CSX CORP
Form 10-Q
October 20, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 25, 2009

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 1-8022

CSX CORPORATION
(Exact name of registrant as specified in its charter)

Virginia (State or other jurisdiction of incorporation or organization)		62-1051971 (I.R.S. Employer Identification No.)
500 Water Street, 15th Floor, Jacksonville, FL	32202	(904) 359-3200
(Address of principal executive offices)	(Zip Code)	(Telephone number, including area code)

No Change
(Former name, former address and former fiscal year, if changed since last report.)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes (X) No ( )

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. (check one)
Large Accelerated Filer (X) Accelerated Filer ( ) Non-accelerated Filer ( )

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

There were 392,558,925 shares of common stock outstanding on September 25, 2009 (the latest practicable date that is closest to the filing date).

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CSX CORPORATION
FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 25, 2009
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ITEM 1: FINANCIAL STATEMENTS

CONSOLIDATED INCOME STATEMENTS (Unaudited)
(Dollars in Millions, Except Per Share Amounts)

	Third Quarters		Nine Months Ended	
	2009	2008	2009	2008
Revenue	$2,289	$2,961	$6,721	$8,581
Expense				
Labor and Fringe	653	754	1,969	2,232
Materials, Supplies and Other	428	568	1,273	1,586
Fuel	223	508	599	1,486
Depreciation	228	227	681	676
Equipment and Other Rents	92	106	303	329
Inland Transportation	67	65	194	196
Total Expense	1,691	2,228	5,019	6,505
Operating Income	598	733	1,702	2,076
Interest Expense	(140)	(131)	(420)	(383)
Other Income - Net (Note 8)	6	5	19	94
Earnings From Continuing Operations				
Before Income Taxes	464	607	1,301	1,787
Income Tax Expense (Note 9)	(171)	(227)	(469)	(653)
Earnings From Continuing Operations	293	380	832	1,134
Discontinued Operations (Note 11)	-	2	15	(16)
Net Earnings	$293	$382	$847	$1,118
Per Common Share (Note 2)				
Net Earnings Per Share, Basic				
Continuing Operations	$0.75	$0.94	$2.12	$2.81
Discontinued Operations	-	0.01	0.04	(0.04)
Net Earnings	$0.75	$0.95	$2.16	$2.77
Net Earnings Per Share, Assuming Dilution				
Continuing Operations	$0.74	$0.93	$2.10	$2.75
Discontinued Operations	-	0.01	0.04	(0.04)
Net Earnings	$0.74	$0.94	$2.14	$2.71
Average Shares Outstanding (Thousands)	392,352	402,224	391,847	404,260
Average Shares Outstanding,				
Assuming Dilution (Thousands)	396,333	408,486	395,268	412,936
Cash Dividends Paid Per Common Share	$0.22	$0.22	$0.66	$0.55

See accompanying notes to consolidated financial statements.

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CSX CORPORATION

ITEM 1: FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS
(Dollars in Millions)

	(Unaudited) September 25, 2009	December 26, 2008
ASSETS		
Current Assets		
Cash and Cash Equivalents	$1,240	$669
Short-term Investments	81	76
Accounts Receivable - Net (Note 1)	928	1,107
Materials and Supplies	239	217
Deferred Income Taxes	171	203
Other Current Assets	111	119
Total Current Assets	2,770	2,391
Properties	30,805	30,208
Accumulated Depreciation	(7,765)	(7,520)
Properties - Net	23,040	22,688
Investment in Conrail (Note 10)	626	609
Affiliates and Other Companies	411	406
Other Long-term Assets	173	194
Total Assets	$27,020	$26,288
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Accounts Payable	$963	$973
Labor and Fringe Benefits Payable	402	465
Casualty, Environmental and Other Reserves (Note 4)	179	236
Current Maturities of Long-term Debt (Note 7)	316	319
Income and Other Taxes Payable	121	125
Other Current Liabilities	95	286
Total Current Liabilities	2,076	2,404
Casualty, Environmental and Other Reserves (Note 4)	580	643
Long-term Debt (Note 7)	7,906	7,512
Deferred Income Taxes	6,551	6,235
Other Long-term Liabilities	1,218	1,426
Total Liabilities	18,331	18,220
Common Stock $1 Par Value	393	391
Other Capital	48	-
Retained Earnings	8,963	8,398
Accumulated Other Comprehensive Loss (Note 1)	(728)	(741)

Noncontrolling Minority Interest	13	20
Total Shareholders' Equity	8,689	8,068
Total Liabilities and Shareholders' Equity	$27,020	$26,288

See accompanying notes to consolidated financial statements.

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ITEM 1: FINANCIAL STATEMENTS

CONSOLIDATED CASH FLOW STATEMENTS (Unaudited)
(Dollars in Millions)

	Nine Months Ended	
	2009	2008
OPERATING ACTIVITIES		
Net Earnings	$847	$1,118
Adjustments to Reconcile Net Earnings to Net Cash Provided by Operating Activities:		
Depreciation	679	686
Deferred Income Taxes	330	356
Contributions to Qualified Pension Plans	(166)	(50)
Other Operating Activities	(150)	(14)
Changes in Operating Assets and Liabilities:		
Accounts Receivable	159	(76)
Other Current Assets	(50)	(4)
Accounts Payable	(4)	86
Income and Other Taxes Payable	39	54
Other Current Liabilities	(80)	35
Net Cash Provided by Operating Activities	1,604	2,191
INVESTING ACTIVITIES		
Property Additions (Note 1)	(1,046)	(1,308)
Purchases of Short-term Investments	-	(25)
Proceeds from Sales of Short-term Investments	-	280
Other Investing Activities	51	27
Net Cash Used in Investing Activities	(995)	(1,026)
FINANCING ACTIVITIES		
Long-term Debt Issued (Note 7)	500	1,000
Long-term Debt Repaid (Note 7)	(110)	(220)
Dividends Paid	(259)	(222)
Stock Options Exercised (Note 3)	19	75
Shares Repurchased	-	(1,307)
Other Financing Activities (Note 1)	(188)	36
Net Cash Used in Financing Activities	(38)	(638)
Net Increase in Cash and Cash Equivalents	571	527
CASH AND CASH EQUIVALENTS		
Cash and Cash Equivalents at Beginning of Period	669	368
Cash and Cash Equivalents at End of Period	$1,240	$895

See accompanying notes to consolidated financial statements.

