1977 ANNUAL REPORT

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY

AND SUBSIDIARIES

Stanley E. G. Hillman, Trustee

516 West Jackson Boulevard

Chicago, Illinois 60606

Chicago, Milwaukee, St. Paul
and Pacific Railroad Company

516 West Jackson Boulevard
Chicago, Illinois 60606
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May 25, 1978

To stockholders and others interested
in the Milwaukee Road:

On December 19, 1977, the Milwaukee Road filed in federal court a voluntary petition for reorganization under Section 77 of the Federal Bankruptcy Act. I began my duties officially as Trustee on February 13, 1978.

Under the Act, title to all of the Railroad's properties is vested in me. I am directed to operate those properties including the Railroad's subsidiaries and, if possible, develop a plan of financial reorganization. Thus has begun a process which will greatly change, and I hope revitalize, the Railroad. My objective will be to complete the process in as short a time as possible.

So that you may be fully informed, I shall report from time to time on the operation of the properties and the progress of the reorganization proceedings.

Attached is a financial report of the Railroad's operations through December 31, 1977. Please read this report carefully. The auditor's opinion and the notes to the financial statements are critical to your understanding of the Railroad's circumstances and of events occurring in 1977 and early 1978. This report reflects not only the onset of the reorganization proceedings and the reason why they became necessary but it also reflects several changes in accounting methods which became effective in 1977 and which have had a material effect on the stated financial results. The changes deal primarily with investment in track structure, capital in excess of par value, and equipment leases.

In 1977, for the purposes of this and other public financial reports, the Railroad conformed its treatment of its investment in its track structure to the treatment long accorded its investments in other types of railroad property, departing in so doing from a method required by the Interstate Commerce Commission for reports to the Commission. The new "depreciation accounting" treatment of track-structure investments is a generally accepted accounting principle and is similar to the method used by industrial firms in accounting for their plant and machinery.

While the bottom line of the Consolidated Statements of Operations indicates that in 1977 the Railroad had net earnings of some $10.6 million, this number is greatly affected by the change to depreciation accounting for track structure. The Railroad was required by accounting rules to include in its 1977 results an adjustment which reflected the cumulative effect of the application of depreciation accounting to years prior to 1977. This adjustment of some $30.9 million had a beneficial effect upon stated 1977 results which bore no relationship to the Railroad's actual performance in the year. It should be noted that 1977 results also benefited from a deferred federal income tax benefit of some $5.6 million, which is explained in the notes to the financial statements.

Taking into account the current effect of the change in track-structure accounting but not the cumulative effect, the Railroad incurred a consolidated loss of some $20.3 million in 1977. In 1976, on a comparable basis, the Railroad had a consolidated loss of $2.6 million.

On the traditional ICC accounting basis, as reflected in its reports to the ICC, the Railroad experienced a loss in 1977 of $36.2 million. On the ICC basis, the Railroad incurred a loss in 1976 of $12.1 million.

I call your attention particularly to note 16 to the financial statements for a reconciliation of financial results as stated under the two accounting methods, and to note 4 for an explanation of the depreciation-accounting method of treating investment in track structure. It is important to understand that, except in the pro-forma figures at the very end of the Consolidated Statements of Operations, final results shown for 1976 are not comparable to those of 1977.

Although the Railroad's total assets substantially exceed its liabilities, its cash levels are marginal. The railroad is being operated within the constraints of its liquidity. Forecasts which were made shortly after the first of the year anticipated a cash shortfall before the end of 1978.

On April 20, 1978, finance and guarantee agreements were executed with the Federal Railroad Administration which permit the borrowing of $5.1 million from the Federal Financing Bank under the Emergency Rail Services Act of 1970. However, on May 12, 1978, the trustees of the Railroad's mortgages and debenture indenture filed an appeal with the

U. S. Court of Appeals from the order of the District Court dated April 14 approving the issuance of the Trustee's Certificate which would secure the ERSA loan. It is not now possible to estimate when, or whether, the funds will become available.

As notes 3 and 11 to the financial statements indicate, negotiations are also in process with the FRA for approximately \$20 million in loan guarantees and \$30 million in Trustee's certificate (redeemable preference share) financing for equipment and track rehabilitation.

While it is far too early to reach any definite conclusions as to the future viability and reorganizability of the Railroad, I have begun the process by which ultimately I shall be able to make these determinations. Consultants are well into their study to determine whether the Railroad has a core of economically self-supportable routes. Their conclusions will be in hand by fall.

In the meantime, the major programs of self-help which the Railroad's management had begun are going forward. The program to shed unproductive light-density lines is well along. We will continue to seek out coordinations with other railroads to eliminate unnecessary parallel trackage. Expenditures for locomotive maintenance and track work have been increased. Employment is being reduced from 1977 levels, in management as well as in the rank and file.

I do not presently subscribe to the view, as expressed by some, that rationalizing the midwest railroads means that those presently in reorganization must necessarily die or be dismembered and sold off. We must first learn from the studies now under way what our business prospects are and ascertain the availability of further federal financial assistance. Not until we have these facts and figures in hand can intelligent judgments be made as to the Milwaukee Road's future.

Respectfully,

Stanley E. G. Hillman
Trustee

PEAT, MARWICK, MITCHELL & CO.
CERTIFIED PUBLIC ACCOUNTANTS
222 SOUTH RIVERSIDE PLAZA
CHICAGO, ILLINOIS 60606

Mr. Stanley E. G. Hillman,
Trustee of the Property of
Chicago, Milwaukee, St. Paul
and Pacific Railroad Company:

We have examined the consolidated balance sheets of Chicago, Milwaukee, St. Paul and Pacific Railroad Company (in reorganization) and subsidiaries (Railroad) as of December 31, 1977 and 1976 and the related consolidated statements of operations and retained earnings and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

On December 19, 1977, the Railroad filed a voluntary petition for reorganization under Section 77 of the Federal Bankruptcy Act. The District Court of the United States for the Northern District of Illinois, Eastern Division, has appointed a trustee of the property and ordered that Railroad's business be continued, operated and managed in the customary and usual manner pending appraisal of reorganization opportunities and development of a plan of reorganization.

Railroad has sustained substantial operating losses during recent years and prior to reorganization proceedings had a substantial deficiency in working capital. The ability of Railroad to continue operations in reorganization on a going-concern basis, to improve its physical plant and to achieve substantially improved operations is dependent upon many factors, including the availability of adequate financial resources and the restructuring of physical plant as explained in note 3 of notes to consolidated financial statements.

As set forth in note 1 of notes to consolidated financial statements, the accompanying consolidated financial statements have been prepared on the basis of accounting principles applicable to a going concern. This basis presumes that cash will be available to finance future operations and the realization of assets and settlement of liabilities, contingent obligations and commitments will occur in the ordinary course of business, rather than through a process of forced liquidation. Accordingly, such consolidated financial statements do not purport to present: (1) realizable value of all assets or their availability on a liquidation basis, (2) the amounts or priorities of liabilities and contingencies which may be allowed in the reorganization proceedings or (3) the effects upon shareholder accounts, or upon future operations, of any changes which may be made in the capitalization of the Railroad or in the manner of conducting its business. The ability of Railroad to continue operations on a going-concern basis depends on a number of factors, and we do not express any opinion as to Railroad's ability to continue operations on a going-concern basis.

P. M. M. & CO.

Our opinion dated March 11, 1977 on the 1976 consolidated financial statements was qualified as Railroad is required to maintain its accounts in accordance with Interstate Commerce Commission rules and treated other elements of investment as a part of the property accounts. Under generally accepted accounting principles, other elements of investment would be treated as capital in excess of par value. As described in note 5 of notes to consolidated financial statements, Railroad has restated the consolidated financial statements for 1976 to conform with generally accepted accounting principles. Accordingly, our present opinion on the 1976 consolidated financial statements, as presented herein, is different from that expressed in our previous report.

