KANSAS CITY SOUTHERN
Form 10-Q
July 27, 2010
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2010

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number 1-4717

KANSAS CITY SOUTHERN

(Exact name of registrant as specified in its charter)

Delaware	**44-0663509**
(State or other jurisdiction of	*(I.R.S. Employer*
incorporation or organization)	*Identification No.)*
427 West 12th Street,	**64105**

Kansas City, Missouri	
(Address of principal executive offices)	*(Zip Code)*

816.983.1303

(Registrant s telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report.)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

(Do not check if a smaller reporting company)

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

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

Class	**Outstanding at July 20, 2010**
Common Stock, $0.01 per share par value	102,554,920 Shares

Table of Contents

Kansas City Southern

Form 10-Q

June 30, 2010

Index

Table of Contents

Kansas City Southern

Form 10-Q

June 30, 2010

PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***
Introductory Comments

The Consolidated Financial Statements included herein have been prepared by Kansas City Southern, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). As used herein, KCS or the Company may refer to Kansas City Southern or, as the context requires, to one or more subsidiaries of Kansas City Southern. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) have been condensed or omitted, pursuant to such rules and regulations. The Company believes that the disclosures are adequate to enable a reasonable understanding of the information presented. The Consolidated Financial Statements and Management s Discussion and Analysis of Financial Condition and Results of Operations included in this Form 10-Q should be read in conjunction with the consolidated financial statements and the related notes, as well as Management s Discussion and Analysis of Financial Condition and Results of Operations, included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. Results for the three and six months ended June 30, 2010 are not necessarily indicative of the results expected for the full year ending December 31, 2010.

Table of Contents

Kansas City Southern

Consolidated Statements of Operations

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
	(In millions, except share and per share amounts) (Unaudited)			
Revenues	$ 461.6	$ 341.3	$ 897.9	$ 687.3
Operating expenses:				
Compensation and benefits	93.7	79.0	184.4	157.0
Purchased services	48.0	46.6	92.9	92.2
Fuel	69.1	40.2	129.9	83.5
Equipment costs	41.3	41.2	80.0	80.3
Depreciation and amortization	46.9	47.4	92.7	94.3
Casualties and insurance	0.2	7.7	12.1	20.2
Materials and other	35.2	36.1	70.5	69.1
Total operating expenses	334.4	298.2	662.5	596.6
Operating income	127.2	43.1	235.4	90.7
Equity in net earnings of unconsolidated affiliates	4.6	2.0	11.0	3.0
Interest expense	(41.9)	(45.4)	(86.3)	(87.2)
Debt retirement costs	(32.5)		(47.4)	(5.9)
Foreign exchange gain (loss)	(1.4)	6.0	1.2	0.9
Other income, net	1.0	2.9	1.5	4.4
Income before income taxes and noncontrolling interest	57.0	8.6	115.4	5.9
Income tax expense	19.6	1.5	43.8	1.6
Net income	37.4	7.1	71.6	4.3
Noncontrolling interest		0.5	(1.1)	0.4
Net income attributable to Kansas City Southern and subsidiaries	37.4	6.6	72.7	3.9
Preferred stock dividends	2.8	0.1	5.5	5.5
Net income (loss) available to common shareholders	$ 34.6	$ 6.5	$ 67.2	$ (1.6)
Earnings (loss) per share:				
Basic earnings (loss) per share	$ 0.35	$ 0.07	$ 0.69	$ (0.02)
Diluted earnings (loss) per share	$ 0.34	$ 0.07	$ 0.68	$ (0.02)
Average shares outstanding *(in thousands)*:				
Basic	99,907	91,955	97,946	91,425
Potentially dilutive common shares	459	7,453	514	
Diluted	100,366	99,408	98,460	91,425

See accompanying notes to consolidated financial statements.

Table of Contents

Kansas City Southern

Consolidated Balance Sheets

	June 30, 2010	December 31, 2009
	(In millions, except share amounts)	
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 84.3	$ 117.5
Accounts receivable, net	176.4	139.4
Restricted funds	30.9	35.8
Materials and supplies	106.1	106.4
Deferred income taxes	166.5	151.7
Other current assets	56.6	63.0
Total current assets	620.8	613.8
Investments	46.4	46.8
Property and equipment (including concession assets), net	4,789.6	4,722.4
Other assets	89.2	71.3
Total assets	$ 5,546.0	$ 5,454.3
LIABILITIES AND EQUITY		
Current liabilities:		
Debt due within one year	$ 84.7	$ 68.1
Accounts payable and accrued liabilities	380.5	342.7
Total current liabilities	465.2	410.8
Long-term debt	1,615.3	1,911.9
Deferred income taxes	604.5	558.6
Other noncurrent liabilities and deferred credits	242.2	247.2
Total liabilities	2,927.2	3,128.5
Commitments and contingencies		
Stockholders equity:		
$25 par, 4% noncumulative, preferred stock, 840,000 shares authorized, 649,736 shares issued, 242,170 shares outstanding	6.1	6.1
Series D cumulative convertible perpetual preferred stock, $1 par, 5.125%, 210,000 shares authorized and issued, 209,995 shares outstanding with a liquidation preference of $1,000 per share	0.2	0.2
$.01 par, common stock, 400,000,000 shares authorized; 116,352,298 and 110,583,068 shares issued at June 30, 2010 and December 31, 2009, respectively; 102,515,767 and 96,213,346 shares outstanding at June 30, 2010 and December 31, 2009, respectively	1.0	0.9
Paid-in capital	886.6	661.4
Retained earnings	1,445.9	1,378.8
Accumulated other comprehensive loss	(2.7)	(4.4)
Total stockholders equity	2,337.1	2,043.0
Noncontrolling interest	281.7	282.8
Total equity	2,618.8	2,325.8

Total liabilities and equity	$ 5,546.0	$ 5,454.3

See accompanying notes to consolidated financial statements.

Table of Contents

Kansas City Southern

Consolidated Statements of Cash Flows

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
	(In millions) (Unaudited)	
Operating activities:		
Net income	$ 71.6	$ 4.3
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	92.7	94.3
Deferred income taxes	42.9	1.1
Equity in undistributed earnings of unconsolidated affiliates	(11.0)	(3.0)
Share-based compensation	4.5	4.9
Excess tax benefit from share-based compensation	(15.5)	
Other deferred compensation	3.2	(1.7)
Distributions from unconsolidated affiliates	10.5	
Gain on sale of assets	(0.4)	(3.6)
Debt retirement costs	47.4	5.9
Changes in working capital items:		
Accounts receivable	(36.5)	(1.1)
Materials and supplies	0.4	(16.5)
Other current assets	5.9	11.6
Accounts payable and accrued liabilities	23.5	(16.3)
Other, net	(18.9)	5.5
Net cash provided by operating activities	220.3	85.4
Investing activities:		
Capital expenditures	(120.9)	(226.1)
Acquisition of an intermodal facility, net of cash acquired	(25.0)	
Property investments in MSLLC	(10.5)	(12.3)
Proceeds from disposal of property	3.5	7.9
Other, net	7.5	0.5
Net cash used for investing activities	(145.4)	(230.0)
Financing activities:		
Proceeds from issuance of long-term debt	295.7	189.8
Repayment of long-term debt	(589.0)	(250.1)
Proceeds from common stock issuance	214.9	51.3
Debt costs	(40.4)	(9.3)
Proceeds from employee stock plans	0.7	0.8
Excess tax benefit from share-based compensation	15.5	
Preferred stock dividends paid	(5.5)	(5.5)
Net cash used for financing activities	(108.1)	(23.0)
Cash and cash equivalents:		
Net decrease during each period	(33.2)	(167.6)
At beginning of year	117.5	229.9

At end of period	$ 84.3	$ 62.3

See accompanying notes to consolidated financial statements.

