**NOTE 1.  Nature of Operations and Significant Accounting Policies**

**Business**

CSX Transportation, Inc. (“CSXT”), and together with its subsidiaries (“Respondent”), based in Jacksonville, Florida, is one of the nation's leading transportation suppliers.  The Respondent provides rail-based transportation services including traditional rail service and the transport of intermodal containers and trailers. The Respondent is a wholly owned subsidiary of CSX Corporation (“CSX”).

The Respondent provides an important link to the transportation supply chain through its approximately 21,000 route mile rail network, which serves major population centers in 23 states east of the Mississippi River, the District of Columbia and the Canadian provinces of Ontario and Quebec.  It has access to over 70 ocean, river and lake port terminals along the Atlantic and Gulf Coasts, the Mississippi River, the Great Lakes and the St. Lawrence Seaway.  The Respondent’s intermodal business, also part of CSXT, links customers to railroads via trucks and terminals. CSXT also serves thousands of production and distribution facilities through track connections to approximately 240 short-line and regional railroads.

*Lines of Business*

During 2012, CSXT’s transportation services generated $11.8 billion of revenue and served three primary lines of business:

* The merchandise business shipped nearly 2.7 million carloads and generated approximately 57% of revenue and 42% of volume in 2012. The Respondent’s merchandise business is the most diverse market and transports aggregates (which includes crushed stone, sand and gravel), metal, phosphate, fertilizer, food, consumer (manufactured goods and appliances), agricultural, automotive, paper and chemical products.
* The coal business shipped 1.3 million carloads and accounted for 27% of revenue and 20% of volume in 2012.  The Respondent transports domestic coal to electricity-generating power plants, steel manufacturers and industrial plants as well as export coal to deep-water port facilities.  Half of export coal and nearly all of the domestic coal that the Respondent transports is used for generating electricity.
* The intermodal business accounted for approximately 14% of revenue and 38% of volume in 2012. The intermodal line of business combines the superior economics of rail transportation with the short-haul flexibility of trucks and offers a competitive cost advantage over long-haul trucking.  Through a network of more than 50 terminals, the intermodal business serves all major markets east of the Mississippi and transports mainly manufactured consumer goods in containers, providing customers with truck-like service for longer shipments.

Other revenue accounted for approximately 2% of the Respondent’s total revenue in 2012.  This revenue category includes revenue from regional subsidiary railroads, demurrage, revenue for customer volume commitments not met, switching and other incidental charges. Revenue from regional railroads includes shipments by railroads that the Respondent does not directly operate.  Demurrage represents charges assessed when freight cars are held beyond a specified period of time.  Switching revenue is primarily generated when CSXT switches cars for a customer or another railroad.

***Basis of Presentation***

In the opinion of management, the accompanying consolidated financial statements contain all normal, recurring adjustments necessary to present fairly the financial position of CSXT and its subsidiaries at December 28, 2012 and December 30, 2011.

In addition, management has evaluated and disclosed all material events occurring subsequent to the date of the financial statements up to the date this annual report is filed on Form R-1.

***Fiscal Year***

CSXT follows a 52/53 week fiscal reporting calendar.  This fiscal calendar allows every quarter to consistently end on a Friday and typically, to be of equal duration (13 weeks), resulting in a 52 week fiscal year.  To maintain this type of reporting calendar every fifth or sixth year (depending on the Gregorian calendar and when leap year falls), an extra week will be included in the fourth quarter (a 14-week fiscal quarter) and, therefore, that full fiscal year will have 53 weeks.

Fiscal years 2012 and 2011 each consisted of 52 weeks ending on December 28, 2012 and December 30, 2011 respectively.  Except as otherwise specified, references to full year indicate CSXT’s fiscal periods ended on these dates.

***Principles of Consolidation***

The consolidated financial statements include results of operations of CSXT and subsidiaries over which CSXT has majority ownership or financial control. All significant intercompany accounts and transactions have been eliminated. Most investments in companies that were not majority-owned were carried at cost (if less than 20% owned and the Respondent has no significant influence) or equity (if the Respondent has significant influence).

P&L Transportation Inc. and subsidiaries (“P&L”) and Midland United Corp. and subsidiaries (“Midland”) have been removed from consolidated R-1 reporting. These entities are now treated like an equity method investment which is consistent with Ex Parte No. 634.

***Cash and Cash Equivalents***

The Respondent participates in the CSX cash management plan, under which excess cash is advanced to CSX for investment. CSX then makes cash available to the Respondent as needed. Cash and cash equivalents consists of cash in banks and highly liquid investments having an original maturity of three months or less at the date of acquisition.

***Allowance for Doubtful Accounts***

The Respondent maintains an allowance for doubtful accounts on uncollectible amounts related to freight receivables, government reimbursement receivables, claims for damages and other various receivables. The allowance is based upon the credit worthiness of customers, historical experience, the age of the receivable and current market and economic conditions. Uncollectible amounts are charged against the allowance account.

***Materials and Supplies***

Materials and supplies in the Schedule 200 are carried at average costs and consist primarily of fuel and parts used in the repair and maintenance of CSXT’s freight car and locomotive fleets, equipment and track structure.

**NOTE 1.  Nature of Operations and Significant Accounting Policies,** *continued*

***Properties***

The Respondent depreciates its rail assets including mainline track, locomotives, and freight cars using the group-life method of depreciation. The Respondent believes this method closely approximates the straight-line method of depreciation. Additionally, due to the nature of most of its assets (e.g. track is one contiguous, connected asset) the Respondent believes that this is the most effective way to properly depreciate its assets.

