Sale of Accounts Receivable

NS Rail sells, without recourse, to a bankruptcy-remote special-purpose NS subsidiary, a pool of accounts receivable. NS Rail services and collects the sold receivables; however, no servicing asset or liability has been recognized because the benefits of servicing are estimated to be just adequate to compensate NS Rail for its responsibilities. Payments collected from sold receivables are remitted to the special-purpose NS subsidiary, which, in turn, reinvests the amounts by purchasing new receivables from NS Rail. NS Rail has no retained interest in the sold receivables. Under the terms of the sale agreement, the receivables are treated as sold and, accordingly, $653 million at Dec. 31, 2007, and $692 million at Dec. 31, 2006, of sold receivables are not included in the Balance Sheet of NS Rail. Fees associated with the sale, which are based on historical dilution and prevailing interest rates, are included in Account 551.

Intercompany Federal Income Tax Accounts

In accordance with the NS Tax Allocation Agreement, intercompany federal income tax accounts are recorded between companies in the NS consolidated group. NS Rail had long-term intercompany federal income tax payables (which are included in "Deferred income taxes" in the Combined Balance Sheets) of $1,325 million at Dec. 31, 2007, and $1,230 million at Dec. 31, 2006.

Cash Required for NS Debt

To finance the cost of the original Conrail transaction, NS issued and sold commercial paper and $4.3 billion of unsecured notes. A significant portion of the funding for the interest and repayments on this and other NS debt is expected to be provided by NS Rail.

NS is subject to various financial covenants with respect to its debt and under its credit agreement, including a maximum leverage ratio restriction and certain restrictions on issuance of further debt. As a major NS subsidiary, NS Rail is subject to certain of those covenants.

14. Operation over Conrail's Lines

Through a limited liability company, NS and CSX Corporation (CSX) jointly own Conrail Inc. (Conrail), whose primary subsidiary is Consolidated Rail Corporation (CRC). NS has a 58% economic and 50% voting interest in the jointly owned entity, and CSX has the remainder of the economic and voting interests. CRC owns and operates certain properties (the Shared Assets Areas) for the joint and exclusive benefit of NSR and CSX Transportation, Inc. (CSXT). The costs of operating the Shared Assets Areas are borne by NSR and CSXT based on usage. Future minimum lease payments due to CRC under the Shared Assets Areas agreements are $28 million in each of 2008 through 2012 and $317 million thereafter. In addition, NSR and CSXT pay CRC a fee for access to the Shared Assets Areas. Railway Operating Expenses include expenses for amounts due to CRC for operation of the Shared Assets Areas of $126 million in 2007 and 2006, and $129 million in 2005.

15. Derivative Financial Instruments

All derivatives are recognized in the financial statements as either assets or liabilities and are measured at fair value. Changes in fair value are recorded as adjustments to the assets or liabilities being hedged in "Other comprehensive income," or in current earnings, depending on whether the derivative is designated and qualifies for hedge accounting, the type of hedge transaction represented and the effectiveness of the hedge.

NS Rail has used derivative financial instruments to reduce the risk of volatility in its diesel fuel costs and to manage its overall exposure to fluctuations in interest rates. NS Rail does not engage in the trading of derivatives. Management has determined that its derivative financial instruments qualify as either fair-value or cash-flow hedges, having values that highly correlate with the underlying hedged exposures, and has designated such instruments as hedging transactions. Credit risk related to the derivative financial instruments is considered to be minimal and is managed by requiring high credit standards for counterparties and periodic settlements.

Diesel Fuel Hedging

From 2001 until May 2004, NS Rail entered into contracts that hedged a portion of its diesel fuel consumption. The intent of the program was to assist in the management of NS Rail's aggregate risk exposure to fuel price fluctuations, which can significantly affect NS Rail's operating margins and profitability, through the use of one or more types of derivative instruments. The goal of this hedging strategy was to reduce the variability of fuel costs over an extended period of time while minimizing the incremental cost of hedging. The program provided that NS Rail would not enter into any fuel hedges with a duration of more than 36 months, and that no more than 80% of NS Rail's average monthly fuel consumption would be hedged for any month within any 36-month period. After taking into account the effect of the hedging, diesel fuel costs represented 15% and 14% of NS Rail's operating expenses for the years ended Dec. 31, 2007 and 2006, respectively. The last remaining contracts were settled in the second quarter of 2006, bringing an end to this program.

NS Rail's fuel hedging activity resulted in decreases in diesel fuel expenses of $20 million in 2006 and $148 million in 2005. Ineffectiveness, or the extent to which changes in the fair value of the heating oil contracts do not offset changes in the fair values of the expected diesel fuel transactions, was a $1 million expense in 2006 and a $5 million expense in 2005.

Interest Rate Hedging

NS Rail manages its overall exposure to fluctuations in interest rates by issuing both fixed and floating-rate debt instruments, and by entering into interest rate hedging transactions to achieve an appropriate mix within its debt portfolio. NS Rail had $59 million, or 8%, and $83 million, or 10%, of its fixed rate debt portfolio hedged as of Dec. 31, 2007, and Dec. 31, 2006, respectively, using interest rate swaps that qualify for and are designated as fair-value hedge transactions. NS Rail's interest rate hedging activity resulted in decreases in interest expenses of $1 million for 2007 and 2006, and $2 million for 2005. These swaps have been effective in hedging the changes in fair value of the related debt arising from changes in interest rates and there has been no impact on earnings resulting from ineffectiveness associated with these derivative transactions.