In our opinion, subject to the possible effects of such adjustments that might have been required had the outcome of the uncertainties discussed in the second through fourth paragraphs above been known, the aforementioned consolidated financial statements present fairly the financial position of Chicago, Milwaukee, St. Paul and Pacific Railroad Company and subsidiaries as of December 31, 1977 and 1976 and the results of their operations and changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied during the period except for the changes, with which we concur, in the method of accounting for investment in railroad track structure as described in note 4 of notes to consolidated financial statements and in the method of accounting for leases as described in note 8 of notes to consolidated financial statements and after restatement for the change, with which we also concur, in the classification of other elements of investment as described in note 5 of notes to consolidated financial statements.

Peat, Marwick, Mitchell & Co.

March 27, 1978

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY
AND SUBSIDIARIES
(In Reorganization Under Section 77
of the Federal Bankruptcy Act)
CONSOLIDATED BALANCE SHEETS
December 31, 1977 and 1976

Assets	1977	1976 As Restated (note 5)
Current assets:		
Cash and temporary cash investments	$ 10,783,637	$ 12,391,757
Accounts receivable	34,701,326	36,533,165
Material and supplies (note 4)	31,117,993	29,625,264
Other current assets	7,300,930	5,815,724
Total current assets	83,903,886	84,365,910
Special funds (note 6)	7,127,250	5,817,963
Investments:		
Affiliated companies	23,175,172	24,738,134
Other companies	479,446	432,058
Total investments	23,654,618	25,170,192
Properties (notes 4 and 8):		
Road	1,178,901,207	640,650,629
Equipment	257,952,996	269,518,690
Equipment under capital leases	9,416,134	-
	1,446,270,337	910,169,319
Less allowances for depreciation and amortization	790,285,960	295,178,637
Transportation properties	655,984,377	614,990,682
Other property, net of accumulated depreciation and amortization	19,259,567	21,751,093
Total properties	675,243,944	636,741,775
Other assets and deferred charges	14,270,652	12,281,575
Total assets	$ 804,200,350	$764,377,415

(Continued)

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY AND SUBSIDIARIES

(In Reorganization Under Section 77 of the Federal Bankruptcy Act)

CONSOLIDATED BALANCE SHEETS (Continued)

December 31, 1977 and 1976

Liabilities and Shareholders' Equity	1977	1976 As Restated (note 5)
Current liabilities:		
Note payable to bank	$ -	$ 1,090,382
Accounts payable	35,104,965	50,857,784
Payroll and vacation pay	19,244,561	19,261,044
Accrued taxes	1,142,337	10,307,219
Other current liabilities	1,041,792	1,665,461
Current maturities of long-term debt (note 7)	7,154,457	7,147,367
Total current liabilities	63,688,112	90,329,257
Reserves and other liabilities (note 1)	18,925,577	29,984,572
Long-term debt (notes 1 and 7)	206,476,188	203,918,092
Accounts payable, accrued and other liabilities deferred under reorganization proceedings (note 1)	54,971,928	-
Deferred Federal income taxes (note 9)	32,576,550	32,341,892
Total liabilities	376,638,355	356,573,813
Shareholders' equity:		
Redeemable Preference Shares - par value $10,000 per share. Authorized 20,000 shares; issued 913 shares (note 11)	9,130,000	-
Preferred Stock - par value $100 a share, 5% participating. Authorized 1,150,000 shares; issued 518,652 shares	51,865,200	51,865,200
Common Stock - no par value (stated value $100 a share). Authorized 2,637,451 shares (including 311,274 shares reserved for conversion of outstanding General Mortgage bonds, Series B); issued 2,179,892 shares	217,989,200	217,989,200
Capital in excess of par value (note 5)	117,830,241	117,830,241
Retained earnings	30,747,354	20,118,961
Total common shareholders' equity	366,566,795	355,938,402
Total shareholders' equity	427,561,995	407,803,602
Contingencies (notes 10 and 17)		
Total liabilities and shareholders' equity	$ 804,200,350	$764,377,415

See accompanying notes to consolidated financial statements.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY
AND SUBSIDIARIES
(In Reorganization Under Section 77
of the Federal Bankruptcy Act)
CONSOLIDATED STATEMENTS OF OPERATIONS
Years Ended December 31, 1977 and 1976

	1977	1976 As Restated (note 5)
Operating revenues:		
Transportation (note 12)	$454,984,072	$449,806,041
Timber and real estate	12,695,027	9,851,010
	467,679,099	459,657,051
Operating expenses and costs:		
Train and yard operations	203,951,600	197,310,737
Maintenance of way and structures, including depreciation	72,417,055	64,875,517
Maintenance of equipment, including depreciation	67,641,121	61,346,704
Traffic	10,901,485	11,037,351
Payroll and other taxes	41,366,438	42,736,523
Equipment and joint facility rents, net	67,789,140	60,387,514
General and other	33,004,965	30,797,140
	497,071,804	468,491,486
Net operating loss	(29,392,705)	(8,834,435)
Other income:		
Gain on sales of transportation properties	3,768,266	2,875,444
Interest	1,436,476	1,481,475
Rents	3,440,600	3,067,302
Miscellaneous, net (note 19)	(1,285,499)	(397,339)
Total other income	7,359,843	7,026,882
	(22,032,862)	(1,807,553)
Fixed interest	5,066,356	5,314,449
Contingent interest on long-term debt (notes 1 and 7)	1,356,374	2,629,838
Litigation settlement (note 17)	-	3,025,316
Loss before deferred Federal income tax benefit, extraordinary item and cumulative effect of change in accounting principle	(28,455,592)	(12,777,156)
Deferred Federal income tax benefit (note 9)	5,655,000	-
Loss before extraordinary item and cumulative effect of change in accounting principle	(22,800,592)	(12,777,156)
Extraordinary item-adjustment of Amtrak reserve (less deferred Federal income taxes of $2,257,658) (note 13)	2,445,796	-
Cumulative effect on years prior to 1977 of change to depreciation accounting for railroad track structure properties (less deferred Federal income taxes of $3,632,000) (note 4)	30,983,189	-
Net earnings (loss)	$ 10,628,393	$(12,777,156)

(Continued)

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY
AND SUBSIDIARIES
(In Reorganization Under Section 77
of the Federal Bankruptcy Act)
CONSOLIDATED STATEMENTS OF OPERATIONS (Continued)
Years Ended December 31, 1977 and 1976

	1977	1976 As Restated (note 5)
Earnings (loss) per common share:		
Primary:		
Loss before extraordinary item and cumulative effect of a change in accounting principle	$(10.46)	$(5.86)
Extraordinary item	1.12	-
Cumulative effect of a change in accounting principle	14.22	-
Net earnings (loss)	$ 4.88	$(5.86)
Fully diluted:		
Loss before extraordinary item and cumulative effect of a change in accounting principle	$ (9.15)	$(5.86)
Extraordinary item	.98	-
Cumulative effect of a change in accounting principle	12.44	-
Net earnings (loss)	$ 4.27	$(5.86)
Pro forma amounts assuming the new depreciation method is applied retroactively:		
Loss before extraordinary item	$(22,800,592)	$(2,587,360)
Net loss	$(20,354,796)	$(2,587,360)
Per share loss applicable to common stock:		
Before extraordinary item	$(10.46)	$(1.19)
Net loss	$ (9.34)	$(1.19)

See accompanying notes to consolidated financial statements.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY
AND SUBSIDIARIES

(In Reorganization Under Section 77
of the Federal Bankruptcy Act)

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

Years Ended December 31, 1977 and 1976

	1977	1976
Balance at beginning of year, as previously reported	$33,350,712	$45,429,777
Less prior period adjustment (note 5)	13,231,751	12,533,660
Balance at beginning of year, as restated	20,118,961	32,896,117
Net earnings (loss)	10,628,393	(12,777,156)
Balance at end of year	$30,747,354	$20,118,961

See accompanying notes to consolidated financial statements.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY
AND SUBSIDIARIES
(In Reorganization under Section 77
of the Federal Bankruptcy Act)
CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION
Years Ended December 31, 1977 and 1976