Under the group-life method of accounting, the service lives and salvage values for each group of assets are determined by completing periodic depreciation studies and applying management’s assumptions regarding the service lives of its properties. A depreciation study (also referred to as a life study) is the periodic review of asset service lives, salvage values, accumulated depreciation, and other related factors for group assets conducted by a third-party specialist, analyzed by the Respondent’s management and approved by the Surface Transportation Board (“STB”), the regulatory board that has broad jurisdiction over railroad practices. The STB requires depreciation studies be performed for equipment assets every three years and for road (e.g. bridges and signals) and track (e.g. rail, ties and ballast) assets every six years. The Respondent believes the frequency currently required by the STB provides adequate review of asset service lives and that a more frequent review would not result in a material change due to the long-lived nature of most of the assets.

The results of the depreciation study process determine the service lives for each asset group under the group-life method. Road assets, including main-line track, have estimated service lives ranging from six years for system roadway machinery to 80 years for grading (construction of protection for the roadway, tracks and embankments). Equipment assets, including locomotives and freight cars, have estimated service lives ranging from six years for technology assets to 38 years for work equipment.

Changes in asset lives due to the results of the depreciation studies are applied on a prospective basis and could significantly impact future periods’ depreciation expense, and thus, the Respondent's results of operations.

There are several factors taken into account during the depreciation study and they include:

* statistical analysis of historical life and salvage data for each group of property;
* statistical analysis of historical retirements for each group of property;
* evaluation of current operations;
* evaluation of technological advances and maintenance schedules;
* previous assessment of the condition of the assets and outlook for their continued use;
* expected net salvage to be received upon retirement; and
* comparison of assets to the same asset groups with other companies.

For retirements or disposals of depreciable rail assets that occur in the ordinary course of business, the asset cost (net of salvage value or sales proceeds) is charged to accumulated depreciation and no gain or loss is recognized. As individual assets within a specific group are retired or disposed of, resulting gains and losses are recorded in accumulated depreciation. As part of the depreciation study, an assessment of the recorded amount of accumulated depreciation is made to determine if it is deficient (or in excess) of the appropriate amount indicated by the study. Any such deficiency (or excess), including any deferred gains or losses, is amortized as a component of depreciation expense over the remaining service life of the asset group until the next required depreciation study. Since the overall assumption with the group-life method of accounting is that the assets within the group on average have the same life and characteristics, it is therefore concluded that the deferred gains and losses offset over time.

In November 2011, the Company sold approximately 61 miles of operating rail corridor to the Florida Department of Transportation. This corridor will be used by the state of Florida for its new commuter rail operation known as SunRail, which is expected to alleviate highway congestion. The Company intends to divert a portion of the corridor's existing rail traffic and relocate terminal operations to an adjacent rail corridor in Florida.

Since the rail network is one contiguous, connected network it is impractical to maintain specific identification records for these assets. For road assets (such as rail and track related items), CSXT utilizes a first-in, first-out approach to asset retirements. The historical cost of these replaced assets is estimated using inflation indices published by the Bureau of Labor Statistics applied to the replacement value based on the age of the retired asset. The indices are used because they closely correlate with the major cost of the materials comprising the applicable road assets.

Equipment assets (such as locomotives and freight cars) are specifically identified. When an equipment asset is retired that has been depreciated using the group life method, the cost is reduced from the cost base and recorded in accumulated depreciation.

In the event that large groups of assets are removed from service as a result of unusual acts or sales, resulting gains and losses are recognized immediately. These acts are not considered to be in the normal course of business and are therefore recognized when incurred. Examples of such acts would be the major destruction of assets due to significant storm damage (e.g. major hurricanes), the sale of a rail line segment or the disposal of an entire class of assets (e.g. disposal of all refrigerated freight cars). Abnormal gains were $104 million gain in 2012 and $14 million gain in 2011.

Recent experience with depreciation studies has resulted in depreciation rate changes, which did not materially affect the Respondent’s annual depreciation. The impact of these studies is not included in financial results as the rates will not be effective until 2013 for R-1 reporting, pending STB approval.

The majority of non-railroad property is depreciated using the straight-line method on a per asset basis. The depreciable lives of this property are periodically reviewed by the Respondent and any changes are applied on a prospective basis. Amortization expense recorded under capital leases is included in depreciation expense on the Schedule 410. For retirements or disposals of non-railroad depreciable assets and all dispositions of land, the resulting gains or losses are recognized in earnings at the time of disposal. During 2012, the Respondent recognized a gain of $57 million related to the sale of non-operating property, which is recognized in other income on the Schedule 210. These gains and losses were not material for any period presented.

Properties and other long-lived assets are reviewed for impairment whenever events or business conditions indicate the carrying amount of such assets may not be fully recoverable. Initial assessments of recoverability are based on estimates of undiscounted future net cash flows associated with an asset or a group of assets in accordance with the Property, Plant, and Equipment Topic in the Financial Accounting Standards Board's (“FASB”) Accounting Standards Codification ("ASC"). Where impairment is indicated, the assets are evaluated and their carrying amount is reduced to fair value based on discounted net cash flows or other estimates of fair value.

**NOTE 1.  Nature of Operations and Significant Accounting Policies,** *continued*

***Revenue and Expense Recognition***

The Respondent recognizes freight revenue using Free-On-Board (“FOB”) Origin pursuant to the *Revenue Recognition Topic* in the ASC.  Accounting guidance in this topic provides for the allocation of revenue between reporting periods based on relative transit time in each reporting period.  Expenses are recognized as incurred.

