UNION PACIFIC CORP
Form 10-Q
October 23, 2008
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

# WASHINGTON, D.C. 20549

# FORM 10-Q

(Mark One)

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

**For the quarterly period ended September 30, 2008**

\- OR -

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

For the transition period from ____________ to ____________

Commission file number 1-6075

# UNION PACIFIC CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **UTAH** | **13-2626465** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**1400 DOUGLAS STREET, OMAHA, NEBRASKA**

(Address of principal executive offices)

**68179**

(Zip Code)

**(402) 544-5000**

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

þ Yes ¨ No

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

¨ Yes þ No

As of October 17, 2008, there were 506,430,904 shares of the Registrant s Common Stock outstanding.

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## PART I. FINANCIAL INFORMATION

### Item 1. Condensed Consolidated Financial Statements

**Condensed Consolidated Statements of Income (Unaudited)**

*Union Pacific Corporation and Subsidiary Companies*

| *Millions, Except Per Share Amounts, for the Three Months Ended September 30,* | ***2008*** | *2007* |
|---|---|---|
| Operating revenues: | | |
| Freight revenues | **$ 4,630** | $ 3,990 |
| Other revenues | **216** | 201 |
| Total operating revenues | **4,846** | 4,191 |
| Operating expenses: | | |
| Compensation and benefits | **1,123** | 1,095 |
| Fuel | **1,135** | 786 |
| Purchased services and materials | **481** | 479 |
| Depreciation | **348** | 332 |
| Equipment and other rents | **326** | 342 |
| Other | **218** | 152 |
| Total operating expenses | **3,631** | 3,186 |
| Operating income | **1,215** | 1,005 |
| Other income (note 6) | **23** | 25 |
| Interest expense | **(130)** | (124) |
| Income before income taxes | **1,108** | 906 |
| Income taxes | **(405)** | (374) |
| Net income | **$ 703** | $ 532 |
| Share and Per Share (notes 3 and 8): | | |
| Earnings per share basic | **$ 1.39** | $ 1.01 |
| Earnings per share diluted | **$ 1.38** | $ 1.00 |
| Weighted average number of shares basic | **506.6** | 526.5 |
| Weighted average number of shares diluted | **511.3** | 531.4 |
| Dividends declared per share | **$ 0.27** | $ 0.175 |

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

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**Condensed Consolidated Statements of Income (Unaudited)**

*Union Pacific Corporation and Subsidiary Companies*

| *Millions, Except Per Share Amounts, for the Nine Months Ended September 30,* | ***2008*** | *2007* |
|---|---|---|
| Operating revenues: | | |
| Freight revenues | **$ 13,038** | $ 11,498 |
| Other revenues | **646** | 588 |
| Total operating revenues | **13,684** | 12,086 |
| Operating expenses: | | |
| Compensation and benefits | **3,356** | 3,405 |
| Fuel | **3,251** | 2,201 |
| Purchased services and materials | **1,444** | 1,400 |
| Depreciation | **1,034** | 984 |
| Equipment and other rents | **1,006** | 1,035 |
| Other | **659** | 550 |
| Total operating expenses | **10,750** | 9,575 |
| Operating income | **2,934** | 2,511 |
| Other income (note 6) | **67** | 76 |
| Interest expense | **(384)** | (357) |
| Income before income taxes | **2,617** | 2,230 |
| Income taxes | **(940)** | (866) |
| Net income | **$ 1,677** | $ 1,364 |
| Share and Per Share (notes 3 and 8): | | |
| Earnings per share basic | **$ 3.27** | $ 2.55 |
| Earnings per share diluted | **$ 3.24** | $ 2.53 |
| Weighted average number of shares basic | **513.1** | 534.7 |
| Weighted average number of shares diluted | **517.8** | 539.5 |
| Dividends declared per share | **$ 0.71** | $ 0.525 |

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

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**Condensed Consolidated Statements of Financial Position (Unaudited)**

