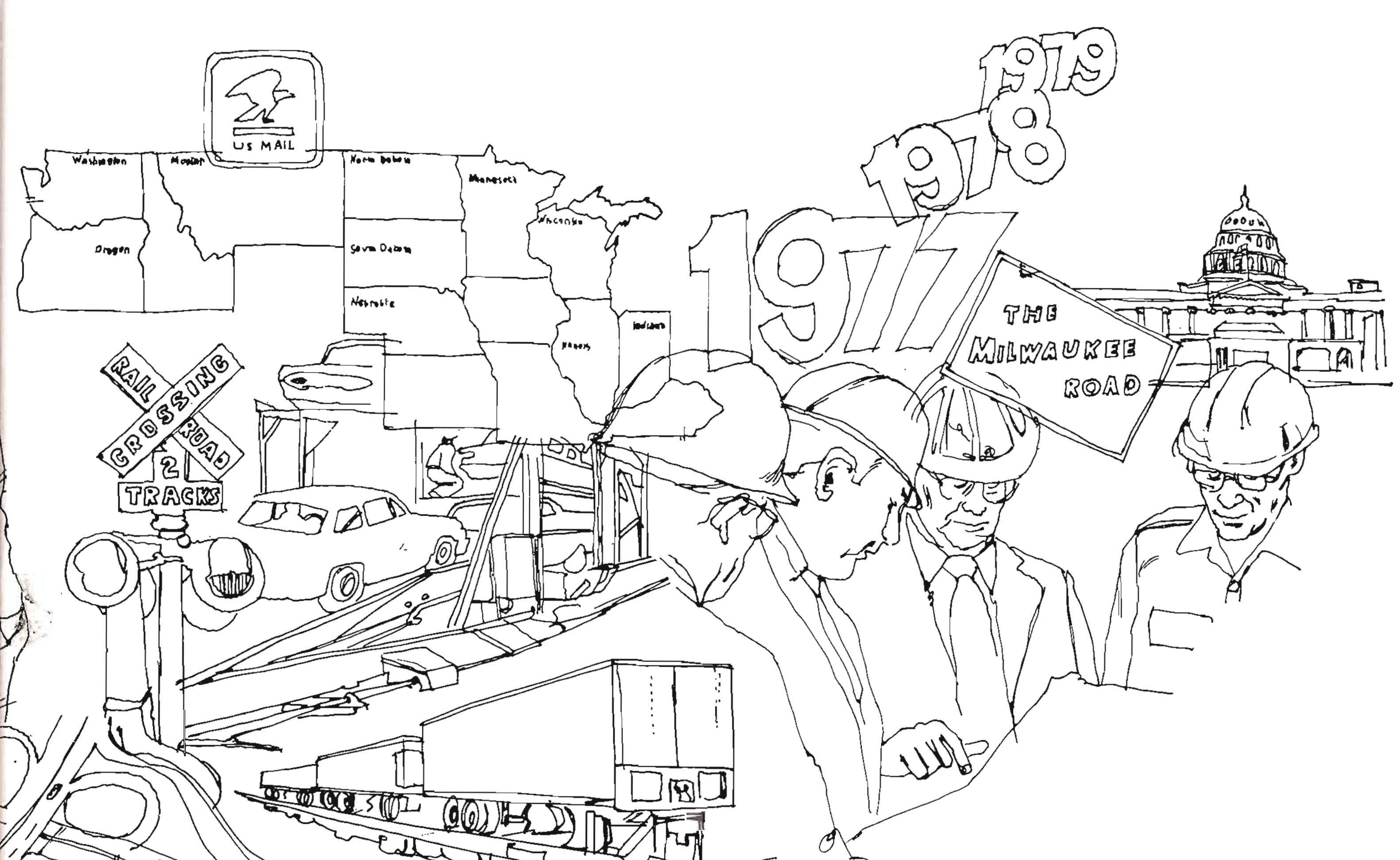
Chicago Milwaukee Corporation 1976 Annual Report



Directors

Tilden Cummings
Former President, Continental Illinois National Bank and 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, New York, New York

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

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

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

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

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

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

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

Robert S. Stevenson
Former Chairman of the Board, Allis-Chalmers Corporation (machinery), Milwaukee, Wisconsin

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

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

The Executive Committee of the Board of Directors is composed of Messrs. Cummings, Karnes, Maun, Quinn and Wirtz. Mr. Wirtz is Chairman.

The Audit Committee of the Board is composed of Messrs. Cummings, Gunness, Karnes and Stauffacher.

The Stock Option and Compensation Committee is composed of Messrs. Cummings, Maun, Williams and Wirtz.

Officers

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

Raymond K. Merrill
Vice President

P. Laurin Cowling
Vice President, Executive Department; Group Vice President, Food Service

Richard V. Nugent, Jr.
Vice President, Finance and Administration

Richard F. Kratochwill
Treasurer

James T. Taussig
Secretary

George G. Grudnowski
Assistant Secretary

Financial Highlights Chicago Milwaukee Corporation and Subsidiaries

	1976	1975
Operating revenues	$524,915,000	$450,576,000
Operating expenses and costs	529,194,000	470,468,000
Operating loss	(4,279,000)	(19,892,000)
Other income	7,339,000	6,315,000
Interest expense	9,545,000	10,550,000
Litigation settlement	3,025,000	—
Loss before income taxes	(9,510,000)	(24,127,000)
Net loss	(8,910,000)	(19,595,000)
Loss per share of common stock	(4.61)	(8.97)
Cash and temporary cash investments, Dec. 31	14,170,000	17,785,000
Working capital, Dec. 31	10,285,000	8,521,000

Corporate Headquarters
Chicago Milwaukee Corporation
516 West Jackson Boulevard
Chicago, Illinois 60606

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, New York 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 1976 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 March 23, 1977, the record date for the 1977 Annual Meeting, were beneficial owners of securities entitled to vote at the meeting.

Contents

To the Stockholders:

The year 1976 was better than 1975, but it was not good enough to return Chicago Milwaukee Corporation to profitability. In 1976, Chicago Milwaukee's consolidated pretax loss of $9.5 million represented an improvement of $14.6 million over the 1975 consolidated pretax loss of $24.1 million. The 1976 pretax loss included a charge of $3 million related to litigation over contingent interest obligations.

There was marked improvement in the financial performance of virtually all of Chicago Milwaukee's lines of business in 1976 compared to 1975. Land and timber pretax earnings improved by $4.6 million, while food service produced additional pretax earnings of $1.5 million. Chicago Milwaukee's highway paving subsidiary also did well, though not quite to the level of 1975. The transportation group operated at a pretax loss, but the pretax loss was reduced from that of 1975 by approximately $9.1 million.

One of the graphs which accompanies this letter shows how operating revenues for Chicago Milwaukee as a whole improved quarter by quarter during 1975 — and how, in contrast, they leveled off during 1976.

The other graph shows, essentially, the impact of continually increasing costs of doing business — particularly in railroading — on a relatively static revenue base.

Simply stated, the Milwaukee Road in 1976 did not operate at a profit because revenues were insufficient to cover the cost of operating a railroad plant with too much capacity for the markets it serves.

The railroad is working constantly to increase revenues through innovative sales and marketing practices and to reduce expenses where it can without adversely affecting its service to customers.

Eliminating excess and unnecessary plant requires time and the cooperation of government, shippers and other railroads. No objective received more attention on the Milwaukee Road during 1976. Beginning on page 9 you will find information on plans for its future with the help of government and shippers and through the mutually beneficial cooperation of other railroads.

Chicago Milwaukee met all its current fixed obligations during 1976. The Milwaukee Road paid the fixed interest on its bonds and on its equipment debt. While it accrued contingent bond interest during 1976, the railroad will not pay any contingent interest or contingent sinking fund obligations in 1977 in respect of 1976 because of the absence of Available Net Income as defined in the debt instruments. For the same reason, the railroad did not accrue $2.8 million in contingent interest for 1976 on its 5 per cent income debentures.

Dividends on Chicago Milwaukee's stock are not in prospect at present. Dividends must first flow out of the earnings of Chicago Milwaukee's subsidiaries. The Milwaukee Road must clear up its obligations to pay contingent interest before it can pay dividends to Chicago Milwaukee. The cash flows of subsidiaries in the food service area are committed largely to retiring the debt incurred in financing their acquisition.

During 1976, significant progress was made in settling the series of class-action lawsuits against Chicago Milwaukee and the Milwaukee Road over the manner in which the Milwaukee Road computes income available for contingent interest and sinking funds. A settlement was reached and was approved by the Federal District Court but is now under appeal. A decision on the appeal is expected this year.

Should the settlement become final, the railroad will pay approximately $4.1 million to holders of its Series A and Series B general mortgage and "Terre Haute" bonds and to certain holders of its 5 per cent income debentures. The details of this matter are contained in Note 12 to the Consolidated Financial Statements in this report.

The Milwaukee Road's financial condition prompts us to supplement the usual data contained in this report with the railroad company's consolidated financial statements, beginning on page 6. The railroad sustained substantial losses in 1975 and 1976. Although these losses were offset in part by the earnings of the subsidiaries of the railroad (Milwaukee Land Company and Milwaukee Motor Transportation Company), they reduced the railroad's consolidated liquidity position. I call your attention to the discussion of the railroad's liquidity in Note 2 to the Consolidated Financial Statements.

During 1976 several actions took place with respect to the Milwaukee Road's long-standing request of the Interstate Commerce Commission that it be included in Burlington Northern Inc. Twice during the year the Milwaukee filed with the Commission formal applications for inclusion in response to Commission rules. Each time the Commission refused to accept the application. Then, on March 2, 1977, following oral arguments on jurisdictional and procedural issues, it denied the Milwaukee's application without a hearing on its merits. The Milwaukee is seeking reconsideration.

During 1976 the Commission held hearings on the application of the Milwaukee Road and two other railroads to acquire and operate portions of the Green Bay & Western Railroad in Wisconsin. The offer of the three railroads to acquire the GB&W, a counter offer to one by Burlington Northern Inc., was rejected by the GB&W.

We reported to you in our Interim Report for the second quarter of 1976 that on June 29 the Securities and Exchange Commission filed a complaint alleging violations of certain sections of the federal securities laws and that, simultaneously and without admitting or denying any of the allegations, the defendants executed consents to the entry of decrees barring them from any future violations of the federal securities laws. The defendants agreed to the consent decrees because it appeared that the costs and burdens of litigation would create no offsetting benefits.

A special committee of independent outside Directors investigated the SEC's allegations and reported its findings and recommendations to the Boards of Directors of Chicago Milwaukee and the Milwaukee Road and filed them with the SEC. A summary of the committee's report was mailed to stockholders of the two corporations on March 29, 1977. While the special committee's recommendations were received after the preparation of this Annual Report began, its recommendations have been incorporated in this report to the maximum extent possible. Further information on the SEC matter is contained in Note 13 to the Consolidated Financial Statements.

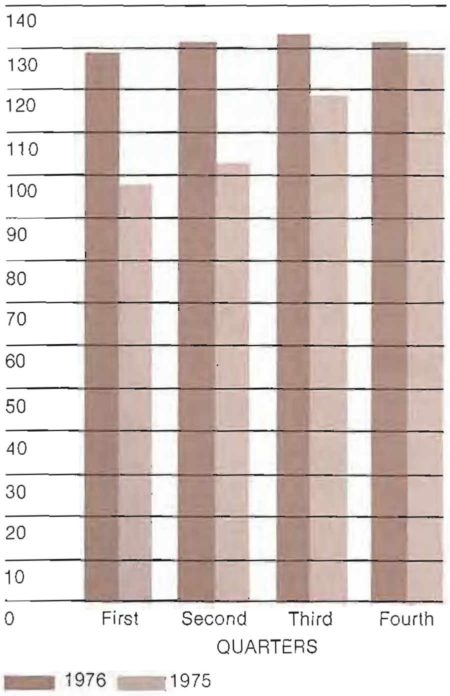
In December, 1976, the Milwaukee Road applied to the Federal Railroad Administration of the U.S. Department of Transportation for a total of $109.4 million in repayable financial assistance under the terms of the Railroad Revitalization and Regulatory Reform Act of 1976. The applications are for both federal guarantees of loans to the railroad and the purchase by the government of redeemable preference shares issued by the railroad. The funds from these borrowings would be used to rehabilitate main-line track and equipment and improve facilities. Further information on this project is on page 9.

An extremely severe winter across much of the railroad's territory gave the year 1977 a slow start. The impact of winter costs and the associated imbalances in the flow of traffic will adversely affect earnings for the first quarter. However, as we prepare this report rail traffic is improving moderately. The other subsidiaries are doing well. We expect 1977 to bring further improvement in all lines of our business.

