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**UNION PACIFIC RAILROAD COMPANY and  
CONSOLIDATED SUBSIDIARY COMPANIES**

**Condensed Consolidated Financial Statements as of  
June 30, 2008 and 2007 and  
for the Three and Six Months Ended June 30, 2008 and 2007**

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**UNION PACIFIC RAILROAD COMPANY and  
CONSOLIDATED SUBSIDIARY COMPANIES**

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**Condensed Consolidated Statements of Income (Unaudited)***Union Pacific Railroad Company and Consolidated Subsidiary Companies*

<i>Millions, for the Three Months Ended June 30,</i>	<b>2008</b>	2007
Operating revenues:		
Freight revenues.....	<b>\$4,349</b>	\$3,853
Other revenues .....	<b>208</b>	185
Total operating revenues.....	<b>4,557</b>	4,038
Operating expenses:		
Compensation and benefits .....	<b>1,084</b>	1,130
Fuel .....	<b>1,159</b>	753
Purchased services and materials.....	<b>489</b>	476
Depreciation.....	<b>346</b>	327
Equipment and other rents .....	<b>337</b>	353
Other .....	<b>213</b>	213
Total operating expenses.....	<b>3,628</b>	3,252
Operating income.....	<b>929</b>	786
Other income.....	<b>14</b>	25
Interest expense.....	<b>(106)</b>	(111)
Income before income taxes .....	<b>837</b>	700
Income taxes .....	<b>(305)</b>	(245)
Net income.....	<b>\$ 532</b>	\$ 455

*The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.*

**Condensed Consolidated Statements of Income (Unaudited)**  
*Union Pacific Railroad Company and Consolidated Subsidiary Companies*

<i>Millions, for the Six Months Ended June 30,</i>	<b>2008</b>	2007
Operating revenues:		
Freight revenues.....	<b>\$8,408</b>	\$7,508
Other revenues .....	<b>408</b>	370
Total operating revenues.....	<b>8,816</b>	7,878
Operating expenses:		
Compensation and benefits .....	<b>2,202</b>	2,281
Fuel .....	<b>2,116</b>	1,415
Purchased services and materials.....	<b>954</b>	917
Depreciation.....	<b>686</b>	652
Equipment and other rents .....	<b>678</b>	691
Other .....	<b>465</b>	419
Total operating expenses.....	<b>7,101</b>	6,375
Operating income.....	<b>1,715</b>	1,503
Other income.....	<b>33</b>	32
Interest expense.....	<b>(216)</b>	(223)
Income before income taxes .....	<b>1,532</b>	1,312
Income taxes .....	<b>(548)</b>	(480)
Net income.....	<b>\$ 984</b>	\$ 832

*The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.*

## Condensed Consolidated Statements of Financial Position (Unaudited)

Union Pacific Railroad Company and Consolidated Subsidiary Companies

<i>Millions of Dollars</i>	<i>Jun. 30, 2008</i>	<i>Dec. 31, 2007</i>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents .....	\$ 331	\$ 256
Accounts receivable, net.....	699	604
Materials and supplies .....	580	453
Current deferred income taxes.....	403	393
Other current assets .....	310	261
<b>Total current assets .....</b>	<b>2,323</b>	1,967
Investments.....	967	923
Net properties (note 8).....	34,951	34,148
Other assets.....	298	314
<b>Total assets .....</b>	<b>\$ 38,539</b>	\$ 37,352
<b>Liabilities and Common Shareholders' Equity</b>		
Current liabilities:		
Accounts payable and other current liabilities (note 9) .....	\$ 2,962	\$ 2,677
Debt due within one year.....	145	139
<b>Total current liabilities .....</b>	<b>3,107</b>	2,816
Intercompany borrowings from UPC .....	4,315	4,415
Debt due after one year.....	1,567	1,506
Deferred income taxes .....	10,139	9,965
Other long-term liabilities .....	1,869	1,868
Commitments and contingencies (note 12)		
<b>Total liabilities.....</b>	<b>20,997</b>	20,570
Common shareholders' equity: (note 13)		
Common shares, \$10.00 par value, 9,200 authorized; 4,465 outstanding, .....	-	-
Class A stock, \$10.00 par value, 800 authorized; 388 outstanding, .....	-	-
Paid-in-surplus.....	4,782	4,782
Retained earnings .....	12,829	12,074
Accumulated other comprehensive loss (note 7).....	(69)	(74)
<b>Total common shareholders' equity .....</b>	<b>17,542</b>	16,782
<b>Total liabilities and common shareholders' equity.....</b>	<b>\$ 38,539</b>	\$ 37,352

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

**Condensed Consolidated Statements of Cash Flows (Unaudited)**  
*Union Pacific Railroad Company and Consolidated Subsidiary Companies*