6

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements

1. Accounting Policies, Interim Financial Statements and Basis of Presentation

In the opinion of the management of KCS, the accompanying unaudited consolidated financial statements contain all adjustments necessary for a fair presentation of the results for interim periods. All adjustments made were of a normal and recurring nature. Certain information and footnote disclosure normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted. These consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. The results of operations for the three and six months ended June 30, 2010 are not necessarily indicative of the results to be expected for the full year ending December 31, 2010. Certain prior year amounts have been reclassified to conform to the current year presentation.

During the first quarter of 2010, the Company elected to change its accounting policy for rail grinding costs from a capitalization method to a direct expense method. Previously, the Company capitalized rail grinding costs as an improvement to the rail. The Company believes it is preferable to expense these costs as incurred to eliminate the subjectivity in determining the period of benefit associated with rail grinding over which to depreciate the associated capitalized costs. The Company has reflected this change as a change in accounting principle from an accepted accounting principle to a preferable accounting principle in accordance with Accounting Standards Codification 250 Accounting for Changes and Error Corrections. Comparative financial statements for all periods have been adjusted to apply the change in accounting principle retrospectively.

The following line items in the consolidated statement of operations were affected by the change in accounting principle *(in millions, except per share amounts):*

	Three Months Ended June 30, 2009		
	As reported	**As adjusted**	**Change**
Compensation and benefits	$ 79.1	$ 79.0	$ (0.1)
Purchased services	46.0	46.6	0.6
Depreciation and amortization	47.6	47.4	(0.2)
Income before income taxes and noncontrolling interest	8.9	8.6	(0.3)
Income tax expense	1.6	1.5	(0.1)
Net income	7.3	7.1	(0.2)
Diluted earnings per share	$ 0.07	$ 0.07	$

	Six Months Ended June 30, 2009		
	As reported	**As adjusted**	**Change**
Compensation and benefits	$ 157.1	$ 157.0	(0.1)
Purchased services	90.5	92.2	$ 1.7
Depreciation and amortization	94.7	94.3	(0.4)
Income before income taxes and noncontrolling interest	7.1	5.9	(1.2)
Income tax expense	2.0	1.6	(0.4)
Net income	5.1	4.3	(0.8)
Diluted loss per share	$ (0.01)	$ (0.02)	$ (0.01)

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

The following line items in the consolidated balance sheet were affected by the change in accounting principle *(in millions):*

	December 31, 2009		
	As reported	As adjusted	Change
Property and equipment (including concession assets), net	$ 4,747.2	$ 4,722.4	$ (24.8)
Deferred income tax liability	567.1	558.6	(8.5)
Other noncurrent liabilities and deferred credits	247.7	247.2	(0.5)
Retained earnings	1,394.6	1,378.8	(15.8)
Total equity	2,341.6	2,325.8	(15.8)

As of January 1, 2008, the cumulative effect of the change in accounting principle on property and equipment (including concession assets), deferred income tax liability, other noncurrent liabilities and deferred credits and retained earnings was ($20.5) million, ($7.3) million, ($0.4) million and ($12.8) million, respectively.

During the third quarter of 2009, the Company identified that changes in accounts payable and accrued liabilities related to capital spending had not been correctly presented in the Company s prior period consolidated cash flow statements. Changes in these accruals had previously been classified within cash flows from operating activities and should have been classified as capital expenditures within investing activities, in order to report capital expenditures on a cash basis rather than on an accrual basis. The accompanying consolidated cash flow statement for the six months ended June 30, 2010 presents capital expenditures on a cash basis. The accompanying consolidated cash flow statement for the six months ended June 30, 2009 has been revised to present capital expenditures on a cash basis. This revision did not impact the change in cash and cash equivalents as previously reported, however, net cash provided by operating activities, capital expenditures and cash used by investing activities increased by $48.0 million for the six months ended June 30, 2009. This revision did not impact operating income or net income, working capital, or any earnings per share measures as previously reported.

The change in accounting principle and the revision related to the classification of capital expenditures on a cash basis rather than on an accrual basis did not have an impact on the change in cash and cash equivalents in the consolidated statement of cash flows; however, the following line items were affected by these adjustments *(in millions):*

	Six Months Ended June 30, 2009		
	As reported	As adjusted	Change
Net cash provided by operating activities	$ 39.1	$ 85.4	$ 46.3
Net cash used for investing activities	(183.7)	(230.0)	(46.3)

2. Earnings (Loss) Per Share Data

Basic earnings (loss) per common share is computed by dividing income (loss) available to common stockholders by the weighted average number of common shares outstanding for the period. Nonvested stock awards granted to employees and officers are included in weighted average shares as they are earned for purposes of computing basic earnings (loss) per common share. Diluted earnings (loss) per share adjusts basic earnings (loss) per common share for the effects of potentially dilutive common shares, if the effect is not anti-dilutive. Potentially dilutive common shares include the dilutive effects of shares issuable upon the conversion of preferred stock to common stock and shares issuable under the Stock Option and Performance Award Plan.

The following table reconciles the weighted average shares used for the basic earnings (loss) per share computation to the shares used for the diluted earnings (loss) per share computation *(in thousands)*:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Basic shares	99,907	91,955	97,946	91,425
Effect of dilution	459	7,453	514	
Diluted shares	100,366	99,408	98,460	91,425

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

For the three and six months ended June 30, 2010, the Company excluded from the computation of dilutive shares the assumed conversion of preferred stock to 7,000,000 shares of common stock and approximately 205,000 stock options because the impact would have been anti-dilutive. For the three months ended June 30, 2009, approximately 72,000 stock options were excluded from the computation of diluted shares because the impact would have been anti-dilutive. For the six months ended June 30, 2009, the assumed conversion of preferred stock to 7,000,000 shares of common stock and approximately 545,000 stock options were excluded from the computation of diluted shares because the impact would have been anti-dilutive due to the loss reported in the period.

There are no reconciling items between net income (loss) available to common stockholders for purposes of basic earnings (loss) per share and net income (loss) available to common stockholders for purposes of diluted earnings (loss) per share.

3. Property and Equipment (including Concession Assets)

Property and equipment, including concession assets, and related accumulated depreciation and amortization are summarized below *(in millions)*:

	June 30, 2010	December 31, 2009
Land	$ 178.2	$ 162.9
Concession land rights	137.6	137.6
Road property	4,789.2	4,644.4
Equipment	690.0	679.3
Technology and other	127.3	125.3
Construction in progress	117.4	165.6
Total property	6,039.7	5,915.1
Accumulated depreciation and amortization	1,250.1	1,192.7
Net property	$ 4,789.6	$ 4,722.4

Concession assets, net of accumulated amortization of $280.6 million and $259.4 million, totaled $1,774.9 million and $1,768.0 million at June 30, 2010 and December 31, 2009, respectively.

4. Fair Value Measurements

The Company s short term financial instruments include cash and cash equivalents, accounts receivable, and accounts payable. The carrying value of the short term financial instruments approximates the fair value due to their short term nature.

The fair value of the Company s debt is estimated using quoted market prices when available. When quoted market prices are not available, fair value is estimated based on current market interest rates for debt with similar maturities and credit quality. The fair value of the Company s debt was $1,771.4 million and $2,031.1 million at June 30, 2010 and December 31, 2009, respectively. The financial statement carrying value was $1,700.0 million and $1,980.0 million at June 30, 2010 and December 31, 2009, respectively.