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CSX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. Nature of Operations and Significant Accounting Policies

Background

CSX Corporation ("CSX") together with its subsidiaries (the "Company"), based in Jacksonville, Florida, is one of the nation's leading transportation suppliers. The Company's rail and intermodal businesses provide rail-based transportation services including traditional rail service and the transport of intermodal containers and trailers.

CSX's principal operating subsidiary, CSX Transportation, Inc. ("CSXT"), provides an important link to the transportation supply chain through its approximately 21,000 route mile rail network, which serves major population centers in 23 states east of the Mississippi River, the District of Columbia and the Canadian provinces of Ontario and Quebec. CSX Intermodal, Inc. ("Intermodal"), one of the nation's largest coast-to-coast intermodal transportation providers, is a stand-alone, integrated intermodal company linking customers to railroads via trucks and terminals.

Other entities

In addition to CSXT, the rail segment includes non-railroad subsidiaries Total Distribution Services, Inc. ("TDSI"), Transflo Terminal Services, Inc. ("Transflo"), CSX Technology, Inc. ("CSX Technology") and other subsidiaries. TDSI serves the automotive industry with distribution centers and storage locations, while Transflo provides logistical solutions for transferring products from rail to trucks. Technology and other support services are provided by CSX Technology and other subsidiaries.

CSX's other holdings include CSX Real Property, Inc., a subsidiary responsible for the Company's real estate sales, leasing, acquisition and management and development activities. These activities are classified in other income – net because they are not considered by the Company to be operating activities and results may fluctuate with the timing of real estate sales. In May 2009, CSX sold the stock of a subsidiary that indirectly owned Greenbrier Hotel Corporation, owner of The Greenbrier resort. For more information, see Note 11, Discontinued Operations.

Basis of Presentation

In the opinion of management, the accompanying consolidated financial statements contain all normal, recurring adjustments necessary to fairly present the following:

- Consolidated income statements for the quarters and nine months ended September 25, 2009 and September 26, 2008;
- Consolidated balance sheets at September 25, 2009 and December 26, 2008; and
- Consolidated cash flow statements for the nine months ended September 25, 2009 and September 26, 2008.

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CSX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

In addition, management has evaluated and disclosed all material events occurring subsequent to the date of the financial statements up to the date this quarterly report is filed on Form 10-Q.

Pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"), certain information and disclosures normally included in the notes to the annual financial statements prepared in accordance with U.S. generally accepted accounting principles have been omitted from these interim financial statements. CSX suggests that these financial statements be read in conjunction with the audited financial statements and the notes included in CSX's most recent Annual Report on Form 10-K, its subsequent Quarterly Reports on Form 10-Q and any Current Reports on Form 8-K.

Fiscal Year

CSX follows a 52/53 week fiscal reporting calendar with the last day of each reporting period ending on a Friday:

- The third fiscal quarter of 2009 and 2008 consisted of 13 weeks ending on September 25, 2009 and September 26, 2008, respectively.
- The nine month periods of 2009 and 2008 consisted of 39 weeks ending on September 25, 2009 and September 26, 2008, respectively.
- Fiscal year 2008 consisted of 52 weeks ending on December 26, 2008.
- Fiscal year 2009 will consist of 52 weeks ending on December 25, 2009.
- Fiscal year 2010 will consist of 53 weeks ending on December 31, 2010.

Except as otherwise specified, references to "third quarter(s)" or "nine months" indicate CSX's fiscal periods ending September 25, 2009 or September 26, 2008, and references to year-end indicate the fiscal year ended December 26, 2008.

Comprehensive Earnings

Total comprehensive earnings are defined as all changes in shareholders' equity during a period, other than those resulting from investments by and distributions to shareholders (i.e., issuance of equity securities and dividends). Generally, for CSX, total comprehensive earnings equals net earnings plus or minus adjustments for pension and other post-retirement liabilities. Total comprehensive earnings represent the activity for a period net of related tax effects and were $300 million and $383 million for third quarters 2009 and 2008, respectively, and $860 million and $1.1 billion for nine months 2009 and 2008, respectively.

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CSX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

While total comprehensive earnings is the activity in a period and is largely driven by net earnings in that period, accumulated other comprehensive income or loss ("AOCI") represents the cumulative balance of other comprehensive income, net of tax, as of the balance sheet date. For CSX, AOCI is primarily the cumulative balance related to the pension and other post-retirement adjustments and reduced overall equity by $728 million and $741 million as of September 2009 and December 2008, respectively.

Allowance for Doubtful Accounts

The Company maintains an allowance for doubtful accounts on uncollectible accounts related to freight receivables, public projects (work done by CSX on behalf of a government agency), claims for damages and other various receivables. The allowance is based upon the credit worthiness of customers, historical experience, the age of the receivable and current market and economic conditions. Uncollectible amounts are charged against the allowance account. Allowance for doubtful accounts of $55 million and $70 million is included in the Consolidated Balance Sheets as of September 2009 and December 2008.