<i>Millions of Dollars, for the Six Months Ended June 30,</i>	<b>2008</b>	<b>2007</b>
<b>Operating Activities</b>		
Net income .....	<b>\$ 984</b>	\$ 832
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation .....	<b>686</b>	652
Deferred income taxes and unrecognized tax benefits .....	<b>165</b>	94
Stock-based compensation expense .....	<b>22</b>	16
Net gain from asset sales .....	<b>(19)</b>	(17)
Other operating activities, net .....	<b>(10)</b>	(215)
Changes in current assets and liabilities, net .....	<b>14</b>	91
Cash provided by operating activities .....	<b>1,842</b>	1,453
<b>Investing Activities</b>		
Capital investments .....	<b>(1,324)</b>	(1,101)
Proceeds from asset sales .....	<b>45</b>	41
Other investing activities .....	<b>(59)</b>	(48)
Cash used in investing activities .....	<b>(1,338)</b>	(1,108)
<b>Financing Activities</b>		
Dividends paid to UPC .....	<b>(229)</b>	(190)
Debt repaid .....	<b>(97)</b>	(84)
Intercompany payments .....	<b>(100)</b>	(106)
Other financing activities .....	<b>(3)</b>	3
Cash used in financing activities .....	<b>(429)</b>	(377)
Net change in cash and cash equivalents .....	<b>75</b>	(32)
Cash and cash equivalents at beginning of year .....	<b>256</b>	400
Cash and cash equivalents at end of period .....	<b>\$ 331</b>	\$ 368
<b>Changes in Current Assets and Liabilities</b>		
Accounts receivable, net .....	<b>\$ (95)</b>	\$ (37)
Materials and supplies .....	<b>(127)</b>	(50)
Other current assets .....	<b>(49)</b>	(44)
Accounts payable and other current liabilities .....	<b>285</b>	222
Total .....	<b>\$ 14</b>	\$ 91
<b>Supplemental Cash Flow Information</b>		
Non-cash investing and financing activities:		
Capital investments accrued but not yet paid .....	<b>\$ 93</b>	\$ 70
Capital lease financings .....	<b>175</b>	41
Cash paid during the year for:		
Interest, net of amounts capitalized .....	<b>\$ (225)</b>	\$ (227)
Income taxes, net of refunds .....	<b>(191)</b>	(393)

*The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.*

**Condensed Consolidated Statements of Changes in Common Shareholders' Equity (Unaudited)**  
*Union Pacific Railroad Company and Consolidated Subsidiary Companies*

<i>Millions of Dollars Thousands of Shares</i>	<i>Common Shares</i>	<i>Treasury Shares</i>	<i>Common Shares</i>	<i>Paid-in- Surplus</i>	<i>Paid-in- Surplus</i>	<i>Retained Earnings</i>	<i>Accumulated Other Comprehensive Income/(Loss) (note 7)</i>	<i>Total</i>
Balance at December 31, 2006.....	4,465	388	\$-	\$-	\$4,782	\$10,661	\$(142)	\$15,301
Cumulative effect of adoption of FIN 48.....	-	-	-	-	-	(35)	-	(35)
Balance at January 1, 2007.....	4,465	388	\$-	\$-	\$4,782	\$10,626	\$(142)	\$15,266
Comprehensive income:								
Net income.....			-	-	-	832	-	832
Other comp. income.....			-	-	-	-	5	5
Total comp. income (note 7).....			-	-	-	832	5	837
Dividends declared.....	-	-	-	-	-	(190)	-	(190)
Balance at June 30, 2007.....	4,465	388	\$-	\$-	\$4,782	\$11,268	\$(137)	\$15,913
Balance at January 1, 2008.....	4,465	388	\$-	\$-	\$4,782	\$12,074	\$(74)	\$16,782
Comprehensive income:								
Net income.....			-	-	-	984	-	984
Other comp. income.....			-	-	-	-	5	5
Total comp. income (note 7).....			-	-	-	984	5	989
Dividends declared.....	-	-	-	-	-	(229)	-	(229)
<b>Balance at June 30, 2008.....</b>	<b>4,465</b>	<b>388</b>	<b>\$-</b>	<b>\$-</b>	<b>\$4,782</b>	<b>\$12,829</b>	<b>\$(69)</b>	<b>\$17,542</b>

*The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.*

# UNION PACIFIC RAILROAD COMPANY AND CONSOLIDATED SUBSIDIARY COMPANIES

## NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

For purposes of this report, unless the context otherwise requires, all references herein to the “Company”, “we”, “us”, and “our” mean Union Pacific Railroad Company and Consolidated Subsidiary Companies. Union Pacific Railroad Company, together with our wholly-owned and majority-owned subsidiaries, is an indirect wholly-owned subsidiary of Union Pacific Corporation, herein “the Corporation” or “UPC”.