Assets and liabilities recognized at fair value are required to be classified into a three-level hierarchy. In general, fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company s assessment of the significance of a particular input to the fair value in its entirety requires judgment and considers factors specific to the asset or liability.

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

The following tables present the Company s liabilities measured at fair value on a recurring basis (*in millions)*:

	Fair Value Measurements			Net Liabilities at Fair Value
	Level 1	Level 2	Level 3	
June 30, 2010				
Interest rate contracts	$	$ 2.3	$	$ 2.3
Fuel swap contracts		2.2		2.2
Net liabilities, at fair value	$	$ 4.5	$	$ 4.5
December 31, 2009				
Interest rate contracts	$	$ 4.9	$	$ 4.9
Net liabilities, at fair value	$	$ 4.9	$	$ 4.9

The Company determines the fair values of its derivative financial instrument positions based upon pricing models using inputs observed from actively quoted markets. Pricing models take into consideration the contract terms as well as other inputs, including forward interest rate curves.

5. Derivative Instruments

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

Credit Risk. As a result of the use of derivative instruments, the Company is exposed to counterparty credit risk. The Company manages the counterparty credit risk by entering into contracts with large financial institutions with which the Company has an established banking relationship. As of June 30, 2010, the Company did not expect any losses as a result of default of its counterparties.

Interest Rate Swaps. During 2008, the Company entered into five forward starting interest rate swaps, which have been designated as cash flow hedges. The forward starting interest rate swaps effectively convert interest payments from variable rates to fixed rates. The swaps are highly effective and as a result there will be de minimus earnings impact associated with ineffectiveness of these hedges. The hedging instruments have an aggregate notional amount of $250.0 million at an average fixed rate of 2.71%, with forward starting settlements indexed to the three-month LIBOR occurring every quarter, expiring September 2010 through March 2011.

Fuel Derivative Transactions. In the first quarter of 2010, the Company entered into fuel swap agreements, which have not been designated as hedging instruments. Gains and losses for derivatives which have not been designated as hedging instruments are recorded in fuel expense in the consolidated statement of operations. As of June 30, 2010, the Company has outstanding fuel swap agreements for 15.3 million gallons of diesel fuel purchases through the end of 2010 at an average swap price of $2.24 per gallon.

In January 2009, the Company entered into fuel swap agreements, which had been designated as cash flow hedges. The effective portion of the gain or loss on the derivative instruments was reported as a component of other comprehensive income (loss) and reclassified into earnings in the same period or periods during which the hedged transaction affected earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of the effectiveness were recognized in current earnings. During the second quarter of 2009, it became probable that the hedged transactions would not occur as forecasted. Therefore, the hedging relationship was dedesignated on May 31, 2009 and hedge accounting was discontinued. Changes in the fair value of the derivative instrument after dedesignation were recorded in earnings.

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

The following table presents the fair value of derivative instruments included in the consolidated balance sheet *(in millions)*:

		Liability Derivatives	
	Balance Sheet Location	**June 30, 2010**	**December 31, 2009**
Derivatives designated as hedging instruments:			
Interest rate contracts	Accounts payable & accrued liabilities	$ 2.3	$ 3.2
Interest rate contracts	Other non-current liabilities & deferred credits		1.7
Total derivatives designated as hedging instruments		2.3	4.9
Derivatives not designated as hedging instruments:			
Fuel swap contracts	Accounts payable & accrued liabilities	2.2	
Total derivatives not designated as hedging instruments		2.2	
Total liability derivatives		$ 4.5	$ 4.9

The following table presents the amounts affecting the consolidated statement of operations for the three months ended June 30 *(in millions)*:

Derivatives in Cash Flow Hedging Relationships	**Amount of Gain/(Loss) Recognized in OCI on Derivative (Effective Portion)**		**Location of Gain/(Loss) Reclassified from Accumulated OCI into Income (Effective Portion)**	**Amount of Gain/(Loss) Reclassified from Accumulated OCI into Income (Effective Portion)**		**Location of Gain/(Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)**	**Amount of Gain/(Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)**	
	2010	**2009**		**2010**	**2009**		**2010**	**2009**
Interest rate contracts	$ 0.1	$ (0.5)	Interest expense	$ (1.6)	$ (0.9)	Interest expense	$	$
Fuel swap contracts		2.5	Fuel expense			Fuel Expense		
Total	$ 0.1	$ 2.0		$ (1.6)	$ (0.9)		$	$

Derivatives not designated as hedging instruments	Location of Gain/(Loss) Recognized in Income on Derivative	Amount of Gain/ (Loss) Recognized in Income on Derivative	
		2010	2009
Fuel swap contracts	Fuel expense	$ (3.2)	$ 0.8
Total		$ (3.2)	$ 0.8

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

The following table presents the amounts affecting the consolidated statement of operations for the six months ended June 30

(in millions):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain/(Loss) Recognized in OCI on Derivative (Effective Portion) 2010	2009	Location of Gain/(Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain/(Loss) Reclassified from Accumulated OCI into Income (Effective Portion) 2010	2009	Location of Gain/(Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Amount of Gain/(Loss) Recognized in Income on Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing) 2010	2009
Interest rate contracts	$ (0.5)	$ (1.2)	Interest expense	$ (3.1)	$ (1.6)	Interest expense	$	$
Fuel swap contracts		0.9	Fuel expense		(0.2)	Fuel Expense		(2.0)
Total	$ (0.5)	$ (0.3)		$ (3.1)	$ (1.8)		$	$ (2.0)

Derivatives not designated as hedging instruments	Location of Gain/(Loss) Recognized in Income on Derivative	Amount of Gain/(Loss) Recognized in Income on Derivative 2010	2009
Fuel swap contracts	Fuel expense	$ (2.9)	$ 0.8
Total		$ (2.9)	$ 0.8

6. Acquisition

On March 3, 2010, the Company acquired an intermodal facility in Mexico. The aggregate purchase price for the intermodal facility was $25.1 million, which was funded by existing cash. As a result of the final valuation completed in the second quarter of 2010, the Company recorded goodwill of $2.6 million and identifiable intangible assets of $2.0 million. The acquisition is not material to the Company s consolidated financial statements.

7. Common Stock Offering

On May 4, 2010, the Company completed a public offering of 5,769,230 shares of its common stock at a price of $39 per share. The Company received net proceeds of approximately $214.9 million after deducting offering expenses, underwriting discounts and commissions.

8. Long-Term Debt

On January 7, 2010, pursuant to an offer to purchase, Kansas City Southern de México, S.A. de C.V. (KCSM), a wholly-owned subsidiary of KCS, commenced a cash tender offer for a portion of its 9 $^{3}/8$ % senior unsecured notes due May 1, 2012 (the 9 $^{3}/8$% Senior Notes). On January 22, 2010, the Company purchased $290.0 million of the tendered 9 $^{3}/8$% Senior Notes in accordance with the terms and conditions of the tender offer set forth in the offer to purchase using the proceeds received from the issuance of $300.0 million of KCSM 8.0% senior unsecured notes due February 1, 2018 (the KCSM 8.0% Senior Notes). Additionally, on February 1, 2010, KCSM repurchased $6.3 million of the 9 $^{3}/8$% Senior Notes. KCSM recorded debt retirement costs of $14.9 million in the first quarter of 2010.

