and none have entered the discovery phase of litigation. None of the lawsuits have made a claim for a specified amount of damages, although each seeks to recover compensatory and treble damages on behalf of a nationwide class of shippers, along with attorneys' fees and costs. KCSR believes it has strong defenses and intends to vigorously contest these lawsuits, through trial and appeal if necessary. In addition, the Company has learned that a state attorney general has initiated an investigation of rail fuel surcharges, has sought information regarding those surcharges from other railroads and intends to request similar information from the Company. KCS is presently unable to reasonably evaluate the likelihood of an unfavorable outcome or quantify the possible damages, if any, associated with these

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

matters, or judge whether or not those damages would be material to its consolidated financial position, results of operations, cash flows or business.

Disputes Relating to Payments for the Use of Trackage and Haulage Rights and Interline Services. KCSM and Ferrocarril Mexicano, S.A. de C.V. (Ferromex) both initiated administrative proceedings seeking a determination by the Mexican *Secretaria de Comunicaciones y Transportes* (Ministry of Communications and Transportation or SCT) of the rates that the companies should pay each other in connection with the use of trackage and haulage rights and interline and terminal services. The SCT, in March of 2002, issued rulings setting the rates for trackage and haulage rights. In August of 2002, the SCT issued a ruling setting the rates for interline and terminal services. KCSM and Ferromex appealed both rulings. Following the trial and appellate court decisions, the Mexican Supreme Court in February of 2006, in a ruling from the bench, sustained KCSM's appeal of the SCT's trackage and haulage rights ruling, vacating the ruling and ordering the SCT to issue a new ruling consistent with the Court's opinion. KCSM has not yet received the written opinion of the Mexican Supreme Court relating to the interline and terminal services appeal. In October 2006, KCSM was served with a claim raised by Ferromex in which Ferromex asked for information concerning the interline traffic between KCSM and Ferromex from January 2002 through December 2004. KCSM filed an answer to this claim and expects this litigation to continue over the next few years. The Company believes that based on its assessment of the facts in this case, there will be no material effect on KCS's results of operations.

Disputes Relating to the Scope of the Mandatory Trackage Rights. KCSM and Ferromex are parties to various civil cases involving disputes over the application and proper interpretation of the mandatory trackage rights. In August 2002, the SCT issued rulings determining Ferromex's trackage rights in Monterrey, Nuevo León. KCSM and Ferromex both appealed the SCT's rulings. At the Mexican Administrative Federal Court level, KCSM obtained what it believes were favorable rulings. Ferromex appealed these rulings and the case was returned to the Mexican Administrative Federal Court. The Administrative Federal Court issued a ruling on June 11, 2007, however, it has not been released to the parties.

Claims Asserted under the TMM Acquisition Agreement. As part of the acquisition of Grupo KCSM, S.A. de C.V. (Grupo KCSM) in 2005, KCS issued escrow notes totaling \$47.0 million which are subject to reduction for certain potential losses related to incorrect representations and warranties or breaches of covenants in the Amended and Restated Acquisition Agreement (Acquisition Agreement) by Grupo TMM, S.A. (TMM). In January 2007, KCS advised TMM that KCS intended to assert claims totaling an amount greater than \$47.0 million for indemnification under the Acquisition Agreement related to representations and warranties made by TMM. In February 2007, KCS received notice from TMM indicating that TMM would seek damages from KCS under the Acquisition Agreement. The parties are obligated under the Acquisition Agreement to attempt to resolve their differences informally and, if not successful, then to submit them to binding arbitration.

Acquisition of Locomotives. In August 2006, KCSR entered into an agreement with Electro-Motive Diesel, Inc. (EMD) to acquire 30 new locomotives to be delivered in August and September of 2007. The Company intends to finance the locomotives through an operating lease.

In April 2007, KCSM and KCSR entered into a definitive purchase agreement with EMD to acquire 70 locomotives for delivery in October 2007 through April 2008 at an aggregate cost of approximately \$143.3 million. KCSR will acquire 30 of these locomotives and KCSM will acquire the other 40. The Company intends to finance the acquisition through operating leases

Letter of Intent. KCSR and KCSM entered into a letter of intent with General Electric Company (GE) in September 2006, to acquire 80 locomotives to be delivered in late 2007 through August 2008. KCSR intends to acquire 30 of these locomotives and KCSM intends to acquire the other 50. KCSR and KCSM each anticipates entering into purchase agreements with GE in the third quarter of 2007 with respect to the 80 locomotives.

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

Lease of Locomotives. In April 2007, KCSM entered into an Equipment Lease Agreement (the Lease) between KCSM and High Ridge Leasing LLC (the Lessor), for 30 GE locomotives delivered to KCSM in December 2006 and January 2007. Pursuant to the terms of the Lease, KCSM agreed to sell the locomotives to the Lessor and to lease the locomotives from the Lessor for an initial term of 20 years under the terms of an operating lease.

Lease of Railcars. In June 2007, KCSR entered into an equipment lease agreement for 60 ballast cars. The lease qualifies as a capital lease with a term of 10 years and total future minimum lease payments of \$17.8 million.