	1977	1976 As Restated (note 5)
Source of funds:		
From operations:		
Loss before extraordinary item and cumulative effect of change in accounting principle	$(22,800,592)	$(12,777,156)
Charges (credits) to operations not requiring funds in the current period:		
Depreciation and retirement charges (note 4)	38,076,127	16,415,920
Deferred Federal income tax benefit	(5,655,000)	-
Contingent interest on long-term debt	1,356,374	2,629,838
Additions to reserves for claims	3,650,000	4,195,329
Other, net	3,510,783	2,026,164
Working capital provided from operations before extraordinary item and cumulative effect of change in accounting principle	18,137,692	12,490,095
Extraordinary item-adjustment of Amtrak reserve	-	-
Cumulative effect on material and supplies, for years prior to 1977, of change to depreciation accounting for railroad track structure properties (note 4)	(1,742,000)	-
Working capital provided from operations	16,395,692	12,490,095
Salvage and sale proceeds	9,385,268	6,729,734
Equipment and other borrowing	1,897,672	1,283,203
Obligations under capital leases	8,789,192	-
Withdrawal of funds on deposit with mortgage trustee	7,112,569	4,436,703
Issuance of Redeemable Preference Shares	9,130,000	-
Liabilities reclassified to non-current due to reorganization proceedings (note 1)	42,079,938	-
Miscellaneous sources, net	1,787,576	(461,155)
	$ 96,577,907	$ 24,478,580

(Continued)

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY AND SUBSIDIARIES
(In Reorganization Under Section 77 of the Federal Bankruptcy Act)

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION (Continued)
Years Ended December 31, 1977 and 1976

	1977	1976 As Restated (note 5)
Application of funds:		
Property additions and betterments (note 4)	$ 51,188,143	$ 9,706,161
Debt retirement	7,883,995	8,117,956
Deposits with mortgage trustee	8,311,668	5,040,837
Reclassification of estimated liabilities for claims ($921,000) and litigation settlement ($1,100,817) to current liabilities	-	2,021,817
Investment in terminal and other companies	510,210	169,855
Reclassification of advances to Chicago Union Station Company to other assets	1,750,000	-
Reclassification of interest receivable to other assets	754,770	-
Increase (decrease) in working capital	26,179,121	(578,046)
	$ 96,577,907	$ 24,478,580
Analysis of changes in working capital:		
Increase (decrease) in current assets:		
Cash and temporary cash investments	$ (1,608,120)	$ (2,467,833)
Accounts receivable	(1,831,839)	(596,205)
Material and supplies	1,492,729	3,022,088
Other current assets	1,485,206	685,940
	(462,024)	643,990
Increase (decrease) in current liabilities:		
Note payable to bank	(1,090,382)	(1,000,000)
Accounts payable	(15,752,819)	6,053,099
Payroll and vacation pay	(16,483)	(2,156,797)
Accrued taxes	(9,164,882)	323,944
Other current liabilities	(623,669)	(897,353)
Current maturities of long-term debt	7,090	(1,100,857)
	(26,641,145)	1,222,036
Increase (decrease) in working capital	$ 26,179,121	$ (578,046)

See accompanying notes to consolidated financial statements.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY AND SUBSIDIARIES

(In Reorganization Under Section 77 of the Federal Bankruptcy Act)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1977 and 1976

(1) Reorganization Proceedings

On December 19, 1977, Chicago, Milwaukee, St. Paul and Pacific Railroad Company (Railroad) filed a petition for voluntary reorganization under Section 77 of the Federal Bankruptcy Act with the United States District Court for the Northern District of Illinois, Eastern Division (No. 77 B 8999). On December 20, 1977, an order was entered in this proceeding by Judge Thomas R. McMillen which approved the petition as properly filed. On January 18, 1978 the Court (hereinafter sometimes referred to as the "Reorganization Court") appointed Mr. Stanley E. G. Hillman as Trustee. Mr. Hillman's appointment was approved by the Interstate Commerce Commission on February 9, 1978, and he began serving as Trustee of the property of Railroad on February 13, 1978.

The Reorganization Court has directed that Railroad's business be continued, operated and managed in substantially the customary and usual manner pending appraisal of reorganization opportunities and development of a plan of reorganization.

The Trustee has been granted broad power, subject to supervision and control by the Reorganization Court, to manage and preserve Railroad's property. Pursuant to authority provided by orders of the Reorganization Court, Railroad has deferred payment of invoices, claims, taxes, interest and other items totaling approximately $55 million, and has classified such amount as accounts payable, accrued and other liabilities deferred under reorganization proceedings (non-current) in the accompanying Consolidated Balance Sheet as of December 31, 1977.

(2) Summary of Significant Accounting Policies

The following summarizes the significant accounting policies of Railroad and its subsidiaries.

Basis of Statement Presentation

The accompanying consolidated financial statements have been prepared, as in the past, on the basis that Railroad including its wholly owned subsidiaries is a going concern, i.e., that it will continue in operation and that the realization of its assets and settlement of its liabilities (certain of which have been delayed) will be in the normal course of business. The consolidated financial statements do not reflect in any way changes that may emerge from the reorganization proceedings.

(Continued)

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY
AND SUBSIDIARIES

(In Reorganization Under Section 77
of the Federal Bankruptcy Act)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(2) Summary of Significant Accounting Policies (Continued)

Consolidation

The consolidated financial statements include the accounts of Chicago, Milwaukee, St. Paul and Pacific Railroad Company (a majority owned subsidiary of Chicago Milwaukee Corporation) and all of Railroad's wholly owned subsidiaries. All significant intercompany items have been eliminated in consolidation.

Investments in unconsolidated affiliates owned 20% or more are carried at the cost of investment plus Railroad's equity in their undistributed net earnings since date of acquisition. Investments in nonaffiliates are reflected principally at cost less an allowance to reflect the estimated amount of any permanent impairment in value.

Revenue Recognition

Transportation freight revenues are recognized upon completion of service except as to interline shipments originating on-line, for which revenues are recorded when service begins. Passenger (commuter) revenues are accounted for on a cash basis, and other transportation revenues are recognized generally at the time service is performed.

Real estate transactions are recorded in accordance with the audit guide of the American Institute of Certified Public Accountants, "Profit Recognition on Sales of Real Estate".

Timber harvested by licensees under long-term contracts is recognized in operating revenues in the period in which cutting and harvesting is performed.

Properties

The investment in road and equipment properties is stated at original cost or estimated original cost, as determined by the Interstate Commerce Commission in 1917 and 1918, plus subsequent additions at cost less retirements.

As of January 1, 1977 Railroad changed its accounting for track structure from the retirement/betterment method to the depreciation method (see note 4).

(Continued)

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY
AND SUBSIDIARIES

(In Reorganization Under Section 77
of the Federal Bankruptcy Act)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(2) Summary of Significant Accounting Policies (Continued)

Railroad follows the policy of providing for depreciation of properties by charging against earnings annual amounts sufficient to amortize the cost of such properties on a straight-line basis over their anticipated useful lives. Composite depreciation rates are used. In the case of normal retirements, cost less salvage is charged to accumulated depreciation.

The approximate ranges of annual depreciation rates for major property classifications are as follows:

Road property:	
Track structure	.70% to 3.57%
Other	.92% to 3.96%
Transportation equipment	2.80% to 9.30%

Prior to 1977, in conformity with Interstate Commerce Commission accounting rules, depreciation provisions were not made in the case of certain roadway properties, principally grading and track. Instead, these properties were accounted for by an alternative generally accepted accounting principle whereby replacement costs are recorded as operating expenses and only additions and betterments are capitalized. Gains or losses on sales and retirements of these nondepreciable properties were reflected in current operations. Road properties for which depreciation provisions were not made amounted to approximately $365 million at December 31, 1976.

Material and Supplies

Material and supplies are stated at cost which is not in excess of replacement market. Cost is determined generally by the first-in, first-out method.

Earnings (Loss) Per Share

Earnings (loss) per share of common stock is based upon the average number of common shares outstanding. Dividends on the preferred stock are not cumulative, and are not included in the determination of per share amounts unless declared.

