Chicago Milwaukee Corporation

Annual Report 1974

DIRECTORS

Tilden Cummings*
Former President, Continental Illinois National Bank & Trust Company of Chicago (banking), Chicago, Illinois

Jerry Finkelstein
Chairman of the Board, Struthers Wells Corporation (engineers and manufacturers of heat transfer and pressure vessels); Publisher, New York Law Journal and Publisher, Civil Service Leader; Commissioner of The Port Authority of New York and New Jersey, New York, New York

Mr. Finkelstein was elected effective March 17, 1975

Robert C. Gunness
Former Vice Chairman of the Board, Standard Oil Company of Indiana (petroleum products), Chicago, Illinois

Mr. Gunness was elected effective April 18, 1974, to fill the vacancy created by the death on April 4, 1974, of Robert W. Lannan, Sr.

Laurence S. Kaplan
President, M. S. Kaplan Company (iron and steel scrap), Chicago, Illinois

William G. Karnes*
Chairman of the Board and Chief Executive Officer, Beatrice Foods Company (diversified food processor), Chicago, Illinois

Joseph A. Maun*
Maun, Hazel, Green, Hayes, Simon & Aretz (lawyers), St. Paul, Minnesota

William J. Quinn*
Chairman of the Board, President and Chief Executive Officer of the Company; Chairman of the Board and Chief Executive Officer, Chicago, Milwaukee, St. Paul & Pacific Railroad Company (transportation), Chicago, Illinois

Worthington L. Smith
President, Chicago, Milwaukee, St. Paul & Pacific Railroad Company (transportation), Chicago, Illinois

Charles B. Stauffacher
President and Chief Executive Officer, Field Enterprises, Inc. (publishing), Chicago, Illinois

Mr. Stauffacher was elected effective November 21, 1974, to fill the vacancy created by the death on August 12, 1974, of Russ Stewart

Robert S. Stevenson
Trustee and Member of the Executive Committee, Northwestern Mutual Life Insurance Company (insurance), Milwaukee, Wisconsin

Emory Williams
Chairman of the Board and Chief Executive Officer, Sears Bank & Trust Company (banking), Chicago, Illinois

Arthur M. Wirtz*
Chairman, Wirtz Corporation (real estate and diversified activities), Chicago, Illinois

*Members of the Executive Committee. Mr. Wirtz is Chairman of the Committee

OFFICERS

William J. Quinn
Chairman of the Board, President and Chief Executive Officer

Richard V. Nugent, Jr.
Assistant to Chairman of the Board

Raymond K. Merrill
Vice President

P. Laurin Cowling
Vice President, Executive Department

Richard F. Kratochwill
Treasurer

James T. Taussig
Secretary

	1974	1973
Operating revenues	$466,174,000	$381,229,000
Operating expenses and costs	453,306,000	368,232,000
Operating income	12,868,000	12,997,000
Other income	11,690,000	8,402,000
Interest expense	10,806,000	7,346,000
Earnings before income taxes	13,752,000	14,053,000
Net earnings	11,274,000	11,399,000
Earnings per share of common stock	3.62	3.67
Working capital	22,918,000	9,591,000

1974 ANNUAL REPORT
CHICAGO MILWAUKEE CORPORATION, 516 West Jackson Boulevard, Chicago, Illinois 60606

Annual Meeting
The 1975 Annual Meeting of Stockholders will be at 11 a.m. Tuesday, May 13, 1975, in The American Mart Building, 17th floor, 666 Lake Shore Drive, Chicago, Illinois.

This report is not and must not be construed to be proxy soliciting material nor as a report or document filed pursuant to the Securities Exchange Act or to any rule or regulation thereunder.

Stock Exchange
Common and Preferred Stocks of Chicago Milwaukee Corporation are traded on the New York Stock Exchange.

Stock Transfer Agents and Registrars
The Chase Manhattan Bank, New York, N.Y. 10015

The First National Bank of Chicago, Chicago, Illinois 60670

Form 10-K
Stockholders of Chicago Milwaukee Corporation may receive without charge a copy of the Corporation's Annual Report to the Securities and Exchange Commission, Form 10-K, by writing to Mr. James T. Taussig, Secretary, Chicago Milwaukee Corporation, 516 West Jackson Boulevard, Chicago, Illinois 60606. This offer is extended to persons who, as of the record date for the Annual Meeting, are beneficial owners of securities entitled to vote at the Meeting.

CHICAGO MILWAUKEE CORPORATION

- The Milwaukee Road
  - Milwaukee Motor Transportation Company
  - Milwaukee Land Company
  - Fractionally owned affiliated railroads
- Aslesen Company
- Hi-Way Paving, Inc.
- Vulcan-Hart Corporation
  - Hanson Porcelain Company, Inc.

As the accompanying organizational chart shows, Chicago Milwaukee Corporation now consists of four subsidiaries, two of which themselves have subsidiaries.

The Milwaukee Road is of course the Corporation's largest subsidiary and the base upon which Chicago Milwaukee was founded in 1972. Acquisitions in 1973 and 1974 have resulted in what is becoming a widely based corporation engaged in common-carrier transportation, timber and real estate operations, highway paving, the manufacture and sale of commercial food-service equipment, and the sale of food items at the wholesale level.

Transportation

Chicago Milwaukee's railroad subsidiary is principally a common carrier of freight serving the Midwest and the northern tier of states to the Pacific Northwest. Uniquely, it extends east of the traditional railroad break-point of Chicago to reach important connections to the east and southeast at Louisville, Kentucky. It reaches foreign markets through Great Lakes and Pacific Coast ports and through a connection with Canadian railroads at Sumas, Washington. The Milwaukee Road operates Amtrak passenger trains between Chicago, Milwaukee, and the Twin Cities. It operates a commuter service between Chicago and suburbs to the west and north. Most piggyback and container terminal services of the railroad are provided for it by a trucking subsidiary which also performs common-carrier trucking operations in some of the states the railroad serves.

Timber and Real Estate

Timber operations consist of tree-growing and the sale of merchantable growth by licensing lumber and plywood producers to harvest the timber, usually under long-term contracts. Reforestation of cut-over timberlands is carried out by means of aerial seeding or hand replanting in favorable growing areas. The operations are carried out on owned lands in Washington, Idaho and Montana. Real estate activities involve principally the acquisition, development and sale of land for industrial sites. Where consistent with other objectives, industries requiring large-volume rail transportation are favored. To a minor degree, commercial, residential and recreational developments are also involved. Real estate operations embrace activities in 13 states.

The information by lines of business which appears in a table elsewhere in this report shows that, in the case of timber and real estate, the amount of pretax earnings closely parallels the amount of revenues, reflecting the relatively low level of costs and expenses in this line during the years covered by the table. In certain of the years, associated other income caused pretax earnings to exceed revenues.

Commercial Food Service Equipment and Wholesale Food

This group serves the institutional food service market. A manufacturing component produces a full line of gas and electric food preparation, handling and storage products. The majority of its products are marketed through a full-time staff of specialists selling to non-exclusive dealers throughout the United States. Internationally, nonaffiliated manufacturers operate in certain foreign countries under licensing arrangements.

A distribution component of this group distributes both dry and frozen food products and nonfood products such as restaurant equipment and supplies. From a facility in Minneapolis, Minnesota, it reaches institutional customers in Minnesota, Wisconsin, North and South Dakota, Upper Michigan and northern Iowa.

High and Low Sales Price of $5 Prior Preferred and Common Stock By Calendar Quarters On the New York Stock Exchange

	$5 Prior Preferred		Common	
Calendar Quarter	High	Low	High	Low
1973				
First quarter	17¼	12⅛	8¼	5½
Second quarter	16⅝	12	9⅜	5⅞
Third quarter	18	12	10¾	6⅞
Fourth quarter	17⅞	11⅛	11½	6⅛
1974				
First quarter	18¼	13¾	11⅞	8¼
Second quarter	15¾	11⅜	9⅝	6⅝
Third quarter	15¼	9⅜	8¾	5
Fourth quarter	13¾	9	8⅛	5⅛

The consolidated operations of Chicago Milwaukee Corporation in 1974 resulted in net earnings for the year of $11,274,000, or $3.62 per share of common stock. In 1973, consolidated net earnings were $11,399,000, or $3.67 per common share on the same basis.

Consolidated operating revenues in 1974 were 22 per cent greater than they were in 1973: $466,174,000 compared with $381,229,000. While 1974 was a year of rising prices and increasing revenues, it was also a year of rapidly ascending costs. Net earnings remained almost equal to those of 1973, however.