*Union Pacific Corporation and Subsidiary Companies*

| *Millions of Dollars* | ***Sep. 30, 2008*** | *Dec. 31, 2007* |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | **$ 857** | $ 878 |
| Accounts receivable, net | **860** | 632 |
| Materials and supplies | **569** | 453 |
| Current deferred income taxes | **343** | 336 |
| Other current assets | **260** | 295 |
| Total current assets | **2,889** | 2,594 |
| Investments | **1,009** | 923 |
| Net properties (note 10) | **35,302** | 34,158 |
| Other assets | **351** | 358 |
| Total assets | **$39,551** | $38,033 |
| **Liabilities and Common Shareholders Equity** | | |
| Current liabilities: | | |
| Accounts payable and other current liabilities (note 11) | **$ 3,095** | $ 2,902 |
| Debt due within one year (note 14) | **346** | 139 |
| Total current liabilities | **3,441** | 3,041 |
| Debt due after one year (note 14) | **8,116** | 7,543 |
| Deferred income taxes | **10,393** | 10,050 |
| Other long-term liabilities | **1,866** | 1,814 |
| Commitments and contingencies (note 15) | | |
| Total liabilities | **23,816** | 22,448 |
| Common shareholders equity (note 3): | | |
| Common shares, $2.50 par value, 800,000,000 and 500,000,000 authorized; 552,776,344 and 276,162,141 issued; 506,424,860 and 260,869,647 outstanding, respectively | **1,382** | 690 |
| Paid-in-surplus | **3,937** | 3,926 |
| Retained earnings | **13,289** | 12,667 |
| Treasury stock | **(2,805)** | (1,624) |
| Accumulated other comprehensive loss | **(68)** | (74) |
| Total common shareholders equity | **15,735** | 15,585 |
| Total liabilities and common shareholders equity | **$39,551** | $38,033 |

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

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**Condensed Consolidated Statements of Cash Flows (Unaudited)**

*Union Pacific Corporation and Subsidiary Companies*

| *Millions of Dollars, for the Nine Months Ended September 30,* | ***2008*** | *2007* |
|---|---|---|
| **Operating Activities** | | |
| Net income | **$ 1,677** | $ 1,364 |
| Adjustments to reconcile net income to cash provided by operating activities: | | |
| Depreciation | **1,034** | 984 |
| Deferred income taxes and unrecognized tax benefits | **325** | 196 |
| Stock-based compensation expense | **48** | 33 |
| Net gain from asset sales | **(30)** | (41) |
| Other operating activities, net | **100** | (158) |
| Changes in current assets and liabilities, net | **(116)** | (11) |
| Cash provided by operating activities | **3,038** | 2,367 |
| **Investing Activities** | | |
| Capital investments | **(2,017)** | (1,842) |
| Proceeds from asset sales | **73** | 94 |
| Acquisition of equipment pending financing | **(386)** | (617) |
| Proceeds from sale of assets financed | **386** | 607 |
| Other investing activities | **(65)** | (50) |
| Cash used in investing activities | **(2,009)** | (1,808) |
| **Financing Activities** | | |
| Debt issued | **1,340** | 1,074 |
| Common share repurchases (note 16) | **(1,410)** | (1,152) |
| Debt repaid | **(735)** | (117) |
| Dividends paid | **(344)** | (272) |
| Cash received for option exercises | **79** | 94 |
| Treasury shares repurchased for employee payroll taxes | **(28)** | (47) |
| Excess tax benefits from equity compensation plans | **52** | 52 |
| Other financing activities | **(4)** | 4 |
| Cash used in financing activities | **(1,050)** | (364) |
| Net change in cash and cash equivalents | **(21)** | 195 |
| Cash and cash equivalents at beginning of year | **878** | 827 |
| Cash and cash equivalents at end of period | **$ 857** | $ 1,022 |
| **Changes in Current Assets and Liabilities** | | |
| Accounts receivable, net | **$ (228)** | $ (141) |
| Materials and supplies | **(116)** | (80) |
| Other current assets | **35** | (33) |
| Accounts payable and other current liabilities | **193** | 243 |
| Total | **$ (116)** | $ (11) |
| **Supplemental Cash Flow Information** | | |
| Non-cash investing and financing activities: | | |
| Capital lease financings | **$ 175** | $ 74 |
| Cash dividends declared but not yet paid | **132** | 89 |
| Capital investments accrued but not yet paid | **100** | 80 |
| Cash paid during the year for: | | |
| Interest, net of amounts capitalized | **$ (414)** | $ (364) |
| Income taxes, net of refunds | **(344)** | (576) |

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

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**Condensed Consolidated Statements of Changes in Common Shareholders Equity (Unaudited)**