On January 22, 2010, KCSM issued the $300.0 million KCSM 8.0% Senior Notes due February 1, 2018, which bear interest semiannually at a fixed annual rate of 8.0%. The KCSM 8.0% Senior Notes were issued at a discount to par value, resulting in a $4.3 million discount and a yield to maturity of 8 $^{1}/4$%. KCSM used the net proceeds from the issuance of the KCSM 8.0% Senior Notes and cash on hand to purchase $290.0 million in principal amount of the 9 $^{3}/8$% Senior Notes tendered under an offer to purchase and pay all fees and expenses incurred in connection with the KCSM 8.0% Senior Notes offering and tender offer. The KCSM 8.0% Senior Notes are redeemable at KCSM s option, in whole or in part, on and after February 1, 2014, at the following redemption prices (expressed as percentages of principal amount) plus any accrued and unpaid interest: 2014 104.000%, 2015 102.000%, 2016 100.000%. In addition, KCSM may redeem up to 35% of the KCSM 8.0% Senior Notes any time prior to February 1, 2013 from the proceeds of the sale of capital stock in KCSM or KCS and are redeemable, in whole but not in part, at KCSM s option at their principal amount in the event of certain changes in the Mexican withholding tax rate.

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

The KCSM 8.0% Senior Notes are denominated in dollars and are unsecured, unsubordinated obligations, rank *pari passu* in right of payment with KCSM s existing and future unsecured, unsubordinated obligations, and are senior in right of payment to KCSM s future subordinated indebtedness. In addition, the KCSM 8.0% Senior Notes include certain covenants which are customary for these types of debt instruments and borrowers with similar credit ratings. The KCSM 8.0% Senior Notes contain certain covenants that, among other things, prohibit or restrict KCSM from taking certain actions, including KCSM s ability to incur debt, pay dividends or make other distributions in respect of its stock, issue guarantees, enter into certain transaction with affiliates, make restricted payments, sell certain assets, create liens, engage in sale-leaseback transactions and engage in mergers, divestitures and consolidations. However, these limitations will be subject to a number of important qualifications and exceptions.

On March 16, 2010, KCS and The Kansas City Southern Railway Company (KCSR), a wholly-owned subsidiary of KCS, entered into a Second Amendment (Amendment No. 2) to KCSR s Amended and Restated Credit Agreement dated April 28, 2006, as amended by Amendment No. 1 dated as of May 31, 2007 (the Existing Credit Agreement), which extends the maturity of the revolving credit facility of the Existing Credit Agreement from April 28, 2011 to April 28, 2013. In consideration for this change, the parties to the agreement agreed to increase the Applicable Margin (as defined in Amendment No. 2) in respect of the revolving and swing line credit facilities. In addition, Amendment No. 2 modified certain covenants of the Existing Credit Agreement to permit the incurrence of certain indebtedness and the creation of liens related to such indebtedness, as well as certain prepayments of existing unsecured debt. Amendment No. 2 also provides for certain conforming revisions to the definitions and other terms set forth in the Existing Credit Agreement. Except as amended and supplemented by Amendment No. 2, all terms of the Existing Credit Agreement remained in full force and effect. In the second quarter of 2010, the Company repaid the outstanding balance of $40.0 million on the KCSR s $125.0 million revolving credit facility.

On June 4, 2010, the Company used the proceeds from the common stock offering, together with other available cash, to redeem $66.5 million principal amount of the 13.0% Senior Notes due 2013 issued by KCSR, $70.0 million principal amount of the 12.5% Senior Notes due 2016 issued by KCSM and $100.0 million principal amount of the 9 $^{3}/8$% Senior Notes issued by KCSM, as well as pay $19.7 million of call premiums and other expenses associated with such redemptions. In addition, the Company wrote-off $12.8 million of unamortized debt issuance costs and original issue discounts associated with the redemption of the notes.

As the Company intends to purchase the remaining 9 $^{3}/8$% Senior Notes issued by KCSM within the next twelve months, the outstanding principal amount of $63.7 million has been classified as a current liability as of June 30, 2010.

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

9. Equity

The following tables summarize the changes in equity (*in millions*):

	Three Months Ended June 30, 2010			Three Months Ended June 30, 2009		
	Kansas City Southern Stockholders Equity	Noncontrolling Interest	Total Equity	Kansas City Southern Stockholders Equity	Noncontrolling Interest	Total Equity
Beginning Balance	$ 2,082.0	$ 281.7	$ 2,363.7	$ 1,890.9	$ 273.6	$ 2,164.5
Comprehensive income:						
Net income	37.4		37.4	6.6	0.5	7.1
Unrealized gain on cash flow hedges, net of tax of less than $0.1 million and $0.8 million	0.1		0.1	1.2		1.2
Reclassification adjustment from cash flow hedges included in net income, net of tax of $0.7 million and $0.2 million	0.9		0.9	0.7		0.7
Cumulative translation adjustment - FTVM, net of tax of less than $(0.1) million and $0.3 million	(0.2)		(0.2)	0.6		0.6
Comprehensive income	38.2		38.2	9.1	0.5	9.6
Contribution from noncontrolling interest					9.6	9.6
Common stock issued	214.9		214.9	51.3		51.3
Dividends on $25 par preferred stock				(0.1)		(0.1)
Dividends on series D cumulative preferred stock	(2.8)		(2.8)			
Options exercised and stock subscribed, net of shares withheld for employee taxes	(0.3)		(0.3)	0.4		0.4
Tax benefit from share-based compensation	3.8		3.8			
Share-based compensation	1.3		1.3	2.8		2.8
Ending Balance	$ 2,337.1	$ 281.7	$ 2,618.8	$ 1,954.4	$ 283.7	$ 2,238.1

14

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

	Six Months Ended June 30, 2010			Six Months Ended June 30, 2009		
	Kansas City Southern Stockholders Equity	Noncontrolling Interest	Total Equity	Kansas City Southern Stockholders Equity	Noncontrolling Interest	Total Equity
Beginning Balance	$ 2,043.0	$ 282.8	$ 2,325.8	$ 1,896.6	$ 273.7	$ 2,170.3
Comprehensive income:						
Net income	72.7	(1.1)	71.6	3.9	0.4	4.3
Unrealized loss on cash flow hedges, net of tax of $(0.2) million and $(0.1) million	(0.3)		(0.3)	(0.2)		(0.2)
Reclassification adjustment from cash flow hedges included in net income, net of tax of $1.3 million and $0.7 million	1.8		1.8	1.1		1.1
Cumulative translation adjustment - FTVM, net of tax of $0.1 million and $(0.1) million	0.2		0.2	0.7		0.7
Comprehensive income	74.4	(1.1)	73.3	5.5	0.4	5.9
Contribution from noncontrolling interests					9.6	9.6
Common stock issued	214.9		214.9	51.3		51.3
Dividends on $25 par preferred stock	(0.1)		(0.1)	(0.1)		(0.1)
Dividends on series D cumulative preferred stock	(5.4)		(5.4)	(5.4)		(5.4)
Options exercised and stock subscribed, net of shares withheld for employee taxes	(9.7)		(9.7)	1.6		1.6
Tax benefit from share-based compensation	15.5		15.5			
Share-based compensation	4.5		4.5	4.9		4.9
Ending Balance	$ 2,337.1	$ 281.7	$ 2,618.8	$ 1,954.4	$ 283.7	$ 2,238.1

10. Share-Based Compensation

Market Based Awards. On March 1, 2010, the Company granted approximately 191,000 stock options and 108,000 shares of nonvested stock (collectively, the Award) under the Kansas City Southern 2008 Stock Option and Performance Award Plan. The Award contains a market condition that accelerates the vesting in three tranches if the closing price of the Company s common stock is above $38.95, $42.85 or $47.14 for a period of thirty consecutive trading days. If the target share prices are not met, the awards will vest in March 2013.

The fair value and service period of each Award is estimated on the date of grant using the Monte Carlo simulation model. The weighted average fair value of stock options and nonvested stock granted during March 2010 was $15.96 and $35.41, respectively, and the derived service period ranges from 1.1 to 3.0 years.