Panama Canal Railway Company. Under the terms of a loan agreement with the International Finance Corporation (IFC), the Company is a guarantor for up to \$3.9 million of the IFC debt of Panama Canal Railway Company (PCRC). Also, if PCRC terminates its concession contract with the Panamanian government without the IFC's consent, KCS is a guarantor for up to \$9.5 million of the outstanding senior loans. The Company is also a guarantor for up to \$0.4 million of PCRC equipment loans and capital leases, and has issued three irrevocable letters of credit totaling approximately \$2.8 million to fulfill the Company's fifty percent guarantee of approximately \$5.6 million of equipment loans.

7. Income Taxes.

In June 2006, the Financial Accounting Standards Board issued Interpretation Number 48 Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109, Accounting for Income Taxes (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 requires the Company to recognize in the financial statements the benefit of a tax position only if the impact is more likely than not of being sustained on audit based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure.

The provisions of FIN 48 were effective for KCS beginning January 1, 2007. The Company recognized a cumulative effect of the change in accounting principle of \$1.3 million recorded as a decrease to opening retained earnings. The total unrecognized tax benefit as of January 1, 2007 was \$26.3 million of which \$5.1 million would affect the effective tax rate if recognized.

The Company recorded a \$3.9 million increase in unrecognized tax benefits in the second quarter due to uncertainty regarding the timing of deducting certain reserves. The increase to unrecognized tax benefits would have no impact on the effective tax rate if recognized.

Within the next twelve months, the Company anticipates a tax examination will be settled which will result in a decrease in unrecognized tax benefits of approximately \$12 million. The tax exam settlement is expected to have an immaterial effect on the Company's consolidated effective tax rate.

Tax returns filed in the United States from 1997 through the current year remain open to examination by the Internal Revenue Service. Tax returns filed in Mexico from 2001 through the current year remain open to examination by the taxing authorities in Mexico.

Interest and penalties related to uncertain tax positions are included in income before taxes on the income statement. Related accruals as of the date of adoption was \$13.5 million, of which \$2.1 million relates to 2007.

8. Pension and Other Postretirement Benefits.

Health and Welfare. Certain U.S. employees that have met age and service requirements are eligible for life insurance coverage and medical benefits during retirement. The retiree medical plan is contributory and provides benefits to retirees, their covered dependents and beneficiaries. The life insurance plan is non-

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

contributory and covers retirees only. The Company's policy, in most cases, is to fund benefits payable under these plans as the obligations become due.

KCSM Union Pension. Under the provisions of a bargaining agreement for covered employees in Mexico, KCSM provides a substantive pension benefit in the form of a lump-sum post-retirement payment to retirees who leave KCSM after age 60. KCSM's practice is to fund benefits under this program as the obligations become due.

9. Business Segments.

The accompanying segment reporting information (*in millions*) has been prepared and presented pursuant to Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information. Operating units are defined as either U.S. or Mexico segments. Appropriate eliminations of revenue and reclassifications of operating revenues and expenses have been recorded in deriving consolidated data. The U.S. segment consists primarily of KCSR and The Texas Mexican Railway Company (Tex-Mex). The Mexico segment consists of KCSM and Arrendadora KCSM, S.A. de C.V. (Arrendadora).

	Three Months Ended June 30, 2007			
	U.S.	Mexico	Elimination	Consolidated
Revenue	\$ 227.7	\$ 199.4	\$	\$ 427.1
Operating expenses:				
Compensation and benefits	63.8	34.7		98.5
Purchased services	22.2	25.2	(4.3)	43.1
Fuel	36.3	29.4		65.7
Equipment costs	20.9	27.9	(0.3)	48.5
Depreciation and amortization	16.6	24.2		40.8
Casualties and insurance	13.4	4.1		17.5
Material and other costs	19.6	6.0	4.3	29.9
Total operating expenses	192.8	151.5	(0.3)	344.0
Operating income	\$ 34.9	\$ 47.9	\$ 0.3	\$ 83.1
Income before income taxes and minority interest	\$ 20.4	\$ 23.7	\$	\$ 44.1
Capital expenditures	45.0	29.4		74.4

Kansas City Southern**Notes to Consolidated Financial Statements (Continued)**

	Three Months Ended June 30, 2006			
	U.S.	Mexico	Elimination	Consolidated
Revenue	\$ 218.3	\$ 194.8	\$	\$ 413.1
Operating expenses:				
Compensation and benefits	64.7	32.9		97.6
Purchased services	21.7	29.5	1.2	52.4
Fuel	35.9	27.2		63.1
Equipment costs	19.5	19.8		39.3
Depreciation and amortization	15.3	21.5		36.8
Casualties and insurance	13.0	2.5		15.5
Material and other costs	20.5	11.6	(1.2)	30.9
Total operating expenses	190.6	145.0		335.6
Operating income	\$ 27.7	\$ 49.8	\$	\$ 77.5
Income before income taxes and minority interest	\$ 11.5	\$ 21.1		\$ 32.6
Capital expenditures	23.1	13.3		36.4