Capital Expenditures

Property additions, which are classified as investing activities on the consolidated cash flow statements, consisted of $1 billion and $1.3 billion for nine months 2009 and 2008, respectively. Total capital expenditures for nine months 2009 also include approximately $160 million of new assets purchased using seller financing, which are included in other financing activities on the consolidated cash flow statements. There were no purchases of new assets under seller financing agreements during 2008. For 2009, the Company plans to spend $1.6 billion for total capital expenditures.

New Accounting Pronouncements and Changes in Accounting Policy

In June 2009, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162. This statement modifies the Generally Accepted Accounting Principles ("GAAP") hierarchy by establishing only two levels of GAAP, authoritative and nonauthoritative accounting literature. Effective July 2009, the FASB Accounting Standards Codification ("ASC"), also known collectively as the "Codification," is considered the single source of authoritative U.S. accounting and reporting standards, except for additional authoritative rules and interpretive releases issued by the SEC. Nonauthoritative guidance and literature would include, among other things, FASB Concepts Statements, American Institute of Certified Public Accountants Issue Papers and Technical Practice Aids and accounting textbooks. The Codification was developed to organize GAAP pronouncements by topic so that users can more easily access authoritative accounting guidance. It is organized by topic, subtopic, section, and paragraph, each of which is identified by a numerical designation. This statement applies beginning in third quarter 2009. All accounting references have been updated, and therefore SFAS references have been replaced with ASC references.

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

Effective beginning second quarter 2009, the Financial Instruments Topic, ASC 825-10-65-1(a), requires disclosures about fair value of financial instruments in quarterly reports as well as in annual reports. For CSX, this statement applies to certain investments and long-term debt. (See Note 12, Fair Value Measurements.)

Effective beginning first quarter 2009, the Consolidation Topic, ASC 810-10-45-16, revised the accounting treatment for noncontrolling minority interests of partially-owned subsidiaries. Noncontrolling minority interests represent the portion of earnings that is not within the parent company's control. These amounts are now required to be reported as equity instead of as a liability on the balance sheet. This change resulted in a $20 million reclassification from other long-term liabilities to shareholders' equity on the December 2008 consolidated balance sheet and are primarily related to CSX's investments in Four Rivers Transportation Inc. and The Indiana Rail Road Company. Additionally, this statement requires net income from noncontrolling minority interests to be shown separately on the consolidated income statements. These amounts are not material for CSX and therefore are not shown separately.

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CSX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 2. Earnings Per Share

The following table sets forth the computation of basic earnings per share and earnings per share, assuming dilution:

	Third Quarters		Nine Months Ended	
	2009	2008	2009	2008
Numerator (Dollars in millions):				
Earnings from Continuing Operations	$293	$380	$832	$1,134
Interest Expense on Convertible Debt - Net of Tax	-	-	-	1
Earnings from Continuing Operations, If Converted	293	380	832	1,135
Discontinued Operations - Net of Tax (a)	-	2	15	(16)
Net Earnings, If Converted	293	382	847	1,119
Interest Expense on Convertible Debt - Net of Tax	-	-	-	(1)
Net Earnings	$293	$382	$847	$1,118
Denominator (Units in thousands):				
Average Common Shares Outstanding	392,352	402,224	391,847	404,260
Convertible Debt	1,116	1,390	1,117	3,612
Stock Option Common Stock Equivalents (b)	2,417	3,634	2,076	4,055
Other Potentially Dilutive Common Shares	448	1,238	228	1,009
Average Common Shares Outstanding, Assuming Dilution	396,333	408,486	395,268	412,936
Net Earnings Per Share, Basic:				
Continuing Operations	$0.75	$0.94	$2.12	$2.81
Discontinued Operations	-	0.01	0.04	(0.04)
Net Earnings	$0.75	$0.95	$2.16	$2.77
Net Earnings Per Share, Assuming Dilution:				
Continuing Operations	$0.74	$0.93	$2.10	$2.75
Discontinued Operations	-	0.01	0.04	(0.04)
Net Earnings	$0.74	$0.94	$2.14	$2.71

(a) For additional information regarding discontinued operations, see Note 11, Discontinued Operations.

(b) When calculating diluted earnings per share for stock option common stock equivalents, the Earnings Per Share Topic, ASC 260, requires CSX to include the potential shares that would be outstanding if all outstanding stock options were exercised. This is offset by shares CSX could repurchase using the proceeds from these hypothetical exercises to obtain the common stock equivalent. This number is different from outstanding stock options, which is included in Note 3, Share-Based Compensation. All stock options were dilutive for the periods presented; therefore, no stock options were excluded from the diluted earnings per share calculation.

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CSX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 2. Earnings Per Share, continued

Basic earnings per share is based on the weighted-average number of shares of common stock outstanding. Earnings per share, assuming dilution, is based on the weighted-average number of shares of common stock outstanding adjusted for the effects of common stock that may be issued as a result of the following types of potentially dilutive instruments:

- convertible debt,
- employee stock options, and
- other equity awards, which include long-term incentive awards.

The Earnings Per Share Topic, ASC 260, requires CSX to include additional shares in the computation of earnings per share, assuming dilution. The additional shares included in diluted earnings per share represents the number of shares that would be issued if all of CSX's outstanding convertible debentures were converted into CSX common stock.

As a result, diluted shares outstanding are not impacted when debentures are converted into CSX common stock because those shares were already included in the diluted shares calculation. Shares outstanding for basic earnings per share, however, are impacted on a weighted average basis when conversions occur. During third quarter 2008, $15 million of face value of convertible debentures were converted into 530,000 shares of CSX common stock. There were no material conversions of convertible debentures during third quarter 2009. As of September 2009, approximately $31 million of convertible debentures at face value remained outstanding, which are convertible into approximately 1 million shares of CSX common stock.