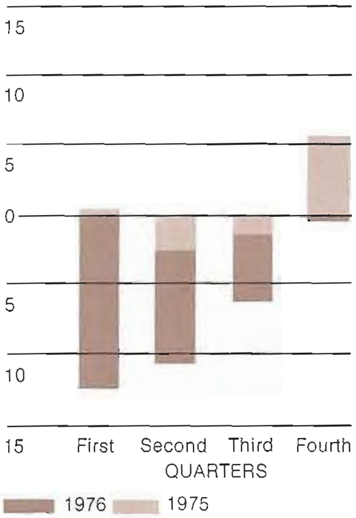
Respectfully,

Chairman of the Board
March 31, 1977

Total Consolidated Operating Revenues
$ millions



Consolidated Net Earnings or Loss
$ millions



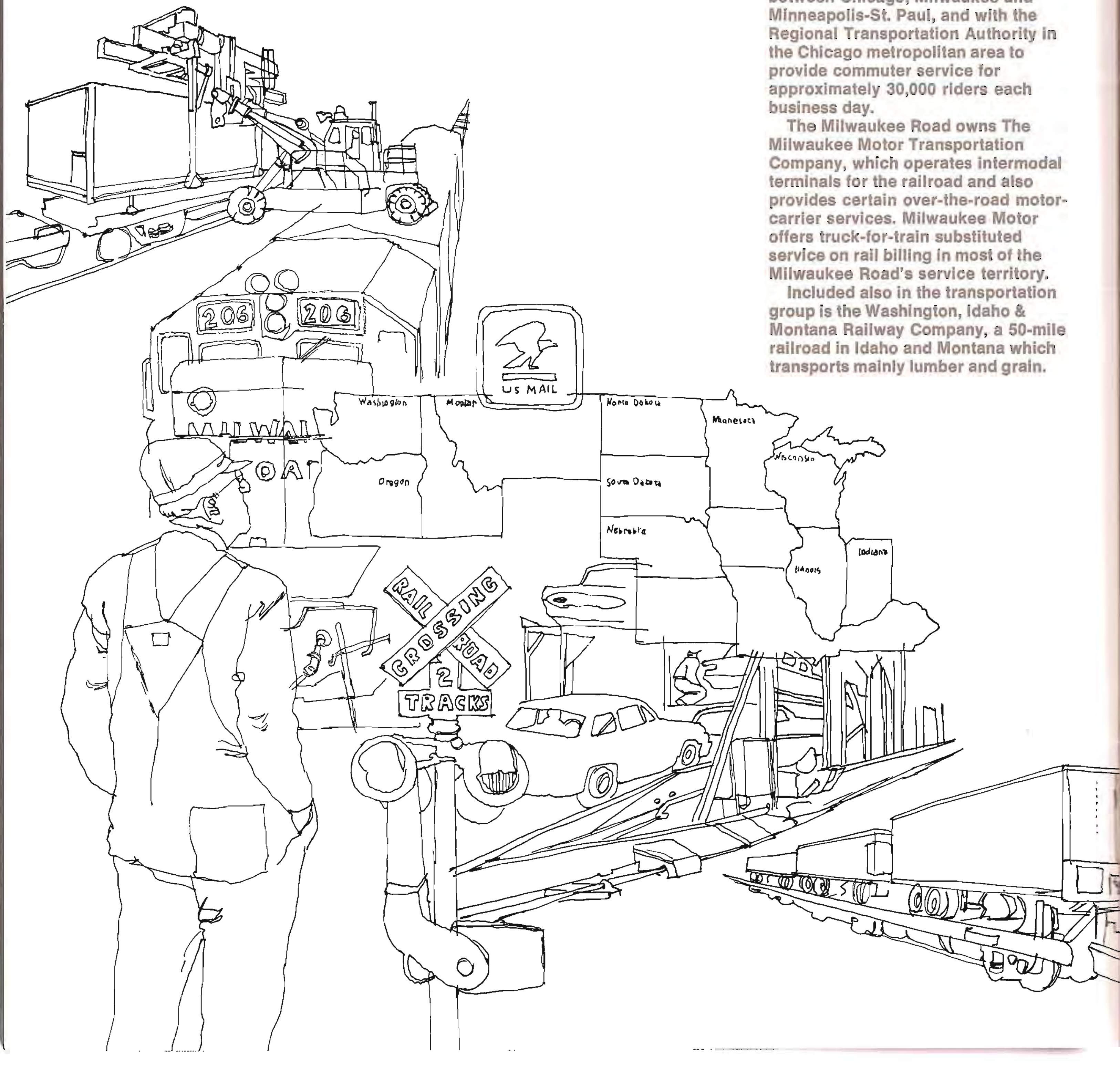
Review of Operations

Transportation

Chicago Milwaukee's principal operations are in common-carrier transportation. The company owns approximately 96 per cent of the stock of a major railroad, the Chicago, Milwaukee, St. Paul and Pacific Railroad Company. The Milwaukee Road operates some 10,000 miles of rail line throughout the Midwest and extending across the northern tier of states to the Pacific North Coast. Its traffic is highly diversified. Major commodities which generate high volumes are farm and food products, lumber and paper products, coal and other minerals and chemicals, automobiles and consumer goods. The Milwaukee Road has contracts with Amtrak to operate passenger trains between Chicago, Milwaukee and Minneapolis-St. Paul, and with the Regional Transportation Authority in the Chicago metropolitan area to provide commuter service for approximately 30,000 riders each business day.

The Milwaukee Road owns The Milwaukee Motor Transportation Company, which operates intermodal terminals for the railroad and also provides certain over-the-road motor-carrier services. Milwaukee Motor offers truck-for-train substituted service on rail billing in most of the Milwaukee Road's service territory.

Included also in the transportation group is the Washington, Idaho & Montana Railway Company, a 50-mile railroad in Idaho and Montana which transports mainly lumber and grain.



The Milwaukee Road

Some areas of the Milwaukee Road's business registered significant gains in 1976, notably automobiles and auto parts, lumber and other forest products, and import-export traffic. Grain traffic, on the other hand, did not. The Milwaukee Road handled fewer carloads of grain in 1976 than it did in 1975, which was itself a relatively poor year for rail grain traffic, because of reduced demand in both the domestic and international markets.

Recovery during 1976 from the business recession of prior years was spotty and slow. Business volumes in many areas of traffic repeatedly fell below even the most conservative projections, although in the over-all both total carloadings and revenue ton-miles increased over their 1975 levels.

Accordingly, the railroad controlled expenses tightly during the year while seeking to retain its place in its markets and to maintain its equipment and fixed facilities. The emphasis of the year was on cash conservation, expense reduction, and efficiency building.

To the extent that it could with its limited funds, the Milwaukee concentrated its efforts on improving the condition of its main-line tracks.

The Milwaukee continued its realignment and simplification of operating divisions to increase management efficiency; combined and eliminated duplicative or unneeded functions and facilities where it could; and abandoned more than 60 miles of branch lines. The number of employees was reduced 5.5 per cent during the year.

An officer with executive, marketing, planning and operating experience joined the Milwaukee's staff at the vice-presidential level in May to strengthen the railroad's operational and planning capabilities. Other changes in management were made to place additional emphasis on operating efficiency, long-range planning, and international marketing.

A new locomotive maintenance facility at St. Paul was placed in operation. Thirty-two new locomotives were acquired early in the year by lease. During the year the Milwaukee acquired through lease 175 new freight cars and 113 tri-level automobile-carrying racks to be mounted on flat cars.

After several years of study and planning, the Milwaukee and a major shipper of forest products jointly implemented a transportation system which concentrates and optimizes the movement of logs for the shipper in the state of Washington. Units trains which require 420 special cars — 352 of which were rebuilt from existing equipment and placed in service in 1976 — now move logs to three points of concentration under procedures which greatly increase the utilization of the railroad's equipment and guarantee the railroad's customer of a steady supply of raw product.

Milwaukee Motor Transportation

The Milwaukee Motor Transportation Company produced pretax earnings of $1.7 million during 1976.

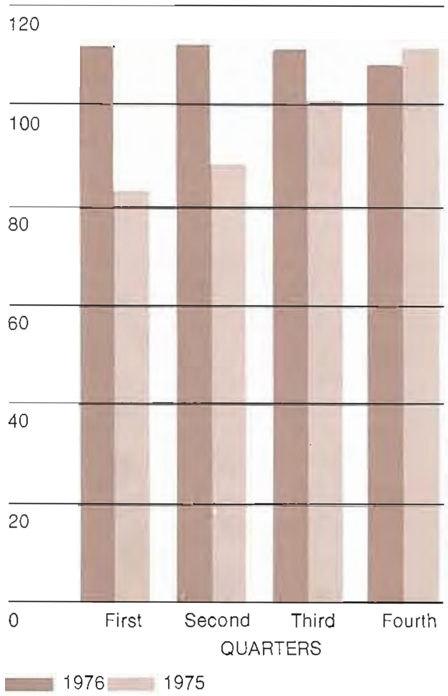
Nineteen new tandem-axle diesel tractors were acquired during 1976 and placed in service at Seattle, St. Paul, Billings and Sioux Falls. Milwaukee Motor also acquired its eighth "Piggy Packer," a special vehicle which handles containers to and from rail cars, and placed it in service at Chicago to assist with the growing volume of containers moving in international trade from the Orient through the Port of Seattle.

Milwaukee Motor continues its program to enlarge its over-the-road motor-carrier authorities in western states.

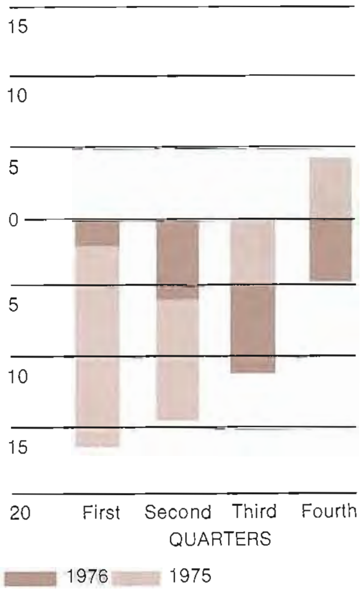
Financial statements

The three pages which follow contain the consolidated financial statements of the Milwaukee Road and its subsidiaries for the years 1976 and 1975.

Transportation Total Operating Revenues
$ millions



Transportation Pre-Tax Income
$ millions



Consolidated Statements of Operations and Retained Earnings Chicago, Milwaukee, St. Paul and Pacific Railroad Company and Subsidiaries

Supplementary Information

	Years ended December 31 1976	1975
	(amounts in thousands)	
Operating revenues:		
Transportation	**$449,806**	$388,008
Timber and real estate	**9,851**	4,834
	459,657	392,842
Operating expenses and costs:		
Transportation	**197,311**	174,823
Maintenance of way and structures	**64,875**	59,136
Maintenance of equipment	**61,347**	56,328
Traffic	**11,037**	10,347
Payroll and other taxes	**42,737**	38,207
Equipment and joint facility rents, net	**60,387**	50,607
General and other	**30,797**	27,039
	468,491	416,487
Net operating loss	**(8,834)**	(23,645)
Other income:		
Gain on sales of railroad land	**2,875**	2,210
Interest	**1,482**	1,689
Rents	**3,067**	2,873
Miscellaneous, net	**301**	47
	7,725	6,819
Total income (loss)	**(1,109)**	(16,826)
Fixed interest	**5,315**	5,849
Contingent interest	**2,630**	2,774
Litigation settlement	**3,025**	—
	10,970	8,623
Loss before income taxes	**(12,079)**	(25,449)
Deferred federal income tax benefit	**—**	4,382
Net loss	**(12,079)**	(21,067)
Retained earnings, beginning of year	**45,430**	66,497
Retained earnings, end of year	**$ 33,351**	$ 45,430

Consolidated Balance Sheets Chicago, Milwaukee, St. Paul and Pacific Railroad Company and Subsidiaries

Supplementary Information

	December 31 1976	1975
	(amounts in thousands)	
Assets		
Current assets:		
Cash and temporary cash investments	**$ 12,392**	$ 14,860
Accounts receivable	**36,533**	37,129
Material and supplies	**29,625**	26,603
Other current assets	**5,816**	5,130
Total current assets	**84,366**	83,722
Special funds	**5,818**	5,782
Investments:		
Affiliated companies	**24,738**	24,263
Other investments	**432**	466
Total investments	**25,170**	24,729
Properties, less accumulated depreciation and amortization:		
Transportation properties	**510,392**	523,916
Other property	**21,751**	23,739
Total properties	**532,143**	547,655
Other assets and deferred charges	**12,282**	10,577
Total assets	**$659,779**	$672,465

	1976	1975
Liabilities and shareholders' equity		
Current liabilities:		
Note payable to bank	**$ 1,090**	$ 2,090
Accounts payable	**50,858**	44,805
Payroll and vacation pay	**19,261**	21,418
Accrued taxes	**10,307**	9,983
Other current liabilities	**1,666**	2,563
Current maturities of long-term debt	**7,147**	8,248
Total current liabilities	**90,329**	89,107
Long-term debt	**203,918**	210,140
Deferred federal income taxes	**32,342**	32,342
Reserves and other liabilities	**29,985**	25,592
Total liabilities	**356,574**	357,181
Shareholders' equity:		
Capital stock:		
Common stock	**217,989**	217,989
Preferred stock	**51,865**	51,865
Retained earnings	**33,351**	45,430
Total shareholders' equity	**303,205**	315,284
Total liabilities and shareholders' equity	**$659,779**	$672,465