**1. Responsibilities for Financial Statements** – Union Pacific Railroad Company (the Company), a Class I railroad incorporated in Delaware and an indirect wholly-owned subsidiary of Union Pacific Corporation, together with a number of wholly-owned and majority owned subsidiaries, operates various railroad and railroad-related businesses. Our Condensed Consolidated Financial Statements are unaudited and reflect all adjustments (consisting only of normal and recurring adjustments) that are, in the opinion of management, necessary for their fair presentation in conformity with accounting principles generally accepted in the United States of America. Our Consolidated Statement of Financial Position at December 31, 2007, is derived from audited financial statements. This Quarterly Report should be read in conjunction with our annual Consolidated Financial Statements and notes thereto contained in our 2007 Consolidated Financial Statements. The results of operations for the three and six months ended June 30, 2008, are not necessarily indicative of the results for the entire year ending December 31, 2008.

Certain prior year amounts have been reclassified to conform to the current period financial statement presentation. The reclassifications include reporting freight revenues instead of commodity revenues. The amounts reclassified from freight revenues to other revenues totaled \$12 million and \$9 million for the three months and six months ended June 30, 2007. In addition, we modified our operating expense categories to report fuel used in railroad operations as a stand-alone category, to combine purchased services and materials into one line, and to reclassify certain other expenses among operating expense categories. These reclassifications had no impact on previously reported operating revenues, total operating expenses, operating income or net income.

**2. Operations and Segmentation** – We are a Class I railroad operating in the United States. We have one reportable operating segment. Although revenue is analyzed by commodity group, we analyze the net financial results as one segment due to the integrated nature of our rail network. The following table provides freight revenues by commodity group:

<i>Millions of Dollars</i>	<i>Three Months Ended</i>		<i>Six Months</i>	
	<i>2008</i>	<i>June 30, 2007</i>	<i>Ended June 30, 2008</i>	<i>2007</i>
Agricultural .....	\$ 778	\$ 605	\$1,534	\$1,216
Automotive .....	352	387	715	741
Chemicals.....	654	574	1,257	1,118
Energy .....	919	761	1,776	1,492
Industrial Products .....	877	805	1,650	1,546
Intermodal .....	769	721	1,476	1,395
Total freight revenues .....	4,349	3,853	8,408	7,508
Other revenues .....	208	185	408	370
Total operating revenues .....	\$4,557	\$4,038	\$8,816	\$7,878



**3. Stock-Based Compensation** – On May 28, 2008, UPC completed a two-for-one stock split, effected in the form of a 100% stock dividend. The stock split entitled all UPC shareholders of record at the close of business on May 12, 2008, to receive one additional share of UPC’s common stock, par value \$2.50 per share, for each share of common stock held on that date. All references to common shares and per share amounts in this footnote, have been restated to reflect the stock split for all periods presented. We participate in the Corporation’s stock incentive programs. The Corporation has several stock-based compensation plans under which our employees receive stock options, nonvested retention shares, and nonvested stock units. We refer to the nonvested shares and stock units collectively as “retention awards.” New shares are issued when retention shares vest. Information regarding stock-based compensation appears in the table below:

<i>Millions of Dollars</i>	<i>Three Months Ended</i>		<i>Six Months Ended</i>	
	<i>2008</i>	<i>June 30, 2007</i>	<i>2008</i>	<i>June 30, 2007</i>
Stock-based compensation, before tax:				
Stock options .....	<b>\$ 4</b>	\$4	<b>\$ 8</b>	\$ 7
Retention awards .....	<b>8</b>	4	<b>14</b>	9
Total stock-based compensation, before tax .....	<b>\$12</b>	\$8	<b>\$22</b>	\$16

**Stock Options** – The fair value of our stock options is estimated using the Black-Scholes option pricing model. Groups of employees that have similar historical and expected exercise behavior are considered separately for valuation purposes. The table below shows the year-to-date weighted-average assumptions used for valuation purposes:

<i>Weighted-Average Assumptions</i>	<i>Six Months Ended</i>	
	<i>2008</i>	<i>June 30, 2007</i>
Risk-free interest rate .....	<b>2.8%</b>	4.9%
Dividend yield .....	<b>1.4%</b>	1.4%
Expected life (years) .....	<b>5.3</b>	4.7
Volatility .....	<b>22.2%</b>	20.9%
Weighted-average grant-date fair value of options granted .....	<b>\$13.35</b>	\$11.17

The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant; the dividend yield is calculated as the ratio of dividends paid per share of common stock to the stock price on the date of grant; the expected life is based on historical and expected exercise behavior; and volatility is based on the historical volatility of our stock price over the expected life of the option.

Stock options are granted at the closing price on the date of grant, have ten-year contractual terms, and vest no later than three years from the date of grant. None of the stock options outstanding at June 30, 2008 are subject to performance or market-based vesting conditions.