*Union Pacific Corporation and Subsidiary Companies*

| *Millions of Dollars* *Thousands of Shares* | *Common Shares* | *Treasury Shares* | *Common Shares* | *Paid-in-Surplus* | *Retained Earnings* | *Treasury Stock* | *Accumulated Other Comprehensive Income/(Loss) (note 9)* | *Total* |
|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2006 | 275,962 | (5,790) | $ 690 | $3,943 | $11,215 | $ (394) | $(142) | $15,312 |
| Cumulative effect of adoption of FIN 48 | | | | | (7) | | | (7) |
| Balance at January 1, 2007 | 275,962 | (5,790) | $ 690 | $3,943 | $11,208 | $ (394) | $(142) | $15,305 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | | 1,364 | | | 1,364 |
| Other comp. income | | | | | | | 2 | 2 |
| Total comp. income (note 9) | | | | | 1,364 | | 2 | 1,366 |
| Conversion, stock option exercises, and other | 203 | 2,282 | | (8) | | 152 | | 144 |
| Share repurchases (note 16) | | (10,226) | | | | (1,152) | | (1,152) |
| Cash dividends declared ($1.05 per share) | | | | | (280) | | | (280) |
| Balance at September 30, 2007 | 276,165 | (13,734) | $ 690 | $3,935 | $12,292 | $(1,394) | $(140) | $15,383 |
| | | | | | | | | |
| Balance at January 1, 2008 | 276,162 | (15,292) | $ 690 | $3,926 | $12,667 | $(1,624) | $ (74) | $15,585 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | | 1,677 | | | 1,677 |
| Other comp. income | | | | | | | 6 | 6 |
| Total comp. income (note 9) | | | | | 1,677 | | 6 | 1,683 |
| Conversion, stock option exercises, and other | 452 | 3,026 | 1 | 11 | | 147 | | 159 |
| Share repurchases (note 16) | | (18,793) | | | | (1,328) | | (1,328) |
| Common stock dividend (note 3) | 276,162 | (15,292) | 691 | | (691) | | | |
| Cash dividends declared ($0.71 per share) | | | | | (364) | | | (364) |
| **Balance at September 30, 2008** | **552,776** | **(46,351)** | **$1,382** | **$3,937** | **$13,289** | **$(2,805)** | **$ (68)** | **$15,735** |

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

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**UNION PACIFIC CORPORATION AND 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 Corporation , UPC , we , us , and our mean U Pacific Corporation and its subsidiaries, including Union Pacific Railroad Company, which will be separately referred to herein as UPRR or the Railroad .

**1. Basis of Presentation** 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 on Form 10-Q should be read in conjunction with our Consolidated Financial Statements and notes thereto contained in our 2007 Annual Report on Form 10-K. The results of operations for the three and nine months ended September 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 $6 million and $15 million for the three months and nine months ended September 30, 2007, respectively. 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** The Railroad, along with its subsidiaries and rail affiliates, is our one reportable operating segment. Although revenue is analyzed by commodity group, we analyze the net financial results of the Railroad as one segment due to the integrated nature of our rail network. The following table provides freight revenue by commodity group:

| | *Three Months Ended September 30,* | | *Nine Months Ended September 30,* | |
|---|---|---|---|---|
| *Millions of Dollars* | ***2008*** | *2007* | ***2008*** | *2007* |
| Agricultural | **$ 848** | $ 670 | **$ 2,382** | $ 1,886 |
| Automotive | **324** | 348 | **1,039** | 1,089 |
| Chemicals | **659** | 586 | **1,916** | 1,704 |
| Energy | **1,051** | 824 | **2,827** | 2,316 |
| Industrial Products | **906** | 789 | **2,556** | 2,335 |
| Intermodal | **842** | 773 | **2,318** | 2,168 |
| Total freight revenues | **4,630** | 3,990 | **13,038** | 11,498 |
| Other revenues | **216** | 201 | **646** | 588 |
| Total operating revenues | **$4,846** | $4,191 | **$13,684** | $12,086 |

**3. Stock Split** On May 28, 2008, we completed a two-for-one stock split, effected in the form of a 100% stock dividend. The stock split entitled all shareholders of record at the close of business on May 12, 2008, to receive one additional share of our 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 (excluding the Condensed Consolidated Statements of Changes in Common Shareholders Equity and December 31, 2007, Condensed Consolidated Statements of Financial Position) have been restated to reflect the stock split for all periods presented.