Consolidated Statements of Changes in Financial Position
Chicago, Milwaukee, St. Paul and Pacific Railroad Company and Subsidiaries

Supplementary Information

	1976	1975
	Years ended December 31 (amounts in thousands)	
Source of funds		
From operations:		
Net loss	**$(12,079)**	$(21,067)
Add (deduct) items not requiring an outlay of working capital in the current period:		
Depreciation and retirement charges	**16,416**	17,995
Deferred federal income tax benefit	**—**	(4,382)
Contingent interest on long-term debt	**2,630**	2,774
Additions to reserves for claims	**4,195**	2,352
Other, net	**1,328**	418
Working capital provided from (used by) operations	**12,490**	(1,910)
Drawdown of funds on deposit with mortgage trustee	**4,437**	9,460
Release of funds segregated in compliance with Interstate Commerce Commission orders	**910**	9,103
Salvage from property	**6,730**	6,063
Equipment and other borrowing	**1,283**	4,203
Miscellaneous, net	**(1,064)**	38
Decrease in working capital	**578**	13,795
	$ 25,364	$ 40,752
Application of funds		
Debt retirement	**$ 8,118**	$ 9,499
Property additions and betterments	**9,706**	21,408
Segregation of funds in compliance with Interstate Commerce Commission orders	**307**	4,451
Deposit of property sale proceeds with mortgage trustee	**5,041**	3,959
Reclassification of estimated liabilities for claims and accumulated contingent interest ($1,101,000 in 1976) to current liabilities	**2,022**	1,629
Investments in (liquidation of) terminals and other companies	**170**	(194)
	$ 25,364	$ 40,752
Analysis of changes in working capital		
Increase (decrease) in current assets:		
Cash and temporary cash investments	**$ (2,468)**	$ (5,549)
Accounts receivable	**(596)**	(788)
Material and supplies	**3,022**	(3,532)
Other current assets	**686**	186
	644	(9,683)
Increase (decrease) in current liabilities:		
Note payable to bank	**(1,000)**	(500)
Accounts payable	**6,053**	1,231
Payroll and vacation pay	**(2,157)**	3,686
Accrued taxes	**324**	236
Other current liabilities	**(897)**	33
Current maturities of long-term debt	**(1,101)**	(574)
	1,222	4,112
Decrease in working capital	**$ (578)**	$ (13,795)

A Program for the Future of The Milwaukee Road

On February 5, 1976, President Ford signed into law the "4R" Act, the Railroad Revitalization and Regulatory Reform Act of 1976. The first major piece of reform legislation in rail transportation in many years, the 4R Act lays the groundwork for the economic redevelopment of a railroad industry which has suffered for generations from imbalanced regulation.

While the 4R Act is not a panacea for all railroad ills, it does appear to remove some of the obstacles which heretofore have blocked the railroads' efforts toward economic and competitive improvement.

Not all of the provisions of the 4R Act are, yet, fully effective. Some depend on studies which are not completed. Some doubtless must be tested in the courts.

The future of a railroad such as the Milwaukee is today being shaped at least as much by events in Washington, D.C., as it is by what the company can do for itself in its own markets and with its own resources. The Milwaukee's intent is to respond fully to the opportunities presented by this highly significant law.

The 4R Act

The provisions of the 4R Act urge and invite a restructuring of much of the nation's railroad system. The Act, according to its policy statements, also seeks to

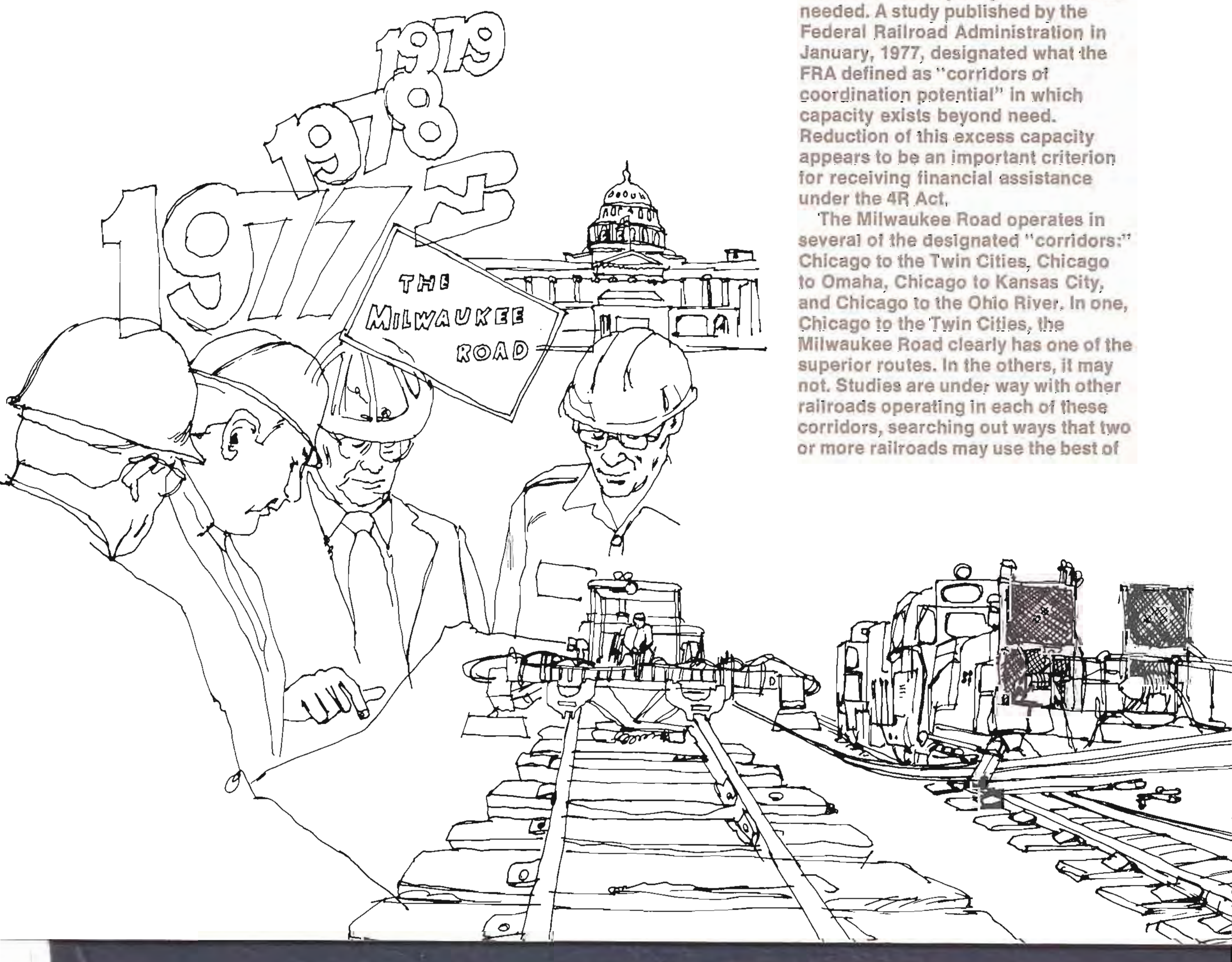
- balance the needs of rail carriers, shippers, and the public;
- foster competition among carriers of all modes, promote more efficient transportation services, and make investing in railroads more attractive;
- build more flexibility into railroad ratemaking so that railroads can better compete; and
- determine adequate revenue levels for railroads.

Clearly, the 4R Act expands the role of the federal government in railroad matters. Yet it doesn't "put the government in the railroad business." Indeed, the fundamental purpose of the Act is to help avoid the need for even greater government involvement with the railroads in the future.

Main-line coordinations

In certain areas of the United States, more railroad capacity exists than is needed. A study published by the Federal Railroad Administration in January, 1977, designated what the FRA defined as "corridors of coordination potential" in which capacity exists beyond need. Reduction of this excess capacity appears to be an important criterion for receiving financial assistance under the 4R Act.

The Milwaukee Road operates in several of the designated "corridors:" Chicago to the Twin Cities, Chicago to Omaha, Chicago to Kansas City, and Chicago to the Ohio River. In one, Chicago to the Twin Cities, the Milwaukee Road clearly has one of the superior routes. In the others, it may not. Studies are under way with other railroads operating in each of these corridors, searching out ways that two or more railroads may use the best of



available routes and retain the others, if necessary, for local service. The coordinations so devised could save participating railroads millions of dollars in maintenance and upgrading expense.

The first breakthrough occurred in March, 1977. The Milwaukee and the Rock Island signed agreements under which the Milwaukee's Kansas City trains would operate over 243 miles of the Rock Island between Muscatine, Iowa, and Polo, Missouri, parallel to a portion of the Milwaukee's own route between these two points. The Interstate Commerce Commission authorized the Milwaukee to do so on a temporary basis effective March 31; the Milwaukee has filed an application for permanent authority.

Based in part upon its coordination with the Milwaukee, the Rock Island will apply to the Federal Railroad Administration for help in financing a major upgrading program on the track which the two railroads will use jointly.

Twin Cities line rehabilitation

The importance of the Milwaukee's own route between Chicago and the Twin Cities underlies its application to the FRA in December, 1976, for a total of $109.4 million in repayable financial assistance. The greater share of that amount would be used to rehabilitate the main line between Milwaukee and St. Paul. The balance would initiate large freight-car and locomotive overhaul programs and provide environmental-protection facilities.

The Milwaukee's application is already supported by at least one other railroad which operates in the Twin Cities corridor.

The total of $109.4 million in financial assistance would include both forms of financial assistance contained in Title V of the 4R Act. A portion of the assistance would take the form of federal guarantees of principal and interest on loans which the Milwaukee would seek from conventional sources. The loans would carry a rate of interest and other terms approved by the FRA. They would mature within 25 years.

Redeemable preference shares

The larger share of the assistance would be through the purchase by the federal government of a new class of railroad security, nonvoting redeemable preference shares. The railroad's shareholders will be asked to approve amendments to its Charter to permit the issuance of up to $200 million in preference shares in series as required by present and future rehabilitation programs.

As presently viewed, the new preference shares would be junior in rank to the railroad's previously issued preferred stock and generally senior to its common stock. The preference shares would mature in 30 years or sooner, and would earn dividends from the 10th year at a rate to be fixed, within limits prescribed by the 4R Act, by the U.S. Secretary of Transportation. The shares would be redeemed at par over a minimum period of 15 years beginning not earlier than the sixth year after they are issued nor later than the 11th year. Effectively, the Milwaukee would repay to the U.S. Government at least 150 per cent of the face value of the shares which the government buys.

There is no assurance that the Milwaukee Road will receive all or any portion of the financing assistance it has applied for.

Light-density lines

A significant feature of the 4R Act, Title VIII, is designed to help railroads shed losses from uneconomic light-density and branch lines and to provide limited federal assistance to states, municipalities and others to acquire and operate such lines for which railroads obtain abandonment authority. The Milwaukee has had a series of internal studies under way for some time which will permit it to take prompt advantage of the full benefits of Title VIII.

To a degree, state and even shipper assistance in operating light-density lines is already playing an important role in the Milwaukee's future. In 1977, a three-year upgrading of 100 miles of an Iowa secondary line which is an important route for grain will be completed with state and shipper aid. A second program covering the initial 32 miles of another line will begin. In Idaho, a group of forest-products shippers is completing plans to advance the Milwaukee funds to rehabilitate a branch line.

In the Iowa state rail plan, on-line shippers and the state together advance the railroad two thirds of the necessary rehabilitation funds, which the railroad then pays back proportionately to the traffic which moves over the line. The State of Minnesota has established and funded a program patterned after Iowa's.

Preliminary studies indicate that in excess of 2,000 miles of the Milwaukee's 10,000-mile network must continue to be studied carefully in order to assess their position with respect to discontinuance, coordination or operation by other parties. In these studies the Milwaukee will give full consideration to present and future market and strategic needs and potentials, always mindful that it is unrealistic to require a railroad which depends by its very technology on high volume to operate services in which high volume simply cannot exist.

Burlington Northern inclusion

In 1973, the Milwaukee Road filed a petition with the Interstate Commerce Commission seeking inclusion in Burlington Northern Inc. The matter is still before the Commission. The Milwaukee's quest for inclusion is founded on the fact that the Milwaukee hasn't been able to become fully competitive with the BN, as the Commission contemplated when it approved the merger which formed the BN itself.

The Milwaukee has requested the ICC to reconsider and clarify its denial on March 2, 1977, on the merits and without a hearing, of the Milwaukee's applications for inclusion and for additional traffic conditions in the alternative to inclusion.

The Milwaukee is seeking to have Burlington Northern be required by the ICC to assume stock control of the Milwaukee through an exchange of BN stock for Milwaukee Road stock.

Joint studies determined that the two companies could be operated more efficiently together than separately. If Burlington Northern were to control the Milwaukee and the operations of the two lines were combined, savings of approximately $25 million per year would be realized by the combination after seven years, according to the latest study.

The Milwaukee considers control by Burlington Northern to be fully in accord with the needs of its service territory and with the concept of a restructured western railroad network which is reflected in the 4R Act. Its plans to apply federal financial assistance under the 4R Act are entirely compatible with inclusion.