At June 30, 2008, there was \$22 million of unrecognized compensation expense related to nonvested stock options, which is expected to be recognized over a weighted-average period of 1.3 years. Additional information regarding stock option exercises appears in the table below:

<i>Millions of Dollars</i>	<i>Three Months Ended</i>		<i>Six Months Ended</i>	
	<i>2008</i>	<i>June 30, 2007</i>	<i>2008</i>	<i>June 30, 2007</i>
Intrinsic value of stock options exercised .....	<b>\$68</b>	\$42	<b>\$99</b>	\$73
UPC tax benefit realized from option exercises .....	<b>25</b>	16	<b>37</b>	27
Aggregate grant-date fair value of stock options vested .....	-	-	<b>15</b>	6

**Retention Awards** – The fair value of retention awards is based on the closing price of the stock at the grant date. Dividend equivalents are paid to participants during the vesting periods. Retention awards are granted at no cost to the employee or non-employee director and vest over periods lasting up to four years. At June 30, 2008, there was \$58 million of total unrecognized compensation expense related to nonvested retention awards, which is expected to be recognized over a weighted-average period of 2.4 years.

**Performance Retention Awards** – In January 2008, the Corporation’s Board of Directors approved performance stock unit grants. Other than higher performance targets, the basic terms of these performance stock units are identical to those granted in January 2006 and January 2007, including using annual return on invested capital (ROIC) as the performance measure. Stock units awarded to selected employees under these grants are subject to continued employment for 37 months and the attainment of certain levels of ROIC. We will expense the fair value of the units that are probable of being earned based on UPC’s forecasted ROIC over the 3-year performance period. We measure the fair value of these performance stock units based upon the closing price of the underlying common stock as of the date of grant, reduced by the present value of estimated future dividends. Dividend equivalents, which are based on UPC’s current dividends per share, are paid to participants only after the units are earned.

The assumptions used to calculate the present value of estimated future dividends related to the January 2008 grant are as follows:

	<i>2008</i>
UPC’s dividend per share per quarter .....	\$0.22
Risk-free interest rate at date of grant .....	2.3%

At June 30, 2008, we had \$15 million of total unrecognized compensation expense related to nonvested performance retention awards, which is expected to be recognized over a weighted-average period of 1.7 years. A portion of this expense is subject to achievement of the ROIC levels established for the performance stock unit grants.

#### **4. Retirement Plans**

##### **Pension and Other Postretirement Benefits**

*Pension Plans* – We provide defined benefit retirement income to eligible non-union employees through the Corporation’s qualified and non-qualified (supplemental) pension plans. Qualified and non-qualified pension benefits are based on years of service and the highest compensation during the latest years of employment, with specific reductions made for early retirements.

*Other Postretirement Benefits (OPEB)* – We provide defined contribution medical and life insurance benefits for eligible retirees. These benefits are funded as medical claims and life insurance premiums are paid.

## Expense

Both pension and OPEB expense are determined based upon the annual service cost of benefits (the actuarial cost of benefits earned during a period) and the interest cost on those liabilities, less the expected return on plan assets. The expected long-term rate of return on plan assets is applied to a calculated value of plan assets that recognizes changes in fair value over a five-year period. This practice is intended to reduce year-to-year volatility in pension expense, but it can have the effect of delaying the recognition of differences between actual returns on assets and expected returns based on long-term rate of return assumptions. Differences in actual experience in relation to assumptions are not recognized in net income immediately, but are deferred and, if necessary, amortized as pension or OPEB expense.

The components of our net periodic pension costs were as follows:

<i>Millions of Dollars</i>	<i>Pension</i>			
	<i>Three Months Ended</i>		<i>Six Months Ended</i>	
	<i>2008</i>	<i>June 30, 2007</i>	<i>2008</i>	<i>June 30, 2007</i>
Service cost.....	\$ 9	\$ 10	\$ 18	\$ 19
Interest cost.....	33	31	66	62
Expected return on plan assets.....	(38)	(36)	(76)	(72)
Amortization of:				
Prior service cost.....	1	1	3	3
Actuarial loss .....	2	4	3	8
Net periodic benefit cost.....	\$ 7	\$ 10	\$ 14	\$ 20

The components of our net periodic OPEB costs/(benefit) were as follows:

<i>Millions of Dollars</i>	<i>OPEB</i>			
	<i>Three Months Ended</i>		<i>Six Months Ended</i>	
	<i>2008</i>	<i>June 30, 2007</i>	<i>2008</i>	<i>June 30, 2007</i>
Service cost.....	\$ 1	\$ 1	\$ 2	\$ 2
Interest cost.....	5	6	10	11
Amortization of:				
Prior service credit.....	(9)	(8)	(17)	(16)
Actuarial loss .....	2	2	3	5
Net periodic benefit cost/(benefit) .....	\$ (1)	\$ 1	\$ (2)	\$ 2

**5. Other Income** – Our other income included the following:

<i>Millions of Dollars</i>	<i>Three Months Ended</i>		<i>Six Months Ended</i>	
	<i>2008</i>	<i>June 30, 2007</i>	<i>2008</i>	<i>June 30, 2007</i>
Rental income .....	<b>\$ 19</b>	\$ 18	<b>\$ 43</b>	\$ 35
Net gain on non-operating asset dispositions .....	<b>8</b>	12	<b>19</b>	17
Interest income .....	<b>1</b>	2	<b>2</b>	3
Sale of receivables fees .....	<b>(5)</b>	(8)	<b>(12)</b>	(17)
Non-operating environmental costs and other .....	<b>(9)</b>	1	<b>(19)</b>	(6)
<b>Total .....</b>	<b>\$ 14</b>	\$ 25	<b>\$ 33</b>	\$ 32

**6. Income Taxes** – We are included in the consolidated income tax return of UPC. The consolidated income tax liability of UPC is allocated among the parent and its subsidiaries on the basis of the separate contributions to the consolidated income tax liability, with the benefit of tax losses and credits utilized in consolidation allocated to the companies generating such losses and credits.