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**4. Stock-Based Compensation** We have several stock-based compensation plans under which employees and non-employee directors receive stock options, nonvested retention shares, and nonvested stock units. We refer to the nonvested shares and stock units collectively as retention awards. We have elected to issue treasury shares to cover option exercises and stock unit vestings, while new shares are issued when retention shares vest. Information regarding stock-based compensation appears in the table below:

| *Millions of Dollars* | *Three Months Ended September 30,* ***2008*** | *2007* | *Nine Months Ended September 30,* ***2008*** | *2007* |
|---|---|---|---|---|
| Stock-based compensation, before tax: | | | | |
| Stock options | **$ 6** | $ 5 | **$18** | $15 |
| Retention awards | **11** | 6 | **30** | 18 |
| Total stock-based compensation, before tax | **$17** | $11 | **$48** | $33 |
| Total stock-based compensation, after tax | **$11** | $ 7 | **$30** | $21 |

**Stock Options** We estimate the fair value of our stock option awards using the Black-Scholes option pricing model. Groups of employees and non-employee directors 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:

| *Weighted-Average Assumptions* | *Nine Months Ended September 30,* ***2008*** | *2007* |
|---|---|---|
| Risk-free interest rate | **2.8%** | 4.9% |
| Dividend yield | **1.4%** | 1.4% |
| Expected life (years) | **5.3** | 4.7 |
| Volatility | **22.2%** | 20.9% |
| Weighted-average grant-date fair value of options granted | **$13.35** | $11.19 |

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.

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A summary of stock option activity during the nine months ended September 30, 2008 is presented below:

| | *Shares (thous.)* | *Weighted-Average Exercise Price* | *Weighted-Average Remaining Contractual Term* | *Aggregate Intrinsic Value (millions)* |
|---|---|---|---|---|
| Outstanding at January 1, 2008 | 15,127 | $35.77 | 6.0 yrs. | $409 |
| Granted | 1,571 | 62.40 | N/A | N/A |
| Exercised | (4,161) | 31.88 | N/A | N/A |
| Forfeited or expired | (325) | 34.11 | N/A | N/A |
| Outstanding at September 30, 2008 | 12,212 | $40.57 | 6.4 yrs. | $374 |
| Vested or expected to vest at September 30, 2008 | 10,616 | $39.63 | 6.2 yrs. | $335 |
| Options exercisable at September 30, 2008 | 8,424 | $34.90 | 5.4 yrs. | $305 |

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 September 30, 2008 are subject to performance or market-based vesting conditions.

At September 30, 2008, there was $27 million of unrecognized compensation expense related to nonvested stock options, which is expected to be recognized over a weighted-average period of 1.2 years. Additional information regarding stock option exercises appears in the table below:

| | *Three Months Ended September 30,* | | *Nine Months Ended September 30,* | |
|---|---|---|---|---|
| *Millions of Dollars* | ***2008*** | *2007* | ***2008*** | *2007* |
| Intrinsic value of stock options exercised | **$38** | $29 | **$163** | $126 |
| Cash received from option exercises | **17** | 16 | **79** | 94 |
| Tax benefit realized from option exercises | **14** | 11 | **61** | 49 |
| Aggregate grant-date fair value of stock options vested | | 1 | **21** | 11 |

**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.

Changes in our retention awards during the nine months ended September 30, 2008 were as follows:

| | *Shares (thous.)* | *Weighted-Average Grant-Date Fair Value* |
|---|---|---|
| Nonvested at January 1, 2008 | 1,624 | $42.04 |
| Granted | 652 | 62.39 |
| Vested | (198) | 32.52 |
| Forfeited | (52) | 46.07 |
| Nonvested at September 30, 2008 | 2,026 | $49.41 |

Retention awards are granted at no cost to the employee or non-employee director and vest over periods lasting up to four years. At September 30, 2008, there was $59 million of total unrecognized compensation expense related to nonvested retention awards, which is expected to be recognized over a weighted-average period of 2.2 years.

**Performance Retention Awards** In January 2008, our Board of Directors approved performance stock unit grants. Other than higher performance targets, the basic terms of these performance stock units are

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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 expense the fair value of the units that are probable of being earned based on our 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 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:

| | *2008* |
|---|---|
| Dividend per share per quarter | $0.22 |
| Risk-free interest rate at date of grant | 2.3% |

Changes in our performance retention awards during the nine months ended September 30, 2008, were as follows:

| | *Shares (thous.)* | *Weighted-Average Grant-Date Fair Value* |
|---|---|---|
| Nonvested at January 1, 2008 | 589 | $45.27 |
| Granted | 325 | 60.25 |
| Vested | (3) | 43.81 |
| Forfeited | (29) | 49.65 |
| Nonvested at September 30, 2008 | 882 | $50.66 |

At September 30, 2008, we had $22 million of total unrecognized compensation expense related to nonvested performance retention awards, which is expected to be recognized over a weighted-average period of 1.4 years. A portion of this expense is subject to achievement of the ROIC levels established for the performance stock unit grants.