The certain key estimates included in the recognition and measurement of revenue and related accounts receivable under the policies described above are as follows:

* revenue associated with shipments in transit, which are based on historical freight car movement data as well as average cycle times to move commodities and products from their origin to their final destination or interchange;
* adjustments to revenue for billing corrections, billing discounts and bad debts or to accounts receivable for allowances for doubtful accounts;
* adjustments to revenue for overcharge claims filed by customers, which are based on historical cash paid to customers for rate overcharges as a percentage of total billing;
* incentive-based refunds to customers, which are primarily based on customers achieving certain volume thresholds and are recorded as a reduction to revenue on the basis of management’s best estimate of the projected liability  (this estimate is based on historical activity, current volume levels and a forecast of future volume); and

  The Respondent regularly updates the estimates described above based on historical experience and current conditions.  All other revenue, such as demurrage, switching and other incidental charges are recorded upon completion of the service.  Amounts received for customer volume commitments not met are recorded upon the completion of the contract term.

***Other Income - Net***

The Respondent derives income from items that are not considered operating activities. Income from these items is reported net of related expense. Income from real estate includes the results of operations of the Respondent’s non-operating real estate sales, leasing, acquisition and management and development activities and may fluctuate as a function of timing of real estate sales. Miscellaneous income (expense) includes equity earnings or losses, investment gains and losses and other non-operating activities and may fluctuate due to timing.

***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires that management make estimates in reporting the amounts of certain assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of certain revenues and expenses during the reporting period.  Actual results may differ from those estimates.  Critical accounting estimates using management judgment are made for the following areas:

* casualty, environmental and legal reserves (see Note 2, Casualty, Environmental and Other Reserves);
* pension and post-retirement medical plan accounting (see Note 4, Employee Benefit Plans);
* depreciation policies for assets under the group-life method (see “Properties” in this note); and
* income taxes.

**NOTE 2.  Casualty, Environmental and Other Reserves**

Activity related to casualty, environmental and other reserves is as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Casualty** | | |  |  | **Environmental** | | | |  | **Other** | | | |  |  | | | |
| *(Dollars in Millions)* |  | **Reserves** | | |  |  | **Reserves** | | | |  | **Reserves*(a)*** | | | |  | **Total** | | | |
| **Balance December 31, 2010** |  | $ | 339 |  |  |  | |  | $ | 107 |  | |  | $ | 12 |  | |  | $ | 458 |  |
| Charged to Expense |  | 59 | |  |  |  | |  | 23 | |  | |  | 35 | |  | |  | 117 | |  |
| Payments |  | (65 | | ) |  |  | |  | (47 | | ) | |  | (27 | | ) | |  | (139 | | ) |
| **Balance December 30, 2011** |  | $ | 333 |  |  |  | |  | $ | 83 |  | |  | $ | 20 |  | |  | $ | 436 |  |
| Charged to Expense |  | 32 | |  |  |  | |  | 35 | |  | |  | 17 | |  | |  | 84 | |  |
| Payments |  | (88 | | ) |  |  | |  | (30 | | ) | |  | (25 | | ) | |  | (143 | | ) |
| **Balance December 28, 2012** |  | $ | 277 |  |  |  | |  | $ | 88 |  | |  | $ | 12 |  | |  | $ | 377 |  |

*(a) Separation liabilities and freight rate dispute reserves have been reclassified to other current liabilities and other long-term liabilities.*

**NOTE 2.  Casualty, Environmental and Other Reserves,** *continued*

These reserves are considered critical accounting estimates due to the need for significant management judgments. They are provided for in the Schedule 200 within accrued accounts payable and other long term liabilities and deferred credits as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **December 28, 2012** | | | | | | | | | | |  | December 30, 2011 | | | | | | | | | | |
| *(Dollars in Millions)* |  | **Current** | | |  | **Long-term** | | |  | **Total** | | |  | Current | | |  | Long-term | | |  | Total | | |
| Casualty: |  |  | | |  |  | | |  |  | | |  |  | | |  |  | | |  |  | | |
| Personal Injury |  | **$** | **68** |  |  | **$** | **117** |  |  | **$** | **185** |  |  | $ | 87 |  |  | $ | 137 |  |  | $ | 224 |  |
| Occupational |  | **5** | |  |  | **31** | |  |  | **36** | |  |  | 6 | |  |  | 37 | |  |  | 43 | |  |
| Asbestos |  | **8** | |  |  | **48** | |  |  | **56** | |  |  | 10 | |  |  | 56 | |  |  | 66 | |  |
| Total Casualty |  | **$** | **81** |  |  | **$** | **196** |  |  | **$** | **277** |  |  | $ | 103 |  |  | $ | 230 |  |  | $ | 333 |  |
| Environmental |  | **33** | |  |  | **55** | |  |  | **88** | |  |  | 31 | |  |  | 52 | |  |  | 83 | |  |
| Other |  | **10** | |  |  | **2** | |  |  | **12** | |  |  | 17 | |  |  | 3 | |  |  | 20 | |  |
| Total |  | **$** | **124** |  |  | **$** | **253** |  |  | **$** | **377** |  |  | $ | 151 |  |  | $ | 285 |  |  | $ | 436 |  |

These liabilities are accrued when estimable and probable in accordance with the *Contingencies Topic* in the ASC. Actual settlements and claims received could differ.  The final outcome of these matters cannot be predicted with certainty.  Considering the legal defenses currently available, the liabilities that have been recorded and other factors, it is the opinion of management that none of these items, when finally resolved, will have a material effect on the Respondent's financial condition, results of operations or liquidity.  Should a number of these items occur in the same period, however, they could have a material effect on the Respondent's financial condition, results of operations or liquidity in that particular period.