NOTE 3. Share-Based Compensation

CSX share-based compensation plans primarily include performance grants, restricted stock awards, stock options and stock plans for directors. CSX has not granted stock options since 2003. Awards granted under the various plans are determined and approved by the Compensation Committee of the Board of Directors or, in certain circumstances, by the Chief Executive Officer for awards to management employees other than senior executives. The Board of Directors approves awards granted to the Company's non-management Directors upon recommendation of the Governance Committee.

Total pre-tax expense associated with share-based compensation and its related income tax benefit is as follows:

	Third Quarters		Nine Months Ended	
(Dollars in millions)	2009	2008	2009	2008
Share-Based Compensation Expense (a)	$9	$24	$12	$48
Income Tax Benefit	(3)	(9)	(4)	(18)

(a) Share-based compensation expense may fluctuate with estimates of the number of performance-based awards that are expected to be awarded in future periods.

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NOTE 3. Share-Based Compensation, continued

The following table provides information about stock options exercised.

	Third Quarters		Nine Months Ended	
(In thousands)	2009	2008	2009	2008
Number of Stock Options Exercised	386	521	952	3,940

As of December 2008, all outstanding options are vested, and therefore, there will be no future expense related to these options. As of September 2009, CSX had approximately 6 million stock options outstanding. However, the impact of options to diluted earnings per share is much smaller (see footnote b in Note 2, Earnings Per Share for more information).

NOTE 4. Casualty, Environmental and Other Reserves

Casualty, environmental and other reserves were determined to be critical accounting estimates due to the need for significant management judgments. They are provided for in the consolidated balance sheets as follows:

	September 2009			December 2008		
(Dollars in millions)	Current	Long-term	Total	Current	Long-term	Total
Casualty:						
Personal Injury	$78	$223	$301	$104	$258	$362
Occupational	22	165	187	32	172	204
Total Casualty	100	388	488	136	430	566
Separation	15	61	76	16	71	87
Environmental	37	60	97	42	58	100
Other	27	71	98	42	84	126
Total	$179	$580	$759	$236	$643	$879

Details with respect to each type of reserve are described below. Actual settlements and claims received could differ. The final outcome of these matters cannot be predicted with certainty. Considering the legal defenses asserted, the liabilities that have been recorded, and other factors, it is the opinion of management that none of these items, when finally resolved, will have a material effect on the Company's financial condition, results of operations or liquidity. However, should a number of these items occur in the same period, they could have a material effect on the Company's financial condition, results of operations or liquidity in that particular period.

During the second quarter of 2009, the Company reduced casualty reserves by a net $85 million. The majority of this reduction is related to personal injury and asbestos claims and is described below. Also included in the net reduction is a write-off of $11 million of reinsurance receivables (expected receivables from outside insurance companies). This receivable write-off is not included in the reserve amounts disclosed above.

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NOTE 4. Casualty, Environmental and Other Reserves, continued

Casualty

Casualty reserves represent accruals for personal injury and occupational injury claims. Currently, no individual claim is expected to exceed the Company's self-insured retention amount of $25 million per injury. To the extent the value of an individual claim exceeds the self-insured retention amount, the Company would present the liability on a gross basis in accordance with the Contingencies Topic, ASC 450, with a corresponding receivable for insurance recoveries. These reserves fluctuate based upon the timing of payments as well as changes in independent third party estimates, which are reviewed by management. Most of the claims relate to CSXT unless otherwise noted below. Defense and processing costs, which historically have been insignificant and are anticipated to be insignificant in the future, are not included in the recorded liabilities.

Personal Injury

Personal injury reserves represent liabilities for employee work-related and third-party injuries. Work-related injuries for CSXT employees are primarily subject to the Federal Employers' Liability Act ("FELA"). In addition to FELA liabilities, employees of other former and current CSX subsidiaries are covered by various state workers' compensation laws, the Federal Longshore and Harbor Workers' Compensation Program or the Maritime Jones Act.

CSXT retains an independent actuarial firm to assist management in assessing the value of personal injury claims and cases. An analysis is performed by the independent actuarial firm semi-annually and is reviewed by management. The methodology used by the actuary includes a development factor to reflect growth or reduction in the value of these personal injury claims. It is based largely on CSXT's historical claims and settlement experience. Actual results may vary from estimates due to the number, type and severity of the injury, costs of medical treatments and uncertainties in litigation.

During second quarter 2009, the Company reduced personal injury reserves by $78 million based on management's review of the actuarial analysis performed by an independent actuarial firm. This reduction is a direct result of the Company's improvement in safety. Claims have shown a continued downward trend in the number of injuries, resulting in a continued reduction of the Company's FRA personal injury rate. Additionally, the trend in the severity of injuries has significantly declined.

Occupational

Occupational claims arise from allegations of exposure to certain materials in the workplace, such as asbestos, solvents (which include soaps and chemicals) and diesel fuels or allegations of chronic physical injuries resulting from work conditions, such as repetitive stress injuries, carpal tunnel syndrome and hearing loss.

CSX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 4. Casualty, Environmental and Other Reserves, continued

An analysis of occupational claims is performed semi-annually by an independent third party and reviewed by management. The methodology used includes an estimate of future anticipated incurred but not reported claims based on the Company's trends in average historical claim filing rates, future anticipated dismissal rates and settlement rates. Actual claims may vary from estimates due to the number, type and severity of the injury, costs of medical treatments and uncertainties in litigation.

During second quarter 2009, the Company reduced its asbestos reserves by $18 million. This reserve reduction is related to approximately 1,500 claims that were deemed to have no medical merit and therefore have been determined to have no value.

Separation

Separation liabilities include the estimated benefits provided to certain union employees as a result of implementing workforce reductions, improvements in productivity and certain other cost reductions at the Company's major transportation units since 1991. These liabilities are expected to be paid out over the next 10 to 15 years from general corporate funds and may fluctuate depending on the timing of payments and associated taxes.