Stock Options. During the six months ended June 30, 2010, 725,315 stock options with an intrinsic value of $18.2 million were exercised. Cash received from option exercises during the period was $0.7 million.

Nonvested Stock. During the six months ended June 30, 2010, 334,571 shares vested and the fair value (at vest date) was $11.5 million.

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

11. Commitments and Contingencies

Concession Duty. Under KCSM s railroad concession from the Mexican government (the Concession), the Mexican government has the right to receive a payment from the Company equivalent to 0.5% of the gross revenue during the first 15 years of the Concession period and 1.25% of the gross revenue during the remaining years of the Concession period. For the three and six months ended June 30, 2010, the concession duty expense, which is recorded within operating expenses, amounted to $1.1 million and $2.1 million, compared to $0.7 million and $1.5 million for the same periods in 2009.

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

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

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

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

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

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

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

Environmental remediation expense was $1.9 million and $3.5 million for the six months ended June 30, 2010 and 2009, respectively, and was included in casualties and insurance expense on the consolidated statements of operations. Additionally, as of June 30, 2010, KCS had a reserve for environmental remediation of $4.7 million. This amount was derived from a range of reasonable estimates based upon the studies and site surveys described above and in accordance with the accounting guidance for the recognition of loss contingencies.

Personal Injury Claim Reserves. The Company s personal injury claim reserve is based on semi-annual actuarial studies performed on an undiscounted basis. This reserve is based on personal injury claims filed and an estimate of claims incurred but not yet reported. Actual results may vary from estimates due to the number, type and severity of the injury, costs of medical treatments and uncertainties in litigation. Adjustments to the liability are reflected within operating expenses in the period in which changes to estimates are known. Personal injury claims in excess of self-insurance levels are insured up to certain coverage amounts, depending on the type of claim and year of occurrence. The personal injury claim reserve balance as of June 30, 2010 is based on an updated actuarial study of personal injury reserves for data through May 31, 2010 and review of the last month s experience. The activity in the reserve follows *(in millions):*

	Six Months Ended June 30,	
	2010	**2009**
Balance at beginning of year	$ 86.9	$ 90.7
Accruals, net (includes the impact of actuarial studies)	(2.5)	
Payments	(8.8)	(7.9)
Balance at end of period	$ 75.6	$ 82.8

Settlement Agreement. On February 9, 2010, (i) KCSM and (ii) *Ferrocarril Mexicano, S.A. de C.V. (Ferromex)*, Ferrosur, S.A. de C.V. (Ferrosur), Minera México, S.A. de C.V., Infraestructura y Transportes Ferroviarios, S.A. de C.V., Infraestructura y Transportes México, S.A. de C.V., Líneas Ferroviarias de México, S.A. de C.V., Grupo Ferroviario Mexicano, S.A. de C.V., and Grupo México, S.A.B. de C.V. (jointly, the Ferromex Parties) entered into a Settlement Agreement (the Settlement Agreement).

Pursuant to the Settlement Agreement, the parties agreed to completely, definitively and irrevocably terminate (i) the private disputes, procedures and controversies among KCSM and the Ferromex Parties, in connection with the merger between Ferromex and Ferrosur, including KCSM s involvement in such procedures as an interested party; and (ii) the lawsuit filed against KCSM and the Mexican Government in connection with several disputes, procedures and controversies before judicial authorities with respect to the acquisition of the shares of Ferrocarril del Noreste, S.A. de C.V. (now KCSM) by Grupo Transportación Ferroviaria Mexicana, S.A. de C.V., in 1997 (the Settlement Procedures). The parties waived their rights to any future actions derived from or related to the Settlement Procedures. Further, the parties did not settle or agree to settle any disputes, controversies or procedures other than the Settlement Procedures.

Under the Settlement Agreement, Ferrosur agreed to grant KCSM certain trackage and switching rights within Veracruz, México, and switching rights in the Puebla-Tlaxcala zone. In a related agreement, the parties further agreed to amend the Ferrocarril y Terminal del Valle de México, S.A. de C.V. (FTVM) by-laws to, among other changes, grant certain veto and voting rights to KCSM at the shareholders and the board of directors levels.

The Settlement Agreement shall remain in effect until the term of the concession title of KCSM expires, unless the parties mutually agree to renew the Settlement Agreement beyond the expiration of KCSM s concession title. The Settlement Agreement may be terminated earlier upon delivery by KCSM of a notice to the Ferromex Parties indicating any breach by the Ferromex Parties of any of their respective obligations under the Settlement Agreement. Notwithstanding, the settlement and termination of the Settlement Procedures shall not be subject to rescission or termination.

The Settlement Agreement may be terminated, at KCSM s option, before its stipulated term if Ferromex is sold or if it transfers, directly or indirectly, its concession under its concession title. A change in control of KCSM or its affiliates, however, shall not be a cause for termination.

Likewise, the Settlement Agreement will terminate three years after Ferromex and Ferrosur cease to be under the common control of one person or group of persons acting jointly or in agreement to adopt coordinated resolutions (Common

17

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

Control). Notwithstanding, if for any reason Ferromex and Ferrosur are under Common Control within five years after the Settlement Agreement is terminated due to Ferromex and Ferrosur ceasing to be under Common Control, the Settlement Agreement would automatically be reinstated.

In November 2005, Ferromex acquired control of and merged with Ferrosur creating Mexico s largest railway, though such merger has been previously rejected by Comisión Federal de Competencia (Mexican Antitrust Commission), (COFECO). If the COFECO does not authorize the merger of Ferromex and Ferrosur, the Settlement Agreement shall be terminated twelve months after the relevant resolution of the Governmental Authority is issued or when the unwinding is effective, whichever is later.

Trackage Rights Settlement Agreement with Ferromex. KCSM s operations are subject to certain trackage rights, switching rights, and interline services with Ferromex. KCSM and Ferromex entered into a Trackage Rights, Switching and Interline Settlement Agreement, dated February 9, 2010 (the Trackage Rights Agreement). Pursuant to the Trackage Rights Agreement, the parties terminated, in a definitive and irrevocable manner, all actions and procedures regarding: (a) rates applicable to trackage rights, switching and interlinear services from January 1, 2009 onward but not regarding the applicable rates before January 1, 2009 or the amounts owed by the parties to one another prior to the execution of the Trackage Rights Agreement; (b) the scope of certain trackage rights in Monterrey, Nuevo León, Guadalajara, Jalisco and Altamira, Tamaulipas, the Long Trackage Right, and Aguascalientes; and (c) court costs, as well as any other directly-related issue or dispute that arises from, is related in any manner directly or indirectly with, the terms and conditions and/or scope of such mandatory trackage and/or switching rights or that arises by reason of the definition of trackage rights (the Settlement Controversies). The parties waived their rights to any future actions derived from or related to the Settlement Controversies. Further, KCSM and Ferromex set the rates applicable for January 1, 2009 for each party for the use of the other party s trackage. The retroactive application of these rates to January 1, 2009 did not have a material impact on the results of operations.

Explicitly excluded from the scope and purpose of the Trackage Rights Agreement are all procedures, disputes, lawsuits, remedies, appeals and disagreements that were not expressly identified in the Trackage Rights Agreement, including without limitation, the disputes, claims and lawsuits that relate to the determination of rates for mandatory trackage and/or switching rights and for interconnection and/or terminal services, accrued prior to January 1, 2009, as well as the disputes among the parties regarding amounts payable to one another for trackage rights, interline services and switching services, that are currently being disputed by both parties at the Federal Court of Fiscal and Administrative Justice. Furthermore, the parties did not settle or agree to settle any other trackage and switching rights not specifically mentioned in the Trackage Rights Agreement.