The Milwaukee Road, Chicago Milwaukee's principal subsidiary, began to experience a sharp decline in business in the fourth quarter of 1974 as the recessionary trend of the economy caught up with the railroad industry. In the fourth quarter, the Milwaukee Road saw the demand for its freight transportation services erode by some 7.5 per cent from the level of the fourth quarter of 1973, as measured by the index of revenue ton-miles of service. The relative rigidity inherent in railroad operations makes it impossible to reduce expenses as rapidly—and often as far—as is possible in other lines of endeavor when business declines.

Chicago Milwaukee's non-transportation subsidiaries performed relatively well during 1974 as a group, although some lines experienced temporary difficulties with cost-price relationships.

Including net current assets added by the acquisition of Vulcan-Hart Corporation in early 1974, consolidated working capital increased by approximately $13 million during the year.

Cash position declined during the year by approximately $12 million. There were many reasons for this decline, the principal ones being inflation-caused increases in inventories and the fact that in 1974 the Milwaukee Road paid the full three-year accumulation of contingent interest on its Series A General Mortgage and Terre Haute Bonds.

The Milwaukee Road

This, in brief, is the financial story of 1974 for Chicago Milwaukee's 10,200-mile railroad subsidiary:

In the first three quarters of 1974, on an increase in operating revenues of 11 per cent over the first three quarters of 1973, pretax earnings were 51 per cent greater than in the comparable period of 1973.

At year's end, with operating revenues holding to their 11 per cent increase over 1973, pretax earnings were 30 per cent below what they were for the full year 1973.

In general, traffic levels through all of 1974 were below what they were in 1973, but revenues were greater due to recent freight-rate increases. The abrupt turndown in business in the fourth quarter, coupled with the astonishing increases in the prices of materials and supplies necessary for railroad operations, wiped out any gains.

Iowa and Minnesota saw the Milwaukee Road's new "mini-unit" grain train service—a new marketing concept—in 1974.

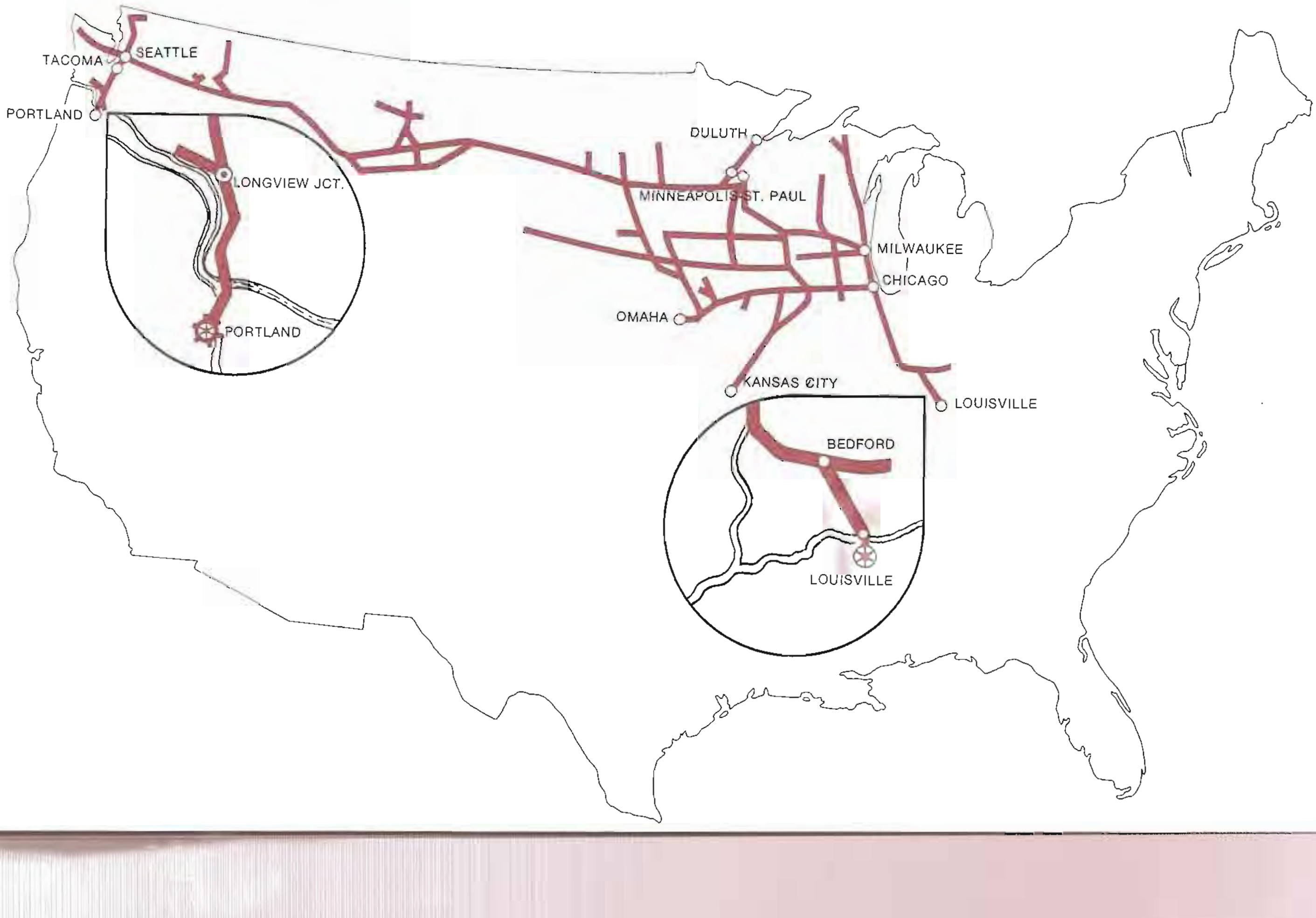
Forty-six new locomotives came to the railroad in 1974, significantly increasing efficiency and reducing fuel consumption.

The largest and most troublesome area in which the impact of increasing prices was felt was the cost of diesel locomotive fuel. Between January and December of 1974 the cost per gallon more than doubled. Each penny increase in the price of fuel is, to the Milwaukee Road, the equivalent of roughly a million dollars annually in increased operating expenses. During 1974 the railroad's inventory of material and supplies increased $11,672,000, a major portion of which was attributable to higher prices.

The gallonage of fuel consumed was reduced during 1974 by nearly 8 per cent, alleviating the cost problem somewhat. While some of the reduction was due to improved operating practices and to the efficiencies inherent in the 46 new locomotives which went into service during the year, some was also due to the fact that the railroad was called upon to provide fewer train-miles of transportation service.

Railroad manpower costs likewise continued to spiral upward. Moreover, negotiations with rail labor unions which began in 1974 are resulting in greatly increased wage rates in 1975, as they will for the years to come. By the end of 1974 the level of employment on the Milwaukee Road was the lowest it has been in generations.

This is the Milwaukee Road's service territory: 16 states, many major freight-transportation markets. The map emphasizes two recent expansions: Portland in 1971, Louisville in 1973.



The Railroad's Traffic

The Milwaukee Road depends heavily on the transportation of grain and of forest products. Thus it was adversely affected in 1974 by the sharply reduced demand for export grain and by the depressed conditions in the housing industry.

Grain and soybean traffic was also influenced by poor growing and harvesting conditions and by uncertainties in grain markets which resulted in large volumes of grain being left in storage. It should be noted, however, that the decline of grain and soybean carloadings in 1974 of 12.2 per cent is measured against the railroad's all-time record traffic in those commodities in 1973.

Lumber traffic declined by 22.3 per cent in 1974 from its 1973 level as measured in carloads. Although the renewed availability of mortgage money and an improvement in lending rates were evident in the early weeks of 1975, no significant increase in housing starts, and thus a return of the railroad's lumber traffic, had been noted as this Report was being prepared.

Despite the greatly reduced levels of production and sales in the automobile industry, the Milwaukee Road's traffic in motor vehicles showed a gain of 6.5 per cent in 1974. Among the factors producing the increase were the company's intensive marketing efforts and the expansion of physical facilities used to handle automobiles in volume and to load and unload trains.

Coal traffic, too, increased slightly in 1974, producing $11.4 million in revenues, despite the month-long strike which occurred late in the year. We expect that the nation's energy demands will materially improve this segment of the railroad's business over time

Trailer-on-flat-car and container-on-flat-car traffic continues to grow in popularity and volume, spurred in part by energy and environmental considerations and aided too by the railroad's steady improvement in terminal facilities and technologies.

"Piggyback" and container loadings were greater in 1974 by 13.4 per cent over 1973; revenues also showed a substantial gain. U. S. Mail, once a mainstay of the passenger service of railroads but in recent years almost no factor in railroad earnings, is returning to the rails in increasing volumes as the result of piggyback and container services geared to its needs. The railroad's movement of steamship line containers to and from import-export points increased in 1974 by 47 per cent.