***Casualty***

Casualty reserves represent accruals for personal injury, occupational injury and asbestos claims.  During 2010, the Respondent increased its self-insured retention amount for these claims from $25 million to $50 million per occurrence for claims occurring on or after June 1, 2010.  Currently, no individual claim is expected to exceed the self-insured retention amount.  In accordance with the *Contingencies Topic* in the ASC, to the extent the value of an individual claim exceeds the self-insured retention amount, the Respondent would present the liability on a gross basis with a corresponding receivable for insurance recoveries.  These reserves fluctuate based upon the timing of payments as well as changes in independent third-party estimates, which are reviewed by management.  Actual results may vary from estimates due to the number, type and severity of the injury, costs of medical treatments and uncertainties in litigation. Defense and processing costs, which historically have been insignificant and are anticipated to be insignificant in the future, are not included in the recorded liabilities.

During 2012 and 2011, there were no significant changes in estimate recorded to adjust casualty reserves. Additionally, casualty expenses during 2012 declined as a result of the Respondent’s continued safety improvements.

*Personal Injury*

Personal injury reserves represent liabilities for employee work-related and third-party injuries.  Work-related injuries for CSXT employees are subject to the Federal Employers’ Liability Act (“FELA”). CSXT retains an independent actuarial firm to assist management in assessing the value of personal injury claims.  An analysis is performed by the independent actuarial firm quarterly and is reviewed by management. The methodology used by the actuary includes a development factor to reflect growth or reduction in the value of these personal injury claims. It is based largely on CSXT's historical claims and settlement experience. During 2012 and 2011, there were no significant changes in estimate of personal injury reserves.

*Occupational & Asbestos*

     Occupational claims arise from allegations of exposures to certain materials in the workplace, such as solvents, soaps, chemicals (collectively referred to as “irritants”) and diesel fuels (like exhaust fumes) or allegations of chronic physical injuries resulting from work conditions, such as repetitive stress injuries, carpal tunnel syndrome and hearing loss.

The Respondent is also party to a number of asbestos claims by employees alleging exposure to asbestos in the workplace.  The heaviest possible exposure for employees resulted from work conducted in and around steam locomotive engines that were largely phased out beginning around the 1950s. Other types of exposures, however, including exposure from locomotive component parts and building materials, continued until these exposures were substantially eliminated by 1985.  Diseases associated with asbestos typically have long latency periods (amount of time between exposure to a disease and the onset of the disease) which can range from 10 to 40 years after exposure.

An analysis of occupational claims is performed quarterly by an independent third-party actuarial firm and reviewed by management. Management performs a quarterly review of asserted asbestos claims, and an analysis is performed annually by an independent third-party specialist and reviewed by management. The objective of the occupational and asbestos claims analyses performed by the third-party actuarial firm and specialist (the "third-party specialists") is to determine the number of incurred but not reported (“IBNR”) claims.  With the exception of carpal tunnel, management has determined that seven years is the most probable time period in which unasserted claim filings and claim values can be estimated.  Carpal tunnel claims use a three-year period to estimate the reserve due to the shorter latency period for these types of injuries.

The third party specialists analyze CSXT’s historical claim filings, settlement amounts, and dismissal rates to determine future anticipated claim filing rates and average settlement values for occupational and asbestos claims reserves.  The potentially exposed population is estimated by using CSXT’s employment records and industry data. From this analysis, the third-party specialists provide an estimate of the IBNR claims liability.

**NOTE 2.  Casualty, Environmental and Other Reserves,** *continued*

Undiscounted liabilities recorded related to occupational and asbestos claims were as follows:

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **December** | | |  | December | | |
| *(Dollars in Millions)* |  | **2012** | | |  | 2011 | | |
| Occupational: |  |  | | |  |  | | |
| Incurred but not reported claims |  | **$** | **24** |  |  | $ | 26 |  |
| Asserted claims |  | **12** | |  |  | 17 | |  |
| Total liability |  | **$** | **36** |  |  | $ | 43 |  |
|  |  |  | | |  |  | | |
| Asbestos: |  |  | | |  |  | | |
| Incurred but not reported claims |  | **$** | **37** |  |  | $ | 41 |  |
| Asserted claims |  | **19** | |  |  | 25 | |  |
| Total liability |  | **$** | **56** |  |  | $ | 66 |  |

In 2012 and 2011, there were no significant changes in estimate of occupational or asbestos reserves.  A summary of occupational and asbestos claims activity is as follows:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  | **Fiscal Years** | | | | |
|  |  | **2012** | |  | 2011 | |
| **Asserted Claims** |  |  | |  |  | |
| Open Claims - Beginning of Year |  | **665** |  |  | 1,278 |  |
| New Claims Filed |  | **139** |  |  | 215 |  |
| Claims Settled |  | **(149** | **)** |  | (345 | ) |
| Claims Dismissed |  | **(214** | **)** |  | (483 | ) |
| Open Claims - End of Year |  | **441** |  |  | 665 |  |

***Environmental***

The Respondent is a party to various proceedings related to environmental issues, including administrative and judicial proceedings involving private parties and regulatory agencies. The Respondent has been identified as a potentially responsible party at approximately 248 environmentally impaired sites. Many of these are, or may be, subject to remedial action under the federal Comprehensive Environmental Response, Compensation and Liability Act of 1980, or CERCLA, also known as the Superfund Law, or similar state statutes.  Most of these proceedings arose from environmental conditions on properties used for ongoing or discontinued railroad operations.  A number of these proceedings, however, are based on allegations that the Respondent, or its predecessors, sent hazardous substances to facilities owned or operated by others for treatment, recycling or disposal.  In addition, some of the Respondent’s land holdings were leased to others for commercial or industrial uses that may have resulted in releases of hazardous substances or other regulated materials onto the property and could give rise to proceedings against the Respondent.

In any such proceedings, the Respondent is subject to environmental clean-up and enforcement actions under the Superfund Law, as well as similar state laws that may impose joint and several liability for clean-up and enforcement costs on current and former owners and operators of a site without regard to fault or the legality of the original conduct.  These costs could be substantial.