For all federal income tax years prior to 1995, the Internal Revenue Service (IRS) examinations have been completed and the statute of limitations bars any additional assessments by the IRS. The IRS has completed its examinations and issued notices of deficiency for tax years 1995 through 2004, and UPC is in the IRS appeals process for these years. The IRS is examining UPC's tax returns for tax years 2005 and 2006. UPC believes it has reached an agreement in principle with the IRS to resolve all of the issues related to tax years 1995 through 1998, including the previously reported dispute over certain donations of property, except for calculations of interest based on that agreement. UPC anticipates signing a closing agreement with the IRS in 2008. Once formalized, we anticipate that this agreement will result in an immaterial reduction of our income tax expense. Additionally, several state taxing authorities are currently examining UPC's state income tax returns for tax years 2001 through 2005.

At June 30, 2008, our liability for unrecognized tax benefits was \$391 million, of which \$300 million was classified as a current liability for our anticipated allocation of tax payments in the next twelve months related to federal and state income tax examinations, primarily the anticipated settlement for tax years 1995 through 1998 described above.

**7. Comprehensive Income** – Comprehensive income was as follows:

<i>Millions of Dollars</i>	<i>Three Months Ended</i>		<i>Six Months Ended</i>	
	<i>2008</i>	<i>June 30, 2007</i>	<i>2008</i>	<i>June 30, 2007</i>
Net income .....	<b>\$532</b>	\$455	<b>\$984</b>	\$832
Other comprehensive income:				
Defined benefit plans .....	-	-	<b>(4)</b>	1
Foreign currency translation .....	<b>6</b>	3	<b>9</b>	3
Derivatives .....	<b>1</b>	1	-	1
<b>Total other comprehensive income [a] .....</b>	<b>\$ 7</b>	\$ 4	<b>\$ 5</b>	\$ 5
<b>Total comprehensive income .....</b>	<b>\$539</b>	\$459	<b>\$989</b>	\$837

[a] Net of deferred taxes of \$4 million and \$6 million during the three and six months ended June 30, 2008, respectively, and \$2 million during both the three and six months ended June 30, 2007.

The components of accumulated other comprehensive loss were as follows:

<i>Millions of Dollars</i>	<i>Jun. 30, 2008</i>	<i>Dec. 31, 2007</i>
Defined benefit plans.....	<b>\$(59)</b>	\$(55)
Foreign currency translation.....	<b>(6)</b>	(15)
Derivatives.....	<b>(4)</b>	(4)
Total.....	<b>\$(69)</b>	\$(74)

## 8. Properties

The following table lists the major categories of property and equipment, as well as the average composite depreciation rate for each category:

<i>Millions of Dollars, Except Percentages</i>	<i>Jun. 30, 2008</i>	<i>Dec. 31, 2007</i>	<i>Depreciation Rate for 2008</i>
Land .....	<b>\$ 4,630</b>	\$ 4,627	N/A
Road [a].....	<b>34,141</b>	33,034	3.1%
Equipment [b] .....	<b>7,375</b>	7,308	4.4%
Computer hardware and software .....	<b>550</b>	510	14.5%
Other .....	<b>158</b>	158	N/A
Total properties .....	<b>46,854</b>	45,637	N/A
Accumulated depreciation.....	<b>(11,903)</b>	(11,489)	N/A
Net properties.....	<b>\$ 34,951</b>	\$ 34,148	N/A

[a] Road property consists of track and other roadway structure such as bridges and signals.

[b] Equipment property includes locomotives, freight cars, and work equipment.

## 9. Accounts Payable and Other Current Liabilities

<i>Millions of Dollars</i>	<i>Jun. 30, 2008</i>	<i>Dec. 31, 2007</i>
Accounts payable.....	<b>\$ 766</b>	\$ 729
Accrued wages and vacation .....	<b>415</b>	391
Accrued casualty costs.....	<b>351</b>	351
Income and other taxes .....	<b>630</b>	507
Dividends and interest .....	<b>54</b>	60
Equipment rents payable .....	<b>105</b>	103
Other .....	<b>641</b>	536
Total accounts payable and other current liabilities .....	<b>\$2,962</b>	\$2,677

## 10. Transactions with Affiliates

At June 30, 2008 and December 31, 2007, we had \$784 million and \$849 million working capital deficit balances, respectively, relating to UPC's management of our cash position. As part of UPC's cash

management activities, we advance excess cash (cash available after satisfying all of our obligations and paying dividends to UPC) to UPC. We declare and pay dividends to UPC that typically approximate the dividends UPC declares to its shareholders; however, there is no formal requirement to do so. The dividend declaration between us and UPC is determined solely by our Board of Directors. To the extent we require additional cash for use in our operations, UPC makes such funds available to us for borrowing. We treat these transactions as intercompany borrowings in the Condensed Consolidated Statements of Financial Position.