## 5. Retirement Plans

### Pension and Other Postretirement Benefits

*Pension Plans* We provide defined benefit retirement income to eligible non-union employees through 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.

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

| | *Pension* | | | |
|---|---|---|---|---|
| | *Three Months Ended September 30,* | | *Nine Months Ended September 30,* | |
| *Millions of Dollars* | ***2008*** | *2007* | ***2008*** | *2007* |
| Service cost | **$ 8** | $ 7 | **$ 26** | $ 26 |
| Interest cost | **35** | 31 | **101** | 93 |
| Expected return on plan assets | **(38)** | (36) | **(114)** | (108) |
| Amortization of: | | | | |
| Prior service cost | **1** | 2 | **4** | 5 |
| Actuarial loss | **3** | 5 | **6** | 13 |
| Net periodic benefit cost | **$ 9** | $ 9 | **$ 23** | $ 29 |

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

| | *OPEB* | | | |
|---|---|---|---|---|
| | *Three Months Ended September 30,* | | *Nine Months Ended September 30,* | |
| *Millions of Dollars* | ***2008*** | *2007* | ***2008*** | *2007* |
| Service cost | **$** | $ | **$ 2** | $ 2 |
| Interest cost | **7** | 5 | **17** | 16 |
| Amortization of: | | | | |
| Prior service credit | **(9)** | (8) | **(26)** | (24) |
| Actuarial loss | **5** | 1 | **8** | 6 |
| Net periodic benefit cost/(benefit) | **$ 3** | $ (2) | **$ 1** | $ |

**6. Other Income** Our other income included the following:

| | *Three Months Ended September 30,* | | *Nine Months Ended September 30,* | |
|---|---|---|---|---|
| *Millions of Dollars* | ***2008*** | *2007* | ***2008*** | *2007* |
| Rental income | **$ 23** | $ 15 | **$ 67** | $ 50 |
| Net gain on non-operating asset dispositions | **11** | 24 | **30** | 41 |
| Interest income | **4** | 8 | **16** | 29 |
| Sale of receivables fees | **(5)** | (9) | **(17)** | (26) |
| Non-operating environmental costs and other | **(10)** | (13) | **(29)** | (18) |
| Total | **$ 23** | $ 25 | **$ 67** | $ 76 |

**7. Income Taxes** 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 tax assessments. Some interest calculation issues remain open back to 1986. In the third quarter, we signed a closing agreement resolving all tax matters at IRS Appeals for tax years 1995 through 1998. The statute of limitations for these years will expire in 2009, except for calculations of interest. This settlement did not have a material effect on our income tax expense.

The IRS has completed its examinations and issued notices of deficiency for tax years 1999 through 2004. We disagree with many of their proposed adjustments, and we are at IRS Appeals for these years. The IRS is examining our tax returns for tax years 2005 and 2006. Additionally, several state tax authorities are examining our state income tax returns for tax years 2000 through 2006.

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At September 30, 2008, our liability for unrecognized tax benefits was $157 million, of which $137 million was classified as current. The majority of this current liability relates to the 1995 through 1998 settlement, which we anticipate will be paid in the fourth quarter.

**8. Earnings Per Share** The following table provides a reconciliation between basic and diluted earnings per share for the three and nine months ended September 30, 2008:

| *Millions, Except Per Share Amounts* | *Three Months Ended September 30,* **2008** | *2007* | *Nine Months Ended September 30,* **2008** | *2007* |
|---|---|---|---|---|
| Net income | **$ 703** | $ 532 | **$1,677** | $1,364 |
| Weighted-average number of shares outstanding: | | | | |
| Basic | **506.6** | 526.5 | **513.1** | 534.7 |
| Dilutive effect of stock options | **3.6** | 4.1 | **3.7** | 4.2 |
| Dilutive effect of retention shares and units | **1.1** | 0.8 | **1.0** | 0.6 |
| Diluted | **511.3** | 531.4 | **517.8** | 539.5 |
| Earnings per share basic | **$ 1.39** | $ 1.01 | **$ 3.27** | $ 2.55 |
| Earnings per share diluted | **$ 1.38** | $ 1.00 | **$ 3.24** | $ 2.53 |
| Stock options excluded as their inclusion would be antidilutive | | | **0.5** | 1.2 |