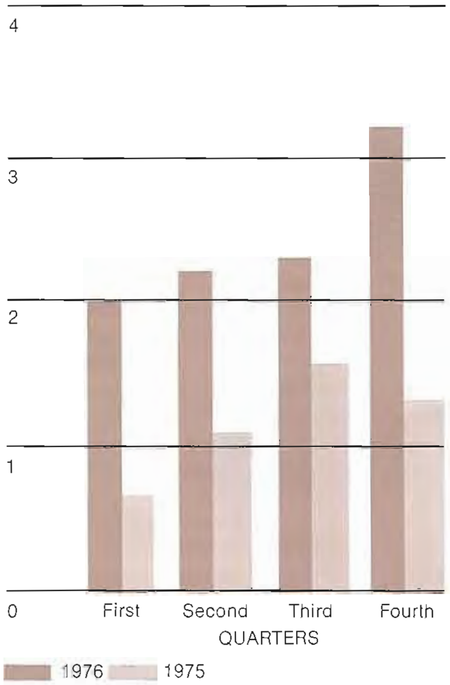
Review of Operations

Land and Timber

Land and timber operations of Chicago Milwaukee Corporation are conducted by Milwaukee Land Company, a wholly owned subsidiary of the Milwaukee Road. Excluded from the land and timber segment of the business is the selling and leasing of real estate originally dedicated to railroad operations but no longer required for that purpose. Earnings from this source are included in the transportation segment and appear in line items under other income. Milwaukee Land Company owns approximately 154,650 acres of land, mostly timber-producing, in Idaho, Washington and Montana.

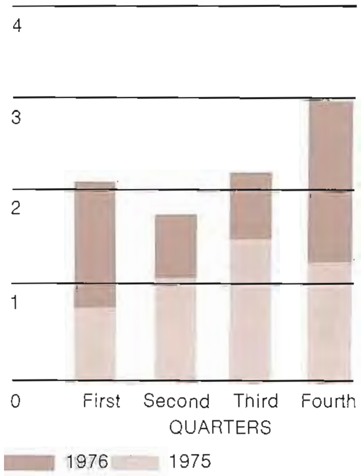
Land and Timber Total Operating Revenues

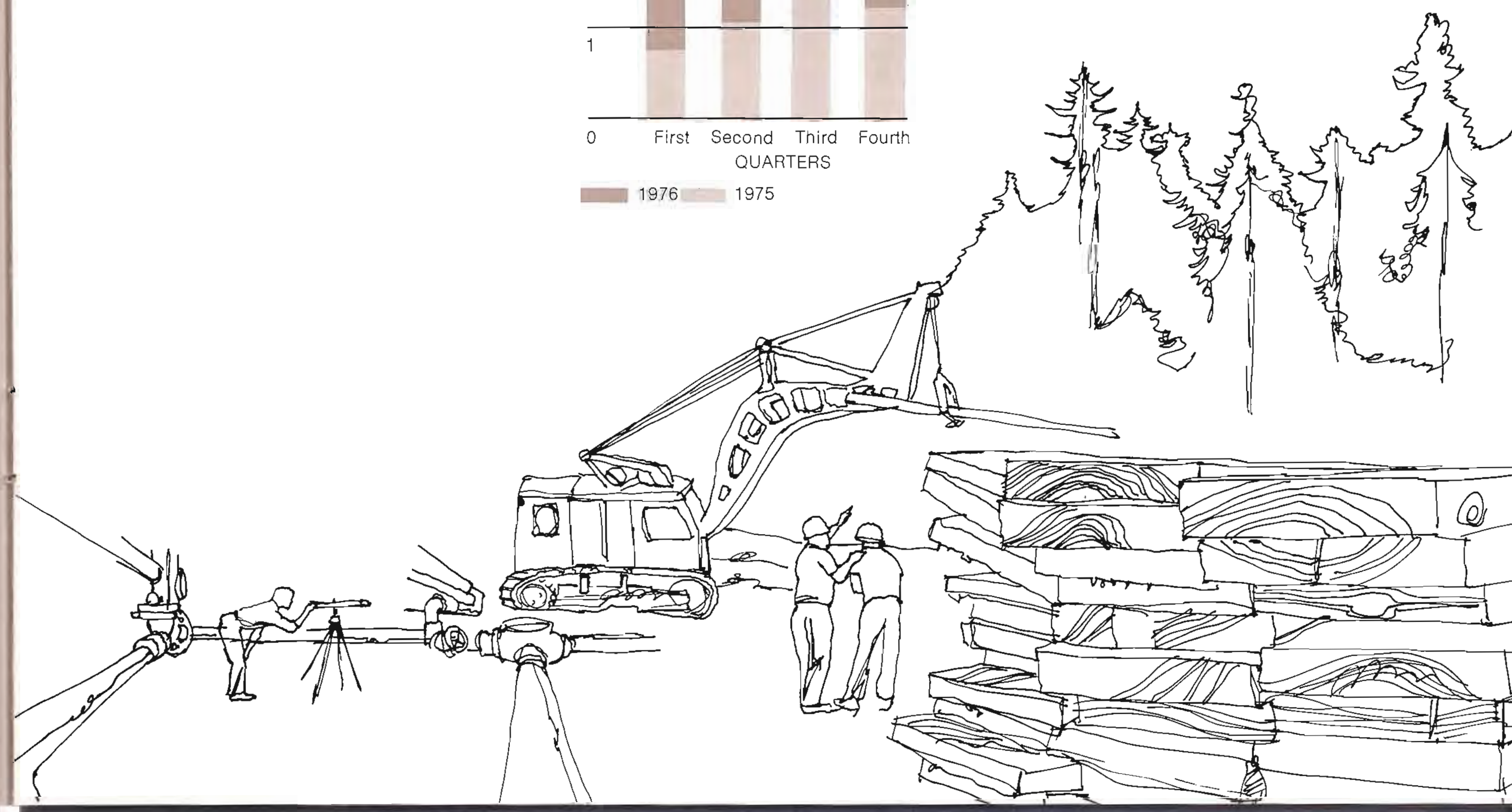
$ millions



Land and Timber Pre-Tax Income

$ millions





Timber operations consist principally of tree-growing and the sale of merchantable growth. Lumber, pulp, paper and plywood producers are licensed to harvest the timber, usually under long-term contracts. Milwaukee Land Company then reforests cut-over timberlands in favorable growth areas either through aerial seeding or by hand planting.

Timber-cutting activities were substantially greater in 1976 than in 1975 due to a higher level of housing starts and increased exports of logs. Nearly 7,500 acres were logged under contract in 1976, compared with approximately 4,600 acres in 1975.

Real estate operations involve principally the acquisition, development and sale of land for industrial sites. Where consistent with other objectives, the company favors industries which require high-volume rail transportation. To a relatively minor extent, Milwaukee Land Company is also involved in commercial, residential and recreational developments. Altogether, it engages in real estate activities in 13 states.

Property sales for industrial purposes increased in 1976, as reflected in the table. Milwaukee Land Company sold acreages in Idaho for a major residential development and in Iowa and Washington for industrial and commercial uses.

In some past years Milwaukee Land Company has made substantial sales of timberland to provide funds for various purposes, including cash advances and dividends to the Milwaukee Road. Some of the funds have also been used to finance other investments of the Land Company. As the accompanying table shows, there were substantial sales of timberland during the period 1972 through 1974, but only nominal sales in 1975 and 1976.

The past sale of timberland will have the effect of reducing income from future sales of timber. In view of the time required for reforestation, it is estimated that this loss of income will occur between 1985 and 2000. However, such loss of income may be offset by income from the reinvestment of a portion of the proceeds from timberland sales and other earnings retained by the Land Company.

The table of information by lines of business which accompanies the Financial Review and Analysis shows that pretax income from land and timber operations closely parallels revenues, reflecting the relatively low costs and expenses associated with this line of business. In certain of the years covered by the table, other income caused pretax income to exceed revenues.

Milwaukee Land Company is participating in a joint venture, Northern Tier Pipeline Company, which is surveying the feasibility of a crude-oil pipeline from Puget Sound to Minnesota, possibly using railroad rights of way for portions of the route. During 1976 Northern Tier continued its research and development activities.

Land and Timber Operations

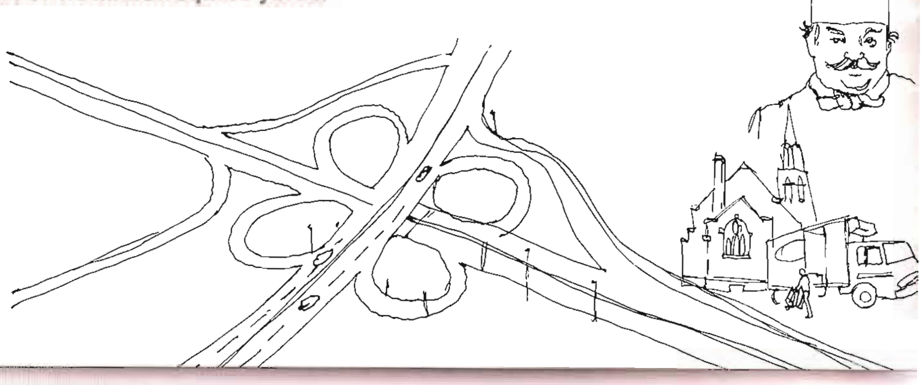
	1976	1975	1974	1973	1972
	(dollar amounts in thousands)				
Sales, less direct costs:					
Timber-cutting contracts	**$ 7,858**	$3,402	$ 4,591	$ 5,456	$2,845
Industrial and residential property	**777**	477	241	102	219
Timberland	**1**	4	3,441	4,273	4,564
	8,636	3,883	8,273	9,831	7,628
Interest, rents and miscellaneous income	**3,650**	3,896	3,308	2,114	1,240
	12,286	7,779	11,581	11,945	8,868
Operating and interest expenses	**3,027**	3,089	1,767	733	713
Pretax earnings	**$ 9,259**	$4,690	$ 9,814	$11,212	$8,155
Acres of timberland sold	**6**	10	9,700	17,300	25,700

Highway Construction

Hi-Way Paving, Inc., of Columbus, Ohio, is a large concrete paving subcontractor which operates principally in Ohio and West Virginia. Chicago Milwaukee acquired Hi-Way Paving in 1973.

During 1976, Hi-Way Paving completed more than a half million square yards of concrete highway. Its schedule for 1977 calls for it to place 700,000 square yards.

New paving contracts awarded during 1976 rose by 23 per cent from their 1975 level. Hi-Way Paving's backlog at year-end 1976 was up 20 per cent from that of a year earlier, to a total of 1.5 million square yards.



Review of Operations

Food Service

In 1973, Chicago Milwaukee Corporation entered the rapidly expanding commercial food-service industry, which is generally defined as the preparation and service of meals in volume away from home.

Chicago Milwaukee's original acquisition of Aslesen Company of Minneapolis was augmented in early 1974 by the acquisition of Vulcan-Hart Corporation of Baltimore. With the fragmented and expanding nature of the food service industry, Chicago Milwaukee continues to seek further acquisitions.

Aslesen Company

Out of its headquarters and principal distribution center in Minneapolis, Aslesen Company sells and distributes institutional food supplies and food-service equipment to approximately 12,000 customers in six states. Aslesen handles both dry and frozen foods. It has departments which provide kitchen contract design, sell furniture and decor items, and sell bakery equipment and used equipment. Aslesen operates an expanding fleet of trucks.

Aslesen's markets are restaurants; hospitals; nursing homes; schools, colleges and other institutions; industrial in-plant feeding; hotels and motels; and catering organizations.

Total dollar sales in 1976 were up 13 per cent from their 1975 level. The sales force, having been enlarged in 1975, was increased again in 1976. Seven new sales territories were established.

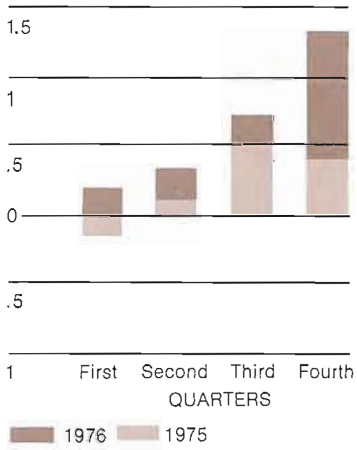
Significant sales gains were registered in 1976 in two areas:

Frozen-food sales increased 51 per cent over their 1975 level. In 1976 an addition to the Minneapolis distribution center was completed to provide for an increase of approximately 200 per cent in the storage space available for frozen foods. Aslesen began in 1976 a major program with a nationally prominent franchiser to distribute supplies and dry and frozen food products to franchised outlets.

Sales of cleaning supplies and equipment out of the "housekeeping" section of the supply department increased 200 per cent.

Aslesen was one of the pioneers in the concept that all items necessary to do volume feeding should be available from a single distributor. The company stocks and distributes approximately 11,000 items.

Food Service
Pre-Tax Income
$ millions



Vulcan-Hart Corporation

Vulcan-Hart is a major manufacturer of food-service equipment, the only manufacturer in the industry to offer full lines of gas and electric equipment. Its four plants produce ranges, dishwashers, mixers, a variety of fast-food equipment, beverage coolers, reach-in and walk-in coolers and freezers, and conventional and convection ovens.