The Trackage Rights Agreement shall remain in effect until the term of the concession title of Ferromex or the concession title of KCSM expire, unless the parties mutually agree to renew the Trackage Rights Agreement beyond the expiration of either party s concession title. The Trackage Rights Agreement may be terminated, at KCSM s option, before its stipulated term if Ferromex is sold or if it transfers, directly or indirectly, its concession under its concession title. A change in control of KCSM or its affiliates, however, shall not be a cause for termination.

Certain Disputes with Ferromex. KCSM s operations are subject to certain trackage rights, haulage rights, and interline services (the Services) with Ferromex. Other than the rates to be charged pursuant to the Trackage Rights Agreement, dated February 9, 2010, between KCSM and Ferromex, the rates payable for these Services have not been agreed upon by KCSM and Ferromex for the periods beginning in 1998 through December 31, 2008. If KCSM cannot reach an agreement with Ferromex for rates applicable for Services prior to January 1, 2009 which are not subject to the Trackage Rights Agreement, the Mexican *Secretaría de Comunicaciones y Transportes* (Ministry of Communications and Transportation or SCT) is entitled to set the rates in accordance with Mexican law and regulations. KCSM and Ferromex both initiated administrative proceedings seeking a determination by the SCT of the rates that KCSM and Ferromex should pay each other in connection with the Services. The SCT issued rulings in 2002 and 2008 setting the rates for the Services and both KCSM and Ferromex challenged these rulings.

In addition, KCSM is currently involved in judicial, civil and administrative proceedings and negotiations with Ferromex regarding the rates payable to each other for the Services for the periods prior to January 1, 2009. Although KCSM and Ferromex have challenged these matters based on different grounds and these cases continue to evolve, management believes the amounts recorded related to these matters are adequate and does not believe there will be a future material impact to the results of operations arising out of these disputes.

SCT Sanction Proceedings. In April 2006, the SCT initiated proceedings against KCSM, claiming that KCSM had failed to make certain minimum capital investments projected for 2004 and 2005 under its five-year business plan filed with the SCT prior to its April 2005 acquisition by KCS (collectively, the Capital Investment Proceedings). KCSM believes it made capital expenditures exceeding the required amounts. KCSM responded to the SCT by providing evidence in support of its investments and explaining why it believes sanctions are not appropriate. In May 2007, KCSM was served with an SCT resolution regarding the Capital

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

Investment Proceeding for 2004, in which the SCT resolved to impose no sanction. In June 2007, KCSM was served with an SCT resolution regarding the Capital Investment Proceeding for 2005, in which the SCT determined that KCSM had indeed failed to make the minimum capital investments required for such year, and imposed a minimal fine. KCSM has filed an action in the Mexican Administrative and Fiscal Federal Court challenging this ruling. KCSM will have the right to challenge any adverse ruling.

In May 2008, the SCT initiated a proceeding against KCSM at the request of a Mexican subsidiary of a large U.S. Auto Manufacturer (the Auto Manufacturer), alleging that KCSM impermissibly bundled international rail services and engaged in discriminatory pricing practices with respect to rail services provided by KCSM to the Auto Manufacturer. In March 2009, the SCT issued a decision determining that KCSM had engaged in the activities alleged, but imposed no sanction since this was the first time KCSM had engaged in such activities. On May 6, 2009, KCSM challenged the SCT s decision and the appeal is currently pending in the Administrative and Fiscal Federal Court.

On July 23, 2008, the SCT delivered notice to KCSM of new proceedings against KCSM, claiming, among other things, that KCSM refused to grant Ferromex access to certain trackage over which Ferromex alleges it has trackage rights on six different occasions and thus denied Ferromex the ability to provide service to the Auto Manufacturer at this location. On August 13, 2008, KCSM filed a response to the SCT. On July 15, 2010, the SCT resolved to consolidate these six sanctioning proceedings into a single proceeding, determining that the actions that motivated the underlying claims constitute a single occasion. Management believes that even if KCSM were to be found liable, a single sanction would be imposed and could be challenged in the Administrative and Fiscal Federal Court. A single sanction would more likely decrease the severity of any penalties levied against KCSM as a consequence thereof and makes it more likely that any unfavorable resolution will not have a material impact on KCSM s results of operations.

KCSM believes it has defenses to the imposition of sanctions for the foregoing proceedings and intends to vigorously contest these allegations. KCSM does not believe that these SCT proceedings will have a material adverse effect on its results of operations or financial condition. However, if KCSM is ultimately sanctioned by the SCT for generic sanctions on five occasions over the term of the Concession, KCSM could be subject to possible future SCT action seeking revocation of the Concession.

Disputes Relating to the Provision of Services to the Auto Manufacturer. KCSM is involved in several disputes related to providing services to the Auto Manufacturer. In March 2008, the Auto Manufacturer filed an arbitration suit against KCSM under a contract for services to the Auto Manufacturer s plants in Mexico, which, as amended, had a stated termination date of January 31, 2008. Among other claims, the Auto Manufacturer claimed that the contract was implicitly extended and continued in effect beyond its stated termination date. The Auto Manufacturer is seeking a declaration by the arbitrator that the rates being assessed by KCSM are discriminatory, even though the rates being charged are within the legal rate limits set by Mexican law for such freight transportation. The Auto Manufacturer has also filed counterclaims against KCSM related to other terms and conditions under the contract. KCSM claimed that the contract did in fact expire on its stated termination date, and that services rendered thereafter are thus subject to the general terms and conditions (including rates) applicable in the absence of a specific contract, pursuant to Mexican law. Accordingly, KCSM filed a counterclaim against the Auto Manufacturer to, among other things, recover the applicable rate difference between the rates under the contract and KCSM s rates. The arbitration was divided in two phases. On May 18, 2009, the arbitrator issued an award on the first phase of the arbitration proceeding ruling that the contract had terminated on May 8, 2008. As of the date of this filing, the second phase of the arbitration proceeding regarding the claim that the rates assessed by KCSM are discriminatory, and the other disputed issues, are in the evidentiary stage and have not been resolved. Management believes the final resolution of these claims will not have any material impact on KCSM s results of operations.

Third Party Contractual Agreements. In the normal course of business, the Company enters into various third party contractual agreements related to commercial arrangements and the use of other railroads or governmental entities infrastructure needed for the operations of the business. The Company is involved or may become involved in certain disputes involving transportation rates, charges, and interpretations related to these agreements. While the outcome of these matters cannot be predicted with certainty, the Company does not believe, when finally resolved, that these disputes will have a material effect on its results of operations or financial condition. However, an unexpected adverse resolution could have a material effect on the results of operations in a particular quarter or fiscal year.

Income tax. Tax returns filed in the U.S. from 2004 through the current year and in Mexico from 2003 through the current year remain open to examination by the taxing authorities. The 2008 U.S. tax return and the 2003 through 2005 Mexico tax returns are currently under examination. The Company received an audit assessment for the year ended December 31, 2003, from Servicio de Administracion Tributaria (SAT), the Mexican equivalent of the Internal Revenue Service. The Company filed its response to this assessment on March 8, 2010. The Company believes that it will resolve this audit in the ongoing negotiations or will prevail if

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

litigated. The Company believes that an adequate provision has been made for any adjustment (tax and interest) that will be due for all open years. However, an unexpected adverse resolution could have a material effect on the results of operations in a particular quarter or fiscal year.

Credit Risk. The Company continually monitors risks related to the economic changes and certain customer receivables concentrations. Significant changes in customer concentration or payment terms, deterioration of customer credit-worthiness or further weakening in economic trends could have a significant impact on the collectability of the Company s receivables and operating results. If the financial condition of the Company s customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. The Company has recorded reserves for uncollectability based on its best estimate at June 30, 2010.