**9. Comprehensive Income** Our comprehensive income was as follows:

| *Millions of Dollars* | *Three Months Ended September 30,* **2008** | *2007* | *Nine Months Ended September 30,* **2008** | *2007* |
|---|---|---|---|---|
| Net income | **$703** | $532 | **$1,677** | $1,364 |
| Other comprehensive income/(loss): | | | | |
| Defined benefit plans | | 1 | **(4)** | 2 |
| Foreign currency translation | **1** | (3) | **10** | |
| Derivatives | | (1) | | |
| Total other comprehensive income/(loss) [a] | **$ 1** | $ (3) | **$ 6** | $ 2 |
| Total comprehensive income | **$704** | $529 | **$1,683** | $1,366 |

*[a] Net of deferred taxes of $1 million and $7 million during the three and nine months ended September 30, 2008, respectively, and $(3) million and $(1) million during the three and nine months ended September 30, 2007, respectively.*

The components of accumulated other comprehensive loss were as follows:

| *Millions of Dollars* | ***Sep. 30, 2008*** | *Dec. 31, 2007* |
|---|---|---|
| Defined benefit plans | **$(59)** | $(55) |
| Foreign currency translation | **(5)** | (15) |
| Derivatives | **(4)** | (4) |
| Total | **$(68)** | $(74) |

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

| *Millions of Dollars, Except Percentages* | *Sep. 30, 2008* | *Dec. 31, 2007* | *Depreciation Rate for 2008* |
|---|---|---|---|
| Land | **$ 4,763** | $ 4,760 | N/A |
| Road | | | |
| Rail and other track material | **11,226** | 10,622 | 4.1% |
| Ties | **6,711** | 6,354 | 2.9% |
| Ballast | **3,579** | 3,369 | 2.9% |
| Other [a] | **12,351** | 11,865 | 2.3% |
| Total Road | **33,867** | 32,210 | 3.1% |
| Equipment | | | |
| Locomotives | **5,200** | 5,092 | 4.6% |
| Freight cars | **2,010** | 2,059 | 4.1% |
| Work equipment and other | **158** | 157 | 3.5% |
| Total Equipment | **7,368** | 7,308 | 4.5% |
| Computer hardware/software and other | **435** | 441 | 13.5% |
| Construction in progress | **946** | 935 | N/A |
| Total properties | **47,379** | 45,654 | N/A |
| Accumulated depreciation | **(12,077)** | (11,496) | N/A |
| Net properties | **$ 35,302** | $ 34,158 | N/A |

*[a] Other includes grading, bridges and tunnels, signals, buildings, and other road assets.*

**11. Accounts Payable and Other Current Liabilities**

| *Millions of Dollars* | *Sep. 30, 2008* | *Dec. 31, 2007* |
|---|---|---|
| Accounts payable | **$ 791** | $732 |
| Accrued wages and vacation | **393** | 394 |
| Accrued casualty costs | **423** | 371 |
| Income and other taxes | **518** | 343 |
| Dividends and interest | **273** | 284 |
| Equipment rents payable | **98** | 103 |
| Other | **599** | 675 |
| Total accounts payable and other current liabilities | **$3,095** | $2,902 |

**12. Fair Value Measurements** During the first quarter of 2008, we fully adopted Financial Accounting Standards Board (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.

FAS 157 applies to all assets and liabilities that are measured and reported on a fair value basis. This enables the reader of the financial statements to assess the inputs used to develop those measurements by establishing a hierarchy for ranking the quality and reliability of the information used to determine fair values. The statement requires that each asset and liability carried at fair value be classified into one of the following categories:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are not corroborated by market data.

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At September 30, 2008, the fair value of our derivative assets was approximately $3 million (see note 13). We determined the fair values of our derivative financial instrument positions based upon current fair values as quoted by recognized dealers or the present value of expected future cash flows. As prescribed by FAS 157, we recognize the fair value of our derivative assets as a Level 2 valuation.