Export traffic as a whole was off in 1974, however. Total export-import traffic declined approximately 12 per cent from its 1973 level. The extent to which the reduced exports of government grain and grain products were a factor is demonstrated by the fact that import traffic through the Pacific North Coast ports served by the Milwaukee Road increased 13 per cent. Much of the export grain which the railroad moves flows out of the country through Gulf ports.

New Train Services

The manner in which modern marketing techniques can increase business for the railroad without increasing shippers' costs was illustrated by a new seasonal service inaugurated for certain portions of the grain trade in 1974.

The service is a "mini-unit train" for grain shuttling between country elevators and Mississippi River barge-loading facilities. Operating six days per week on fast turnaround schedules, with three-man train crews and assigned equipment of a maximum of 30 large covered grain hopper cars, the trains greatly improved car utilization and revenues per car-day. "MUT" trains operated between central Iowa points and Davenport, and between Minnesota points and St. Paul. The concept is being applied again in 1975.

Coal, too, began to move on the Milwaukee Road in new unit movements. The Milwaukee Road is participating with the Burlington Northern in a joint unit coal train movement between Colstrip, Montana, and a new power plant at Columbia, Wisconsin. Beginning in October, 1974, two trains were assigned to the service. A third will be assigned in 1975.

In 1974 the Milwaukee Road completed arrangements to begin a second unit coal train service early in 1975 between a mine at Gascoyne, North Dakota, and a power plant at Big Stone City, South Dakota. Both points are Milwaukee Road stations; the entire operation is on the Milwaukee Road. Together, the Columbia and Gascoyne services will double the railroad's volume of coal.

Bodily lifting a highway trailer from a flat car, a unit of the railroad's motor-carrier subsidiary demonstrates some of the technology of "piggyback" service.

Railroad Freight Rates

The inability of railroads to price their services in a manner consistent with the costs they incur and with their needs for funds for improvement remains a major industry problem.

Among the more significant increases granted were those of 4 per cent effective in March, 1974, and of 10 per cent effective in June. Both contained certain exceptions, and the June increase contained conditions which required the railroads to dedicate revenues generated by it to deferred maintenance, delayed capital improvements and the offsetting of higher costs of supplies other than fuel. Some of these restrictions were later modified, but they continue to restrict the use of new revenue dollars. An increase in rates on grain and grain products was in effect for most of 1974.

During 1974 the Commission also allowed rates to be increased slightly to cover additional costs of employee retirement benefit programs, and it increased the surcharge designed to cover increases in fuel oil prices.

Railroad Operations

Despite declining traffic volumes and soaring costs, the Milwaukee Road was able to reduce its ratio of operating expenses to revenues to 79.45 per cent in 1974. The operating ratio in 1973 was 80.34 per cent. Not since 1967 has the operating ratio been below 80 per cent.

Greater operating efficiency is both the product of improved management and maintenance practices and a source of funds with which to make further improvements. Through early 1974 the railroad was able to budget additional amounts for increased track maintenance. Work on the track—new rail, new crossties, better ballast, and resurfacing and realignment work—proceeded to the maximum extent possible considering the availability of funds.

During 1974 the railroad acquired 46 new diesel-electric locomotives. An additional 18 existing locomotives were overhauled and upgraded in the company's shops. Some of the new locomotives are equipped with remote-control devices which permit them to be placed in the body of a train and be controlled from the leading locomotive. The practice is helpful in the mountainous terrain which the railroad traverses in the West.

The year saw the end of an era of Milwaukee Road history: the electrified operation of the Rocky Mountain Division in Montana and Idaho. On June 16, the railroad

Public funds provided the railroad with new commuter coaches and locomotives in 1974.

retired from active service its last remaining electric locomotives. The electric power transmission line which parallels the railroad was sold to a local power utility. Railroad forces began dismantling the copper, aluminum and steel trolley system so that the metal could be sold for scrap.

More than 1,300 new freight cars entered service for the Milwaukee Road in 1974. During the year the railroad's shop forces rebuilt 550 existing cars.

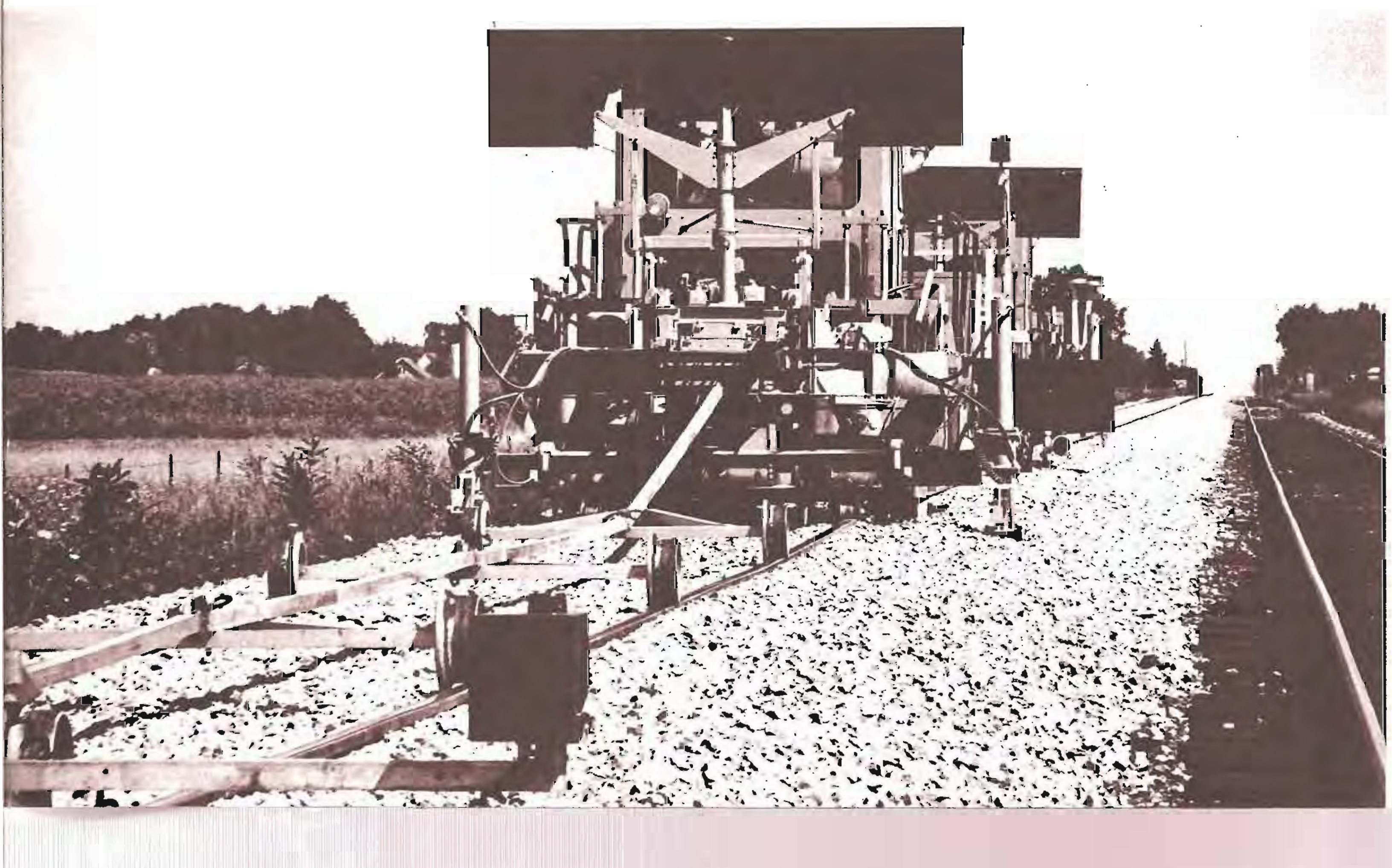
Railroad Labor Matters

There were no labor difficulties on the Milwaukee Road in 1974.

During 1974 unions representing Milwaukee Road employees as well as those throughout the railroad industry requested wage increases ranging from 20 to 30 per cent to become effective in 1975, plus an additional 15 to 20 per cent to become effective in 1976. They also requested cost-of-living increases, improved health and welfare programs, and various changes in work rules.

By early February, 1975, six of the labor organizations had reached a tentative agreement with the railroads on a wage benefit package. The agreement calls for increase in wages and benefits totaling an estimated 40.5 per cent over a three-year period. This amount includes a 10 per cent wage increase effective January 1, 1975, and an additional 5 per cent effective October 1,1975. Negotiations with the other unions continued.

This machine corrects the alignment of the railroad's track. Here it is at work on the high-density main line between Chicago and Milwaukee.



Commuter and Amtrak Operations

Fifteen new diesel-electric locomotives and 41 new stainless-steel bi-level commuter coaches joined the railroad's suburban-service fleet in 1974. The equipment was purchased by two Mass Transit Districts out of federal and State of Illinois funds previously granted for that and for other capital-improvement purposes. All locomotives and cars now operated in commuter service are owned by the Mass Transit Districts and are leased to the Milwaukee Road.