(Continued)

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY AND SUBSIDIARIES

(In Reorganization Under Section 77 of the Federal Bankruptcy Act)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(2) Summary of Significant Accounting Policies (Continued)

Federal Income Taxes

Provisions for deferred Federal income taxes in the accompanying consolidated financial statements reflect the results of timing differences in computing income for financial reporting and income tax purposes. Investment tax credits are recorded as a reduction of the Federal income tax provision in the year they are available for financial reporting purposes. Railroad and its subsidiaries are included in the consolidated Federal income tax return of Chicago Milwaukee Corporation. Under a 1972 tax allocation agreement between Railroad and Chicago Milwaukee Corporation, Chicago Milwaukee Corporation is required to credit Railroad for any tax benefits which become unavailable to Railroad as a result of their having been used by members of the Chicago Milwaukee Corporation consolidated tax group, other than Railroad and its subsidiaries, if such benefits could have been used by Railroad and its subsidiaries. The Trustee has not yet evaluated the factual and legal issues involved to determine the present status of the tax allocation agreement and whether it should be affirmed or rejected. Taxes are provided by Railroad and its subsidiaries as if they were filing a separate consolidated return.

(3) Liquidity; Replacement and Maintenance Deferrals

Railroad's consolidated working capital position improved at December 31, 1977 because of the reclassification to non-current status of liabilities deferred in reorganization proceedings; however, consolidated operations are expected to be decidedly unprofitable throughout 1978 and consolidated cash position remains marginal.

Railroad's liquidity problems are primarily a result of its operating losses. Recently, and particularly in 1977 and continuing into 1978, losses have been worsened by operational disabilities attributable to weather and to track and equipment replacement and maintenance deferrals.

The extent of such replacement and maintenance deferrals is considerable. While there is not at this time any practical and generally accepted method of measuring such deferrals in dollars, certain statistics are indicative. As to freight cars owned and leased, the ratio of "bad order" (out of service awaiting repairs) cars to the total fleet was 8.4% at December 31, 1976, and 13.1% at February 28, 1978. As to road locomotives, the ratio of bad order units to the total fleet was 14.7% at December 31, 1976, and 46.4% at February 24, 1978.

(Continued)

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY
AND SUBSIDIARIES

(In Reorganization Under Section 77
of the Federal Bankruptcy Act)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(3) Liquidity; Replacement and Maintenance Deferrals (Continued)

Annual cross tie and rail replacements expressed as a percentage of the total number of units in the track structure have averaged 1.63% and 0.62%, respectively, over the past ten years. The quantity of ballast placed per year has averaged 152,000 cubic yards over the past ten years; the 1977 quantity of 254,000 cubic yards compares to an estimated total 27,821,000 cubic yards in the track structure at the beginning of that year. Track-miles of trackage surfaced have averaged 0.83% of total track miles over the past ten years. These data indicate that insufficient amounts of material have been put into the property to replace worn-out components. Derailments and other accidents have increased over the past few years, and there has been an overall upward trend of slow orders on Railroad's running trackage.

Railroad's liquidity is more favorable on a consolidated basis, assuming full availability of subsidiary operating earnings; however, a $5.8 million cash dividend paid to the Trustee of Railroad by its Milwaukee Land Company subsidiary in February, 1978 has been challenged in the United States District Court in Chicago by the trustees for holders of its First and General Mortgage bonds (see note 17). In addition the proceeds from sales of railroad property are being held in escrow subject to further order of the Reorganization Court (note 6). It appears that Railroad will require an additional infusion of cash during 1978.

Railroad has made application to the Federal government for a loan guarantee under the Emergency Rail Services Act of 1970. As of the date of this report there is pending before the Reorganization Court a request for authority to issue a $5.1 million guaranteed trustee's certificate which would have the highest priority in payment under the Bankruptcy Act. The loan proceeds, which will be available for certain operating expenses, will be used primarily for locomotive repairs and track maintenance.

Longer-range solution of Railroad's liquidity problems requires substantial reduction, if not elimination, of its operating losses. Cash infusions to reduce maintenance deferrals are desirable in this respect. In this regard Railroad is seeking

(Continued)

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(3) Liquidity; Replacement and Maintenance Deferrals (Continued)

approximately $50 million of financial assistance at this time under Sections 505 and 511 of the Railroad Revitalization and Regulatory Reform Act of 1976 (4-R Act) for rehabilitation of its properties. The extent to which Railroad may be successful with these 4-R Act assistance applications is not known. Railroad is also actively pursuing solution of its operating loss and liquidity problems through major programs to restructure its plant by abandoning uneconomic lines, selling lines and/or arranging with other railroads for joint use of track and other facilities. Provisions designed to facilitate such plant restructuring are contained in Title IV and Title VIII of the 4-R Act. Approximately 3,700 miles of line have been identified for near-term abandonment or study for possible future abandonment, and about 1,200 of these miles are covered by formal abandonment applications already on file with the Interstate Commerce Commission. Completion of at least some of these actions and additional studies will be necessary before any firm conclusion can be reached with respect to the likelihood of an income based reorganization.

(4) Accounting Change - Track Structure

During 1977 Railroad changed for financial reporting purposes its method of accounting for investment in railroad track structure from the retirement/betterment method to the depreciation method. Railroad continues to report to the Interstate Commerce Commission under the retirement/betterment method. The depreciation method has long been employed by Railroad for its depreciable properties other than track structure.

The Interstate Commerce Commission has historically required retirement/betterment accounting for railroad track structure. This method requires a charge against income only when a segment of track structure is replaced or permanently taken out of service. Most costs of track structure replacement are charged off immediately as operating expenses; only betterments (the current cost of the excess weight of heavier rail, for example) and new construction are capitalized. Reusable track structure components recovered from retirements or betterments are taken into inventory of material and supplies as secondhand material.

(Continued)

(11) Redeemable Preference Shares (Continued)

Railroad's Charter and Articles of Incorporation were amended in 1977 to authorize its Board of Directors to issue 20,000 redeemable preference shares from time to time in one or more series, and to issue an initial "Series One" consisting of a maximum of 930 shares. During 1977, 913 Series One shares were sold at par to the Secretary of Transportation. Substantially all of the proceeds from such sales were applied by Railroad during the year, in conformity with the Financing Agreement referred to elsewhere in this note, to the replacement of track structure components in its main line between Milwaukee and Minneapolis-St. Paul.

Redeemable preference shares rank senior to Railroad's Preferred Stock and Common Stock as to dividend, redemption, liquidation and dissolution rights, but subordinate in such matters to senior debt. Upon any conversion of the shares to a fixed interest debt obligation (pursuant to any Board of Directors' resolution creating the series or any agreement pursuant to which they were issued) they would rank generally on a parity with subsequently incurred indebtedness. In liquidation the holder of the redeemable preference shares is generally entitled to receive the outstanding par value or principal amount plus unpaid accrued dividends or interest.

The Series One redeemable preference shares are entitled to annual cash dividend and redemption payments in the amount of $750 per share in each of the years 1988 through 2007, subject to possible acceleration as explained below. The dividend portion of each $750 payment is equal to approximately 4.2% of par value at the time of payment. Par value will be reduced by the amount of each redemption installment paid. Dividends are payable only if Railroad is not insolvent or if payment would not render it insolvent, and only if certain conditions governing the availability of capital for the payment are met.

The Series One redeemable preference shares are subject to and entitled to the benefits of a Financing Agreement, dated as of July 15, 1977, between Railroad and the United States of America. The agreement defines various events, including bankruptcy, insolvency or reorganization, as "Events of Default" thereunder. Upon the happening of any Event of Default the agreement provides that the holder of the outstanding redeemable

(Continued)

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(9) Federal Income Taxes (Continued)

Other income taxes consisting of various state income taxes are minor in amount and are included in operating expenses and costs.

(10) Pensions

Generally, all non-union employees of Railroad and its subsidiaries are covered by trusteed noncontributory qualified pension plans providing defined benefits integrated with Railroad Retirement Act or Social Security Act benefits. Pension expense is accrued at the actuarially computed normal cost plus 40-year amortization of prior service cost, and the plans are funded on the same basis.

Consolidated pension expense amounted to $2,760,000 in 1977 and $2,271,000 in 1976. The actuarially computed value of vested benefits in excess of plan assets was $18,184,000 as of July 1, 1977.