In accordance with the *Asset Retirement and Environmental Obligations Topic* in the ASC, the Respondent reviews its role with respect to each site identified at least quarterly, giving consideration to a number of factors such as:

* type of clean-up required;
* nature of the Respondent’s alleged connection to the location (e.g., generator of waste sent to the site or owner or operator of the site);
* extent of the Respondent’s alleged connection (e.g., volume of waste sent to the location and other relevant factors); and
* number, connection and financial viability of other named and unnamed potentially responsible parties at the location.

**NOTE 2.  Casualty, Environmental and Other Reserves,** *continued*

Based on the review process, the Respondent has recorded amounts to cover contingent anticipated future environmental remediation costs with respect to each site to the extent such costs are estimable and probable.  The recorded liabilities for estimated future environmental costs are undiscounted.  The liability includes future costs for remediation and restoration of sites as well as any significant ongoing monitoring costs, but excludes any anticipated insurance recoveries.  Payments related to these liabilities are expected to be made over the next several years.  Environmental remediation costs are included in the Schedule 410.

Currently, the Respondent does not possess sufficient information to reasonably estimate the amounts of additional liabilities, if any, on some sites until completion of future environmental studies.  In addition, conditions that are currently unknown could, at any given location, result in additional exposure, the amount and materiality of which cannot presently be reliably estimated.  Based upon information currently available, however, the Respondent believes its environmental reserves are adequate to fund the current remedial actions.

***Other***

Other reserves of $12 million and $20 million for 2012 and 2011, respectively, include liabilities for various claims, such as disability claims, freight claims and claims for property.  Separation liabilities and freight rate dispute reserves have been reclassified to other current liabilities and other long-term liabilities and deferred credits, which were not considered material to the consolidated financial statements.

**NOTE 3.  Commitments and Contingencies**

***Lease Commitments***

The Respondent has various lease agreements with other parties with terms up to 30 years.  Non-cancelable, long-term leases generally include provisions for maintenance, options to purchase and options to extend the terms.  The Respondent uses the straight-line method to recognize rent expense associated with operating leases that include escalations over their terms.

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Fiscal Years** | | | | | |
| *(Dollars in Millions)* |  | **2012** | |  | 2011 | |  | |
| Rent Expense on Operating Leases | $ | **7** |  | $ | 5 |  |  | |

At December 2012, minimum rentals on land, buildings, track and equipment under operating leases are disclosed in the table below.  Also, payments to Conrail, Inc. (“Conrail”) for leases on equipment and shared rail infrastructure are included in these amounts.

|  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| *(Dollars in Millions)* | | | | | | | | | | | | |
|  |  | **Operating** | | |  | **Sublease** | | |  | **Net Lease** | | |
| **Years** |  | Leases | | |  | **Income** | | |  | **Commitments** | | |
| 2013 |  | $ | 52 |  |  | $ | (2 | ) |  | $ | 50 |  |
| 2014 |  | 42 | |  |  | (2 | | ) |  | 40 | |  |
| 2015 |  | 35 | |  |  | — | |  |  | 35 | |  |
| 2016 |  | 33 | |  |  | — | |  |  | 33 | |  |
| 2017 |  | 28 | |  |  | — | |  |  | 28 | |  |
| Thereafter |  | 140 | |  |  | — | |  |  | 140 | |  |
| Total |  | $ | 330 |  |  | $ | (4 | ) |  | $ | 326 |  |

***Purchase Commitments***

CSXT has a commitment under a long-term maintenance program that currently covers 44% of CSXT’s fleet of locomotives.  The agreement is based on the maintenance cycle for each locomotive.  Under CSXT’s current obligations, the agreement will expire no earlier than 2031.  The costs expected to be incurred throughout the duration of the agreement fluctuate as locomotives are placed into or removed from service, or as required maintenance schedules are revised.  The table below includes both active and inactive locomotives covered under this agreement.

The following table summarizes the number of locomotives covered and CSXT’s payments under the long-term maintenance program.

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Fiscal Years** | | | | | | | |
| *(Dollars in Millions)* |  | **2012** | | |  | 2011 | | |  |
| Amounts Paid |  | **$** | **287** |  |  | $ | 281 |  |  |
| Number of Locomotives |  | **1,899** | |  |  | 1,928 | |  |  |

Annual payments related to the locomotive purchase obligations, including amounts that would be payable under the long-term maintenance program, are estimated in the table below. The amount of the ultimate purchase commitment depends upon the model of locomotive acquired and the timing of delivery.

**NOTE 3.  Commitments and Contingencies,** *continued*

Additionally, the Respondent has various other commitments to purchase railcar maintenance and other services from various suppliers.  Total annual payments under all of these purchase commitments are also estimated in the table below.

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| *(Dollars in Millions)* | **Locomotive & Maintenance Payments** | | |  | **Other**  **Commitments** | | |  | **Total** | | |
| 2013 | $ | 472 |  |  | $ | 254 |  |  | $ | 726 |  |
| 2014 | 347 | |  |  | 111 | |  |  | 458 | |  |
| 2015 | 263 | |  |  | 27 | |  |  | 290 | |  |
| 2016 | 257 | |  |  | 14 | |  |  | 271 | |  |
| 2017 | 247 | |  |  | 5 | |  |  | 252 | |  |
| Thereafter | 1,833 | |  |  | 53 | |  |  | 1,886 | |  |
| Total | $ | 3,419 |  |  | $ | 464 |  |  | $ | 3,883 |  |

***Insurance***

The Respondent maintains numerous insurance programs with substantial limits for property damage (which includes business interruption) and third-party liability.  A certain amount of risk is retained by the Respondent on each of the liability and property programs.  The Respondent has a $25 million retention per occurrence for the non-catastrophic property program (such as a derailment) and a $50 million retention per occurrence for the liability and catastrophic property programs (such as hurricanes and floods).