The grants will also be used to improve commuter station and platform facilities, to install new lighting and signaling equipment and to provide for other physical improvements for the commuter services.

In December, 1974, the Milwaukee Road applied to the new six-county Regional Transportation Authority for an emergency grant of funds to cover operating deficits incurred during the second half of 1974 and projected for the first half of 1975. In January, 1975, the RTA granted the railroad an amount equal to approximately 70 per cent of the deficit from commuter operations during the last half of 1974, conditioned on the railroad's agreement that it would neither raise commuter fares nor reduce commuter services prior to July 1, 1975. It is on that date that a purchase-of-service contract between the Milwaukee Road and the RTA is expected to become effective.

A new contract between the railroad and Amtrak, the National Railroad Passenger Corporation, became effective on July 1, 1974. The two-year agreement deals with compensation matters and provides for incentives and penalties based on service and equipment standards.

Legislative and Regulatory Matters

Many states among the 16 which the Milwaukee Road serves are developing Departments of Transportation to foster, among other things, stronger rail systems. Their planning efforts and other evidences of concern are resulting in helpful communication and cooperation.

An example is a project initiated in Iowa during 1974. The State and the railroads serving it are engaged in a number of projects designed to finance, cooperatively, the rehabilitation of certain branch lines. A line which originates considerable grain traffic for the Milwaukee Road is one of them. The State of Iowa is contributing a grant of $800,000. Shippers are lending $400,000 interest free, to be refunded on a per-carload basis. The railroad is assuming the balance—$800,000—of the three-year, $2 million rehabilitation project.

Not all branch lines are thus salvagable, however. The Milwaukee Road continues to take the necessary steps before regulatory bodies to discontinue those which have no forseeable economic benefit, and to cooperate with other railroads to coordinate services, where possible, to eliminate parallel or duplicating lines.

The federal Surface Transportation Act failed of enactment in the Congress during 1974. This bill would have provided the nation's railroads with federally guaranteed loans for the acquisition of equipment and facilities. It would also have expedited the abandonment of uneconomic lines of railroad and would have eliminated discriminatory taxation of railroad companies. The railroad industry will continue to seek passage of these measures in 1975.

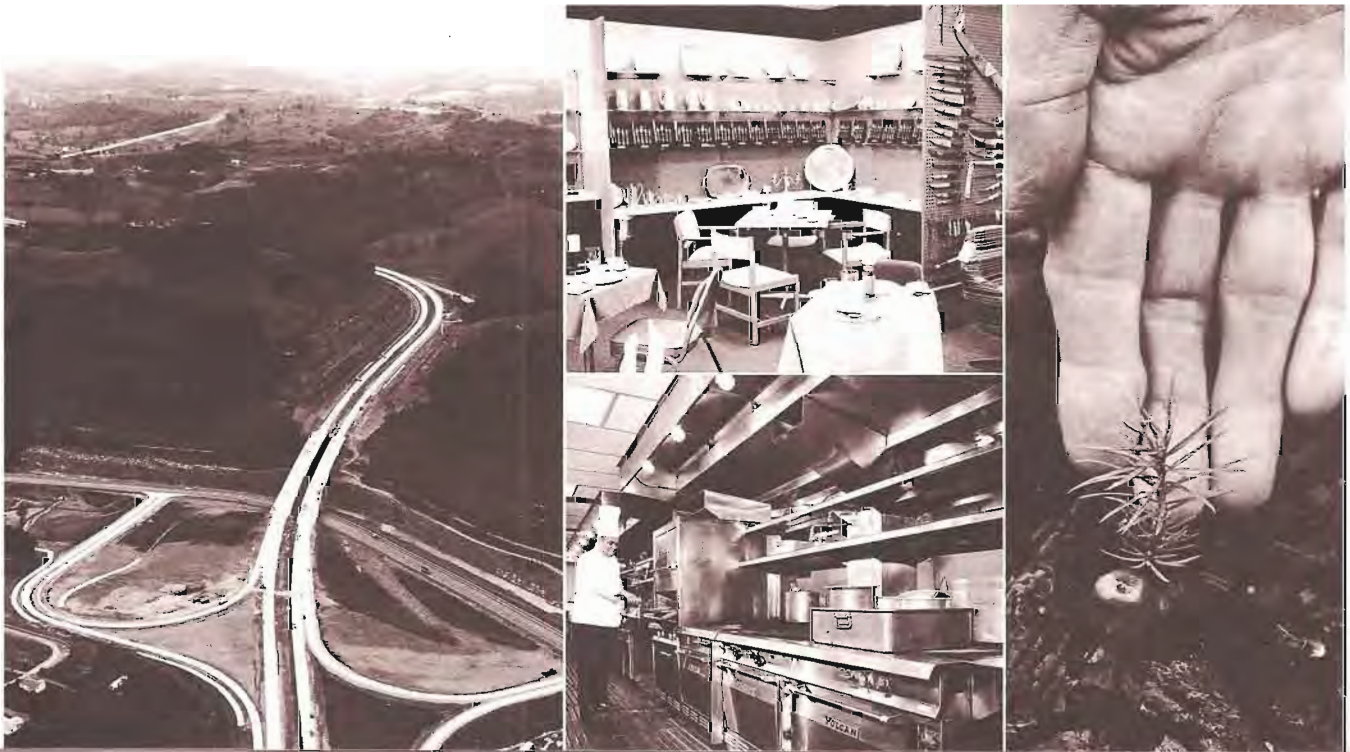
In May, 1974, the Burlington Northern announced that it was discontinuing the joint studies it had been conducting with the Milwaukee Road looking to the possible unification of the two systems. The Interstate Commerce Commission has informally indicated that in its view a unification of the two systems would not be in the public interest. The Milwaukee Road, in March, 1975, amended its petition for inclusion in the Burlington Northern to request, as an alternative, a grant of trackage rights over various lines of the Burlington Northern in Washington, Montana and Iowa and other conditions which would strengthen the Milwaukee Road as a competitor of the Burlington Northern. Hearings are expected to begin in 1975.

With the filing of a petition for reorganization under the Bankruptcy Act by the Chicago, Rock Island & Pacific Railroad Company, there appears no present likelihood of a Union Pacific-Rock Island merger. Should the Rock Island discontinue operations, the Milwaukee Road has expressed its willingness to cooperate with other railroads in providing service to Rock Island shippers as directed by the Commission.

Railroad Freight Traffic By Commodity Groups

Commodity Groupings	Per Cent of Freight Revenues				
	1974	1973	1972	1971	1970
Farm products	15.9%	16.1%	13.3%	12.4%	14.7%
Food and food products	13.2	13.2	14.0	15.2	15.2
Lumber products	12.8	15.2	15.7	16.1	13.8
Transport equipment	10.2	10.1	9.8	9.1	6.0
Pulp paper products	9.2	8.9	9.5	9.6	9.6
Chemicals	6.0	5.3	5.4	5.8	5.8
Primary metal products	5.4	5.3	5.3	5.4	5.9
Waste and scrap metal	3.2	2.5	2.3	2.0	2.2
Coal	3.1	2.9	3.1	3.6	4.0
Stone, clay and glass products	3.0	2.8	2.9	3.2	3.0
All other	18.0	17.7	18.7	17.6	19.8
	100.0%	100.0%	100.0%	100.0%	100.0%

A visual glance at some Chicago Milwaukee Corporation activities: highway paving; institutional food service supply and equipment manufacturing; reforestation after timber production.



CONSOLIDATED BALANCE SHEETS December 31, 1974 and 1973

ASSETS	1974	1973
	(amounts in thousands)	
Current Assets		
Cash and temporary cash investments	$ 21,278	$ 33,625
Accounts receivable	45,549	33,585
Inventories (note 3)	44,116	21,068
Other current assets	5,408	3,948
Total current assets	116,351	92,226
Special Funds (note 4)	16,031	12,890
Investments		
Affiliated companies	24,441	21,541
Other companies	858	1,235
Total investments	25,299	22,776
Properties (notes 1 and 5)		
Transportation properties		
Road	633,940	643,171
Equipment	297,132	297,951
	931,072	941,122
Less allowances for depreciation and amortization	295,792	300,597
	635,280	640,525
Other property, less accumulated depreciation	29,563	12,510
Total properties	664,843	653,035
Other Assets and Deferred Charges	12,264	11,992
Total assets	$834,788	$792,919

See accompanying notes to consolidated financial statements.