If Railroad were to cease operations instead of achieving a reorganization, or otherwise terminate its pension plan, the Employee Retirement Income Security Act of 1974 guarantees the payment of certain benefits and makes Railroad liable for any shortage of plan funds, up to 30 per cent of Railroad's net worth. At July 1, 1977 the amount of Railroad's potential liability with respect to guaranteed benefits was approximately $6,700,000.

(11) Redeemable Preference Shares

The Railroad Revitalization and Regulatory Reform Act of 1976 established, among other things, certain financing mechanisms designed to assist in rehabilitation and improvement of railway facilities and equipment, including the purchase by the Secretary of Transportation of the United States of redeemable preference shares issued by railroads. The Act requires redeemable preference shares to be nonvoting and to have an initial par value of $10,000 per share, and establishes basic characteristics of the shares including priority relative to other securities of the issuer, accrual and amount of dividends, and mandatory redemption provisions.

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(9) Federal Income Taxes (Continued)

	1977		1976	
	Tax Expense (Benefit) (in thousands)	Effective Tax Rate	Tax Expense (Benefit) (in thousands)	Effective Tax Rate
Federal corporate income tax rate	$(13,659)	(48.0)%	$(6,133)	(48.0)%
Increases (decreases) resulting from:				
Capital gain without tax benefit	2,066	7.2	-	-
Investment tax credit	5,655	19.9	-	-
Other items, net	283	1.0	(93)	(.8)
Loss carryforward without tax benefit	-	-	6,226	48.8
Deferred Federal income tax benefit	$ (5,655)	(19.9)%	$ 0	0 %
Extraordinary item-adjustment of Amtrak reserve	$ 2,258	48.0 %	-	-
Cumulative effect of change in accounting for track structure	$ 16,615	48.0 %	-	-
Benefit of loss carryforward	(7,285)	(21.0)	-	-
Benefit of capital gain tax rate	(2,066)	(6.0)	-	-
Utilization of investment tax credit	(3,632)	(10.5)	-	-
Tax expense for cumulative effect of change in accounting for track structure	$ 3,632	10.5 %	-	-

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(9) Federal Income Taxes

Federal income tax liabilities have been settled through the year 1967. Based in part upon unaudited returns and estimated 1977 tax data, Railroad had available at December 31, 1977, consolidated tax loss carryforwards of approximately $73,532,000, of which $28,832,000 will expire in 1982, $6,251,000 in 1985 and $38,449,000 in 1986.

The available investment tax credit carryforward for tax purposes as of December 31, 1977 amounted to approximately $13,360,000, which will expire as follows: 1978 - $1,927,000, 1979 - $2,257,000, 1980 - $1,538,000, 1981 - $1,815,000, 1982 - $1,679,000, 1983 - $1,680,000 and 1984 - $2,464,000. For financial reporting purposes approximately $13,193,000 of investment tax credit carryforward was available to reduce future Federal income tax provisions.

The deferred Federal income tax expense reported in the accompanying 1977 Consolidated Statement of Operations represents the recognition given to the tax effect of timing differences, as between tax reporting and financial statement reporting, attributable principally to depreciation expense. The following table reconciles the United States Federal income tax rate of 48% to the effective rates:

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(8) Leased Properties and Lease Commitments (Continued)

Total rental expense for the years ended December 31, 1977 and 1976 was $30,239,080 and $29,063,000, respectively.

The foregoing rental expense figures are exclusive of net car-hire expenses incurred by Railroad on a per diem and/or mileage basis for the use of railroad rolling stock in interchange service with other railroads. Also excluded are railroad joint-facility "rents" representing essentially operating expenses shared with other joint owners or joint users.

Future minimum rental payments due as of December 31, 1977 under all leases accounted for as operating leases (including those which are capital leases under the new lease accounting standards) are as follows:

1978	$ 29,104,817
1979	28,092,854
1980	26,254,213
1981	23,858,136
1982	23,124,683
Later years	116,292,347
Total	$246,727,050

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(8) Leased Properties and Lease Commitments (Continued)

Certain of the pre-1977 leases, however, are capital leases under the new lease accounting standards, primarily under criterion (d), above. If Railroad had accounted for these leases as capital leases, assets in the accompanying Consolidated Balance Sheets would have increased by approximately $71,000,000 and $78,000,000, and liabilities would have been increased by approximately $79,000,000 and $84,000,000 at December 31, 1977 and 1976, respectively. Net earnings for the year ended December 31, 1977 would have been reduced by approximately $3,000,000 ($1.38 per share).

Capital leases entered into since January 1, 1977, are reported in the accompanying Consolidated Balance Sheet as of December 31, 1977, as follows:

Transportation equipment	$9,416,134
Less accumulated amortization	283,377
	$9,132,757

Minimum rental payments due under such capital leases entered into since January 1, 1977 are as follows:

1978	$ 1,664,074
1979	1,605,290
1980	1,605,290
1981	1,605,290
1982	1,605,290
Later years	8,319,430
Total minimum lease payments	16,404,664
Implicit interest (rates ranging from 9% to 16%)	7,228,254
Present value of net minimum lease payments	$ 9,176,410*

* Included in the balance sheet as current and noncurrent obligations of $637,835 and $8,538,575, respectively.

(Continued)

(8) Leased Properties and Lease Commitments

Railroad has made extensive use of long-term lease-financing to acquire transportation equipment properties. Substantially all of the leases cover new or rebuilt locomotives, freight cars and other railroad rolling stock.

Most of Railroad's leases are net leases requiring the lessee to pay related taxes, maintenance, insurance and certain other operating expenses applicable to the leased property. Typically, the leases do not contain renewal or purchase options other than options at termination of many of the rolling stock leases to renew or purchase the equipment on the basis of its then fair rental or market value.

New lease accounting standards have been established by the Financial Accounting Standards Board effective for lease agreements entered into on or after January 1, 1977. Retroactive application of these standards to earlier leases is required starting in 1981, and is optional until that time.

The new standards include criteria for classifying leases as between "capital" leases and "operating" leases. In general, a capital lease is one which meets any one or more of four criteria: (a) transfers ownership of the leased property to the lessee by the end of the lease term; (b) contains a bargain purchase option; (c) lease term is equal to 75% or more of the estimated economic life of the leased property; or (d) the present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90% of the fair value of the leased property to the lessor at inception. All leases which are not capital leases are operating leases.

Under the new standards a capital lease shall in general be recorded as an asset and an obligation, at an amount equal to the present value at the beginning of the lease term of minimum lease payments. Such asset amounts are required to be amortized by periodic charges against earnings similar to depreciation provisions. Minimum lease payments are required to be allocated between reduction of the capital lease obligation amounts and interest expense. Operating lease rentals are generally expensed as incurred.

As to pre-1977 leases, Railroad has continued in 1977 its previous practice of accounting for all leases as operating leases, as permitted by the optional transition rule referred to herein.

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(7) Long-Term Debt (Continued)

(a) Cumulative to a maximum of 13-1/2%.
(b) Cumulative to a maximum of 4-1/2%.
(c) Noncumulative.
(d) Convertible into Railroad common stock on the basis of one share of common stock for each $100 principal amount of bonds.
(e) Bonds held by Railroad include $100,000 principal amount pledged under Chicago, Terre Haute and Southeastern Railway Company first and refunding mortgage.
(f) Bonds held by Railroad include $1,515,000 principal amount pledged under Chicago, Milwaukee, St. Paul and Pacific Railroad Company first mortgage.
(g) See note 17.
(h) The filing by Railroad of a petition for reorganization under the Federal Bankruptcy Act (note 1) constituted or resulted in an Event of Default under each of the mortgages listed above, the indenture covering the income debentures of 2055, and the equipment obligations. Trustees under certain mortgages and the debenture indenture have issued notices declaring to be immediately due and payable the principal of all debt outstanding thereunder and all accumulations of unpaid interest. By order of the Reorganization Court, no long-term debt principal or interest payments may be made until further order of the Court except in the case of equipment obligations issued, guaranteed or assumed by the Trustee. The Trustee of Railroad, pursuant to authorization of the Court, has adopted the obligations of Railroad under substantially all equipment obligations and long-term equipment leases, without prejudice to his right to reject them in a plan of reorganization.