Environmental

The Company is a party to various proceedings related to environmental issues, including administrative and judicial proceedings, involving private parties and regulatory agencies. The Company has been identified as a potentially responsible party at approximately 263 environmentally impaired sites. Many of those are, or may be, subject to remedial action under the Federal Comprehensive Environmental Response, Compensation and Liability Act of 1980, or CERCLA, also known as the Superfund Law, or similar state statutes. Most of these proceedings arose from environmental conditions on properties used for ongoing or discontinued railroad operations. However, a number of these proceedings are based on allegations that the Company, or its predecessors, sent hazardous substances to facilities owned or operated by others for treatment or disposal. In addition, some of the Company's land holdings were leased to others for commercial or industrial uses that may have resulted in releases of hazardous substances or other regulated materials onto the property and could give rise to proceedings against the Company.

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

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CSX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 4. Casualty, Environmental and Other Reserves, continued

In accordance with the Asset Retirement and Environmental Obligations Topic, ASC 410-30, the Company reviews its role with respect to each site identified at least once a quarter. Based on the review process, the Company has recorded amounts to cover anticipated contingent future environmental remediation costs with respect to each site to the extent such costs are estimable and probable. The recorded liabilities for estimated future environmental costs are undiscounted and include amounts representing the Company's estimate of unasserted claims, which the Company believes to be immaterial. The liability includes future costs for remediation and restoration of sites as well as any significant ongoing monitoring costs, but excludes any anticipated insurance recoveries. Payments related to these liabilities are expected to be made over the next several years.

Currently, the Company does not possess sufficient information to reasonably estimate the amounts of additional liabilities, if any, on some sites until completion of future environmental studies. In addition, changes in conditions, or conditions that are currently unknown could, at any given location, result in exposure, the amount and materiality of which cannot presently be reliably estimated. Based upon information currently available, however, the Company believes its environmental reserves are adequate to fund remedial actions to comply with present laws and regulations, and that the ultimate liability for these matters, if any, will not materially affect its overall financial condition, results of operations or liquidity.

Other

Other reserves include liabilities for various claims, such as longshoremen disability claims primarily associated with former subsidiaries' activities, freight claims and claims for property, automobile and general liability. These liabilities are accrued at the estimable and probable amount in accordance with the Contingencies Topic, ASC 450.

NOTE 5. Commitments and Contingencies

Insurance

The Company maintains numerous insurance programs with substantial limits for third-party casualty liability and Company property damage and business interruption. A certain amount of risk is retained by the Company on each of the casualty and property programs. For the first event in any given year, the Company has a $25 million deductible for each of the casualty and non-catastrophic property programs and a $50 million deductible for the catastrophic property program.

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CSX CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 5. Commitments and Contingencies, continued

Guarantees

CSX and certain of its subsidiaries are contingently liable, individually and jointly with others, as guarantors of approximately $42 million in obligations principally relating to leased equipment, vessels and joint facilities used by the Company in its current and former business operations. Utilizing the Company's guarantee for these obligations allows the obligor to take advantage of lower interest rates and obtain other favorable terms. Guarantees are contingent commitments issued by the Company that could require CSX or one of its affiliates to make payment to, or to perform certain actions for, the beneficiary of the guarantee based on another entity's failure to perform. These guarantees do not include CSX's guarantee of applicable CSXT secured notes because these notes are included on CSX's consolidated balance sheet.

As of third quarter 2009, the Company's guarantees primarily related to the following:

- Guarantee of approximately $38 million of obligations of a former subsidiary, CSX Energy, in connection with a sale-leaseback transaction. CSX is, in turn, indemnified by several subsequent owners of the entity against payments made with respect to this guarantee. Management does not expect that CSX will be required to make any payments under this guarantee for which CSX will not be reimbursed. CSX's obligation under this guarantee will be completed in 2012.

- Guarantee of approximately $4 million of lease commitments assumed by A.P. Moller-Maersk ("Maersk") for which CSX is contingently liable. CSX believes Maersk will fulfill its contractual commitments with respect to such lease commitments, and CSX will have no further liabilities for those obligations. CSX's obligation under this guarantee will be completed in 2011.

As of third quarter 2009, the Company has not recognized any liabilities in its financial statements in connection with any guarantee arrangements described above. The maximum amount of future payments the Company could be required to make under these guarantees is the sum of the guaranteed amounts noted above.

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NOTE 5. Commitments and Contingencies, continued

Legal Proceedings

There were no material developments during the quarter concerning the fuel surcharge anti-trust litigation or the Seminole Electric Cooperative, Inc. rate case. For further details, see Note 6, Commitments and Contingencies, in CSX's most recent Annual Report on Form 10-K.

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

NOTE 6. Employee Benefit Plans

The Company sponsors defined benefit pension plans principally for salaried, management personnel. The plans provide eligible employees with retirement benefits based predominantly on years of service and compensation rates near retirement. For employees hired after December 31, 2002, benefits are determined based on a cash balance formula, which provides benefits by utilizing interest and pays credits based upon age, service and compensation.

In addition to these plans, CSX sponsors a post-retirement medical plan and a life insurance plan that provide benefits to full-time, salaried, management employees hired on or before December 31, 2002 upon their retirement if certain eligibility requirements are met. The post-retirement medical plan is contributory (partially funded by retirees), with retiree contributions adjusted annually. The life insurance plan is non-contributory.