LIABILITIES AND SHAREHOLDERS' EQUITY	1974	1973
	(amounts in thousands)	
Current Liabilities		
Notes payable to banks	$ 2,890	$ 4,090
Accounts payable	48,784	40,216
Payroll and vacation pay	18,302	16,846
Accrued taxes	10,269	8,815
Other current liabilities	2,579	2,414
Current maturities of long-term debt	10,609	10,254
Total current liabilities	93,433	82,635
Long-Term Debt (note 5)	236,208	219,463
Deferred Federal Income Taxes (note 6)	37,352	34,874
Reserves and Other Liabilities	24,912	24,743
Total liabilities	391,905	361,715
Minority Interest	19,699	19,294
Shareholders' Equity (notes 2, 7, 8 and 9)		
Capital stock		
$5 Prior Preferred Stock—without par value (stated value $100 per share), nonparticipating, noncumulative. Authorized 518,652 shares, issued and outstanding 477,946	47,795	47,795
Common Stock—$1.00 par value per share. Authorized 15,000,000 shares, issued and outstanding 2,451,708	2,452	2,452
	50,247	50,247
Capital in excess of par value	318,771	318,771
Retained earnings	54,166	42,892
Total shareholders' equity	423,184	411,910
Contingent Liabilities (notes 12 and 13)		
Total liabilities and shareholders' equity	$834,783	$792,919

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF EARNINGS AND RETAINED EARNINGS

Years Ended December 31, 1974 and 1973

	1974	1973
	(amounts in thousands except per share figures)	
OPERATING REVENUES		
Transportation	$402,304	$362,619
Non-transportation	63,870	18,610
	466,174	381,229
OPERATING EXPENSES AND COSTS		
Transportation		
Maintenance of way and structures	61,012	59,074
Maintenance of equipment	55,299	51,456
Transportation	171,148	151,092
Traffic and general	34,026	31,639
Taxes other than federal income taxes	39,101	30,827
Equipment and joint facility rents, net	40,201	35,127
	400,787	359,215
Non-Transportation		
Cost of sales	42,378	7,105
Operating expenses	10,141	1,912
	453,306	368,232
Operating income	12,868	12,997
OTHER INCOME		
Gain on sales of property	4,647	3,573
Interest	4,062	2,950
Rents	2,228	2,276
Miscellaneous	753	(397)
	11,690	8,402
Total income	24,558	21,399
FIXED INTEREST	8,029	5,972
CONTINGENT INTEREST (note 12)	2,777	1,374
	10,806	7,346
Earnings before income taxes	13,752	14,053
DEFERRED FEDERAL INCOME TAXES (note 6)	2,478	2,654
Net earnings	$ 11,274	$ 11,399
RETAINED EARNINGS, beginning of year:		
As previously reported	$ 43,520	$ 32,121
Less prior period adjustment (note 10)	628	628
As restated	42,892	31,493
RETAINED EARNINGS, end of year	$ 54,166	$ 42,892
PER SHARE EARNINGS		
Applicable to Common Stock	$ 3.62	$ 3.67

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

Years Ended December 31, 1974 and 1973

	1974	1973
	(amounts in thousands)	
SOURCE OF FUNDS		
From operations:		
Net earnings	$ 11,274	$ 11,399
Add items not requiring outlay of working capital in the current period:		
Depreciation and retirement charges	17,622	17,604
Deferred federal income taxes	2,478	2,654
Other	3,053	3,259
Working capital provided from operations	34,427	34,916
Salvage	12,418	4,527
Borrowing, including $13,800,000 in 1974 and $6,985,000 in 1973 for business acquisitions	28,530	8,498
Release of funds on deposit with mortgage trustee	8,639	2,259
Miscellaneous sources, net	924	1,746
	$ 84,938	$ 51,946
APPLICATION OF FUNDS		
Property additions and betterments	$ 34,954	$ 8,934
Debt retirement	12,395	11,063
Investment in rail terminal and other companies	1,233	881
Deposit of property sale proceeds with mortgage trustee	8,218	6,099
Segregation of funds in compliance with Interstate Commerce Commission orders	3,210	730
Reclassification of accumulated contingent interest and estimated liabilities for claims ($998,000 in 1974) to current liabilities	2,554	4,194
Business acquisitions (note 2):		
Noncurrent assets acquired, at fair value, including property, plant and equipment of $8,095,000 in 1974 and $2,279,000 in 1973	8,415	2,942
Excess of purchase price over net assets acquired (1973 acquisitions)	632	1,771
Increase in working capital	13,327	15,332
	$ 84,938	$ 51,946
ANALYSIS OF CHANGES IN WORKING CAPITAL		
Increase (decrease) in current assets:		
Cash and temporary cash investments	$ (12,347)	$ 19,668
Accounts receivable	11,964	2,545
Inventories	23,048	1,973
Other current assets	1,460	(933)
	24,125	23,253
Increase (decrease) in current liabilities:		
Notes payable to banks	(1,200)	—
Accounts payable	8,568	6,213
Payroll and vacation pay	1,456	1,687
Accrued taxes	1,454	658
Other current liabilities	165	(805)
Current maturities of long-term debt	355	168
	10,798	7,921
Increase in working capital	$ 13,327	$ 15,332

See accompanying notes to consolidated financial statements.

1. SIGNIFICANT ACCOUNTING POLICIES

Consolidation—The consolidated financial statements include the accounts of Chicago Milwaukee Corporation and all of its majority owned subsidiaries. All significant intercompany items have been eliminated in consolidation.

Revenue Recognition—Freight transportation 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. Revenues from long-term construction contracts are recognized under the percentage-of-completion method. Revenues from timber harvested by licensees under long-term contracts are recognized in the period in which cutting and harvesting is performed.

Investments—Investments in affiliates (companies in which 20% but not more than 50% of the voting stock is held) are accounted for by the equity method. Investments in non-affiliates are reflected principally at cost, less allowances to reflect the estimated amount of any permanent impairment in value.

Transportation Properties—The investment in railroad properties is stated at original cost or estimated original cost, as determined by the Interstate Commerce Commission in 1917 and 1918, with subsequent additions and betterments at cost.

The Corporation follows the policy of providing for depreciation of equipment and certain road properties by charging against earnings amounts sufficient to amortize the cost of such properties on a straight-line basis over their anticipated useful lives.

In conformity with Interstate Commerce Commission accounting rules, ratable depreciation provisions are not made in the case of certain roadway properties, principally land, grading and track, amounting to approximately $400 million. Instead, these properties are 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 non-depreciable properties are reflected in current operations. Normal gains or losses on sales and retirement of depreciable railroad properties are reflected as adjustments of accumulated depreciation. All dismantling and removal costs are treated as current operating expenses as incurred.

Net gains or losses resulting from sale-and-lease-back transactions are amortized over the term of the respective leases as an adjustment of the rental cost.

Inventories—Inventories are stated at the lower of cost or market. Cost is determined generally by the first-in, first-out method.

Earnings Per Share—Earnings per share of common stock are based upon the average number of outstanding shares of common stock and common stock equivalents, and are computed after giving recognition to preferred dividend requirements.

Federal Income Taxes—The Corporation follows the practice of providing for income taxes based upon income reported for financial statement purposes rather than amounts payable under current tax laws. Net tax benefits resulting from timing differences are deferred to future periods when the differences may reverse.

Stock Options—Proceeds from the sale of stock under the Corporation's long-range incentive program are credited to Common Stock at par value and the excess of the option price over par value is credited to capital in excess of par value. No charges are made against operations in respect of stock options.

2. BUSINESS ACQUISITIONS

On February 28, 1974, the Corporation acquired the net assets of Vulcan-Hart Corporation and Hanson Porcelain Company, Inc. The two companies manufacture and sell equipment for the institutional food service market and porcelain enameling. The acquisitions were accounted for by the purchase method of accounting and accordingly results of operations of the two companies are included in the consolidated financial statements from the acquisition date. The total cash purchase price of $18,070,000 was financed in part by bank borrowings. The excess of fair value of the acquired net assets over the purchase price was distributed to non-current assets.

The Corporation purchased the capital stock of Hi-Way Paving, Inc. as of April 1, 1973, and the capital stock of Aslesen Company on October 16, 1973. The Corporation amortizes the excess of purchase price over fair value of the acquired net assets over 40 years on a straight-line basis. Amounts paid based upon post-acquisition earnings are treated as additional goodwill and are amortized over the remainder of the 40-year term.

Consolidated results of operations on a pro forma basis as though the companies had been acquired as of January 1, 1973, are as follows:

	1974	1973
	(amounts in thousands except per share figures)	
Operating revenues	$466,174	$424,474
Net earnings	$ 11,274	$ 11,889
Per share earnings applicable to Common Stock	$ 3.62	$ 3.87

3. INVENTORIES

Year-end inventories consist of (a) material and supplies to be consumed or used in transportation operations, maintenance or construction: 1974—$30,135,000, 1973—$18,439,000; and (b) manufactured products and merchandise held for sale including raw materials and parts therefor: 1974—$13,981,000, 1973—$2,629,000.