While the Respondent’s current insurance coverage is adequate to cover its damages, future claims could exceed existing insurance coverage or insurance may not continue to be available at commercially reasonable rates.

***Collective Bargaining Agreements***

Most of CSXT's employees are represented by labor unions and are covered by collective bargaining agreements. The majority of these agreements are bargained for nationally by the National Carriers Conference Committee and negotiated over the course of several years and previously have not resulted in any extended work stoppages. Under the Railway Labor Act's procedures (which include mediation, cooling-off periods and the possibility of Presidential intervention), during negotiations neither party may take action until the procedures are exhausted. If, however, CSXT is unable to negotiate acceptable agreements, or if terms of existing agreements are disputed, the employees covered by the Railway Labor Act could strike, which could result in loss of business and increased operating costs as a result of higher wages or benefits paid to union members.

***Fuel Surcharge Antitrust Litigation***

In May 2007, class action lawsuits were filed against CSXT and three other U.S.-based Class I railroads alleging that the defendants' fuel surcharge practices relating to contract and unregulated traffic resulted from an illegal conspiracy in violation of antitrust laws. In November 2007, the class action lawsuits were consolidated and are now pending in federal court in the District of Columbia. The suit seeks treble damages allegedly sustained by purported class members as well as attorneys' fees and other relief. Plaintiffs are expected to allege damages at least equal to the fuel surcharges at issue.

On June 21, 2012, the court certified the case as a class action. The decision was not a ruling on the merits of plaintiffs' claims, rather a decision to allow the plaintiffs to seek to prove the case as a class. The defendant railroads petitioned the U.S. Court of Appeals for the D.C. Circuit for permission to appeal the District Court's class certification decision. On August 28, 2012, the Court of Appeals referred the petition to a merits panel, and directed that the parties to the case submit briefs addressing both the petition and the merits of the appeal. The District Court stayed dissemination of notice to members of the class certified pending the outcome of the appeal.

CSXT believes that its fuel surcharge practices were arrived at and applied lawfully and that the case is without merit. Accordingly, the Company intends to defend itself vigorously. However, penalties for violating antitrust laws can be severe, and an unexpected adverse decision on the merits could have a material adverse effect on the Company's financial condition, results of operations or liquidity in that particular period or for the full year.

***Other Legal Proceedings***

In addition to the matters described above, the Respondent is involved in litigation incidental to its business and is a party to a number of legal actions and claims, various governmental proceedings and private civil lawsuits, including, but not limited to, those related to environmental and hazardous material exposure matters, FELA claims by employees, other personal injury or property claims and disputes and complaints involving certain transportation rates and charges. Some of the legal proceedings include claims for compensatory as well as punitive damages and others are, or are purported to be, class actions. While the final outcome of these matters cannot be predicted with certainty, considering, among other things, the legal defenses available and liabilities that have been recorded along with applicable insurance, it is currently the opinion of CSXT management that none of these pending items will have a material adverse effect on the Respondent's financial condition, results of operations or liquidity. An unexpected adverse resolution of one or more of these items, however, could have a material adverse effect on the Respondent's financial condition, results of operations or liquidity in that particular period.

The Company is able to estimate a range of possible loss for certain legal proceedings for which a loss is reasonably possible in excess of reserves established. The Company has estimated this range to be $3 million to approximately $20 million in aggregate at December 28, 2012. This estimated aggregate range is based upon currently available information and is subject to significant judgment and a variety of assumptions. Accordingly, the Company's estimate will change from time to time, and actual losses may vary significantly from the current estimate.

**NOTE 4.** **Employee Benefit Plans**

***Pension and Other Postretirement Benefit Plans***

The Respondent, in conjunction with CSX, sponsors defined benefit pension plans principally for salaried, management personnel.  For employees hired on or before December 31, 2002, the plans provide eligible employees with retirement benefits based predominantly on years of service and compensation rates near retirement. For employees hired in 2003 or thereafter,, benefits are determined based on a cash balance formula, which provides benefits by utilizing interest and pay credits based upon age, service and compensation. CSX allocates to the Respondent a portion of the pension expense or benefit for the CSX pension plans based on the Respondent’s relative level of participation. In addition, the Respondent sponsors one pension plan for retired United Transportation Union employees. The expenses for this plan along with the allocated expenses from the various CSX pension plans amounted to $49 million and $43 million in 2012 and 2011, respectively.

In addition to these plans, the Respondent sponsors a self-insured, post-retirement medical plan and a life insurance plan that provide benefits to full-time, salaried, management employees, hired prior to January 1, 2003, upon their retirement, if certain eligibility requirements are met.  Prior to 2011, the post-retirement medical plan was partially funded by all participating retirees, with retiree contributions adjusted annually.  Beginning in 2011, Medicare-eligible retirees are covered by a health reimbursement arrangement, which is an employer-funded account that can be used for reimbursement of eligible medical expenses. Non-Medicare eligible retirees will continue to be covered by the existing self-insured program. The life insurance plan is non-contributory. CSX allocates to the Respondent a portion of the expense for these plans based on the Respondent’s relative level of participation. The allocated expense amounted to $25 million and $17 million in 2012 and 2011, respectively.

The Respondent engages independent, external actuaries to compute the amounts of liabilities and expenses relating to these plans subject to the assumptions that the Respondent selects.

The benefit obligation for these plans represents the liability of the Respondent for current and retired employees and is affected primarily by the following:

* service cost (benefits attributed to employee service during the period);
* interest cost (interest on the liability due to the passage of time);
* actuarial gains/losses (experience during the year different from that assumed and changes in plan assumptions); and
* benefits paid to participants.