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NOTE 6. Employee Benefit Plans, continued

The Company engages independent, external actuaries to compute the amounts of liabilities and expenses relating to these plans subject to the assumptions that the Company selects. The following table describes the components of expense/(income) related to net periodic benefit cost:

	Pension Benefits			
(Dollars in millions)	Third Quarters		Nine Months Ended	
	2009	2008	2009	2008
Service Cost	$8	$8	$24	$25
Interest Cost	32	29	94	89
Expected Return on Plan Assets	(37)	(36)	(108)	(108)
Amortization of Prior Service Cost	1	1	2	2
Amortization of Net Loss	6	6	19	17
Net Periodic Benefit Cost	$10	$8	$31	$25

	Other Post-retirement Benefits			
(Dollars in millions)	Third Quarters		Nine Months Ended	
	2009	2008	2009	2008
Service Cost	$2	$2	$4	$5
Interest Cost	5	5	17	15
Amortization of Prior Service Cost	-	-	-	(1)
Amortization of Net Loss	1	-	3	2
Net Periodic Benefit Cost	$8	$7	$24	$21

In accordance with the Pension Protection Act ("the Act") of 2006, companies are required to be 94% funded for their outstanding qualified pension obligations as of January 1, 2009 in order to avoid a scheduled series of required annual contributions. Recent market volatility and overall investment losses of pension assets reduced the funded status of CSX's qualified plans; however, required minimum contributions under funding rules for 2009 were approximately $5 million. The Company intends to pre-fund contributions up to $250 million pre-tax, or $160 million after-tax due to likely contribution requirements over the next several years. Through September 2009, the Company made contributions of $166 million and currently anticipates that additional contributions of up to $84 million may be made in the remainder of 2009. For further details, see Note 7, Employee Benefit Plans, in CSX's most recent Annual Report on Form 10-K.

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NOTE 7. Debt and Credit Agreements

Debt

Total activity related to long-term debt as of September 2009 was as follows:

(Dollars in millions)	Current Portion	Long-term Portion	Total Long-term Debt Activity
Total long-term debt at December 2008	$319	$7,512	$7,831
2009 activity:			
Issued	-	500	500
Repaid	(110)	-	(110)
Reclassifications	107	(107)	-
Other	-	1	1
Total long-term debt at September 2009	$316	$7,906	$8,222

For fair value information related to the Company's long-term debt, see Note 12, Fair Value Measurements.

Revolving Credit Facility

CSX has a $1.25 billion unsecured revolving credit facility with a syndicate of banks. The facility allows borrowings at floating rates based on the London interbank offered rate ("LIBOR"), plus a spread depending upon ratings assigned by Moody's Investors Service and Standard & Poor's Ratings Group to CSX's senior, unsecured, long-term indebtedness for borrowed money. The facility requires CSX to maintain a ratio of total debt to total capitalization below a prescribed limit. The facility does not require CSX to post collateral under any circumstances. As of September 2009, this facility was not drawn on, and CSX was in compliance with all covenant requirements under the facility. This facility expires in 2012.

Receivables Securitization Facility

On September 28, 2009, following the end of the fiscal quarter, the Company entered into a $250 million receivables securitization facility. The purpose of this facility is to provide an alternative to commercial paper and a low cost source of short-term liquidity. This facility has a 364-day term. As of the date of this filing, CSX has not drawn on this facility. Under the terms of this facility, CSX Transportation and CSX Intermodal transfer eligible third-party receivables to CSX Trade Receivables, a bankruptcy-remote special purpose subsidiary. A separate subsidiary of CSX will service the receivables. Upon transfer, the receivables become assets of CSX Trade Receivables and are not available to the creditors of CSX or any of its other subsidiaries. The cash received in exchange for these receivables when CSX Trade Receivables monetizes them by selling them to third party lenders will be recorded as debt on CSX's consolidated financial statements.

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CSX CORPORATION
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NOTE 8. Other Income - Net

The Company derives income from items that are not considered operating activities. Income from these items is reported net of related expense in other income – net on the consolidated income statements. Other income – net consists primarily of interest income, income from real estate and miscellaneous income (expense).

Interest income fluctuates as a result of interest rates and balances that earn interest based on CSX’s cash, cash equivalents and short-term investments. Income from real estate includes the results of operations of the Company’s non-operating real estate sales, leasing, acquisition and management and development activities. This real estate income may fluctuate as a function of timing of real estate sales. Miscellaneous income includes a number of items which can be income or expense. Examples of these items are equity earnings or losses, noncontrolling minority interest expense, investment gains and losses and other non-operating activities. Other income – net consisted of the following:

	Third Quarters		Nine Months Ended	
(Dollars in millions)	2009	2008	2009	2008
Interest Income	$2	$10	$9	$31
Income from Real Estate	11	3	18	36
Miscellaneous Income (Expense) (a)	(7)	(8)	(8)	27
Total Other Income - Net	$6	$5	$19	$94

(a) In first quarter 2008, CSX recorded additional income of $30 million for an adjustment to correct equity earnings from a non-consolidated subsidiary.

Previously, the results of operations from The Greenbrier resort were included in other income – net. In May 2009, CSX sold the stock of a subsidiary that indirectly owned Greenbrier Hotel Corporation, owner of The Greenbrier resort. The results of this resort are now presented in discontinued operations on the consolidated income statements and all prior periods have been reclassified. For more information, see Note 11, Discontinued Operations.

NOTE 9. Income Taxes

As of September 2009 and December 2008, the Company had approximately $50 million and $57 million of total unrecognized tax benefits, respectively. For the same periods, after consideration of the impact of federal tax benefits, $42 million and $50 million, respectively, of net unrecognized tax benefits could favorably affect the effective income tax rate. As of September 2009, the Company estimates that approximately $13 million of the net unrecognized tax benefits for various state and federal income tax matters will be resolved over the next 12 months. Approximately $4 million of this total will be recognizable upon the expiration of various statutes of limitation. The final outcome of the remaining uncertain tax positions, however, is not yet determinable.

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NOTE 9. Income Taxes, continued

During second quarter 2008, the Internal Revenue Service ("IRS") completed its examination of tax years 2004 through 2006. As a result of this examination and the resolution of other income tax matters, the Company recorded an income tax benefit of $18 million.