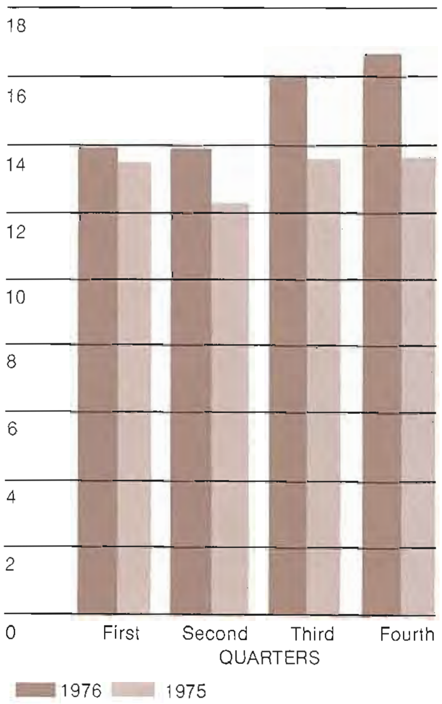
Vulcan-Hart distributes to its nationwide domestic market through dealers. It has licensees in Australia, Canada, England, Japan, Mexico and Venezuela.

Sales, in total, increased nearly 20 per cent over sales in 1975. That portion of Vulcan-Hart's business which is related to government and export increased 34 per cent.

The year 1976 saw Vulcan-Hart introduce the first items of a new generation of food-service equipment in which a primary objective of the design is the reduction in energy consumption. Depending on energy considerations and other requirements, Vulcan-Hart's customers may order their cooking equipment to be operated by gas, electricity, or steam.

Manufacturing efficiency also received much emphasis in 1976. Value-engineering programs conducted during the year concerned themselves with changes in equipment design and the application of capital funds to manufacturing processes. One result of these programs was the application of numerically controlled turret punches which will reduce the labor content of manufacturing.

Food Service
Total Operating Revenues
$ millions



Financial Review and Analysis

Consolidated pretax loss in 1976 was $9.5 million, an improvement of $14.6 million over 1975. Excluding the one-time litigation settlement charge (see note 12 of the Notes to Consolidated Financial Statements), the 1976 pretax loss was $6.5 million.

There was improvement in all major areas. In relationship to the trend of the economy generally, performance in land and timber and in food service was good. Performance of the transportation segment was, at best, inadequate.

Perspective on operating results is provided by the Five-Year Consolidated Summary of Operations on page 29 and the table of Information by Lines of Business on page 16. Your attention is also invited to the five-year tables of Railroad Freight Traffic by Commodity Groups (page 16) and of Land and Timber Operations (page 12). The latter table shows the amounts and trends of gross earnings from timber cutting, industrial and residential property sales, and timberland sales.

The Milwaukee Road and its subsidiaries were in a negative consolidated working capital position at December 31, 1976, and experienced declines in working capital and in cash during both 1975 and 1976. Note 2 of the Notes to Consolidated Financial Statements contains a discussion concerning the liquidity of the railroad and its subsidiaries. The consolidated financial statements of the railroad and its subsidiaries are included in this report.

Transportation volume during 1976 was generally flat at about the late-1975 level except for the fourth quarter, when carloads and ton-miles eased downward in parallel with general economic indicators. Full-year 1976 volume was about equal to that of the year 1974, regarded as a bench mark of relative acceptability in terms of the railroad's historical earnings performance. Operating income, however, was far off the 1974 mark because of lagging freight rate adjustments and a shift in traffic mix.

With respect to traffic mix, 1976 vs. 1974, there were volume declines in most major commodity groups, except lumber and automobiles, and this slack was taken up by gains in relatively low-margin commodities such as coal and primary forest products. Predominant among the volume declines was the traffic in grain, which continued to languish as exports remained sluggish and grain in storage increased. The United States Department of Agriculture estimated in January that, when the 1977 harvests begin, left-over stocks of wheat and corn will exceed year-ago amounts by 65 per cent and 82 per cent, respectively.

The land and timber segment doubled its 1975 revenues and had pretax earnings approximately equal to revenues, continuing a historic pattern. Most of the improvement in land and timber came from increased timber-cutting revenues, reflecting the upturn in housing production that started in 1975. Sales of timberland were minimal: $4,041 in 1975 and $1,008 in 1976.

Food service had its best year since this segment was acquired by Chicago Milwaukee, with a revenue gain over 1975 of just under 16 per cent and pretax earnings of $2.4 million.

1976 fourth quarter

As noted, transportation volume weakened in the fourth quarter. Revenue ton-miles were about 3 per cent lower than the average of the first three quarters of 1976, as contrasted with the year-ago situation in which fourth quarter volume was on the upswing. As a result, the transportation segment

Quarterly Financial Data (Unaudited) (amounts in thousands except per-share data and stock prices)

	1976 Calendar Quarter 1	2	3	4	1975 Calendar Quarter 1	2	3	4
Operating revenues	**$129,278**	**$131,071**	**$133,265**	**$131,301**	$98,544	$103,619	$118,886	$129,527
Operating income (loss)	**1,174**	**(2,201)**	**(2,783)**	**(469)**	(15,124)	(11,715)	(1,316)	8,263
Net earnings (loss)	**458**	**(2,534)**	**(6,722)**	**(112)**	(12,743)	(10,642)	(1,471)	5,261
Per share net earnings (loss) applicable to Common Stock	**$(.06)**	**$(1.27)**	**$(2.99)**	**$(.29)**	$(5.44)	$(4.59)	$(.84)	$1.90

Note: There were no extraordinary items or accounting-change adjustments during the periods shown in the foregoing table. Results for the third quarter of 1976 give effect to a $3 million provision for litigation settlement expense (see note 12).

	1976 Q1	Q2	Q3	Q4	1975 Q1	Q2	Q3	Q4
Sale prices of the Corporation's capital stock on the New York Stock Exchange								
$5 Prior preferred:								
High	**13⅞**	**14⅝**	**13⅞**	**14⅝**	15	12¾	12⅞	10½
Low	**8½**	**11⅜**	**11¼**	**11**	10	10⅛	9	7¾
Common:								
High	**7⅞**	**9**	**8¾**	**7⅞**	11¼	7¾	7⅜	4⅞
Low	**4⅝**	**7**	**5½**	**5**	5⅜	6	4¾	4

had a $4.8 million operating loss in the fourth quarter of 1976, compared to $6.2 million of operating income in the fourth quarter of 1975.

Nontransportation operations produced $4.3 million of operating income in the 1976 fourth quarter compared to $2.1 million in the fourth quarter of 1975. Much of this improvement was attributable to a higher level of timber sales.

Revenues, 1976 vs. 1975

Freight transportation revenues were $433.8 million, an increase of $59.8 million, or 16.0 per cent, over 1975. Of the increase, an estimated $30.8 million was attributable to higher rates. Total carloadings and revenue ton-miles increased, respectively, 7.1 per cent and 10.3 per cent.

The major commodity groups handled in terms of freight transportation revenue produced are listed in the table of Railroad Freight Traffic by Commodity Groups. All groups showed revenue ton-mile increases over 1975 except waste and scrap materials, which had a ton-mile decrease of 5.5 per cent. The ton-mile percentage increases over 1975 for each group were: primary metal products, 20.5 per cent; all other, 16.3 per cent; pulp and paper products, 16.1 per cent; lumber products, 14.6 per cent; coal, 11.6 per cent; transport equipment (including automobiles), 11.2 per cent; chemicals, 6.8 per cent; farm products, 6.4 per cent; stone, clay and glass products, 1.9 per cent; food and food products, 1.4 per cent.

Of the $2.0 million increase in passenger transportation revenues, $1.7 million represents added contract payments under a commuter purchase-of-service agreement which became effective July 1, 1975.

The increase in food-service sales is attributable to both the distribution and manufacturing components of the group. In addition to a substantial increase in sales of frozen food, a greater penetration of the restaurant market helped increase sales of other products handled by the distribution component. The increase in sales of food preparation and storage equipment by the manufacturing component was influenced by the major remodeling of food facilities plus the expansion of the replacement and fast food market; these factors appear to be the result of the pick-up in the general economy.

Operating expenses and costs, 1976 vs. 1975

Consolidated operating expenses and costs of $529.2 million represent an increase over 1975 of $58.7 million, or 12.5 per cent. About 88 per cent of this increase was in the transportation segment.

Despite an approximate 10 per cent increase in revenue ton-miles, the total quantity of transportation labor expended in 1976 remained about the same as in 1975. Service hours were up 2.6 per cent in train, truck and yard operation, while other labor classifications were down slightly. Locomotive fuel consumption rose approximately 7.3 per cent, and the quantity of other transportation material and supplies used increased about 8.4 per cent, accounting for about $5.4 million of the increase in transportation operating expense.

Higher rates or prices for labor, material, taxes and services were the principal factors contributing to the higher operating expenses. Identifiable items in this category include salaries and wages, $15.7 million; materials and fuel, $5.3 million; freight car hire, $1.3 million; payroll taxes and other wage supplements, $6.6 million. Other transportation expense increases included $4.1 million for long-term lease payments on rolling stock, $1.1 million for lading damage, $1.2 million for injury claims and $700,000 for pensions.

Nontransportation operating costs and expenses were up 12.6 per cent, primarily because of higher sales volume. In food service, the percentage of cost of sales to net sales dropped from 76.1 per cent to 75.7 per cent.

Other income

Year-to-year changes in other income are affected principally by the timing of sales of transportation property not required for transportation purposes, the effect on interest income of varying levels of short-term rates and amounts of funds available for temporary investment, and the level of earnings or losses from certain investments accounted for by the equity method.

Special charges against other income in the time span covered by the Summary of Operations include $1.2 million in 1975 to write off accounts receivable from the bankrupt Chicago, Rock Island and Pacific Railroad, and $800,000 in 1974 related to the bankruptcy of REA Express.

Interest expense, taxes and extraordinary item

Lower fixed interest charges in 1976 are attributable to payments of principal debt installments, and approximately $249,000 to reduction in the floating rate on debt incurred to make food-service acquisitions.

Contingent interest on the railroad's mortgage bonds was accrued in both 1976 and 1975. Such interest is not currently payable in respect of either year because Available Net Income amounts, as defined, were negative in both years. Such amounts would also be negative in both years under the terms of the pending litigation settlement.

Interest expense increased $3.5 million in 1974 because contingent interest was not accrued in 1973 on the railroad's Series B General Mortgage bonds and because of charges on new borrowings to finance business acquisitions.

The deferred federal income tax benefits in 1976 and 1975 represent the effect of carryback of losses in those years to 1974 and 1973.

The 1972 extraordinary item was a special rail property retirement charge of $1,920,000, less related deferred income tax benefit of $924,000 and minority interest of $40,000.

1975 vs. 1974

Freight transportation volume was down in all major commodity groups except coal, beverages and malt, automobile parts and forwarder traffic. Carloadings dropped 10.9 per cent. Excluding coal, which accounted for 11.7 per cent of 1975 carloads but only 5.8 per cent of revenues, the decline was 17.6 per cent. Revenue ton-miles showed a decline of 8.2 per cent over-all and 16.4 per cent for all commodities other than coal. The combined adverse effect on revenues of the volume decline and changes in traffic mix was approximately $56.7 million. Higher freight rates had an approximate $39 million offsetting effect.

Passenger transportation revenues were up $3.4 million as government mass transit assistance increased $2.1 million and commuter ridership increased. Land and timber revenues were down mainly because there were minimal timberland sales in 1975 whereas there were $3.5 million in timberland sales in 1974.

Transportation operating expenses and costs of $414.5 million were higher than in 1974 by $13.7 million. The quantity of transportation labor expended, measured in total service hours, was down from 1974 by 10.3 per cent. Including related reductions in payroll taxes, the resulting labor-cost savings were almost exactly offset by the $16.7 million effect of general wage-rate increases. Transportation materials other than fuel cost $700,000 less in 1975 than in 1974 due to decreased usage of $7.8 million, less price increases of $7.1 million. Transportation fuel cost approximately $1.5 million more, with price increases of $2.5 million offsetting $1 million in decreased usage. Other major items were a $4.7 million increase in long-term lease payments on rolling stock and a $6.8 million increase in payments to other carriers for the use of freight cars.

Food-service revenues were higher principally because Vulcan-Hart Corporation is included in the figures for all of 1975 and for only ten months of 1974. Vulcan-Hart was purchased on February 28, 1974. The units engaged in the manufacture of commercial and institutional cooking, food-preparation and storage equipment experienced generally lower demand and volume in 1975; the related reduction in sales of these units was only partially recovered through price increases. Food-service units engaged in the distribution of wholesale food showed meaningful gains in physical sales volume; however, the overall gain in dollar sales of these units was only 6 per cent because of lower food prices. An increase of $3.1 million in food-service costs and expenses was attributable to the higher wholesale food volume, inflationary factors in the manufacturing units, and inclusion of Vulcan-Hart for the full twelve months of 1975.