Substantially all of the properties of Railroad and its investments in common stock of certain subsidiaries are pledged under the mortgages and equipment obligations. Investments in affiliated companies include $7,389,110 pledged as collateral to mortgage bonds.

Maturities of equipment obligations and obligations under capital leases during each of the years 1978-1982 inclusive, are approximately $7,154,457, $6,255,941, $5,162,391, $3,353,006 and $1,895,665, respectively.

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(7) Long-Term Debt

Long-term debt, exclusive of installments due within one year, is summarized as follows:

	Interest Rates		Principal Amount	
	Fixed	Contingent (g)	(In Default)(h) Dec.31,1977	Dec.31,1976
Chicago, Milwaukee, St. Paul and Pacific Railroad Company:				
First mortgage bonds, Series A, 1994	4%	-	$ 48,735,300	$ 48,735,300
General mortgage income bonds, Series A, 2019	-	4-1/2%(a)	24,684,700	24,684,700
General mortgage convertible income bonds, Series B, 2044 (d)	-	4-1/2%(a)	31,127,400	31,127,400
Income debentures, Series A, 2055	-	5%(c)	55,604,000	55,604,000
The Bedford Belt Railway Company first mortgage bonds, 1994 (e)	2-3/4%	1-1/2%(b)	148,000	178,000
The Southern Indiana Railway Company first mortgage bonds, 1994	2-3/4%	1-1/2%(b)	5,102,000	5,466,000
Chicago, Terre Haute and Southeastern Railway Company:				
First and refunding mortgage bonds, 1994 (f)	2-3/4%	1-1/2%(b)	7,170,000	7,170,000
Income mortgage bonds, 1994	2-3/4%	1-1/2%(b)	4,738,800	4,738,800
Equipment obligations	5-12%	-	19,909,672	24,890,359
Obligations under capital leases	9-16%	-	8,538,575	-
Other	6-11%	-	717,741	1,323,533
Total			$206,476,188	$203,918,092

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(5) Capital in Excess of Par Value

Capital in excess of par value arose in connection with the reorganization of Railroad as of January 1, 1944. It is the amount (after adjustments during ensuing years) by which the properties and other assets of Railroad exceeded its capitalization and other liabilities established by the Court at that time.

Prior to 1977, in keeping with accounting requirements of the Interstate Commerce Commission, Railroad reported this item (under the caption "other elements of investment") as a negative component of the investment in road properties and amortized it by writing off to miscellaneous other income an allocated portion of the account when pre-reorganization road properties were retired.

Effective as of January 1, 1977, in order to conform to generally accepted accounting principles, Railroad reclassified the account from properties to shareholders' equity and the practice of amortizing the account to other income was discontinued retroactively. Accordingly, no such amortization is included in the Consolidated Statement of Operations for the year ended December 31, 1977, and the Consolidated Statement of Operations for the year ended December 31, 1976 has been restated to remove $698,091 of amortization previously reported in miscellaneous other income for that year.

The $117,830,241 reclassified as of January 1, 1977 from properties to shareholders' equity is after restoring to the account the cumulative amount that had been amortized to miscellaneous other income for the period January 1, 1944 through December 31, 1976.

The former accounting treatment as described above has been retained for reports to the Interstate Commerce Commission.

(6) Special Funds

Special funds are held under the mortgages or in escrow, subject to orders of the Reorganization Court (note 1). The funds, derived principally from sales of railroad real estate, are in the form of cash, United States Treasury Bills and bank certificates of deposit (see notes 3 and 17).

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(4) Accounting Change - Track Structure (Continued)

Railroad made the accounting change because its management believed that the depreciation method of accounting is preferable in the circumstances since it achieves a better matching of revenues and expenses in view of management's expressed intention to make extensive use of funds available under the Railroad Revitalization and Regulatory Reform Act of 1976, particularly provisions of the Act relating to Federally assisted track rehabilitation involving expenditures significantly in excess of what would otherwise be incurred. Such track rehabilitation programs were commenced by Railroad during the third quarter of 1977 and are expected to be expanded in the future (see notes 3 and 11). Since these expenditures improve Railroad's ability to provide timely service, management believes a better matching of revenues and expenses is achieved by allocating the cost of improvements using the depreciation method of accounting over the periods expected to be benefited. Using the retirement/betterment method, these improvement expenditures would be charged to operating expense during the year incurred. In addition, depreciation accounting provides for the recording on the balance sheet of the actual costs of assets currently in service, rather than the initial cost of original construction. Depreciation accounting for track structure places all of Railroad's operating properties on a uniform and comparable basis with other industries.

The cumulative effect of the change on years prior to 1977 ($30,983,189, after reduction of $3,632,000 for deferred Federal income taxes) is included as a separate line item in the Consolidated Statement of Operations for the year ended December 31, 1977. The accounting change lowered 1977 operating expenses and costs by $12,520,119 ($5.74 per common share assuming no dilution, $5.03 per common share assuming full dilution), and this effect is included in the applicable line items (principally maintenance of way and structures expense, including depreciation) of the Consolidated Statement of Operations for the year ended December 31, 1977. The cumulative effect of the change in accounting principle did not impact Railroad's cash position.

Railroad's consolidated financial statements for 1976 are not restated in respect of the change to depreciation accounting for track structure; however, the 1976 consolidated financial statements include pro forma amounts of net loss stated as if depreciation accounting for track structure had been applied during 1976.

(Continued)

(4) Accounting Change - Track Structure (Continued)

Under the depreciation method, investment in track structure, less estimated net salvage, is charged against income annually at rates calculated to allocate the investment over the estimated useful lives of the track structure components. Costs of replacing track structure units are capitalized (added to investment) rather than expensed, and normal retirements are charged to accumulated depreciation, after giving effect to net salvage. As in the case of its other properties Railroad is using the composite depreciation method for track structure. Under the newly adopted depreciation method, routine repairs such as rail tightening and grinding, build-up of switch points, ballast replacements of less than 500 cubic yards per mile, etc. are charged to expense by Railroad as incurred. Secondhand material is retained in the property accounts at its cost less depreciation until scrapped. The following estimated useful composite lives for material, labor and overhead have been assigned to the track structure assets except for rail labor and overhead, which has a composite life of 36 years:

	Estimated Useful Composite Life
Ties	28 years
Rail	50 years
Grading	143 years
Tunnels	125 years
Ballast	35 years
Other track material	33 years

This accounting change was effective as of January 1, 1977, and as of that date track structure assets under retirement/betterment accounting were valued at $364,790,000. The change to depreciation accounting had the effect of increasing recorded track structure investment to $882,813,000 and required the recording of accumulated depreciation of $483,408,000, the net result being a net write-up of these assets in the amount of $34,615,000. In addition, the inventory of material and supplies was decreased by $1,742,000 in respect of secondhand track structure material.

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(11) Redeemable Preference Shares (Continued)

preference shares may declare the shares to be a fixed interest debt obligation, accelerate the redemption installments to a maximum of fifteen annual payments to begin on the sixth anniversary of original issuance of the shares, and raise the dividend rate to the maximum permissible by law. If the Event of Default is the filing of a petition in bankruptcy or an event of similar character, the agreement provides that such conversion to debt and acceleration will occur automatically. However, the shares may become a fixed interest debt obligation only if, when and to the extent such conversion would not violate the laws of Railroad's state of incorporation. Railroad's Law Department believes that the Series One redeemable preference shares have not become a fixed interest debt obligation because such conversion may be deemed to violate provisions of the Wisconsin Business Corporation Law, in view of Railroad's filing of the petition for reorganization and pending reorganization proceeding; this matter may be litigated in the reorganization proceeding.

The Financing Agreement contains covenants requiring that Railroad report to the Administrator of the Federal Railroad Administration with respect to various actions, including encumbrance of properties, guarantees, additional indebtedness, capital stock transactions, charter amendments, purchase of investment securities, lending or advancing funds, purchase or lease of assets, maintenance of working capital and net worth levels, and use of insurance proceeds. Upon the happening of any Event of Default the agreement provides that such actions automatically become subject to the prior written consent of the Administrator. The Trustee has not yet evaluated the facts and legal issues involved to determine whether to affirm the financing agreement.