The majority of our intercompany borrowings from UPC relate to the acquisitions of the Chicago and North Western Transportation Company and Southern Pacific Rail Corporation that were funded by UPC on our behalf. We assumed these acquisition costs in the form of intercompany borrowings from UPC. The intercompany borrowings accrue interest at an annual rate of 7.5%, which may be adjusted from time to time, and are payable on demand. We do not expect to be required by UPC to pay back the intercompany borrowings within the next 12 months. There are no restrictions on the amount we are able to borrow from UPC. Intercompany borrowings are unsecured and rank equally with all of our other unsecured indebtedness.

UPC provides us with various services, including strategic planning, legal, treasury, accounting, auditing, insurance, human resources, and corporate affairs. Pursuant to a services agreement, UPC provides services to us, and we pay our share of the costs as determined by an independent review. Billings for these services were \$32 million and \$28 million for the six months ended June 30, 2008 and 2007 respectively.

## **11. Financial Instruments**

**Strategy and Risk** – We may use derivative financial instruments in limited instances for other than trading purposes to assist in managing our overall exposure to fluctuations in interest rates and fuel prices. We are not a party to leveraged derivatives and, by policy, do not use derivative financial instruments for speculative purposes. Derivative financial instruments qualifying for hedge accounting must maintain a specified level of effectiveness between the hedging instrument and the item being hedged, both at inception and throughout the hedged period. We formally document the nature and relationships between the hedging instruments and hedged items at inception, as well as our risk-management objectives, strategies for undertaking the various hedge transactions, and method of assessing hedge effectiveness. Changes in the fair market value of derivative financial instruments that do not qualify for hedge accounting are charged to earnings. We may use swaps, collars, futures, and/or forward contracts to mitigate the risk of adverse movements in interest rates and fuel prices; however, the use of these derivative financial instruments may limit future benefits from favorable price movements.

**Market and Credit Risk** – We address market risk related to derivative financial instruments by selecting instruments with value fluctuations that highly correlate with the underlying hedged item. We manage credit risk related to derivative financial instruments, which is minimal, by requiring high credit standards for counterparties and periodic settlements. At June 30, 2008 and December 31, 2007, we were not required to provide collateral, nor had we received collateral, relating to our hedging activities.

**Interest Rate Cash Flow Hedges** – We report changes in the fair value of cash flow hedges in accumulated other comprehensive loss until the hedged item affects earnings. At June 30, 2008, and December 31, 2007, we recorded reductions of \$4 million as an accumulated other comprehensive loss that is being amortized on a straight-line basis through September 30, 2014. As of June 30, 2008, and December 31, 2007, we had no interest rate cash flow hedges outstanding.

**Sale of Receivables** – We transfer most of our accounts receivable to Union Pacific Receivables, Inc. (UPRI), a bankruptcy-remote subsidiary, as part of a sale of receivables facility. UPRI sells, without

recourse on a 364-day revolving basis, an undivided interest in such accounts receivable to investors. The total capacity to sell undivided interests to investors under the facility was \$600 million at June 30, 2008, and December 31, 2007. The value of the outstanding undivided interest held by investors under the facility was \$600 million at June 30, 2008, and December 31, 2007, respectively. The value of the outstanding undivided interest held by investors is not included in our Condensed Consolidated Financial Statements. The value of the undivided interest held by investors was supported by \$1,166 million and \$1,071 million of accounts receivable held by UPRI at June 30, 2008, and December 31, 2007, respectively. At June 30, 2008, and December 31, 2007, the value of the interest retained by UPRI was \$566 million and \$471 million, respectively. This retained interest is included in accounts receivable in our Condensed Consolidated Financial Statements. The interest sold to investors is sold at carrying value, which approximates fair value, and there is no gain or loss recognized from the transaction.

The value of the outstanding undivided interest held by investors could fluctuate based upon the availability of eligible receivables and is directly affected by changing business volumes and credit risks, including default and dilution. If default or dilution percentages were to increase one percentage point, the amount of eligible receivables would decrease by \$6 million. Should UPC's credit rating fall below investment grade, the value of the outstanding undivided interest held by investors would be reduced, and, in certain cases, the investors would have the right to discontinue the facility.

We have been designated to service the sold receivables; however, we do not recognize any servicing asset or liability as the servicing fees adequately compensate us for these responsibilities. We collected approximately \$4.5 billion and \$3.9 billion during the three months ended June 30, 2008 and 2007, and \$8.6 billion and \$7.7 billion during the six months ended June 30, 2008 and 2007, respectively. UPRI used certain of these proceeds to purchase new receivables under the facility.