4. SPECIAL FUNDS

Special funds consist principally of cash and temporary cash investments restricted under debt instrument provisions or by Interstate Commerce Commission order requiring the funds to be invested in transportation property additions and betterments.

5. LONG-TERM DEBT

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

	Interest		Principal Amount	
	Fixed	Contingent	Dec. 31, 1974	Dec. 31, 1973
Chicago, Milwaukee, St. Paul and Pacific Railroad Company first mortgage bonds, Series A, 1994 (d)	4%	—	$ 48,735,300	$ 49,235,300
Chicago, Milwaukee, St. Paul and Pacific Railroad Company general mortgage income bonds, Series A, 2019	—	4½% (a)	24,684,700	24,684,700
Chicago, Milwaukee, St. Paul and Pacific Railroad Company general mortgage convertible income bonds, Series B, 2044 (e)	—	4½% (a)	31,127,400	31,127,400
The Bedford Belt Railway Company first mortgage bonds, 1994 (f)	2¾%	1½% (b)	178,000	178,000
The Southern Indiana Railway Company first mortgage bonds, 1994	2¾%	1½% (b)	5,639,000	5,659,000
Chicago, Terre Haute and Southeastern Railway Company first and refunding mortgage bonds, 1994 (g)	2¾%	1½% (b)	7,170,000	7,170,000
Chicago, Terre Haute and Southeastern Railway Company income mortgage bonds, 1994	2¾%	1½% (b)	4,738,800	4,738,800
Chicago, Milwaukee, St. Paul and Pacific Railroad Company income debentures, Series A, 2055	—	5% (c)	55,634,000	55,634,000
Equipment obligations	4-12¼%	—	34,587,919	34,756,748
Other	6% to prime plus 1%	—	23,712,684	6,278,949
Total			$236,207,803	$219,462,897

(a) Cumulative to a maximum of 13½%.
(b) Cumulative to a maximum of 4½%.
(c) Noncumulative.
(d) Chicago, Milwaukee, St. Paul and Pacific Railroad Company first mortgage Series B bonds in the principal amount of $3,900,000 have been authenticated and pledged, along with a mortgage note receivable in the principal amount of $819,305 as collateral to note payable to bank.
(e) Convertible into Railroad common stock on the basis of one share of common stock for each $100 principal amount of bonds.
(f) Bonds held by Railroad include $100,000 principal amount pledged under Chicago, Terre Haute and Southeastern Railway Company first and refunding mortgage.
(g) Bonds held by Railroad include $1,515,000 principal amount pledged under Chicago, Milwaukee, St. Paul and Pacific Railroad Company first mortgage.

Substantially all of the properties and the investments in common stock of certain non-transportation subsidiaries are pledged under the mortgages and/or debt obligations. Investments in affiliated companies include $7,111,974 pledged as collateral to mortgage bonds.

Maturities of long-term debt, exclusive of contingent sinking fund requirements, during each of the years 1975-1979 inclusive are approximately $10,609,000, $11,599,000, $9,434,000, $8,222,000 and $5,688,000.

6. FEDERAL INCOME TAXES

Federal income tax liabilities have been settled through the year 1967. Based in part upon unaudited returns and estimated 1974 tax data, the Corporation had available at December 31, 1974, consolidated tax operating loss carryforwards of approximately $15,800,000, which will expire in 1976.

The available investment credit carryforward as of December 31, 1974, amounted to approximately $14,852,000, which will expire as follows: 1975—$1,941,000, 1976—$2,900,000, 1977—$2,861,000, 1978—$1,928,000, 1979—$2,262,000, 1980—$1,560,000, 1981—$1,400,000. For financial reporting purposes approximately $11,000,000 of investment credit carryforwards were available to reduce future income tax provisions.

The deferred federal income tax expense reported in the accompanying consolidated statement of earnings 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:

	Per cent of pretax income	
	1974	1973
Federal corporate income tax rate	48.0%	48.0%
Increases (reductions) resulting from:		
Investment tax credit	(18.0)	(18.9)
Capital gains at 30% rate	(10.7)	(9.7)
Income taxable as dividend income	(3.5)	(1.3)
Excess of accounting basis over tax basis of inventories purchased in business acquisitions	2.5	—
Miscellaneous items	(0.3)	0.8
Effective rate	18.0%	18.9%

Although the Corporation utilizes a 30% federal income rate for tax provision purposes with respect to capital gains, the 30% tax rate will not be used in the Corporation's tax return due to the utilization of the operating loss carryforward.

Other income taxes consisting of various state income taxes are minor in both 1974 and 1973 and are included in operating expenses and costs.

7. LEASED ASSETS AND LEASE COMMITMENTS
Total rental expense included in operating expenses and costs amounted to $21,585,000 in 1974 and $17,251,000 in 1973. Of these amounts $18,381,000 in 1974 and $14,326,000 in 1973 represent rentals on non-capitalized financing leases. For purposes of the following disclosure, a distinction has been made between "financing" lease arrangements and other lease arrangements. A "financing" lease is one which, during the non-cancelable lease period, either (a) covers 75 per cent or more of the economic life of the property or (b) has terms which assure the lessor a full recovery of the fair market value of the property at the inception of the lease, plus a reasonable return on his investment.

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. Such expenses amounted to $20,314,000 in 1974 and $18,915,000 in 1973. Also excluded are railroad joint-facility "rents" of $4,255,000 in 1974 and $4,609,000 in 1973 representing essentially operating expenses shared with other joint owners or joint users.

The following table summarizes minimum rental commitments under all non-cancellable leases as of December 31, 1974 (amounts in thousands):

Year or Period	Railroad Rolling Stock	Other Equipment	Real Property	Totals Financing Leases	Totals Other Leases
1975	$ 20,382	$ 479	$ 366	$ 19,767	$1,460
1976	20,289	444	315	19,855	1,193
1977	19,444	300	295	18,984	1,055
1978	18,556	263	297	18,248	868
1979	17,970	168	284	18,039	383
1980-1984	78,693	507	1,295	79,200	1,295
1985-1989	41,286	101	336	41,387	336
1990-1994	—	—	20	—	20
Totals	$216,620	$2,262	$3,208	$215,480	$6,610

With relatively minor exceptions the leases represented in the foregoing table 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 market value. The leases typically require the lessee to pay taxes, maintenance and other operating expenses applicable to the leased property. Leases represented in the foregoing table by rental commitments of $55,500,000 require the lessor to pay for maintenance, and some of these in turn include provisions for price-level escalation of lease payments attributable to maintenance.

The present value of minimum rental commitments under non-capitalized financing leases at December 31, 1974 and 1973, is summarized by the following table, which also indicates the level of interest rates implicit in the leases and used for purposes of discounting net lease payments to present value:

	Present Value 1974	Present Value 1973	Interest Rates Used in Present Value Computations: Weighted Average 1974	Weighted Average 1973	Range 1974	Range 1973
	(amounts in thousands)					
Railroad rolling stock	$142,138	$96,296	7.15%	6.88%	4.54%-10.41%	4.54%-10.41%
Other equipment	1,681	1,963	7.73%	7.77%	4.05%-12.34%	4.05%-12.34%
	$143,819	$98,259				

Assuming all the above financing leases were capitalized, the related property rights were amortized on a straight-line basis over the lease term, and the interest costs were accrued on the basis of the outstanding present value lease commitment, net earnings for 1974 and 1973 would have been reduced by $1,837,000 and $1,263,000, respectively. Amortization included in the foregoing computation of net earnings impact is $11,885,000 and $9,477,000 in 1974 and 1973, respectively, and interest cost included in the computation is $8,701,000 and $6,-512,000 in 1974 and 1973, respectively.

8. STOCK OPTIONS AND INCENTIVES

On May 9, 1972, the stockholders approved a Long-Range Incentive Program, which became effective August 1, 1972, and consists of an Incentive Stock Compensation Plan and a Stock Option Plan. Under the Incentive Stock Compensation Plan selected employees may be awarded incentive stock compensation units which qualify them to receive cash and/or shares of the Corporation's Common Stock upon termination of employment. The amounts which accrue to grantees under the incentive plan are based upon dividends paid by the Corporation on its Common Stock and the increase in market value of the Common Stock subsequent to the time the units were awarded.

Under the Stock Option Plan key officers of the Corporation and its subsidiaries may be awarded qualified and non-qualified options to purchase an aggregate of 150,000 shares of the Corporation's Common Stock at prices not less than 100% of fair market value at the date of grant. Options were granted in 1972 for the purchase of 27,500 shares at $9.75 a share; in 1973 for the purchase of 22,500 shares at $9.00 a share, 500 shares at $6.50 a share and 500 shares at $10.00 a share; and, in 1974, for the purchase of 500 shares at $8.63 a share. At December 31, 1974, the foregoing options totaling 51,500 shares were outstanding but not exercisable and 98,500 shares were available for option.