***Other Plans***

Under collective bargaining agreements, the Respondent participates in a multi-employer benefit plan, which provides certain post-retirement health care and life insurance benefits to eligible contract employees. Premiums under this plan are expensed as incurred and amounted to $46 million and $48 million in 2012 and 2011, respectively.

The Respondent maintains savings plans for virtually all full-time salaried employees and certain employees covered by collective bargaining agreements.  Expense associated with these plans was $26 million and $25 million for 2012 and 2011, respectively.

Certain officers and key employees of the Respondent participate in stock performance and award plans of CSX. The Respondent is allocated its share of any cost to participate in these plans. Those amounts were $5 million and $14 million for 2012 and 2011, respectively.

**NOTE 5.  Debt Agreements**

Debt was as follows:

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  |  |  | **Average**  **Interest**  **Rates at**  **December 28,** | |  | **December 28,** | | |  | December 30, | | |
| *(Dollars in Millions)* |  | **Maturity** |  | **2012** | |  | **2012** | | |  | 2011 | | |
| Equipment Obligations |  | 2012-2023 |  | 7.2 | % |  | **$** | **666** |  |  | $ | 741 |  |
| Notes*(a)* |  | 2012-2043 |  | 7.1 | % |  | **536** | |  |  | 481 | |  |
| Capital Leases |  | 2012-2017 |  | 11.1 | % |  | **12** | |  |  | 7 | |  |
| Total Long-term Debt (including current portion) |  |  |  |  | |  | **$** | **1,214** |  |  | $ | 1,229 |  |
| Less Debt Due within One Year |  |  |  |  | |  | **(67** | | **)** |  | (105 | | ) |
| Total Long-term Debt (excluding current portion) |  |  |  |  | |  | **$** | **1,147** |  |  | $ | 1,124 |  |

1. *2012 notes include $100 million of demand loans with a subsidiary of P&L Transportation, Inc. For additional information see Note 6 Related Party Transactions.*

***Fair Value Measurements***

The *Financial Instruments Topic* in the ASC requires disclosures about fair value of financial instruments in annual reports as well as in quarterly reports.  For the Respondent, this statement applies to certain investments, pension plan assets and long-term debt.  Also, the *Fair Value Measurements and Disclosures Topic* in the ASC clarifies the definition of fair value for financial reporting, establishes a framework for measuring fair value and requires additional disclosures about the use of fair value measurements.

**NOTE 5.  Debt Agreements,** *continued*

Various inputs are considered when determining the value of the Respondent's investments, pension plan assets and long-term debt.  The inputs or methodologies used for valuing securities are not necessarily an indication of the risk associated with investing in these securities.  These inputs are summarized in the three broad levels listed below.

* Level 1 – observable market inputs that are unadjusted quoted prices for identical assets or liabilities in active markets
* Level 2 – other significant observable inputs (including quoted prices for similar securities, interest rates, credit risk, etc.)
* Level 3 – significant unobservable inputs (including the Respondent’s own assumptions in determining the fair value of investments)

The valuation methods described below may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Respondent believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

Long-term debt is reported at carrying amount on the Schedule 200 and is the Respondent's only financial instrument with fair values significantly different from their carrying amounts.  The majority of the Respondent's long-term debt is valued with assistance from an independent third party. For those investments not valued by the third party, the fair value has been estimated by applying market rates of similar instruments to the scheduled contractual debt payments and maturities.  These market rates are provided by the same third party. All of the inputs used to determine the fair value of the Respondent's long-term debt are Level 2 inputs.

The fair value of outstanding debt fluctuates with changes in a number of factors.  Such factors include, but are not limited to, interest rates, market conditions, values of similar financial instruments, size of the transaction, cash flow projections and comparable trades.  Fair value will exceed carrying value when the current market interest rate is lower than the interest rate at which the debt was originally issued.  The fair value of a company's debt is a measure of its current value under present market conditions.  It does not impact the financial statements under current accounting rules.  [The fair value and carrying value of the Respondent's long-term debt is as follows:](file:///\\Cjax5006fs\corpacctfinn\02%20ACCOUNTING%20&%20REPORTING\01%20A&R\02%20Reporting\6%20STB%20Reporting\1%20R-1\2012\03%20Support\2012%20200%20Note%205-LT%20Debt%20FMV.xls#'10-K Disclosure'!a14:i22)

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| *(Dollars in Millions)* |  | **December 2012** | | |  | December 2011 | | |
| Long-term Debt Including Current Maturities: |  |  | | |  |  | | |
| Fair Value |  | **$** | **1,482** |  |  | $ | 1,477 |  |
| Carrying Value |  | **$** | **1,214** |  |  | $ | 1,229 |  |

***Long-term Debt Maturities***

|  |  |  |  |
| --- | --- | --- | --- |
| *(Dollars in Millions)* |  | **Maturities as of** | |
| **Fiscal Years Ending** |  | **December 2012** | |
| 2013 |  | $ | 67 |  |
| 2014 |  | 427 | |  | |
| 2015 |  | 29 | |  | |
| 2016 |  | 20 | |  | |
| 2017 |  | 19 | |  | |
| 2018 and Thereafter |  | 652 | |  | |
| Total Long-term Debt Maturities (including current portion) |  | $ | 1,214 |  |

**NOTE 6.  Related Party Transactions**

The Respondent had a receivable of $1,270 million and $1,069 million in 2012 and 2011, respectively, relating to the Respondent’s participation in the CSX cash management plan. The receivable is included in Receivables from Affiliated Companies in the Schedule 200. Under this plan, excess cash is advanced to CSX for investment and CSX makes cash funds available to its subsidiaries as needed for use in their operations. The Respondent and CSX are committed to repay all amounts due each other on demand should circumstances require. The companies are charged for borrowings or compensated for investments based on the short-term applicable Federal rate, which was 0.24% and 0.2% as of the end of 2012, and 2011, respectively. Net interest income related to this plan was $2 million in 2012 and 2011, respectively.