Financial Results by Lines of Business

	1976	1975	1974	1973	1972
			(amounts in thousands)		
Revenues:					
Transportation:					
Freight	**$433,795**	$373,950	$391,681	$355,258	$312,328
Passenger	**16,011**	14,058	10,623	7,361	6,910
Land and timber	**9,851**	4,834	8,680	10,320	7,960
Food service	**60,333**	52,051	49,340	4,371	—
Other	**4,925**	5,683	5,850	3,919	—
	$524,915	$450,576	$466,174	$381,229	$327,198
Earnings (loss) before federal income taxes and extraordinary item:					
Transportation:					
Freight*	**$ (21,773)**	$ (31,085)	$ 3,813	$ 5,138	$ (4,978)
Passenger	**(263)**	(75)	(1,616)	(1,979)	(2,009)
Land and timber	**9,259**	4,690	9,814	11,212	8,155
Food service	**2,351**	835	1,423	243	—
Minority interest	**511**	883	(405)	(470)	(35)
Other, including unallocated corporate expenses	**405**	625	723	(91)	(289)
	$ (9,510)	$ (24,127)	$ 13,752	$ 14,053	$ 844
*Includes earnings from the selling and leasing of railroad real estate not required for operating purposes:					
Gain on sales of railroad land	**$ 2,875**	$ 2,210	$ 4,647	$ 3,573	$ 2,304
Rents	**2,354**	2,195	2,164	2,214	2,219

Railroad Freight Traffic by Commodity Groups

Commodity groupings:	**1976**	1975	1974	1973	1972
			Per cent of freight revenues		
Lumber products	**14.3%**	13.3%	12.8%	15.2%	15.7%
Farm products	**13.2**	14.0	15.9	16.1	13.3
Food and food products	**12.9**	13.6	13.2	13.2	14.0
Transport equipment	**12.1**	11.4	10.2	10.1	9.8
Pulp paper products	**9.0**	8.6	9.2	8.9	9.5
Chemicals	**6.1**	6.0	6.0	5.3	5.4
Coal	**5.6**	5.8	3.1	2.9	3.1
Primary metal products	**4.9**	4.7	5.4	5.3	5.3
Waste and scrap metal	**2.8**	2.9	3.2	2.5	2.3
Stone, clay and glass products	**2.6**	2.9	3.0	2.8	2.9
All other	**16.5**	16.8	18.0	17.7	18.7
	100.0%	100.0%	100.0%	100.0%	100.0%

1974 vs. 1973

Overall results in 1974 were about the same as in 1973 despite the gathering impact of the business recession as the year progressed and the sharp economic downturn in the fourth quarter; however, there were important differences. Both operating revenues and operating expenses and costs were significantly higher, and an increase in other income was offset by a similar increase in interest expense.

The 1974 revenue increase of $84.9 million was concentrated in freight transportation ($36.4 million) and food service ($45 million). The increase in food service reflects revenues added by business acquisitions in late 1973 and early 1974. The acquisitions added $1.3 million to pretax earnings in 1974.

The 10 per cent increase in freight transportation revenues in 1974 was attributable to higher rates. Freight volume dropped 4 per cent, mainly in the latter part of the year. A $3.3 million increase in passenger revenues was partially offset by a $1.6 million decline in land and timber revenues. This decline reflected in part the continuing depression in housing construction. Passenger revenues were helped by growing commuter patronage and by state and local government operating grants, which totaled $1.7 million in 1974 and $400,000 in 1973.

Of the $85.1 million increase in operating expenses and costs in 1974 over 1973, approximately $42 million is the result of business acquisitions. Transportation operating expenses and costs increased $41.6 million or 12 per cent, including these estimated inflationary effects: 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.

Transportation maintenance expenses increased $5.8 million in 1974. In addition to the material and wage inflationary effects previously mentioned, the increase reflects a greater quantity of labor expended on track upgrading projects.

	Years ended December 31 1976	1975
	(amounts in thousands except per share amounts)	
Operating revenues:		
Transportation (note 10)	**$449,806**	$388,008
Land and timber	**9,851**	4,834
Food service	**60,333**	52,051
Other	**4,925**	5,683
	524,915	450,576
Operating expenses and costs (note 15):		
Transportation	**466,108**	414,461
Land and timber	**1,791**	1,433
Food service	**56,418**	49,204
Other	**4,877**	5,370
	529,194	470,468
Net operating loss	**(4,279)**	(19,892)
Other income:		
Gain on sales of railroad land	**2,875**	2,210
Interest	**1,375**	1,564
Rents	**2,475**	2,280
Miscellaneous, net	**614**	261
	7,339	6,315
Total income (loss)	**3,060**	(13,577)
Fixed interest	**6,915**	7,776
Contingent interest (note 12)	**2,630**	2,774
Litigation settlement (note 12)	**3,025**	—
	12,570	10,550
Loss before income taxes	**(9,510)**	(24,127)
Deferred federal income tax benefit (note 6)	**600**	4,532
Net loss	**(8,910)**	(19,595)
Retained earnings, beginning of year	**34,571**	54,166
Retained earnings, end of year	**$ 25,661**	$ 34,571
Per share loss applicable to common stock	**$ (4.61)**	$ (8.97)

See accompanying Supplementary Information and Notes to Consolidated Financial Statements.

Assets	December 31 1976	1975
	(amounts in thousands)	
Current assets:		
Cash and temporary cash investments	**$ 14,170**	$ 17,785
Accounts receivable	**44,151**	43,087
Inventories (note 3)	**43,907**	38,888
Other current assets	**6,140**	5,512
Total current assets	**108,368**	105,272
Special funds (notes 4 and 13)	**5,818**	5,782
Investments:		
Affiliated companies	**24,738**	24,263
Other companies	**432**	466
Total investments	**25,170**	24,729
Properties (notes 1, 2 and 5):		
Transportation properties:		
Road	**640,650**	638,672
Equipment	**269,519**	293,778
	910,169	932,450
Less allowances for depreciation and amortization	**295,178**	303,238
	614,991	629,212
Other property, less accumulated depreciation	**28,254**	30,276
Total properties	**643,245**	659,488
Other assets and deferred charges	**13,991**	12,007
Total assets	**$796,592**	$807,278

See accompanying Supplementary Information and Notes to Consolidated Financial Statements.

Liabilities and shareholders' equity	December 31 1976	1975
	(amounts in thousands)	
Current liabilities:		
Notes payable to banks	**$ 1,090**	$ 2,240
Accounts payable	**55,489**	48,834
Payroll and vacation pay	**19,944**	21,929
Accrued taxes	**10,821**	10,342
Other current liabilities	**1,750**	2,604
Current maturities of long-term debt (note 5)	**8,989**	10,802
Total current liabilities	**98,083**	96,751
Long-term debt (notes 5 and 12)	**223,110**	229,490
Deferred federal income taxes (note 6)	**32,220**	32,820
Reserves and other liabilities	**30,196**	25,813
Total liabilities	**383,609**	384,874
Minority interest	**18,304**	18,815
Shareholders' equity (notes 5, 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	**25,661**	34,571
Total shareholders' equity	**394,679**	403,589
Contingencies (notes 12 and 13)		
Total liabilities and shareholders' equity	**$796,592**	$807,278

See accompanying Supplementary Information and Notes to Consolidated Financial Statements.

	Years ended December 31 1976	1975
	(amounts in thousands)	
Source of funds		
From operations:		
Net loss	$ (8,910)	$ (19,595)
Add (deduct) items not requiring outlay of working capital in the current period:		
Depreciation and retirement charges	17,345	18,880
Deferred federal income tax benefit	(600)	(4,532)
Contingent interest on long-term debt	2,630	2,774
Additions to reserves for claims	4,195	2,352
Other	1,748	879
Working capital provided from operations	16,408	758
Salvage from property	6,765	6,147
Borrowing	4,800	4,353
Release of funds on deposit with mortgage trustee	4,437	9,460
Release of railroad funds segregated in compliance with Interstate Commerce Commission orders (note 13)	910	9,103
Miscellaneous sources (deductions), net	(1,071)	120
	$ 32,249	$ 29,941
Application of funds		
Property additions and betterments	$ 10,709	$ 22,103
Debt retirement	11,860	11,958
Investment in rail terminal and other companies	170	(194)
Deposit of funds with mortgage trustee	5,041	3,959
Segregation of railroad funds in compliance with Interstate Commerce Commission orders	307	4,451
Reclassification of estimated liabilities for claims and accumulated contingent interest ($1,101,000 in 1976) to current liabilities	2,022	1,629
Excess of purchase price over net assets acquired (1973 acquisitions)	376	432
Increase (decrease) in working capital	1,764	(14,397)
	$32,249	$ 29,941
Analysis of changes in working capital		
Increase (decrease) in current assets:		
Cash and temporary cash investments	$ (3,615)	$ (3,493)
Accounts receivable	1,064	(2,462)
Inventories	5,019	(5,228)
Other current assets	628	104
	3,096	(11,079)
Increase (decrease) in current liabilities:		
Notes payable to banks	(1,150)	(650)
Accounts payable	6,655	50
Payroll and vacation pay	(1,985)	3,627
Accrued taxes	479	73
Other current liabilities	(854)	25
Current maturities of long-term debt	(1,813)	193
	1,332	3,318
Increase (decrease) in working capital	$ 1,764	$ (14,397)

See accompanying Supplementary Information and 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.

Investment in Corporation's railroad subsidiary, Chicago, Milwaukee, St. Paul and Pacific Railroad Company ("Railroad"), is carried at equity in underlying net assets. At December 31, 1976 the underlying net assets exceeded the carrying amount of investments in other subsidiaries by $2,384,000 included in the Consolidated Balance Sheet as other assets and deferred charges ($3,021,000), properties ($562,000) and long-term debt reduction ($113,000), less undistributed earnings since acquisition of $6,080,000 included in retained earnings.

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) fares 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.

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 grading and track, amounting to approximately $365 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 nondepreciable 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-leaseback 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 (loss) per share — Earnings (loss) 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—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 sale of stock under 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.

Business acquisitions—Corporation amortizes the excess of purchase price over fair value of the acquired net assets on a straight-line basis over the estimated benefit period not to exceed 40 years.

2. Railroad Liquidity; Maintenance of Transportation Properties

Consolidated working capital position of Railroad and its subsidiaries at December 31, 1976 was a negative $6.0 million, having declined $13.8 million in 1975 and $0.6 million in 1976. Railroad's consolidated cash position declined $5.5 million in 1975 and $2.5 million in 1976, to $12.4 million at December 31, 1976. In early 1977, seasonal requirements and weather-related problems further reduced Railroad's consolidated cash position, prompting the activation of special cash conservation measures. Current projections, with effect given to such conservation measures, the Settlement Agreement described in note 12 and an update of revenue forecasts, indicate Railroad and its subsidiaries will have a consolidated net loss but positive cash flow of approximately $6 million for the full year 1977. Reference should also be made to certain contingencies described in note 13 in regard to the outlook for working capital and cash position.

Railroad and its subsidiaries have significant cash-generation potential in saleable timber, timberland and industrial sites. However, aside from timber under contract to be cut by licensees, no major sales of timber, timberland or industrial sites are imminent, and the timing of potential sales is uncertain. Railroad's Milwaukee Land Company subsidiary is pursuing a line of credit secured by certain timber-cutting contracts and underlying timberland. It is estimated that these timber-cutting contracts will generate proceeds approximating $20 million during the period 1977 through 1982; however, these proceeds are not indicative of the amount of the line of credit which can be presently obtained.

On December 21, 1976, Railroad filed applications with the Federal Railroad Administration for a total of $109.4 million in Federal financial assistance to rehabilitate portions of its tracks and equipment. The applications, made under Sections 505 and 511 of the Railroad Revitalization and Regulatory Reform Act of 1976, call for Railroad over a three-year period to (i) rehabilitate with rail, crossties and ballast its main line between Milwaukee and Minneapolis-St. Paul at a cost of approximately $66.4 million and install a centralized traffic control system on the line at a cost of approximately $12.2 million; (ii) overhaul and upgrade 337 locomotives at a cost of approximately

$16.7 million; (iii) repair 1,194 freight cars presently unsuitable for service at a cost of approximately $7.5 million; (iv) purchase approximately $5.5 million in track-maintenance equipment and ballast cars to be used in the track-rehabilitation project; and (v) install approximately $1.1 million in environmental-protection facilities at its shops in Milwaukee.

Section 505 of the Act involves the purchase by the Federal government of redeemable nonvoting "preference shares". It is expected that the stockholders of Railroad will be asked to approve a proposed charter amendment authorizing a new class of 20,000 shares of Redeemable Preference Stock with a par value of $10,000 per share issuable for the purpose of obtaining governmental financial assistance for facilities rehabilitation and improvement. Section 511 assistance would be in the form of Federal government guarantees of principal and interest on loans from conventional financing sources. Total appropriations by Congress for preference share financing in the fiscal year ending September 30, 1977 amount to only $70 million of the $600 million authorized by the Act. There is no assurance that Railroad will receive all or any portion of the financial assistance sought in the pending applications.