**13. 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 September 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 Fair Value Hedges** We manage our overall exposure to fluctuations in interest rates by adjusting the proportion of fixed and floating rate debt instruments within our debt portfolio over a given period. We generally manage the mix of fixed and floating rate debt through the issuance of targeted amounts of each as debt matures or as we require incremental borrowings. We employ derivatives, primarily swaps, as one of the tools to obtain the targeted mix. In addition, we also obtain flexibility in managing interest costs and the interest rate mix within our debt portfolio by evaluating the issuance of and managing outstanding callable fixed-rate debt securities.

Swaps allow us to convert debt from fixed rates to variable rates and thereby hedge the risk of changes in the debt s fair value attributable to the changes in interest rates. We account for swaps as fair value hedges using the short-cut method pursuant to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133); therefore, we do not record any ineffectiveness within our Condensed Consolidated Financial Statements.

The following is a summary of our interest rate derivatives qualifying as fair value hedges:

| *Millions of Dollars, Except Percentages* | ***Sep. 30, 2008*** | *Dec. 31, 2007* |
|---|---|---|
| Amount of debt hedged | **$250** | $250 |
| Percentage of total debt portfolio | **3%** | 3% |
| Gross fair value asset position | **$ 3** | $ 2 |

**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 September 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 September 30, 2008, and December 31, 2007, we had no interest rate cash flow hedges outstanding.

**Sale of Receivables** The Railroad transfers most of its 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 September 30, 2008, and December 31, 2007. The value of the outstanding undivided interest held by investors under the facility was $600 million at September 30, 2008, and December 31, 2007. 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 $1,231 million and $1,071 million of accounts receivable held by UPRI at September 30, 2008, and December 31, 2007, respectively. At September 30, 2008, and December 31, 2007, the value of the interest retained by UPRI was $631 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 our 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.

The Railroad services the sold receivables; however, the Railroad does not recognize any servicing asset or liability, as the servicing fees adequately compensate us for these responsibilities. The Railroad collected approximately $4.7 billion and $4.1 billion during the three months ended September 30, 2008 and 2007, respectively, and $13.3 billion and $11.8 billion during the nine months ended September 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 $9 million for the three months ended September 30, 2008 and 2007, respectively, and $17 million and $26 million for the nine months ended September 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 the Railroad s other assets except for customary warranty and indemnity claims. Creditors of the Railroad do not have recourse to the assets of UPRI. In October 2008, we extended the sale of receivables program to August 2009 without any significant changes in terms, except to increase the capacity to sell undivided interests to $660 million.

**14. Debt**

**Credit Facilities** On September 30, 2008, $1.9 billion of credit was available under our revolving credit facility (the facility). The facility is designated for general corporate purposes and supports the issuance of commercial paper. We have not drawn on the facility during 2008. Commitment fees and interest rates payable under the facility are similar to fees and rates available to comparably rated, investment-grade borrowers. The facility allows borrowings at floating rates based on London Interbank Offered Rates, plus a spread, depending upon our senior unsecured debt ratings. The facility requires maintaining a debt-to-net-worth coverage ratio. At September 30, 2008, and December 31, 2007, we were in compliance with this covenant. The facility does not include any other financial restrictions, credit rating triggers (other than rating-dependent pricing), or any other provision that could require us to post collateral. The facility expires in April 2012 and includes a change-of-control provision.

At September 30, 2008, we had $200 million of commercial paper outstanding. Our commercial paper balance is supported by our revolving credit facility but does not reduce the amount of borrowings available under the facility. During the nine months ended September 30, 2008, we issued $500 million of commercial paper and repaid $300 million. Despite the deterioration of the credit and financial markets, we were able to issue an additional $75 million of commercial paper in October of 2008. We also repaid $75 million of existing commercial paper during October of 2008. As of October 20, 2008, our current outstanding commercial paper balance totaled $200 million and was issued as follows:

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$25 million issued at 4.2%, maturing in October 2008,

$75 million issued at 5.2%, maturing in November 2008, and

$100 million issued at 3.9%, maturing in January 2009.

**Shelf Registration Statement and Significant New Borrowings** Under our current shelf registration statement, we may issue, from time to time, any combination of debt securities, preferred stock, common stock, or warrants for debt securities or preferred stock in one or more offerings. In July 2008, our Board of Directors authorized the issuance of an additional $3 billion of debt securities under our shelf registration. As a result, at September 30, 2008, we had total authority to issue up to $3.75 billion of debt securities.

On October 7, 2008, we issued $750 million of 7.875% unsecured fixed-rate notes due January 15, 2019. The net proceeds from this offering are for general corporate purposes, including the repurchase of common stock pursuant to our share repurchase program. These debt securities include change-of-control provisions.