Railroad has made formal application to the Secretary of Transportation for additional preference shares (trustee certificates during Railroad's reorganization) and/or guaranteed-loan financial assistance for rehabilitation projects originally in the amount of about $100 million. This application is being amended to reduce the amount of assistance requested to approximately $50 million.

(12) Mass Transit Assistance

Transportation revenues include government contract payments of $6,878,415 in 1977 and $5,501,208 in 1976 in respect of Railroad's Chicago-area commuter service operations.

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(13) Extraordinary Item

The 1977 extraordinary item adjusts an estimated liability which Railroad established by an extraordinary charge in 1971 to cover one-time costs and losses resulting from the assumption by Amtrak of Railroad's intercity passenger services. Studies completed in 1977 determined certain elements of the estimated liability to be in excess of the indicated remaining costs and losses. Such excess is reflected in the Consolidated Statement of Operations for 1977 as an extraordinary credit to income, net of deferred Federal income taxes.

(14) Per Share Earnings (Loss)

No recognition has been given in the per-share computations to preferred dividend requirements because of Railroad's entry into reorganization proceedings in 1977 (note 1) and, with respect to 1976, because of action by the Board of Directors of Railroad to omit the preferred dividend. Dilution of 1977 per-share amounts results from the assumed conversion of outstanding Series B General Mortgage bonds into Common Stock.

(15) Related Party Transactions

Railroad makes loans and advances to a number of its unconsolidated affiliates. The loans have an average interest rate of approximately 7.0% and are due in the years 1997 and 1999. The advances are generally on open account and non-interest bearing. Net reduction of loans and advances in 1977 was $566,571, and net loans and advances made in 1976 were $933,850. At December 31, 1977 and 1976 loans and advances outstanding were $17,475,945, and $18,042,516, respectively. Railroad guarantees of the indebtedness of affiliated companies are described in note 17.

Milwaukee Land Company held a $1,700,000 promissory note of Chicago Milwaukee Corporation at December 31, 1977 and 1976, which note bears interest at the floating prime rate. Interest income of $117,000 and $118,000 has been accrued in 1977 and 1976, respectively. The terms of the promissory note provide for payment of principal and accrued interest at the maturity date, March 1, 1985.

Milwaukee Land Company owns manufacturing facilities having a net book value of $2,212,336 and $3,746,671 at December 31, 1977 and 1976, respectively. On December 16, 1977, Milwaukee Land Company entered into a sale and leaseback arrangement with an unrelated party with respect to one of the locations. These facilities were leased or subleased to affiliated companies (Vulcan-Hart Corporation and Hanson Porcelain Company, subsidiaries of Chicago Milwaukee Corporation) for approximately $593,000 per year in 1977 and 1976.

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(15) Related Party Transactions (Continued)

Railroad has been billed by Chicago Milwaukee Corporation for an allocated portion of the Corporation's corporate overhead expenses. Such charges, reported by Railroad as deductions from other income, amounted to $452,658 in 1977 and $421,416 in 1976. Amounts payable to Chicago Milwaukee Corporation at December 31, 1977 and 1976 for this expense were $527,658 and $407,416, respectively.

Railroad and The Milwaukee Motor Transportation Company have billed Chicago Milwaukee Corporation for administrative services of $196,430 in 1977 and $224,658 in 1976. At December 31, 1977 and 1976, amounts due from Chicago Milwaukee Corporation for these services were $220,785 and $237,134, respectively.

(16) Interstate Commerce Commission Reporting

Operating results reported in the accompanying consolidated financial statements on the basis of generally accepted accounting principles differ in certain respects from results reported by Railroad to the Interstate Commerce Commission and other regulatory authorities. The following table reconciles net operating results in regulatory reportings to the accompanying Consolidated Statements of Operations.

	1977	1976
Net loss as reported to the Interstate Commerce Commission	$(36,246,980)	$(12,079,065)
Accounting change to depreciation method of accounting for investment in track structure (see note 4):		
Effect for 1977	12,520,119	-
Cumulative effect on years prior to 1977, less deferred Federal income taxes	30,983,189	-
Deferred Federal income tax benefit	5,655,000	-
Amortization of other elements of investment (see note 5)	(2,282,935)	(698,091)
Net earnings (loss)	$ 10,628,393	$(12,777,156)

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(17) Litigation and Contingencies

Railroad is liable, jointly with other railroads, as guarantor of obligations of affiliated companies amounting to $48,093,000 at December 31, 1977. Also, Railroad is contingently liable as guarantor along with other railroads for its proportion (2.44%), and its proportionate share of any contingent obligations not met by other railroad participants, of obligations of Trailer Train Company aggregating $7,723,124. Certain lease agreements include guaranty by Railroad of approximately $49,000,000 invested indirectly in the leased property by loan participants.

Railroad carries a service interruption insurance policy under which it may be obligated to pay additional premiums up to a maximum of $11,084,840 for work stoppages on other participating railroads.

Several lawsuits have been brought by bondholders and debenture holders against Railroad, Chicago Milwaukee Corporation, and certain of their officers and directors in the United States District Court in Chicago, claiming contingent interest should have been paid for certain years beginning in 1972 on bonds issued under the General Mortgage and the Terre Haute Mortgages and on Railroad's income debentures, and that payments into sinking funds under mortgage and debenture indentures were also required. A settlement agreement was reached and filed with the District Court in August 1976, which would require the payment by Railroad of approximately $4.1 million in settlement of said claims totaling approximately $12 million. The settlement was approved by the District Court and affirmed on appeal by the United States Court of Appeals for the Seventh Circuit. The litigation settlement charge of $3,025,316 included in the 1976 Consolidated Statement of Operations represents that portion of the $4.1 million settlement not previously accrued on Railroad's books.

The Trustee has not yet evaluated the facts and legal issues involved to determine whether to affirm or reject the agreements under which it is a guarantor of obligations (other than equipment lease agreements) or the settlement agreement referred to in the preceding paragraph.

The Equal Employment Opportunity Commission (EEOC), on April 30, 1975, filed a complaint against Railroad in the United States District Court for the Northern District of Illinois, Eastern Division, alleging that Railroad had engaged in racially discriminatory employment practices at its corporate headquarters in Chicago in violation of Title VII of the Civil Rights Act of 1964. The complaint sought a permanent injunction against Railroad restraining the alleged unlawful practices, an order

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(17) Litigation and Contingencies (Continued)

directing Railroad to institute and carry out an effective Affirmative Action Plan, and monetary damages for persons affected by the alleged unlawful employment practices. A settlement agreement was reached between EEOC and Railroad requiring a cash payment by Railroad to affected persons aggregating approximately $160,000 and implementation of a more comprehensive Affirmative Action Program. The Court approved the settlement and entered a Consent Judgment. The Judgment is in effect for a period of 5 years unless modified by a Court order. Payment of $10,000 of the agreed settlement has been made.

Railroad is a defendant in three actions brought by REA Express, Inc. against numerous railroads and other defendants alleging, among other things, violations of Federal antitrust laws, breach of fiduciary obligations and breach of contract. Substantial damages are claimed. Counsel for Railroad believes that it has substantial defenses to all claims made in these suits.

Upon the filing by Railroad on December 19, 1977, of its petition for reorganization under the Federal Bankruptcy Act in the United States District Court at Chicago, the Court entered orders which stay prosecution all of the foregoing actions or the enforcement of any liens arising therefrom against Railroad.