The costs of the sale of receivables program are included in other income and were \$5 million and \$8 million for the three months ended June 30, 2008 and 2007, respectively, and \$12 million and \$17 million for the six months ended June 30, 2008 and 2007, respectively. The costs include interest, program fees paid to banks, commercial paper issuing costs, and fees for unused commitment availability.

The investors have no recourse to our other assets except for customary warranty and indemnity claims. Our creditors do not have recourse to the assets of UPRI. In August 2007, the sale of receivables program was renewed for an additional 364-day period without any significant changes in terms.

## **12. Commitments and Contingencies**

**Asserted and Unasserted Claims** – Various claims and lawsuits are pending against us and certain of our subsidiaries. We cannot fully determine the effect of all asserted and unasserted claims on our consolidated results of operations, financial condition, or liquidity; however, to the extent possible, where asserted and unasserted claims are considered probable and where such claims can be reasonably estimated, we have recorded a liability. We do not expect that any known lawsuits, claims, environmental costs, commitments, contingent liabilities, or guarantees will have a material adverse effect on our consolidated results of operations, financial condition, or liquidity after taking into account liabilities previously recorded for these matters.

**Personal Injury** – The cost of personal injuries to employees and others related to our activities is charged to expense based on estimates of the ultimate cost and number of incidents each year. We use third-party actuaries to assist us in measuring the expense and liability, including unasserted claims, on a semi-annual basis. Compensation for work-related accidents is governed by the Federal Employers' Liability Act (FELA). Under FELA, damages are assessed based on a finding of fault through litigation or out-of-court settlements.

As a result of improvements in our safety experience, lower estimated ultimate settlement costs, and the completion of an actuarial study, we reduced personal injury expense by approximately \$12 million for the six months ended June 30, 2008. Our personal injury liability activity was as follows:

<i>Millions of Dollars</i>	<i>Six Months Ended</i>	
	<i>2008</i>	<i>June 30, 2007</i>
Beginning balance.....	<b>\$ 592</b>	\$ 629
Accruals .....	<b>108</b>	91
Payments .....	<b>(85)</b>	(86)
Ending balance at June 30.....	<b>\$ 615</b>	\$ 634
Current portion, ending balance at June 30.....	<b>\$ 203</b>	\$ 232

Our personal injury liability is discounted to present value using applicable U.S. Treasury rates. Because of the uncertainty surrounding the ultimate outcome of personal injury claims, it is reasonably possible that future costs to settle these claims may range from approximately \$615 million to \$666 million. We believe that the \$615 million liability recorded at June 30, 2008, is the best estimate of the present value of the future settlement costs of personal injury claims.

**Asbestos** – We are a defendant in a number of lawsuits in which current and former employees and other parties allege exposure to asbestos. Additionally, we have received claims for asbestos exposure that have not been litigated. The claims and lawsuits (collectively referred to as “claims”) allege occupational illness resulting from exposure to asbestos-containing products. In most cases, the claimants do not have credible medical evidence of physical impairment resulting from the alleged exposures. Additionally, most claims filed against us do not specify an amount of alleged damages.

Our asbestos-related liability activity was as follows:

<i>Millions of Dollars</i>	<i>Six Months Ended</i>	
	<i>2008</i>	<i>June 30, 2007</i>
Beginning balance.....	<b>\$ 265</b>	\$ 302
Accruals .....	-	-
Payments .....	<b>(7)</b>	(6)
Ending balance at June 30.....	<b>\$ 258</b>	\$ 296
Current portion, ending balance at June 30.....	<b>\$ 11</b>	\$ 13

We have insurance coverage for a portion of the costs incurred to resolve asbestos-related claims, and we have recognized an asset for estimated insurance recoveries at June 30, 2008, and December 31, 2007.

We believe that our estimates of liability for asbestos-related claims and insurance recoveries are reasonable and probable. The amounts recorded for asbestos-related liabilities and related insurance recoveries were based on currently known facts. However, future events, such as the number of new claims filed each year, average settlement costs, and insurance coverage issues, could cause the actual costs and insurance recoveries to be higher or lower than the projected amounts. Estimates also may vary in the future if strategies, activities, and outcomes of asbestos litigation materially change; federal and state laws governing asbestos litigation increase or decrease the probability or amount of compensation of claimants; or there are material changes with respect to payments made to claimants by other defendants.



**Environmental Costs** – We are subject to federal, state, and local environmental laws and regulations. We have 339 projects with which we are or may be liable for remediation costs associated with alleged contamination or for violations of environmental requirements. This includes 36 projects that are the subject of actions taken by the U.S. government, 20 of which are currently on the Superfund National Priorities List. Certain federal legislation imposes joint and several liability for the remediation of identified projects; consequently, our ultimate environmental liability may include costs relating to activities of other parties, in addition to costs relating to our own activities with each project.