12. Geographic Information

The Company strategically manages its rail operations as one reportable business segment over a single coordinated rail network that extends from the midwest and southeast portions of the United States south into Mexico and connects with other Class I railroads. Financial information reported at this level, such as revenues, operating income and cash flows from operations, is used by corporate management, including the Company s chief operating decision-maker, in evaluating overall financial and operational performance, market strategies, as well as the decisions to allocate capital resources.

The Company s strategic initiatives, which drive its operational direction, are developed and managed at the Company s headquarters and targets are communicated to its various regional activity centers. Corporate management is responsible for, among others, KCS marketing strategy, the oversight of large cross-border customer accounts, overall planning and control of infrastructure and rolling stock, the allocation of capital resources based upon growth and capacity constraints over the coordinated network, and other functions such as financial planning, accounting, and treasury.

The role of each region is to manage the operational activities and monitor and control costs over the coordinated rail network. Such cost control is required to ensure that pre-established efficiency standards set at the corporate level are attained. The regional activity centers are responsible for executing the overall corporate strategy and operating plan established by corporate management as a coordinated system.

The following tables *(in millions)* provide information by geographic area in accordance with the accounting guidance on segment reporting:

	Three Months Ended June 30,		Six Months Ended June 30,	
Revenues	**2010**	**2009**	**2010**	**2009**
U.S.	$ 254.8	$ 198.4	$ 500.3	$ 407.1
Mexico	206.8	142.9	397.6	280.2
Total revenues	$ 461.6	$ 341.3	$ 897.9	$ 687.3

Property and equipment (including concession assets), net	**June 30, 2010**	**December 31, 2009**
U.S.	$ 2,533.3	$ 2,482.7
Mexico	2,256.3	2,239.7
Total property and equipment (including concession assets), net	$ 4,789.6	$ 4,722.4

13. Condensed Consolidating Financial Information

KCSR has outstanding $275.0 million of 8.0% Senior Notes due 2015 and $123.5 million of 13.0% Senior Notes due 2013, which are unsecured obligations of KCSR, which are also jointly and severally and fully and unconditionally guaranteed on an unsecured senior basis by KCS and certain wholly-owned domestic subsidiaries. As a result, the following accompanying condensed consolidating financial information *(in millions)* has been prepared and presented pursuant to SEC Regulation S-X Rule 3-10 Financial statements of guarantors and issuers of guaranteed securities registered or being registered. The 8.0% Senior Notes were registered by means of an amendment to KCS shelf registration statement filed and automatically effective as of May 23, 2008. The 13.0% Senior Notes were registered under KCS shelf registration statement filed and automatically effective as of November 21, 2008.

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS

	Three Months Ended June 30, 2010					
	Parent	KCSR	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Revenues	$	$ 224.4	$ 3.6	$ 239.9	$ (6.3)	$ 461.6
Operating expenses	1.3	163.0	6.1	171.4	(7.4)	334.4
Operating income (loss)	(1.3)	61.4	(2.5)	68.5	1.1	127.2
Equity in net earnings (losses) of unconsolidated affiliates	35.3	(0.1)		20.5	(51.1)	4.6
Interest income (expense)		(25.1)	0.3	(26.6)	9.5	(41.9)
Debt retirement costs		(15.8)		(16.7)		(32.5)
Foreign exchange loss				(1.4)		(1.4)
Other income, net	9.1	1.2		1.8	(11.1)	1.0
Income (loss) before income taxes and noncontrolling interest	43.1	21.6	(2.2)	46.1	(51.6)	57.0
Income tax expense (benefit)	4.9	8.6	(0.8)	6.9		19.6
Net income (loss)	38.2	13.0	(1.4)	39.2	(51.6)	37.4
Noncontrolling interest						
Net income (loss) attributable to Kansas City Southern and subsidiaries	$ 38.2	$ 13.0	$ (1.4)	$ 39.2	$ (51.6)	$ 37.4

	Three Months Ended June 30, 2009					
	Parent	KCSR	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Revenues	$	$ 174.7	$ 3.3	$ 171.2	$ (7.9)	$ 341.3
Operating expenses	1.2	138.2	5.6	161.8	(8.6)	298.2
Operating income (loss)	(1.2)	36.5	(2.3)	9.4	0.7	43.1
Equity in net earnings (losses) of unconsolidated affiliates	(0.4)			(15.4)	17.8	2.0
Interest income (expense)	0.6	(15.0)		(32.0)	1.0	(45.4)
Foreign exchange gain				6.0		6.0
Other income, net	0.3	3.6		0.7	(1.7)	2.9
Income (loss) before income taxes and noncontrolling interest	(0.7)	25.1	(2.3)	(31.3)	17.8	8.6
Income tax expense (benefit)	(7.3)	10.3	(0.8)	(0.7)		1.5
Net income (loss)	6.6	14.8	(1.5)	(30.6)	17.8	7.1
Noncontrolling interest				0.5		0.5

Net income (loss) attributable to Kansas City Southern and subsidiaries	$ 6.6	$ 14.8	$ (1.5)	$ (31.1)	$ 17.8	$ 6.6

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

CONDENSED CONSOLIDATING STATEMENTS OF OPERATIONS (Continued)

	Six Months Ended June 30, 2010					
	Parent	KCSR	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Revenues	$	$ 441.4	$ 7.6	$ 461.8	$ (12.9)	$ 897.9
Operating expenses	2.4	326.1	12.8	335.8	(14.6)	662.5
Operating income (loss)	(2.4)	115.3	(5.2)	126.0	1.7	235.4
Equity in net earnings of unconsolidated affiliates	67.1	3.3		29.8	(89.2)	11.0
Interest income (expense)	(0.1)	(52.5)	0.3	(54.6)	20.6	(86.3)
Debt retirement costs		(15.8)		(31.6)		(47.4)
Foreign exchange gain				1.2		1.2
Other income, net	19.4	2.2		2.7	(22.8)	1.5
Income (loss) before income taxes and noncontrolling interest	84.0	52.5	(4.9)	73.5	(89.7)	115.4
Income tax expense (benefit)	10.5	20.8	(1.8)	14.3		43.8
Net income (loss)	73.5	31.7	(3.1)	59.2	(89.7)	71.6
Noncontrolling interest				(1.1)		(1.1)
Net income (loss) attributable to Kansas City Southern and subsidiaries	$ 73.5	$ 31.7	$ (3.1)	$ 60.3	$ (89.7)	$ 72.7

	Six Months Ended June 30, 2009					
	Parent	KCSR	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Revenues	$	$ 358.6	$ 6.2	$ 337.4	$ (14.9)	$ 687.3
Operating expenses	2.5	291.4	9.4	309.5	(16.2)	596.6
Operating income (loss)	(2.5)	67.2	(3.2)	27.9	1.3	90.7
Equity in net earnings (losses) of unconsolidated affiliates	4.8	0.4		(14.3)	12.1	3.0
Interest expense	(0.1)	(33.6)		(55.0)	1.5	(87.2)
Debt retirement costs		(5.3)		(0.6)		(5.9)
Foreign exchange gain				0.9		0.9
Other income, net	0.5	4.9		1.8	(2.8)	4.4
Income (loss) before income taxes and noncontrolling interest	2.7	33.6	(3.2)	(39.3)	12.1	5.9
Income tax expense (benefit)	(1.2)	14.4	(1.2)	(10.4)		1.6
Net income (loss)	3.9	19.2	(2.0)	(28.9)	12.1	4.3
Noncontrolling interest				0.4		0.4
	$ 3.9	$ 19.2	$ (2.0)	$ (29.3)	$ 12.1	$ 3.9