	Six Months Ended June 30, 2007			
	U.S.	Mexico	Elimination	Consolidated
Revenue	\$ 448.8	\$ 389.6	\$	\$ 838.4
Operating expenses:				
Compensation and benefits	128.3	70.1		198.4
Purchased services	47.0	51.0	(8.2)	89.8
Fuel	69.8	58.4		128.2
Equipment costs	41.0	52.7	(0.3)	93.4
Depreciation and amortization	31.5	47.4		78.9
Casualties and insurance	29.6	7.3		36.9
Material and other costs	37.2	11.9	8.2	57.3
Total operating expenses	384.4	298.8	(0.3)	682.9
Operating income	\$ 64.4	\$ 90.8	\$ 0.3	\$ 155.5
Income before income taxes and minority interest	\$ 37.6	\$ 38.1	\$	\$ 75.7
Total assets	\$ 2,349.4	\$ 2,405.6	\$ (42.9)	\$ 4,712.1

Edgar Filing: KANSAS CITY SOUTHERN - Form 10-Q

Total liabilities	1,774.0	1,148.5	(42.9)	2,879.6
Capital expenditures	82.4	50.3		132.7

17

Kansas City Southern**Notes to Consolidated Financial Statements (Continued)**

	Six Months Ended June 30, 2006			
	U.S.	Mexico	Elimination	Consolidated
Revenue	\$ 430.9	\$ 370.6	\$	\$ 801.5
Operating expenses:				
Compensation and benefits	128.8	63.8		192.6
Purchased services	41.4	63.5	2.4	107.3
Fuel	67.4	54.0		121.4
Equipment costs	43.6	40.4		84.0
Depreciation and amortization	30.6	44.6		75.2
Casualties and insurance	21.8	6.3		28.1
Material and other costs	40.3	16.2	(2.4)	54.1
Total operating expenses	373.9	288.8		662.7
Operating income	\$ 57.0	\$ 81.8	\$	\$ 138.8
Income before income taxes and minority interest	\$ 26.1	\$ 26.4	\$	\$ 52.5
Total assets	\$ 2,161.6	\$ 2,369.3	\$ (69.5)	\$ 4,461.4
Total liabilities	1,782.5	1,150.1	(69.5)	2,863.1
Capital expenditures	74.9	28.5		103.4

10. Condensed Consolidating Financial Information.

KCSR has outstanding \$200.0 million of 9 1/2% Senior Notes due 2008 and \$200.0 million of 7 1/2% Senior Notes due 2009. These notes are unsecured obligations of KCSR, however, they are also jointly and severally and fully and unconditionally guaranteed on an unsecured senior basis by KCS and certain wholly-owned domestic subsidiaries. For each of these note issues, KCSR registered exchange notes with the SEC that have substantially identical terms and associated guarantees and all of the initial senior notes for each issue have been exchanged for \$200.0 million of registered exchange notes for each respective note issue.

The accompanying condensed consolidating financial information (*in millions*) has been prepared and presented pursuant to SEC Regulation S-X Rule 3-10 Financial statements of guarantors and affiliates whose securities collateralize an issue registered or being registered. This condensed information is not intended to present the financial position, results of operations and cash flows of the individual companies or groups of companies in accordance with U.S. GAAP.

Kansas City Southern**Notes to Consolidated Financial Statements (Continued)**
CONDENSED CONSOLIDATING STATEMENTS OF INCOME

	Three Months Ended June 30, 2007					
	Parent	KCSR	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Revenues	\$	\$ 203.2	\$ 2.6	\$ 228.5	\$ (7.2)	\$ 427.1
Operating expenses	6.0	174.0	3.8	167.1	(6.9)	344.0
Operating income (loss)	(6.0)	29.2	(1.2)	61.4	(0.3)	83.1
Equity in net earnings of unconsolidated affiliates	35.5	1.4		2.4	(36.5)	2.8
Interest expense	(1.5)	(16.7)	(0.4)	(23.5)	0.5	(41.6)
Debt retirement costs				(6.9)		(6.9)
Foreign exchange gain				3.4		3.4
Other income (expense)	(0.3)	0.6		3.2	(0.2)	3.3
Income (loss) before income taxes and minority interest	27.7	14.5	(1.6)	40.0	(36.5)	44.1
Income tax expense (benefit)	(2.6)	5.5	(0.6)	11.5		13.8
Minority interest	0.1					0.1
Net income (loss)	\$ 30.2	\$ 9.0	\$ (1.0)	\$ 28.5	\$ (36.5)	\$ 30.2

	Three Months Ended June 30, 2006					
	Parent	KCSR	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Revenues	\$	\$ 196.8	\$ 2.6	\$ 219.8	\$ (6.1)	\$ 413.1
Operating expenses	4.7	165.4	5.0	166.5	(6.0)	335.6
Operating income (loss)	(4.7)	31.4	(2.4)	53.3	(0.1)	77.5
Equity in net earnings (losses) of unconsolidated affiliates						