The Company files a consolidated federal income tax return, which includes its principal domestic subsidiaries. CSX and its subsidiaries are subject to U.S. federal income tax as well as income tax of multiple state jurisdictions. During 2008, the Internal Revenue Service ("IRS") completed examinations of tax years 2004 through 2006 as well as for 2007. The Company has appealed a tax adjustment proposed by the IRS with respect to the 2004 through 2006 period and a related amount is included in the uncertain tax positions above. This appeals process is expected to last more than one year. Federal examinations of original federal income tax returns for all years through 2007 are otherwise resolved. During the third quarter of 2009, the IRS began its examination of the 2008 federal income tax return.

CSX's continuing practice is to recognize interest and penalties (net of related federal or state tax benefits or expense) associated with income tax matters in income tax expense. As of September 2009 and December 2008, the Company had a $6 million and a $2 million gross payable before the consideration of state tax impacts, respectively, accrued for interest and penalties.

NOTE 10. Related Party Transactions

Through a limited liability company, CSX and Norfolk Southern Corporation ("NS") jointly own Conrail, Inc. ("Conrail"). CSX has a 42% economic interest and 50% voting interest in the jointly-owned entity, and NS has the remainder of the economic and voting interests. Pursuant to the Investments - Equity Method and Joint Ventures Topic, ASC 323, CSX applies the equity method of accounting to its investment in Conrail. At September 2009 and December 2008, CSX's investment in Conrail was $626 million and $609 million, respectively.

CSX's income statement is impacted in several ways by the joint ownership of Conrail. First, Conrail owns and operates rail infrastructure for the joint benefit of CSX and NS. This is known as the shared asset area. Conrail charges fees for right-of way usage, equipment rentals and transportation, and switching and terminal service charges in the shared asset area. In addition, because of CSX's equity interest in Conrail, CSX also includes a share of Conrail's income which is recorded as a contra-expense and reduces the total amount of expense recorded for Conrail. Also, purchase price amortization primarily represents the additional after-tax depreciation expense related to the write-up of Conrail's fixed assets when the original purchase price, from the 1997 acquisition of Conrail, was allocated based on fair value. Lastly, interest expense is recorded on long-term payables to Conrail.

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NOTE 10. Related Party Transactions, continued

Dollar amounts of these items impacting the consolidated income statements were as follows:

	Third Quarters		Nine Months Ended	
(Dollars in millions)	2009	2008	2009	2008
Income Statement Information:				
Rents, Fees and Services	$26	$31	$76	$84
Equity in Income of Conrail	(6)	(6)	(20)	(18)
Purchase Price Amortization and Other	1	1	3	3
Interest Expense Related to Conrail	1	1	3	3
Income Statement Impact	$22	$27	$62	$72

Additional information about the investment in Conrail is included in CSX's most recent Annual Report on Form 10-K.

NOTE 11. Discontinued Operations

As previously reported in March 2009, Greenbrier Hotel Corporation ("GHC"), owner of The Greenbrier resort and then an indirect subsidiary of CSX, filed for Chapter 11 bankruptcy protection in the U.S. Bankruptcy Court for the Eastern District of Virginia, Richmond Division ("Bankruptcy Court"). In conjunction with the bankruptcy, GHC also announced an agreement to sell the resort pursuant to an asset purchase agreement (the "APA") with Marriott Hotel Services, Inc.

In May 2009, CSX sold the stock of a subsidiary that indirectly owned GHC to Justice Family Group, LLC ("JFG") for approximately $21 million in cash. CSX recognized a gain on the sale of $25 million after tax in the second quarter of 2009. The gain was calculated using cash proceeds, net book value, deal-related costs incurred and tax benefits. The previously reported bankruptcy financing that CSX made available to The Greenbrier was paid down and no amounts were outstanding at the time of the sale. Also in May 2009, the Bankruptcy Court entered an order dismissing GHC's bankruptcy proceeding and terminating the APA. CSX has no continuing obligations to finance post-sale resort operations. CSX has retained responsibility for certain pre-closing Greenbrier pension obligations.

This transaction is reportable as discontinued operations under the subsection Impairment or Disposal of Long-Lived Assets, ASC 360-10-45-2. Therefore, the gain on sale as well as results from operations are reported as discontinued operations. Previously, all amounts associated with the operations of The Greenbrier were included in Other Income - Net. All prior periods have been reclassified to reflect this change.

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CSX CORPORATION
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NOTE 11. Discontinued Operations, continued

Income statement information:

	Third Quarters		Nine Months Ended	
(Dollars in millions)	2009	2008	2009	2008
Net Income (Loss) From Operations, after tax	$ -	$2	$(10)	$(16)
Gain on Sale, after tax	-	-	25	-
Net Income (Loss) From Discontinued Operations	$ -	$2	$15	$(16)
Earnings per Share				
From Discontinued Operations, Assuming Dilution	$ -	$0.01	$0.04	$(0.04)

NOTE 12. Fair Value Measurements

Effective beginning second quarter 2009, the Financial Instruments Topic, ASC 825, requires disclosures about fair value of financial instruments in quarterly reports as well as in annual reports. For CSX, this statement applies to certain investments and long-term debt. Also, the Fair Value Measurements and Disclosures Topic, ASC 820, clarifies the definition of fair value for financial reporting, establishes a framework for measuring fair value and requires additional disclosures about the use of fair value measurements.

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

- Level 1 – observable market inputs that are unadjusted quoted prices for identical assets or liabilities in active markets

- Level 2 – other significant observable inputs (including quoted prices for similar securities, interest rates, credit risk, etc.)