Net income (loss) attributable to Kansas City Southern and subsidiaries	

22

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

CONDENSED CONSOLIDATING BALANCE SHEETS

	June 30, 2010					
	Parent	KCSR	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Assets:						
Current assets	$ 2.7	$ 203.7	$ 6.0	$ 420.3	$ (11.9)	$ 620.8
Investments held for operating purposes and affiliate investment	1,764.4	26.8	1.9	1,687.5	(3,434.2)	46.4
Property and equipment (including concession assets), net		1,765.2	209.9	2,814.5		4,789.6
Other assets	1.3	51.4		68.1	(31.6)	89.2
Total assets	$ 1,768.4	$ 2,047.1	$ 217.8	$ 4,990.4	$ (3,477.7)	$ 5,546.0
Liabilities and equity:						
Current liabilities	$ (555.9)	$ 645.4	$ 131.6	$ 255.6	$ (11.5)	$ 465.2
Long-term debt	0.2	703.9	0.4	910.8		1,615.3
Deferred income taxes	(17.9)	438.4	77.9	106.1		604.5
Other liabilities	4.2	136.2	0.4	133.4	(32.0)	242.2
Stockholders equity	2,337.8	123.2	7.5	3,302.8	(3,434.2)	2,337.1
Noncontrolling interest				281.7		281.7
Total liabilities and equity	$ 1,768.4	$ 2,047.1	$ 217.8	$ 4,990.4	$ (3,477.7)	$ 5,546.0

	December 31, 2009					
	Parent	KCSR	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Assets:						
Current assets	$ 0.5	$ 219.1	$ 3.4	$ 428.8	$ (38.0)	$ 613.8
Investments held for operating purposes and affiliate investment	1,562.0	31.7	1.9	1,616.0	(3,164.8)	46.8
Property and equipment (including concession assets), net		1,717.5	212.1	2,792.8		4,722.4
Other assets	1.3	42.0		90.9	(62.9)	71.3
Total assets	$ 1,563.8	$ 2,010.3	$ 217.4	$ 4,928.5	$ (3,265.7)	$ 5,454.3
Liabilities and equity:						
Current liabilities	$ (455.7)	$ 567.6	$ 124.0	$ 211.7	$ (36.8)	$ 410.8
Long-term debt	0.2	793.8	0.4	1,147.5	(30.0)	1,911.9
Deferred income taxes	(27.8)	416.8	79.5	90.1		558.6
Other liabilities	4.1	142.0	3.0	132.2	(34.1)	247.2
Stockholders equity	2,043.0	58.7	10.5	3,064.2	(3,133.4)	2,043.0
Noncontrolling interest		31.4		282.8	(31.4)	282.8
Total liabilities and equity	$ 1,563.8	$ 2,010.3	$ 217.4	$ 4,928.5	$ (3,265.7)	$ 5,454.3

23

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

	Six Months Ended June 30, 2010					
	Parent	KCSR	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Operating activities:						
Excluding intercompany activity	$ 10.9	$ 118.6	$ (3.8)	$ 94.6	$	$ 220.3
Intercompany activity	(100.3)	98.6	5.4	(3.7)		
Net cash provided (used)	(89.4)	217.2	1.6	90.9		220.3
Investing activities:						
Capital expenditures		(69.6)	(1.7)	(49.6)		(120.9)
Acquisition of an intermodal facility, net of cash acquired				(25.0)		(25.0)
Property investments in MSLLC				(10.5)		(10.5)
Proceeds from sale (acquisition) of Mexrail, Inc.	(41.0)			41.0		
Distribution to affiliates	(95.0)				95.0	
Other investing activities		(0.5)	0.1	41.4	(30.0)	11.0
Net cash used	(136.0)	(70.1)	(1.6)	(2.7)	65.0	(145.4)
Financing activities:						
Proceeds from issuance of long-term debt				295.7		295.7
Repayment of long-term debt	(0.4)	(145.9)		(472.7)	30.0	(589.0)
Proceeds from common stock issuance	214.9					214.9
Debt costs		(10.4)		(30.0)		(40.4)
Excess tax benefit from share-based compensation	15.5					15.5
Contribution from affiliates				95.0	(95.0)	
Other financing activities	(4.8)					(4.8)
Net cash provided (used)	225.2	(156.3)		(112.0)	(65.0)	(108.1)
Cash and cash equivalents:						
Net increase	(0.2)	(9.2)		(23.8)		(33.2)
At beginning of year	(0.1)	12.7	0.3	104.6		117.5
At end of period	$ (0.3)	$ 3.5	$ 0.3	$ 80.8	$	$ 84.3

Table of Contents

Kansas City Southern

Notes to Consolidated Financial Statements (Continued)

CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS (Continued)

	Six Months Ended June 30, 2009					
	Parent	KCSR	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated KCS
Operating activities:						
Excluding intercompany activity	$ 73.2	$ 46.9	$ 1.8	$ (36.5)	$	$ 85.4
Intercompany activity	(120.8)	(76.4)	0.4	196.8		
Net cash provided (used)	(47.6)	(29.5)	2.2	160.3		85.4
Investing activities:						
Capital expenditures		(139.1)	(1.9)	(86.1)	1.0	(226.1)
Return of investment				65.0	(65.0)	
Property investments in MSLLC				(12.3)		(12.3)
Loans to affiliates				(45.0)	45.0	
Other investing activities		170.1		(160.7)	(1.0)	8.4
Net cash provided (used)		31.0	(1.9)	(239.1)	(20.0)	(230.0)
Financing activities:						
Proceeds from issuance of long-term debt	0.8	53.7		189.0	(53.7)	189.8
Repayment of long-term debt		(223.2)		(35.6)	8.7	(250.1)
Proceeds from common stock issuance	51.3					51.3
Other financing activities	(4.7)	(5.1)		(69.2)	65.0	(14.0)
Net cash provided (used)	47.4	(174.6)		84.2	20.0	(23.0)
Cash and cash equivalents:						
Net increase (decrease)	(0.2)	(173.1)	0.3	5.4		(167.6)
At beginning of year		177.9	0.2	51.8		229.9
At end of period	$ (0.2)	$ 4.8	$ 0.5	$ 57.2	$	$ 62.3

14. Subsequent Event

Rail service in northern Mexico has been disrupted by damage resulting from Hurricane Alex, which made landfall on June 30, 2010. The hurricane and resulting flooding continued into early July and caused significant track damage around the Monterrey and Saltillo areas as well as on the lines to Laredo and Matamoros. There have been multiple track related incidents due to the hurricane. The Company is currently in the repair and restoration process and continues to assess the related financial impact, including service interruption, on the Company s third quarter results. KCSM maintains insurance intended to cover events such as this. KCSM s property and casualty insurance program covers loss or damage to its own property and third party property over which it has custody and control, with a self-insured retention amount of $10.0 million for flood related losses. KCSM also maintains liability insurance with a self-insured retention of $1.0 million covering claims from third parties.

Table of Contents

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Kansas City Southern:

We have reviewed the accompanying consolidated balance sheet of Kansas City Southern and subsidiaries (the Company) as of June 30, 2010, and the related consolidated statements of operations for the three-month and six-month periods ended June 30, 2010 and 2009, and the related consolidated statement of cash flows for the six-month periods ended June 30, 2010 and 2009. These consolidated financial statements are the responsibility of the Company s management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the consolidated financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of the Company as of December 31, 2009, and the related consolidated statements of income, changes in equity and comprehensive income, and cash flows for the year then ended (not presented herein); and in our report dated February 11, 2010, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2009 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.