In connection with the business acquisitions made in 1973 (see note 2) the Corporation issued warrants entitling the purchasers of the warrants to purchase 60,000 shares of the Corporation's Common Stock at $8.00 a share and 50,000 shares at $10.00 a share. Consideration of $220,000 for the warrants was accounted for as an addition to capital in excess of par value. At December 31, 1974, these warrants were outstanding and exercisable as to 25,000 shares, and outstanding but not exercisable as to 85,000 shares.

9. DIVIDENDS
No dividends have been declared on the capital stock of the Corporation since its inception in 1971.

Under its debt indentures Railroad may pay dividends on its capital stock from available net income, as defined, only to the extent there is available net income remaining after specified requirements. The major requirements having priority under the indentures as of December 31, 1974 and 1973, are current contingent interest of approximately $5,560,000, accumulated contingent interest of approximately $2,646,000 in 1974 and $4,202,000 in 1973, and available net income deficit carryforwards of approximately $28,884,000 in 1974 and $28,031,000 in 1973 (see note 12).

10. PRIOR PERIOD ADJUSTMENT AND RECLASSIFICATIONS
The $628,000 adjustment is required to reduce the Corporation's equity-basis investment in affiliates to reflect recognition by the affiliates of their liability for deferred income taxes. The affiliates involved are subject to the accounting rules of the Interstate Commerce Commission, which ordered carriers in 1974 to adopt interperiod income tax allocation.

In the 1974 Consolidated Statement of Earnings operating income includes earnings from timber and non-transportation real estate operations whereas such earnings have previously been classified as other income. The Consolidated Statement of Earnings for 1973 has been reclassified to make it comparable in this respect with 1974.

11. PENSIONS
Executive and supervisory employees of Railroad are covered by an unfunded non-contributory plan. The accounting practice followed is to accrue the cost of current benefit payments to beneficiaries under the plan, but not less than the actuarially computed normal cost plus 40-year amortization of prior service cost. Pension expense under this plan amounted to $1,466,000 in 1974 and $1,441,000 in 1973. The actuarially computed value of vested benefits was approximately $15,535,000 as of June 1, 1974.

Plan changes to conform with the Pension Reform Act of 1974 and to improve the plan have been approved in principle by Railroad's Board of Directors. Actuarial studies indicate that such changes will not have a significant effect on pension charges against income, funding requirements or the present value of unfunded vested benefits.

12. CONTINGENT INTEREST AND LITIGATION
Contingent interest charges relate to Railroad obligations on which the accrual of interest is dependent upon the level of railroad earnings ("Available Net Income") as defined by the applicable debt instruments.

Based upon the principal amount of contingent interest obligations outstanding at the end of 1974, the annual amounts of such contingent interest items are: Series A General Mortgage Bonds and Terre Haute Bonds, $1,398,000; Series B General Mortgage Bonds, $1,401,000; 5% Income Debentures, $2,782,000. If earnings are not sufficient, contingent interest on the General Mortgage and Terre Haute Bonds is nevertheless accruable up to a maximum of three years' interest, and such accumulations become payable when subsequent railroad earnings permit. As of December 31, 1974, there was such a three-year accumulation on the Series B General Mortgage Bonds. These accumulated interest charges were accrued and reported as expense in years prior to 1972. There is no accumulation feature in the case of the 5% Income Debentures.

Contingent interest expense for the year 1974 includes contingent interest on the Series A General Mortgage Bonds, Terre Haute Bonds and Series B General Mortgage Bonds. For 1973, contingent interest is included only on the Series A General Mortgage Bonds and the Terre Haute Bonds.

On the basis of the 1974 Available Net Income determinations made by the Railroad's Board of Directors, Railroad contingent interest will be payable on April 1, 1975, as follows: full current contingent interest for 1974 on Series A and Series B General Mortgage Bonds and on Terre Haute Bonds, and a portion (5%) of the accumulated interest (13½%) on the Series B General Mortgage Bonds. There will be no Available Net Income for payment of interest on March 15, 1975, or on September 15, 1975, on the 5% Income Debentures.

On the advice of Railroad's outside counsel the 1974 Available Net Income determinations have been made, as in prior years, on the basis of the separate company income of Railroad exclusive of the Railroad's equity in undistributed earnings or losses of subsidiaries and other affiliated companies.

Recently, the Interstate Commerce Commission ordered railroads, "for financial statement purposes only," to follow, effective January 1, 1974, the so-called equity method of accounting for investments in any company of which 20% or more of the outstanding voting stock is owned. Generally, under the equity method an investor company includes in its earnings its share of any undistributed earnings or losses of such companies. Because of the Commission's order, the Trustees of the General Mortgage and of the Debenture Indenture of Railroad have taken the position that the railroad should include in the computation of Available Net Income for 1974 its proportionate share of the undistributed earnings for 1974 and prior years of those companies coming within the scope of the Commission's order.

The Trustee of the Debenture Indenture has also raised the question of the propriety of carrying forward negative Available Net Income under the 5% Income Debenture Indenture. As of December 31, 1974, in the opinion of management, there was an accumulated deficit in Available Net Income of $28,883,960 which must be offset by subsequent earnings before interest is payable on the Debentures. The Trustee under this Indenture has taken the position that the carryforward of such a deficit from one year to the next is not authorized except in a limited set of circumstances. Outside counsel has advised Railroad, however, that such carryforward is proper.

On January 20, 1975, Railroad filed an action in the Circuit Court of Cook County, Illinois, naming the Trustees under the applicable Indentures as defendants, seeking a judicial determination of these issues.

If it is finally determined that Railroad's share of the 1974 earnings of its subsidiaries and affiliates owned 20% or more must be included in Available Net Income, the remaining 8½% of accumulated interest on the Series B General Mortgage Bonds, amounting to $2,646,000, would be payable out of 1974 income, and a $543,000 deposit into the sinking fund for the retirement of General Mortgage Bonds would be required. In the event of such an outcome, neither of these payments would affect reported earnings of Railroad or of Chicago Milwaukee Corporation.

If it is finally determined, in addition to the determination described in the preceding paragraph, that either (a) 1974 Available Net Income must include the accumulated equity in undistributed earnings and losses of affiliates from their acquisition dates up to 1974, or (b) Available Net Income deficits should not be carried forward and do not accumulate, 1974 interest of $2,782,000 on the 5% Income Debentures and a $300,000 deposit into the sinking fund for the retirement of 5% Income Debentures would also be payable. In such event, the after-tax charge for interest on the Debentures would be reported against 1974 earnings as a prior-period adjustment in the year of the determination.

If it is finally determined that Available Net Income does not include any undistributed earnings and losses of affiliates, but that Available Net Income deficits should not be carried forward and do not accumulate, there would be no effect on interest payments or sinking fund deposits in the year 1975.

On March 20, 1974, a class action was filed by a holder of Railroad Series B General Mortgage Bonds seeking a redetermination of Available Net Income for the years 1969 through 1973, and the payment of any additional contingent interest which the Court might find to be due on the Series B bonds. Such a redetermination could result in additional payments for such years under the Railroad mortgages in the amount of approximately $6,851,000 as additional contingent interest and approximately $1,435,000 as additional sinking fund payments. Of the foregoing amount of $6,851,000, $2,646,000 has been accrued in prior years under the three-year accumulation feature described elsewhere in this note and is included as a liability in the accompanying consolidated balance sheet as of December 31, 1974. This same obligation of $2,646,000 is also referred to earlier in this Note 12 in connection with other litigation. Management and counsel believe that defendants have meritorious defenses to this action, and management intends to contest it vigorously.

13. CONTINGENT LIABILITIES

Railroad is liable, jointly with other railroads, as guarantor of certain obligations of affiliated companies amounting to $60,587,200 at December 31, 1974. 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 $17,881,982. Certain lease agreements include guaranty by a subsidiary of the Corporation of approximately $57,917,000 invested indirectly in 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 $9,110,980 for certain work stoppages.

Railroad is a defendant in lawsuits brought by REA Express, Inc. against a number of railroads and other companies, seeking monetary damages and nullification of certain amounts heretofore treated as indebtedness to the railroads. The suits have not yet reached the trial stage. Counsel believes that, under the present state of the law and on basis of facts now known, Railroad has substantial defenses to all claims made in these suits. Upon receipt of notice in February, 1975, that REA Express, Inc. has filed a Chapter 11 Bankruptcy Act petition, Railroad wrote off against 1974 earnings its entire investment in that company.

ACCOUNTANTS' REPORT

The Board of Directors
Chicago Milwaukee Corporation:

We have examined the consolidated balance sheets of Chicago Milwaukee Corporation and subsidiaries as of December 31, 1974 and 1973, and the related consolidated statements of earnings and retained earnings and changes in financial position for the years then ended. Our examination was 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.