**NOTE 6.  Related Party Transactions,** *continued*

**Detail of Related Party Service Fees (Proceeds)**

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **Fiscal Years** | | | | | | | |
| *(Dollars in Millions)* |  | **2012** | | |  | 2011 | | |  |
| Intermodal Terminals |  | **$** | **576** |  |  | $ | 530 |  |  |
| CSX Management Service Fee |  | **456** | |  |  | 387 | |  |  |
| CSX Technology |  | **231** | |  |  | 193 | |  |  |
| TDSI |  | **75** | |  |  | 63 | |  |  |
| Other |  | **46** | |  |  | 46 | |  |  |
| Total Related Party Service Fees (Proceeds) |  | **$** | **1,384** |  |  | $ | 1,219 |  |  |

Related Party Service Fees (Proceeds) consists of amounts related to:

* CSX Intermodal Terminals, Inc. (“Intermodal Terminals”) – Charges from Intermodal Terminals for services provided to the Respondent at intermodal terminal locations. These charges are calculated based on direct costs.
* CSX Management Service Fee – A management service fee charged by CSX as compensation for certain corporate services provided to the Respondent. These services include, but are not limited to, the areas of human resources, finance, administration, benefits, legal, tax, internal audit, corporate communications, risk management and strategic management services. The fee is calculated as a percentage of the Respondent’s revenue.
* CSX Technology, Inc. (“CSX Technology”) Charges – Data processing charges from CSX Technology for the development, implementation and maintenance of computer systems, software and associated documentation for the day-to-day operations of the Respondent. These charges are based on a mark-up of direct costs.
* Total Distribution Services, Inc. (“TDSI”) Charges – Charges from TDSI for services provided to the Respondent at automobile ramps. These charges are calculated based on direct costs.
* Other consists of premiums paid to CSX Insurance Company (“CSX Insurance”) for personal injury coverage and proceeds from specialized services billed to TRANSFLO Corporation (“TRANSFLO”).

Intermodal Terminals, CSX Technology, TDSI, CSX Insurance, and TRANSFLO are wholly owned subsidiaries of CSX.

**Detail of Payables (Receivables) to Affiliated Companies**

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **December** | | | |  | December | | | |
| *(Dollars in Millions)* |  | **2012** | | | |  | 2011 | | | |
| CSX Corporation |  | **$** | **(1,131** | **)** | |  | $ | (928 | ) | |
| CSX Trade Receivables |  |  | **(467** | | **)** |  |  | (576 | | ) |
| CSX Technology |  |  | **157** |  | |  |  | 157 |  | |
| Intermodal Terminals |  |  | **45** |  | |  |  | (67 | ) | |
| Other |  |  | **10** |  | |  |  | 17 |  | |
| Total Payable/(Receivable) to/from Affiliated Companies |  | **$** | **(1,386** | **)** | |  | $ | (1,397 | ) | |

The Respondent has an agreement to transfer eligible third-party receivables to CSX Trade Receivables, Inc., a bankruptcy-remote special purpose subsidiary of CSX. A separate subsidiary of CSX, CSX Business Management, Inc. will service the receivables. Upon transfer, the receivables become assets of CSX Trade Receivables, Inc. and are shown above.

The Respondent and CSX Insurance have entered into a loan agreement whereby the Respondent may borrow up to $125 million from CSX Insurance. The loan is payable in full on demand. $55 million was outstanding under the agreement for both 2012 and 2011, respectively. Interest on the loan is payable monthly at 0.45% over the LIBOR rate, which was 0.66% and 0.72% at the end of 2012 and 2011, respectively. Interest expense related to the loan was $0.4 million for both 2012 and 2011, respectively.

As required by the *Related Party Disclosures Topic* in the ASC, the Respondent has identified amounts below owed to Conrail, or its subsidiaries, representing a promissory note as well as liabilities under the operating, equipment and shared area agreements with Conrail.   Additionally, as a result of the change in consolidated R-1 reporting in 2012, the table below discloses a demand loan with a subsidiary of P&L Transportation, Inc., originally executed in 2011. See Note 1. Nature of Operations and Significant Accounting Policies for additional information on the principles of consolidation.

**NOTE 6.  Related Party Transactions,** *continued*

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | **December** | | |  | December | | |
| *(Dollars in Millions)* |  | **2012** | | |  | 2011 | | |
| **Balance Sheet Information:** |  |  | | |  |  | | |
| CSXT Payable to Conrail *(a)* |  | **$** | **175** |  |  | $ | 143 |  |
| Promissory Notes Payable to Conrail Subsidiary |  |  | | |  |  | | |
| 4.52% CSXT Promissory Note due March 2035 *(b)* |  | **$** | **23** |  |  | $ | 23 |  |
|  |  |  |  |  |  |  |  |  |
| Demand Loan to P&L Transportation, Inc. Subsidiary  Variable interest rate CSXT Promissory Note due January 2014 |  | **$** | **100** |  |  | $ | - |  |

*(a) Included on the Schedule 200 as accrued accounts payable because it is short term in nature.*

*(b) Included on the Schedule 200 as funded debt unmatured.*

Interest expense from the promissory notes payable to a Conrail subsidiary was $1 million for 2012 and 2011, respectively. Interest expense from the demand loan payable to a subsidiary of P&L Transportation, Inc. was less than $1 million for 2012.