Successful consummation of all or a large part of such assistance could result in important transportation service improvements and significant reduction of maintenance deferrals necessitated by inadequate cash availability in Railroad over the years. Approximately 33% of Railroad's trackage was operated under slow orders at year-end 1976, compared to 30% a year earlier. Railroad's cumulative deferred maintenance of roadway properties was estimated in 1976 by consultants to the Federal Railroad Administration at $336 million. This amount relates to all of Railroad's trackage except lines being considered for retirement through abandonment or coordination with neighboring carriers. It was developed through a standardized statistical methodology applied to physical data furnished by each railroad pursuant to Section 504 of the Railroad Revitalization and Regulatory Reform Act of 1976. Deferred maintenance was defined for this purpose as the cost in 1975 dollars to achieve a 50% remaining life for the roadway properties existing at December 31, 1975. See note 14 for roadway maintenance statistics.

3. Inventories

Year-end inventories consist of (a) material and supplies to be consumed or used in transportation operations, maintenance or construction: 1976 — $29,625,000, 1975 — $26,603,000; and (b) merchandise held for sale and manufactured products including raw materials and parts therefor: 1976 — $14,282,000, 1975 — $12,285,000.

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. See note 13.

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, 1976	Dec. 31, 1975
Chicago, Milwaukee, St. Paul and Pacific Railroad Company first mortgage bonds, Series A, 1994 (d)	4%	—	$ 48,735,300	$ 48,735,300
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)	5,466,000	5,514,000
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)	55,604,000	55,604,000
Equipment obligations	4½ to 12¼%	—	24,890,359	30,694,078
Other (h)	6 to 11%	—	20,514,972	21,043,762
Total			$223,109,531	$229,490,040

(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 $1,600,000 have been authenticated and pledged along with mortgage notes receivable in the unpaid principal amount of $933,522 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.
(h) Corporation is guarantor of a loan of one of its subsidiaries, both as to the outstanding principal amount ($13,300,000) of the indebtedness and as to certain aspects of the financial condition of the subsidiary. Under a December 1975 amendment to the loan Corporation has agreed with the lender (a) that to the extent it pays cash dividends on its capital stock it will make equal capital contributions to the subsidiary up to a maximum of $2,000,000, and (b) that until such maximum amount of capital contributions is reached, it will in general make no investments other than business acquisitions involving only the issuance of capital stock or the issuance of debt secured only by the investment acquired. This indebtedness is collateralized by substantially all of the subsidiary's assets, other than cash, totaling approximately $18,000,000. The indebtedness bears interest at the prime bank rate plus 1%, and the effective annual rate of interest paid was 8.74% in 1976 and 10.51% in 1975.

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 $6,970,585 pledged as collateral to mortgage bonds.

Maturities of long-term debt, exclusive of contingent sinking fund requirements, during each of the years 1977-1981 inclusive are approximately $8,990,000, $8,198,000, $5,715,000, $6,862,000 and $4,998,000.

6. Federal Income Taxes

Federal income tax liabilities have been settled through the year 1967. Based in part upon unaudited returns and estimated 1976 tax data, Corporation had available at December 31, 1976, consolidated tax loss carryforwards of approximately $33,440,000, of which $27,798,000 will expire in 1982 and $5,642,000 in 1985. For financial reporting purposes, Corporation had available at December 31, 1976, consolidated operating loss carryforwards of approximately $7,604,000, which will expire in 1985.

The available investment credit carryforward for tax purposes as of December 31, 1976 amounted to approximately $13,647,000, which will expire as follows: 1977 — $2,861,000, 1978 — $1,928,000, 1979 — $2,262,000, 1980 — $1,560,000, 1981 — $1,836,000, 1982 — $1,672,000, 1985 — $1,528,000. For financial reporting purposes approximately $13,590,000 of investment credit carryforwards were available to reduce future tax provisions.

The deferred Federal income tax benefit reported in the accompanying Statements 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 to the effective rates:

	1976 Tax Benefit % of Pretax Loss	1975 Tax Benefit % of Pretax Loss
Federal corporate income tax rate	48.0%	48.0%
Increase (decreases) resulting from:		
Income taxable as dividend income	(0.9)	(0.3)
Tax benefit of loss carryback	(6.3)	(30.5)
Loss carryforward without tax benefit	(38.4)	—
Miscellaneous items	3.9	1.6
Effective rate	6.3%	18.8%

Other income taxes consisting of various state income taxes are minor in amount 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 $29,512,000 in 1976 and $26,476,000 in 1975. Of these amounts $25,336,000 in 1976 and $22,663,000 in 1975 represent rentals under non-capitalized financing leases. For purposes of disclosure, a distinction has been made between "financing" lease arrangements and other lease arrangements. A "financing" lease is one which, during the noncancelable lease period, either (a) covers 75% 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 $31,910,000 in 1976 and $27,448,000 in 1975. Also excluded are railroad joint-facility "rents" of $5,342,000 in 1976 and $4,885,000 in 1975 representing essentially operating expenses shared with other joint owners or joint users.

The following table summarizes minimum rental commitments under all noncancelable leases as of December 31, 1976 (amounts in thousands):

Year or Period	Railroad Rolling Stock	Other Equipment	Real Property	Total: Financing Leases	Total: Other Leases
1977	$ 25,713	$2,553	$ 376	$ 25,744	$2,898
1978	25,210	1,140	354	25,102	1,602
1979	24,834	561	327	24,893	829
1980	24,408	125	283	24,533	283
1981	23,492	100	277	23,592	277
1982-1986	100,528	357	971	100,885	971
1987-1991	32,803	25	129	32,828	129
Total	$256,988	$4,861	$2,717	$257,577	$6,989

Note — The above figures for real property leases include $78,000 of sublease rental income.

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 $59,943,000 require the lessor to pay for maintenance, and some of these in turn include provisions for price-level escalation of that portion of lease payments attributable to maintenance.

The present value of minimum rental commitments under non-capitalized financing leases at December 31, 1976 and 1975 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		Interest Rates Used in Present Value Computations Weighted Average		Range	
	1976	1975	1976	1975	1976	1975
	(amounts in thousands)					
Railroad rolling stock	$167,438	$158,727	8.24%	7.72%	4.54% to 14.00%	4.54% to 11.46%
Other equipment	1,043	1,375	7.44%	7.64%	4.05% to 12.34%	4.05% to 12.34%
	$168,481	$160,102				

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, the net loss for 1976 and 1975 would have been increased by $3,507,000 and $3,786,000, respectively. Amortization included in the foregoing computation of earnings impact is $15,385,000 and $14,019,000 in 1976 and 1975, respectively, and interest cost included in the computation is $13,239,000 and $12,169,000 in 1976 and 1975, 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 Corporation's Common Stock upon termination of employment. The amounts which accrue to grantees under the incentive plan are based upon dividends paid by 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 Corporation and its subsidiaries may be awarded qualified and non-qualified options to purchase an aggregate of 150,000 shares of 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; in 1974, for the purchase of 500 shares at $8.63 a share; in 1975, for the purchase of 500 shares at $8.37 a share; and, in 1976 for the purchase of 500 shares at $7.75 a share. At December 31, 1976, options totaling 51,166 shares were outstanding and exercisable, 1,334 shares were outstanding but not exercisable and 97,500 shares were available for option.

In connection with certain business acquisitions Corporation issued warrants entitling the purchasers of the warrants to purchase 60,000 shares of 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, 1976, these warrants were outstanding and exercisable.

9. Dividends

No dividends have been declared on the capital stock of 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, 1976, were current contingent interest of $5,555,000, accumulated contingent interest of $6,992,000 and Available Net Income deficit carryforwards of $49,691,000. The propriety of carrying forward Available Net Income deficits is in litigation, as explained in note 12. Under the terms of the Settlement Agreement described in note 12, the deficit carryforward of $49,691,000 would be eliminated.

10. Mass Transit Grants

Transportation revenues include state and local government grants and contract payments of $5,501,208 for 1976 and $3,825,961 for 1975 in respect of commuter-service operating losses. Under agreement reached in December 1975 and consummated in March 1976 with the Chicago-area Regional Transportation Authority, Railroad contracted to receive annual base compensation of $4,650,000 for costs of commuter operations in excess of revenues collected from service. Because the agreement was retroactive to July 1, 1975, one-half of the annual base amount of compensation was included in 1975 revenues. On July 1, 1976, the annual base compensation was increased to $5,857,000. In October 1976 the annual base was adjusted to $5,473,000 as a result of a fare increase.

11. Pensions and Profit Sharing

Corporation's subsidiaries maintain several pension plans providing for benefits upon retirement to qualified employees.

Executive and supervisory employees of Railroad and its subsidiaries were covered by unfunded non-contributory plans prior to January 1, 1976. Changes intended to comply with the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code applicable to qualified employee retirement plans were implemented, along with certain benefit improvements, by Railroad and its subsidiaries effective January 1, 1976. Pension expense in 1976 under the trusteed non-contributory plans was $2,271,000. Pension expense in 1975 under the former unfunded plans was $1,505,000. The actuarially computed value of vested benefits in excess of plan assets was $17,851,000 as of June 1, 1976. Railroad and its subsidiaries accrue pension expense at the actuarially computed normal cost plus 40-year amortization of prior service cost, and fund the plans on the same basis.

The non-rail subsidiaries maintain funded pension and profit-sharing plans covering substantially all full-time employees. Total costs of such plans charged against earnings for the years ended December 31, 1976 and 1975, were $268,144 and $283,332, respectively. The accounting policy is to fund pension costs accrued.

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 1976, the annual amounts of such contingent interest items are: Series A General Mortgage bonds, $1,111,000; Terre Haute bonds, $263,000; Series B General Mortgage bonds, $1,401,000; 5% Income Debentures, $2,780,000. If Available Net Income is 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 Available Net Income permits. There is no interest accumulation feature in the case of the 5% Income Debentures.

Contingent interest expense for both 1976 and 1975 consists of interest on Railroad's Series A and Series B General Mortgage bonds and the contingent portion of the interest on the Terre Haute bonds. As of December 31, 1976, there was a two-year contingent interest accumulation on the Series A General Mortgage and Terre Haute bonds and a full three-year accumulation on the Series B General Mortgage bonds.

In September, 1974, the Interstate Commerce Commission ordered railroads to follow, "for financial statement purposes only," the equity method of accounting for investments in any company of which 20% or more of the outstanding voting stock is owned. The order became effective January 1, 1974. In general, under the equity method an investor company includes in its earnings its share of any undistributed earnings or losses of investee companies. After the issuance of the Commission's order, the Trustees of the General Mortgage and of the Debenture Indenture of Railroad took the position that Railroad should include in the computation of Available Net Income commencing January 1, 1974, its proportionate share of the undistributed earnings of those companies coming within the scope of the Commission's order and should include in the computation of Available Net Income for 1974 its proportionate share of the accumulated undistributed earnings of such companies for prior years.

In December 1974, outside counsel for Railroad advised that in its opinion, under the terms of the applicable indentures, the Available Net Income determinations should continue to be made, as in prior years, on the basis of the separate income of Railroad exclusive of Railroad's equity in undistributed earnings or losses of subsidiaries and other affiliated companies. Railroad has computed Available Net Income in this manner for 1976, 1975 and 1974.

The Trustee of the Debenture Indenture also raised the question of the propriety of carrying forward negative Available Net Income under the terms of the 5% Income Debenture Indenture. In the opinion of management, there was an accumulated deficit in Available Net Income of $49,691,000 as of December 31, 1976, 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 authorized by the terms of the Indenture.

Railroad, in order to clarify these matters, brought 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. The Court has ruled that deficits in Available Net Income under the Debenture Indenture for the years 1969 through 1974 should not be carried forward to offset earnings in subsequent years except in a limited set of circumstances. An appeal from this ruling has been taken to the Appellate Court of Illinois. The Trustees have filed motions for partial summary judgment on the equity accounting issue, and briefs on the motions are presently scheduled to be filed through June 1977.

Several lawsuits brought by bondholders and debentureholders against Railroad, Chicago Milwaukee Corporation and certain of their officers and directors are pending in the United States District Court in Chicago. These suits involve essentially the same issues as are included in the declaratory judgment action described above plus additional allegations including (i) that certain subsidiary corporations of Railroad are "Railroad Subsidiaries" as defined in the General Mortgage, (ii) that Railroad failed to cause its subsidiaries to pay dividends or disguised dividend payments as loans, and (iii) that Railroad changed a 1971 dividend payment to a loan to avoid contingent interest payments.

Claims raised in these suits are included in a Settlement Agreement filed with the District Court in August 1976. If finally approved, the settlement will dispose of claims for contingent interest and sinking fund payments totaling approximately $12 million but may also result in increased payments for contingent interest and sinking funds in future years, with the amount dependent on future earnings.

Under the settlement, Railroad would:

- pay approximately $4.1 million, less court-approved attorneys' fees and certain costs, to the holders of the affected debt securities;
- agree that effective January 1, 1975, it will interpret the indentures of the aforesaid debt securities to require it, in computing Available Net Income, to follow the principles of equity accounting pursuant to instructions contained in a 1974 order of the Interstate Commerce Commission so long as those instructions remain substantially in effect. This will require Railroad to include in its future computations of Available Net Income all earnings of Milwaukee Land Company and The Milwaukee Motor Transportation Company, and its proportionate share of the earnings of any other company in which it holds 20% or more of the stock;
- accept an order entered by the Circuit Court of Cook County, Illinois to the effect that only certain deficits in Available Net Income may be carried forward to subsequent years, and eliminate a deficit of approximately $49.7 million which otherwise would have had to be overcome before interest would be due on the Income Debentures; and
- agree not to deduct certain of the payments made as a result of the settlement in making future calculations of Available Net Income.