On February 28, 1978, Milwaukee Land Company (Land Company), a 100%-owned subsidiary of Railroad, paid a $5.8 million cash dividend to Railroad from retained earnings. Complaint was then brought by the Continental Illinois National Bank and Trust Company of Chicago (CINB), trustee of Railroad's First Mortgage, asking that the Reorganization Court: enjoin the Railroad Trustee from causing Land Company to declare and pay dividends or from otherwise using the assets of Land Company on Railroad's behalf; direct the Railroad Trustee to account to the Reorganization Court for the expenditure of, sequester and set aside, and repay to Land Company all dividends received by Railroad from Land Company since December 20, 1977; and enter an order providing that CINB may vote all the shares of stock of Land Company pledged to it under the First Mortgage and to collect and receive all dividends on such stock. Harris Trust and Savings Bank, trustee of Railroad's General Mortgage, filed a complaint seeking similar relief except for the last mentioned order sought by CINB. The Railroad Trustee has submitted answers to both complaints asking for their denial. The case will be decided following the submission by the Mortgage and Railroad Trustees of memoranda in support of their positions.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(17) Litigation and Contingencies (Continued)

On June 29, 1976, the Securities and Exchange Commission filed a Complaint for Permanent Injunction and Certain Ancillary Relief in the United States District Court for the District of Columbia against Railroad, Chicago Milwaukee Corporation and four individuals alleging violations of Section 17(a) of the Securities Act of 1933, Sections 10(b) and 13(a) of the Securities Exchange Act of 1934 and Rules 10b-5 and 13a-1 thereunder. The corporate defendants to the suit executed consents and undertakings and the individual defendants executed consents, all of which were filed contemporaneously with the complaint. The consents and undertakings were executed solely for the purpose of settling the action and without admitting or denying any of the allegations of the complaint except as to jurisdiction. The consents provided for the entry of judgments and orders of permanent injunction barring future violations of the antifraud provisions of the 1933 and 1934 Acts and the reporting provisions of the 1934 Act and requiring the corporate defendants to carry out their undertakings, including investigation of the matter, reporting of findings and recommendations to shareholders and the SEC, and review for a period of three years on a continuing basis of the procedures adopted to assure compliance with the respective judgments and orders of permanent injunction and consents and undertakings.

The complaint referred to in the preceding paragraph includes an allegation that Railroad's accounting for a 1969 sale to another railroad of a one-half interest in an automobile marshaling yard was improper, and that Railroad has a contingent obligation to deposit the $1.5 million proceeds of the sale with the trustee of its First Mortgage.

Under a 1974 Interstate Commerce Commission order granting a general freight rate increase, railroads have been required to segregate a specified portion of the revenues generated by the increase and to expend such funds only on deferred maintenance or delayed capital improvements. Because of its financial condition, Railroad sought and obtained from the Commission permission to use for general operating purposes funds which would otherwise be subject to segregation and restriction under the Commission's order. Through December 31, 1976, the funds so released amounted to $7,124,000. The permission, extending through December 31, 1977, was subject to certain repayment and reporting conditions. Deferred maintenance expenditures during 1977 were sufficient to eliminate the fund segregation requirement referred to in this paragraph.

(Continued)

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(17) Litigation and Contingencies (Continued)

The Interstate Commerce Commission in a decision and order served on railroads on February 7, 1977 revised one of its regulations relating to the use which railroads may make of funds generated from incentive per diem settlements. Incentive per diem (IPD) is a rental charge assessed pursuant to ICC order on certain freight cars in addition to regular per diem rentals. Funds derived from this source are required to be earmarked and used to build, lease or purchase new cars, or rebuild cars. The February 7, 1977 order revised the aforesaid regulation to indicate that earmarked IPD funds may not be used for non-equity box car leases entered into prior to January 1, 1975. Railroad had previously interpreted prior ICC orders and regulations to permit it to use earmarked IPD funds for payments on non-equity leases of new box cars including leases entered into prior to January 1, 1975, and since January 1, 1975, Railroad has used IPD funds for current rental payments made after that date on such leases. From January 1, 1975 through December 31, 1976 the amount of IPD funds which have been drawn down for that purpose approximated $4.1 million. Railroad did not generate IPD fund balances during 1977 and anticipates that it will not generate such balances in the future. Railroad has requested the ICC to waive any requirement to reimburse the IPD funds expended in 1975 and 1976.

(Continued)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(18) Business Segments

The following table presents certain 1977 operating and financial data separated into the two basic industry segments (rail transportation, and land and timber) which make up Railroad's significant activities, and reconciles such data to indicated applicable items appearing in the accompanying consolidated financial statements.

	Rail Transportation(a)	Land and Timber	Eliminations(b)	Consolidated
	(amounts in thousands)			
Revenues	$454,984	$13,463	$(768)	$467,679
Operating profit (loss)	$(34,279)	$12,455	$(355)	$(22,179)
Interest income				1,436
Equity in loss of 49%-owned railroad				(1,290)
Interest expense				(6,423)
Loss before Federal income taxes, extraordinary item and cumulative effect of change in accounting principle				$(28,456)
Identifiable assets at year-end	$759,041	$34,376(c)		$793,417
Corporate assets (cash and temporary cash investments)				10,783
Total assets				$804,200
Depreciation, amortization and retirement charges	$ 37,436	$ 640		$ 38,076
Additions to properties	$ 50,770	$ 418		$ 51,188

(Continued)

(18) Business Segments (Continued)

(a) Rail transportation amounts, other than revenues, include the effect of a change in method of accounting for investment in track structure (see note 4).

(b) Eliminations consist of intersegment revenues and profit in the land and timber segment.

(c) Includes $11,378,000 representing railroad equipment under long-term lease to Railroad.

The rail transportation segment consists of a common rail carrier operating approximately 10,000 route miles in the northern tier of states between the Midwest and Pacific Northwest. The most important commodity groups transported are lumber products, farm products, food and food products, motor vehicles and other transport equipment. Railroad is heavily regulated by both federal and state governments as to freight rates and various operating aspects.

Included in the rail transportation segment in addition to Railroad is a wholly-owned trucking subsidiary operated principally for pick-up and delivery of highway trailers handled in trailer-on-flat-car service and similar adjunct activities. Also included in the rail transportation segment is intercity passenger service between Chicago, Milwaukee and Minneapolis under contract to National Railroad Passenger Corporation (Amtrak), and commuter passenger service in the Chicago area under contract to Regional Transportation Authority. Rolling stock used in these passenger operations is government-owned. Following entry by Railroad into a commuter purchase-of-service contract with RTA in 1975, its passenger operations have been financially assisted to an extent that they are no longer significant elements of the rail transportation segment, which is engaged essentially in the transportation of freight. Because it is so directly a result of railroad activities and because certain of the proceeds are contractually committed to reinvestment therein, other income from sales and rentals of transportation property not used in transportation service is included in the rail transportation segment.

The land and timber segment is conducted mainly in Washington, Idaho and Montana by a wholly-owned subsidiary, Milwaukee Land Company. Timber operations consist principally of tree-growing, reforestation, and sale of merchantable growth by licensing lumber and other producers to harvest the timber, usually under long-term contracts. Real estate operations involve principally

(Continued)

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(18) Business Segments (Continued)

the acquisition, development and sale of land for industrial sites. Commercial, residential and recreational developments are also involved to some extent. In some years Milwaukee Land Company has made sizeable sales of timberland. The following table summarizes Milwaukee Land Company operations for the years ended December 31, 1977 and 1976:

	1977	1976
Sales:		
Timber-cutting contracts	$ 9,461	$ 7,944
Industrial and residential property	3,063	1,906
Timberland	939	1
	13,463	9,851
Direct Costs:		
Timber-cutting contracts	62	86
Industrial and residential property	1,137	1,129
Timberland	1	-
	1,200	1,215
	12,263	8,636
Interest, rents and miscellaneous income	3,602	3,650
	15,865	12,286
Operating and interest expenses	3,135	3,027
Pretax earnings	$12,730	$ 9,259
Acres of timberland sold	614	6

The financial accounting pronouncement which requires disclosure of the segment information referred to above in this note 18 also calls for information relating to major customers, foreign operations and export sales. A major customer is defined for this purpose as any single customer, including domestic government agencies, whose purchases account for 10% or more of consolidated revenues. Railroad and its subsidiaries had no foreign operations, export sales or major customers during 1977.

(19) Other Income

Miscellaneous other income is principally equity in undistributed losses of an unconsolidated affiliate of $1,290,045 and $217,177 for 1977 and 1976, respectively.