When an environmental issue has been identified with respect to property owned, leased, or otherwise used in our business, we and our consultants perform environmental assessments on the property. We expense the cost of the assessments as incurred. We accrue the cost of remediation where our obligation is probable and such costs can be reasonably estimated. We do not discount our environmental liabilities when the timing of the anticipated cash payments is not fixed or readily determinable. At June 30, 2008, approximately 14% of our environmental liability was discounted at 3.88%, while approximately 13% of our environmental liability was discounted at 4.15% at December 31, 2007.

Our environmental liability activity was as follows:

<i>Millions of Dollars</i>	<i>Six Months Ended</i>	
	<i>2008</i>	<i>June 30, 2007</i>
Beginning balance.....	\$ 209	\$ 210
Accruals .....	20	11
Payments .....	(23)	(24)
Ending balance at June 30.....	\$ 206	\$ 197
Current portion, ending balance at June 30.....	\$ 59	\$ 53

The environmental liability includes costs for remediation and restoration of sites, as well as for ongoing monitoring costs, but excludes any anticipated recoveries from third parties. Cost estimates are based on information available for each project, financial viability of other potentially responsible parties, and existing technology, laws, and regulations. We believe that we have adequately accrued for our ultimate share of costs at sites subject to joint and several liability. However, the ultimate liability for remediation is difficult to determine because of the number of potentially responsible parties involved, site-specific cost sharing arrangements with other potentially responsible parties, the degree of contamination by various wastes, the scarcity and quality of volumetric data related to many of the sites, and the speculative nature of remediation costs. Estimates of liability may vary over time due to changes in federal, state, and local laws governing environmental remediation. We do not expect current obligations to have a material adverse effect on our results of operations or financial condition.

**Guarantees** – At June 30, 2008, we were contingently liable for \$445 million in guarantees. We have recorded a liability of \$5 million for the fair value of these obligations as of both June 30, 2008, and December 31, 2007. We entered into these contingent guarantees in the normal course of business, and they include guaranteed obligations related to our headquarters building, equipment financings, and affiliated operations. The final guarantee expires in 2022. We are not aware of any existing event of default that would require us to satisfy these guarantees. We do not expect that these guarantees will have a material adverse effect on our consolidated financial condition, results of operations, or liquidity.

**Indemnities** – Our maximum potential exposure under indemnification arrangements, including certain tax indemnifications, can range from a specified dollar amount to an unlimited amount, depending on the

nature of the transactions and the agreements. Due to uncertainty as to whether claims will be made or how they will be resolved, we cannot reasonably determine the probability of an adverse claim or reasonably estimate any adverse liability or the total maximum exposure under these indemnification arrangements. We do not have any reason to believe that we will be required to make any material payments under these indemnity provisions.

**Income Taxes** – As discussed in note 6, the IRS has completed its examinations and issued notices of deficiency for tax years 1995 through 2004, and UPC is in the IRS appeals process for these years. The IRS is examining UPC's tax returns for tax years 2005 and 2006. UPC believes it has reached an agreement in principle with the IRS to resolve all of the issues related to tax years 1995 through 1998, including the previously reported dispute over certain donations of property, except for calculations of interest based on that agreement. UPC anticipates signing a closing agreement with the IRS in 2008. At June 30, 2008, we have recorded a current liability of \$300 million for our anticipated allocation of these tax payments. We do not expect that the ultimate resolution of these examinations will have a material adverse effect on our Condensed Consolidated Financial Statements.

**13. Capital Stock** – The number of shares shown in the Common Stock section of the Condensed Consolidated Statement of Changes in Common Shareholders' Equity excluded 2,665 shares of Common Stock and 232 shares of Class A Stock owned by Southern Pacific Rail Corporation, an affiliate of the Company, whose results are included in our Condensed Consolidated Financial Statements.

**14. Accounting Pronouncements** – In March 2008, the Financial Accounting Standards Board (FASB) issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133* (FAS 161). FAS 161 amends and expands the disclosure requirements of FAS 133 to clarify how and why companies use derivative instruments. In addition, FAS 161 requires more disclosures regarding how companies account for derivative instruments and the impact derivatives have on a company's financial statements. This statement is effective for us beginning in 2009. We are in the process of evaluating the impact FAS 161 may have on our consolidated financial position, results of operations and cash flows.

In May 2008, the FASB issued Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (FAS 162). FAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles in the United States. FAS 162 is effective 60 days following the SEC's approval of PCAOB amendments to AU Section 411, "The Meaning of 'Present fairly in conformity with generally accepted accounting principles'". FAS 162 is not expected to have a material impact on our financial statements.

During the first quarter of 2008, we fully adopted FASB Statement No. 157, *Fair Value Measurements* (FAS 157). FAS 157 established a framework for measuring fair value and expanded disclosures about fair value measurements. The adoption of FAS 157 had no impact on our financial position or results of operations.