Of the $4.1 million cash payment, an amount equal to one year's accrued contingent interest would be paid to holders of General Mortgage bonds, Series A and Series B, and to holders of Terre Haute bonds. In addition, approximately $1.1 million of accumulated but unpaid interest on the Series B bonds would be paid. Holders of Debentures who sold their securities between March 15, 1975 and August 6, 1976 would receive a maximum of $50 per $1,000 principal amount, up to a total amount of $250,000. Payments would be made on the first interest due date following the date on which the agreement becomes final and effective — in the case of coupon bonds, upon the surrender of the coupon falling due on that interest date. The one-time litigation settlement charge of $3,025,316 included in the 1976 Statement of Operations represents that portion of the $4.1 million proposed settlement payment not previously accrued on Railroad's books.

On December 9, 1976, the District Court approved the settlement. On January 10, 1977, a Joint Notice of Appeal was filed by two plaintiff securityholders to the United States Court of Appeals for the Seventh Circuit which has ordered an expedited briefing schedule extending through early April, 1977 and has indicated that the case will be scheduled for oral argument during either the week of April 18 or April 25, 1977. The settlement will not be implemented until the Court of Appeals affirms the approval of the settlement by the District Court and the time for any further appeal has expired.

Contingent interest on Railroad's mortgage bonds was accrued in both 1976 and 1975. Such interest is not currently payable in respect of either year because Available Net Income amounts were negative in both years. Such amounts would also be negative in both years under the terms of the pending litigation settlement.

13. Contingencies

Railroad is liable, jointly with other railroads, as guarantor of obligations of affiliated companies amounting to $51,843,000 at December 31, 1976. 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 $9,438,124. Certain lease agreements include guaranty by Railroad of approximately $52,000,000 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 $10,194,500 for work stoppages on other participating railroads.

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 has 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 extends through December 31, 1977, and is subject to certain conditions, including requirements that funds released be considered a borrowing to be "repaid" to the Special Funds account when Railroad's financial condition warrants, that monthly financial reports of Railroad be furnished to the Commission and that Railroad be prohibited from transferring any assets to its parent company or to any affiliated company without Commission approval until all "borrowed" funds are repaid.

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 box 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 box cars, or rebuild box cars. The February 7, 1977 order, which would become effective 35 days thereafter, 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 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 had informally discussed its interpretation with representatives of the ICC prior to the February 7, 1977 order, and is seeking reconsideration of this matter. If necessary, Railroad may formally seek an interpretation or waiver of this regulation, as now interpreted by the ICC, so that it will not be required to reimburse IPD funds so expended in 1976 and 1975. Railroad presently anticipates that it will not generate IPD fund balances in the future.

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 Corporation, Railroad, three individuals who serve as executive officers (two of whom are directors) of both companies and one individual who presently serves as a director and previously as an executive officer of Railroad. The Commission alleged 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. Said undertakings provide for the continuation of the previously established special committee comprised of independent outside directors of Corporation to conduct an investigation into the factual matters contained in the complaint and any other matters it deems appropriate, which committee will prepare and submit a written report of its findings, opinions and recommendations to the full Board of Directors of both corporate defendants. Said undertakings further provide that said report will be filed as an exhibit to a report on Form 8-K for the month in which the report is submitted to the Boards and that the report or a summary thereof shall be furnished to the shareholders of the corporate defendants; further, that each Board will, after receipt of the report, appoint a new committee of directors found by said special committee not to be involved in certain matters alleged in the complaint to independently review the report and take such action as it deems necessary and proper. The corporate defendants also undertake, through their respective Boards or such an appointed committee thereof, to review for a period of three years on a continuing basis the procedures adopted to assure compliance with the respective judgments and orders of permanent injunction and consents and undertakings. The judgments were entered simultaneously with the filing of the complaint.

The complaint referred to in the two preceding paragraphs 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. House counsel has advised that in his opinion Railroad does not have such an obligation. If the deposit were made, the funds could be drawn down and restored to Railroad's general cash as subsequent property additions or betterments are made.

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 7 of the Civil Rights Act of 1964. The complaint seeks a permanent injunction against Railroad restraining the alleged unlawful practices, an order directing Railroad to institute and carry out an effective Affirmative Action Plan and monetary damages for persons affected by the alleged unlawful employment practices. Settlement negotiations between EEOC and Railroad are being conducted which would contemplate a cash payment to affected persons aggregating approximately $150,000 and implementation of a more comprehensive Affirmative Action Program.

On January 27, 1977, Railroad was served with a complaint by the Attorney General of Illinois before the Illinois Pollution Control Board alleging unlawful emission of noise and air contaminants by diesel locomotives used in Chicago suburban passenger operations while stored at night and on holidays and week ends at Fox Lake, Illinois. The Complaint seeks a cease and desist order and a penalty of $10,000 for the violations alleged and an additional penalty of not more than $1,000 for each day they continue.

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.

On April 1, 1976, Consolidated Rail Corporation (Conrail) began operating the lines of the former Penn Central, Erie Lackawanna, Reading and other northeast railroads in reorganization, all of which had interline accounts with Railroad. While Conrail has continued to pay charges due for periods subsequent to April 1, 1976 there remains approximately $3,327,000 (including $1,884,000 in an unconsolidated affiliate owned 51% by Conrail and 49% by Railroad) due from the said railroads' estates for periods prior to April 1, 1976.

Railroad considers these amounts to be fully collectible and accordingly has not provided an allowance for loss. It anticipates that payment of these obligations will be received from funds which have been made available as a result of legislation enacted as part of the Railroad Revitalization and Regulatory Reform Act of 1976, as amended, as well as the proceeds from liquidation of the estates.

14. Maintenance Statistics (Unaudited)

Railroad operated 10,074 miles of road at year-end 1976. The following table sets forth certain data relating to the maintenance of such roadway:

	1976	1975	1974	1973	1972
	(dollar amounts in thousands)				
Way and structures maintenance expense:					
Total	$64,875	$59,136	$61,012	$59,074	$57,902
Track labor	19,556	17,727	19,989	18,162	17,090
Ties	4,048	3,393	4,395	3,817	4,393
Ballast	555	522	675	892	432
Rail	1,604	1,193	(40)	1,463	1,540
Indexes of average railway material prices and wage rates for the Western District (1967 = 100):					
Combined	239.4	217.4	187.4	163.6	145.5
Material other than fuel	207.4	192.8	145.0	123.5	118.1
Wages	230.0	207.2	187.9	173.6	153.2
Number of crossties installed (000):					
Main track	362	315	562	535	663
Side track	52	68	64	54	49
Miles of track laid:					
New rail	10	18	36	25	32
Used rail	60	57	71	67	72

15. Cost of Sales

Operating expenses and costs as shown in the Consolidated Statements of Operations include cost of sales as follows:

	Year Ended December 31 1976	1975
	(amounts in thousands)	
Land and timber	$ 1,216	$ 949
Food service	45,679	39,606
Other	3,978	4,535
	$50,873	$45,090

16. 1976 Unaudited Interim Financial Information

The 1976 unaudited quarterly financial information on page 14 is incorporated herein by reference.

17. Supplementary Information

The consolidated financial statements of Railroad and its subsidiaries, included herein as supplementary information, have been prepared in accordance with Interstate Commerce Commission rules. In keeping with such rules transportation properties are stated net of other elements of investment, which arose in connection with reorganization of Railroad as of January 1, 1944. The account was credited as of that date with an amount sufficient to reduce properties and other assets to the aggregate of the capitalization and other liabilities established by the Court. Starting in 1962, Railroad has followed the practice of writing off to other income an equitable portion of the account assignable to nondepreciable pre-reorganization properties retired. In Railroad's Consolidated Statements of Operations and Retained Earnings, miscellaneous other income includes amortization of other elements of investment amounting to $698,000 in 1976 and $1,022,000 in 1975. At December 31, 1976 the unamortized balance of other elements of investment amounted to $104,599,000. In the accompanying consolidated financial statements of Corporation and its subsidiaries the account has been treated as capital in excess of par value and the amortization entries have been eliminated.

18. Replacement Cost Data (Unaudited)

Inflationary factors have had a significant impact upon the Corporation's costs and expenses. The non-transportation segments of the business have generally been able to compensate for escalating costs and expenses by adjusting selling prices, by negotiating contract escalation provisions or by obtaining firm price quotations from vendors of materials. The transportation segment, on the other hand, has experienced a serious lag in obtaining compensating rate increases. Such lag is attributed principally to delays in the regulatory process, but also to subsidized competition and the fact that compensating rate adjustments must be applied on an industry-wide or district-wide basis whereas individual rail carriers have differing revenue needs and capabilities for coping with inflationary factors.

Not fully reflected in costs and expenses as determined on the basis of historical cost is the potential or hypothetical financial burden of replacing properties and inventories at inflated prices. This burden appears particularly heavy with respect to the Corporation's transportation properties even though existing accounting practice in this area (see note 1) has the effect of including in current expenses at current prices much of the recurring cost of replacing the rail track structure. Very substantial amounts of additional capital would be required if all of the Corporation's transportation properties were to be replaced at one time at today's prices.

In accordance with a reporting rule adopted by the Securities and Exchange Commission during 1976, the Corporation's 1976 annual report to the Commission on Form 10-K (a copy of which is available upon request) contains certain data intended to provide a general indication of the year-end replacement cost of productive capacity and inventories, and of the effect of determining costs and expenses on a replacement-cost basis instead of a historical-cost basis. As explained therein, such information necessarily relies heavily upon subjective judgments and is inherently prone to errors of estimation. No representation is made that the Corporation's entire productive capacity would or could be replaced at one time in the manner assumed (according to the applicable SEC rule and interpretations) in the underlying computations, and no effect is given in the Form 10-K data to any benefits from such assumed replacement of productive capacity.

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, 1976 and 1975, and the related consolidated statements of operations, 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.

Chicago Milwaukee Corporation's subsidiary, Chicago, Milwaukee, St. Paul and Pacific Railroad and subsidiaries (Railroad), has incurred losses of $12,079,000 and $21,067,000 in 1976 and 1975, respectively, and has a deficiency in working capital of $5,963,000 at December 31, 1976. As discussed in note 2, Railroad has instituted programs to conserve cash and improve operations. Railroad's continuity is dependent upon its ability to achieve improved operating results and to strengthen its liquidity position.

In our opinion, the aforementioned consolidated financial statements present fairly the financial position of Chicago Milwaukee Corporation and subsidiaries at December 31, 1976 and 1975, 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. Financial statements of Chicago, Milwaukee, St. Paul and Pacific Railroad Company and subsidiaries are presented as supplementary information on pages 6 through 8 and have been subjected to the same auditing procedures and, in our opinion, are stated fairly in all material respects when considered in conjunction with the financial statements taken as a whole.

Peat, Marwick, Mitchell & Co.

Chicago, Illinois
March 24, 1977

Five-Year Consolidated Summary of Operations Chicago Milwaukee Corporation and Subsidiaries

(amounts in thousands except per share amounts)

	1976	1975	1974	1973	1972
Operating revenues	**$524,915**	$450,576	$466,174	$381,229	$327,198
Operating expenses and costs	**529,194**	470,468	453,306	368,232	325,602
Operating income (loss)	**(4,279)**	(19,892)	12,868	12,997	1,596
Other income	**7,339**	6,315	11,690	8,402	5,624
Total income (loss)	**3,060**	(13,577)	24,558	21,399	7,220
Fixed interest	**6,915**	7,776	8,029	5,972	6,376
Contingent interest	**2,630**	2,774	2,777	1,374	—
Litigation settlement	**3,025**	—	—	—	—
Earnings (loss) before income taxes and extraordinary item	**(9,510)**	(24,127)	13,752	14,053	844
Deferred federal income taxes (benefit)	**(600)**	(4,532)	2,478	2,654	285
Earnings (loss) before extraordinary item	**(8,910)**	(19,595)	11,274	11,399	559
Extraordinary item — after deducting deferred federal income tax benefit ($924,000) and minority interest ($40,000)	**—**	—	—	—	(956)
Net earnings (loss)	**$ (8,910)**	$ (19,595)	$ 11,274	$ 11,399	$ (397)
Net earnings (loss) applicable to common stock, after preferred dividend requirements	**$ (11,300)**	$ (21,985)	$ 8,884	$ 9,009	$ (2,787)
Per share earnings (loss) applicable to common stock:					
Before extraordinary item	**$ (4.61)**	$ (8.97)	$ 3.62	$ 3.67	$ (.75)
Extraordinary item	**—**	—	—	—	(.39)
Net earnings (loss)	**$ (4.61)**	$ (8.97)	$ 3.62	$ 3.67	$ (1.14)

Chicago Milwaukee Corporation 516 West Jackson Boulevard Chicago, Illinois 60606