In our opinion, the aforementioned consolidated financial statements present fairly the financial position of Chicago Milwaukee Corporation and subsidiaries at December 31, 1974 and 1973, and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

PEAT, MARWICK, MITCHELL & CO.

Chicago, Illinois
March 21, 1975

MANAGEMENT'S DISCUSSION AND ANALYSIS OF THE SUMMARY OF OPERATIONS

1974 vs. 1973

The summary presents a picture of striking similarity between these two years, the only surface changes of any consequence being the higher level of both operating revenues and operating expenses and costs in 1974 and the fact that an increase in other income was offset by a similar increase in interest expense; however, there were these important shifts in the make-up of operating income:

Businesses acquired in the diversification program starting in 1973 contributed operating income of $3.6 million in 1974 and $0.4 million in 1973. Timber and real estate contributed $7.6 million in 1974 and $9.2 million in 1973. Transportation, while generating the bulk of the revenues, produced $1.6 million of operating income in 1974 compared to $3.4 million in 1973.

The 1974 revenue increase of $84.9 million was concentrated in freight transportation ($36.4 million) and food service equipment and wholesale food ($45.0 million), as shown by the accompanying information by lines of business. The increase in food service equipment and wholesale food reflects revenues added by business acquisitions in late 1973 and early 1974. Physical sales volume of these businesses, comparing calendar 1974 with calendar 1973, was substantially unchanged in food service equipment and was up about 3% in wholesale food.

The 10% increase in freight transportation revenues is attributable to higher rates. Freight volume dropped 4%, mainly in the latter part of the year as the business recession took hold. Mirroring general business conditions in the United States, volume was down in all broad groups of commodities transported, except motor vehicles and chemicals, including major revenue-producing groups such as farm products and lumber products. The rate increase effect on revenues is estimated at $48.0 million, which includes approximately $16.2 million from upward adjustments granted by the Interstate Commerce Commission in respect of specific cost increases in diesel fuel and payroll taxes.

A $3.3 million increase in passenger revenues was partially offset by a $1.6 million decline in timber and real estate revenues. This decline reflects in part the continuing depression in housing. Passenger revenues were helped by growing commuter patronage and by state and local government operating grants, which totaled $1.7 mililon in 1974 and $0.4 million in 1973. Passenger revenues in 1974 include for the first time Amtrak performance bonuses, amounting to $0.7 million.

Of the $85.1 million increase in operating expenses and costs, approximately $42.0 million is the result of business acquisitions.

Transportation operating expenses and costs increased $41.6 million or 12%, including estimated inflationary effects on fuel ($13.7 million), other material and supplies ($5.5 million), wages ($8.2 million) and payroll taxes ($7.8 million). Rail rolling stock rents, including payments under long-term leases, increased $5.6 million. As noted, certain of these items were offset in part by special revenue rate adjustments. Depreciation and retirement charges were lower by $0.7 million.

Transportation maintenance expenses increased $5.8 million. In addition to the material and wage inflationary effects referred to in the preceding paragraph, this reflects a greater quantity of labor expended on track upgrading projects. The quantity of train-operation labor was reduced 2.5% in 1974.

Other income improved by $3.3 million, including $1.1 million in gain on sales of transportation property no longer needed for operations and $1.1 million in interest income as a result of higher short-term interest rates and temporary investment balances. An increase of $1.2 million in miscellaneous other income was principally in undistributed earnings of affiliates and profit on bonds purchased for sinking fund purposes.

Interest expense increased $3.5 million because contingent interest was accrued in 1974 on the Series B General Mortgage bonds (see Notes to Consolidated Financial Statements) and because of charges on borrowings to finance business acquisitions.

1973 vs. 1972

The improvement in operating results during 1973 was attributable principally to achievement in that year of a relatively satisfactory level of transportation volume and to a modest move by the Interstate Commerce Commission to correct the shortfall in freight revenue rate increases versus cost escalations. According to railroad industry indices, average wage and material prices rose more than 50% during the period 1970 through 1973.

Timber and real estate operations also made an important contribution to the upturn. The impact on overall results of other lines was minimal, as shown by the accompanying table of information by lines of business.

Freight transportation volume increased 12% over 1972, and revenues were up 14%. Rate increases, occurring late in the year, provided an estimated $9.2 million in added revenues.

Roughly one-half of the $42.6 million increase in operating expenses and costs came from higher wage and payroll tax rates written into national railroad labor contracts in 1973. Material prices were not as significant a factor except in the case of diesel fuel following the energy crisis triggered by the foreign oil embargo. Total fuel costs rose $3.4 million. Rail rolling stock rentals increased $8.0 million, or 32%.

Other income increased $2.8 million because of a higher level of interest earnings and higher gains on property sales. Interest expense increased because contingent interest on the Series A General Mortgage bonds and Terre Haute bonds was accrued in 1973, whereas no contingent interest was earned in 1972.

The 1972 extraordinary item was a special rail property retirement charge amounting to $1,920,000 before deducting the applicable deferred income tax benefit of $924,000 and minority interest.

1971 Extraordinary Item

This charge represents one-time costs and losses incurred as a result of the take-over by National Railroad Passenger Corporation (Amtrak) of intercity rail passenger service on May 1, 1971. The costs and losses consisted principally of an "entry fee" of $5.9 million, severance and protective payments to employees, charges for termination of joint terminal arrangements and loss on passenger rolling stock.

Remaining intercity passenger runs over Milwaukee Road lines have been performed by the Road under contract with Amtrak. As required by the Interstate Commerce Commission the Amtrak contract reimburses the railroad only for avoidable costs, and provides nc compensation for use of the railroad's right-of-way and trackage nor for any return on its investment in such properties. In the accompanying information by lines of business contract reimbursements are netted against operating expenses and costs. Any excess of full cost over avoidable cost of performing intercity passenger service is reflected at the earnings level in "freight transportation."

FIVE-YEAR CONSOLIDATED SUMMARY OF OPERATIONS (amounts in thousands)

	1974	1973	1972	1971	1970
Operating revenues	$466,174	$381,229	$327,198	$307,355	$285,564
Operating expenses and costs	453,306	368,232	325,602	298,921	290,159
Operating income (loss)	12,868	12,997	1,596	8,434	(4,595)
Other income	11,690	8,402	5,624	4,110	1,392
Total income (loss)	24,558	21,399	7,220	12,544	(3,203)
Interest expense	10,806	7,346	6,376	9,530	10,164
Earnings (loss) before income taxes and extraordinary items	13,752	14,053	844	3,014	(13,367)
Deferred federal income taxes (benefit)	2,478	2,654	285	918	(6,252)
Earnings (loss) before extraordinary items	11,274	11,399	559	2,096	(7,115)
Extraordinary items—after deducting deferred federal income tax benefit ($924,000 in 1972, $7,944,000 in 1971) and minority interest ($40,000 in 1972, $650,000 in 1971)	—	—	(956)	(15,602)	—
Net earnings (loss)	$ 11,274	$ 11,399	$ (397)	$ (13,506)	$ (7,115)
Per share earnings (loss) applicable to common stock					
Before extraordinary items	$ 3.62	$ 3.67	$ (.75)	$ (.12)	$ (3.88)
Extraordinary items	—	—	(.39)	(6.36)	—
Net earnings (loss)	$ 3.62	$ 3.67	$ (1.14)	$ (6.48)	$ (3.88)

FINANCIAL RESULTS BY LINES OF BUSINESS (amounts in thousands)

REVENUES	1974	1973	1972	1971	1970
Transportation					
Freight	$391,681	$355,258	$312,328	$293,894	$268,771
Passenger	10,623	7,361	6,910	7,675	14,427
Timber and real estate	8,680	10,320	7,960	5,786	2,366
Commercial food service equipment and wholesale food	49,340	4,371	—	—	—
Other	5,850	3,919	—	—	—
	$466,174	$381,229	$327,198	$307,355	$285,564

EARNINGS (LOSS) BEFORE FEDERAL INCOME TAXES AND EXTRAORDINARY ITEMS	1974	1973	1972	1971	1970
Transportation					
Freight	$ 3,813	$ 5,138	$ (4,978)	$ 3,001	$ (5,613)
Passenger	(1,616)	(1,979)	(2,009)	(5,303)	(10,500)
Timber and real estate	9,814	11,212	8,155	5,362	2,330
Commercial food service equipment and wholesale food	1,423	243	—	—	—
Minority interest	(405)	(470)	(35)	(87)	416
Other, including unallocated corporate expenses	723	(91)	(289)	41	—
	$ 13,752	$ 14,053	$ 844	$ 3,014	$ (13,367)

CHICAGO MILWAUKEE CORPORATION
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