We have no immediate plans to issue equity securities; however, we will continue to explore opportunities to replace existing debt or access capital through issuances of debt securities under our shelf registration. Accordingly, we may issue additional debt securities at any time.

On April 17, 2008, we borrowed $100 million under a 5-year-term loan facility (the loan). The loan has a floating rate based on London Interbank Offered Rates, plus a spread, and is prepayable in whole or in part without a premium prior to maturity. The agreement documenting the loan has provisions similar to our revolving credit facility, including identical debt-to-net-worth covenant and change-of-control provisions and similar customary default provisions. The agreement does not include any other financial restrictions, credit rating triggers, or any other provision that would require us to post collateral.

As of September 30, 2008, and December 31, 2007, we have reclassified as long-term debt approximately $650 million and $550 million, respectively, of debt due within one year that we intend to refinance. This reclassification reflects our ability and intent to refinance any short-term borrowings and certain current maturities of long-term debt on a long-term basis.

**15. 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.

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Personal injury expense was lower for the nine months ended September 30, 2007 compared to the first nine months of 2008 primarily as a result of completion of actuarial studies during 2007, which reflected improvements in our safety experience and lower than expected ultimate settlement costs. A new actuarial study will be completed during the fourth quarter of 2008.

Our personal injury liability activity was as follows:

| | *Nine Months Ended September 30,* | |
|---|---|---|
| *Millions of Dollars* | ***2008*** | *2007* |
| Beginning balance | **$ 593** | $ 631 |
| Accruals | **162** | 109 |
| Payments | **(123)** | (131) |
| Ending balance at September 30 | **$ 632** | $ 609 |
| Current portion, ending balance at September 30 | **$ 204** | $ 233 |

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 $632 million to $684 million. We believe that the $632 million liability recorded at September 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:

| | *Nine Months Ended September 30,* | |
|---|---|---|
| *Millions of Dollars* | ***2008*** | *2007* |
| Beginning balance | **$265** | $302 |
| Accruals/(credits) | | (20) |
| Payments | **(9)** | (10) |
| Ending balance at September 30 | **$256** | $272 |
| Current portion, ending balance at September 30 | **$ 11** | $ 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 September 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.

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**Environmental Costs** We are subject to federal, state, and local environmental laws and regulations. We have 332 projects with which we are or may be liable for remediation costs associated with alleged contamination or for violations of environmental requirements. This includes 33 projects that are the subject of actions taken by the U.S. government, 18 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 September 30, 2008, approximately 14% of our environmental liability was discounted at 3.89%, while approximately 13% of our environmental liability was discounted at 4.15% at December 31, 2007.

Our environmental liability activity was as follows:

| | Nine Months Ended September 30, | |
|---|---|---|
| *Millions of Dollars* | ***2008*** | *2007* |
| Beginning balance | **$209** | $210 |
| Accruals | **34** | 28 |
| Payments | **(35)** | (34) |
| Ending balance at September 30 | **$208** | $204 |
| Current portion, ending balance at September 30 | **$ 58** | $ 54 |

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 September 30, 2008, we were contingently liable for $467 million in guarantees. We have recorded a liability of $5 million for these obligations as of both September 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

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arrangements. We do not have any reason to believe that we will be required to make any material payments under these indemnity provisions.

**16. Share Repurchase Program** On January 30, 2007, our Board of Directors authorized the repurchase of up to 40 million shares of Union Pacific Corporation common stock through the end of 2009. On May 1, 2008, our Board of Directors authorized the repurchase of an additional 40 million common shares by March 31, 2011. As of September 30, 2008, we have repurchased a total of $2.8 billion of Union Pacific Corporation common stock since the original repurchase plan was authorized. Our assessments of market conditions and other pertinent facts guide the timing and volume of all repurchases. We expect to fund our common stock repurchases through cash generated from operations, the sale or lease of various operating and non-operating properties, debt issuances, and cash on hand.

| | *Number of Shares Purchased [a]* | | *Average Price Paid [a]* | |
|---|---|---|---|---|
| | ***2008*** | *2007* | ***2008*** | *2007* |
| First quarter | **6,512,278** | 4,088,000 | **$61.83** | $49.34 |
| Second quarter | **6,337,197** | 7,299,400 | **$75.83** | $58.20 |
| Third quarter | **5,943,111** | 9,064,042 | **$74.85** | $57.97 |
| Total | | | | |