- Level 3 – significant unobservable inputs (including the Company’s own assumptions in determining the fair value of investments)

The Company’s investment assets are valued by a third-party trustee, consist primarily of corporate bonds and are carried at fair value on the consolidated balance sheet. As of September 2009, these bonds had a fair value of $116 million. All inputs used to determine fair value are considered level 2 inputs.

Long-term debt is the Company’s only financial instrument with fair values significantly different from their carrying amounts. The fair value of long-term debt has been estimated using discounted cash flow analysis based upon the Company's current incremental borrowing rates for similar types of financing arrangements which are considered level 2 inputs.

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NOTE 12. Fair Value Measurements, continued

The fair value of outstanding debt fluctuates with changes in applicable interest rates. Fair value will exceed carrying value when the current market interest rate is lower than the interest rate at which the debt was originally issued. The fair value of a company's debt is a measure of its current value under present market conditions. It does not impact the financial statements under current accounting rules. The fair value and carrying value of the Company's long-term debt is as follows:

(Dollars in millions)	September 2009	December 2008
Long-term Debt Including Current Maturities:		
Fair Value	$9,192	$7,415
Carrying Value	$8,222	$7,831

NOTE 13. Business Segments

The Company's consolidated operating income results are comprised of two business segments: Rail and Intermodal. The Rail segment provides rail freight transportation over a network of approximately 21,000 route miles in 23 states, the District of Columbia and the Canadian provinces of Ontario and Quebec. The Intermodal segment provides integrated rail and truck transportation services and operates a network of dedicated intermodal facilities across North America. These segments are strategic business units that offer different services and are managed separately. Performance of each segment is evaluated and resources are allocated based on several factors, of which the principal financial measures are business segment operating income and operating ratio. The accounting policies of the segments are the same as those described in Note 1, Nature of Operations and Significant Accounting Policies, in CSX's most recent Annual Report on Form 10-K. Business segment information is as follows:

	Third Quarters					
(Dollars in millions)	Rail (a)	Intermodal	CSX Consolidated			
	2009					
Land	$	43,747	$ 25,899	$ 17,848	69	%
Marine	64,549		48,558	15,991	33	%
Total Multi-Client	108,296		74,457	33,839	45	%
Contract:						
Land	48,817		47,647	1,170	2	%
Marine	73,718		46,574	27,144	58	%
Total Contract	122,536		94,221	28,314	30	%
Total Revenue	$	230,831	$ 168,678	$ 62,153	37	%

Revenue by segment is as follows:

For the Three Months Ended October 31,

Change

	2006 (Dollars in thousands)	2005	$	%
NASA	$ 139,294	$ 102,842	$ 36,452	35 %
EAME	54,248	34,769	19,479	56 %
APAC	32,202	26,783	5,419	20 %
VHR	5,087	4,284	803	19 %
Total Revenue	$ 230,831	$ 168,678	$ 62,153	37 %

Operating income. Operating income for the first quarter of fiscal 2007 of $37.9 million more than doubled from the $18.3 million in the prior year s first fiscal quarter. The increase in the operating income was primarily due to higher revenue and margins in both multi-client and contract work. Margin increases were generated by marine multi-client sales in the Gulf of Mexico, Canada, North Sea and Kazakhstan.

Operating income included $10.3 million of merger and related costs. We terminated discussions with a third party relating to the possible sale of our land seismic acquisition business, during the first quarter of fiscal 2007. The $10.3 million includes fees in connection with the termination of those discussions, consisting of amounts paid in settlement of all claims by the third party buyers and professional fees, including accounting and legal fees, and professional fees related to the pending merger with CGG.

Also included in operating income in the first quarter of fiscal 2007 was approximately $2.7 million of depreciation that related to the land seismic acquisition assets that were previously considered held for sale during fiscal 2006. Another significant item within operating income was $1.4 million of professional fees related to obtaining a significant refund from a foreign taxing authority. The benefit of the refund was recorded as a reduction of income tax expense, which is discussed below.

General and administrative expenses increased $2.6 million from the prior year s first fiscal quarter primarily due to the professional fees incurred related to obtain the tax refund discussed above and discussed in the income tax section below.

Interest expense. Interest expense increased by $0.7 million from the prior year s first fiscal quarter as a result of increases in the LIBOR rate applicable to the $155 million convertible debt.

Interest income. Interest income increased $3.1 million compared to the prior year s first fiscal quarter due to a higher cash balance and higher interest rates.

Involuntary conversion of assets. The company recognized a pre-tax insurance gain of $2.0 million in the first quarter of fiscal 2006 related to insurance settlements for the equipment loss on the Veritas Viking experienced in the second quarter of fiscal year 2005.

Other income (expense), net. Other income and expense, net consisted of foreign exchange losses of $0.3 million and other miscellaneous gains of $0.3 million in the first quarter of fiscal 2007. For the first quarter of fiscal year 2006, other income and expense, net consisted of $0.9 million of foreign exchange losses and other miscellaneous gains of $1.0 million.

Income taxes. The company s effective tax rate for the quarter ended October 31, 2006 was 32%, which is lower than the 35% U.S. statutory rate and the prior year s first quarter tax rate of 43%. The reduction in the current quarter rate was attributable to non-U.S. activities and a $5.0 million tax benefit related to a refund received from a foreign taxing authority with respect to certain prior year tax matters. This reduction was partially offset by a $3.6 million tax provision related to $10.3 million of non-deductible merger and related costs.

Liquidity and capital resources

Cash flow and liquidity

Our internal sources of liquidity are cash on hand and cash flow from operations. External sources include existing credit facilities, public financing, equity sales, equipment financing, existing credit facilities, and trade credit. We believe that our current cash balance and cash flow from operations will be adequate to meet our liquidity needs over the next twelve months.

Net cash provided by operating activities was $42.7 million for the first three months of fiscal 2007, which is an increase from $29.4 million for the first three months of fiscal 2006 primarily due to the increase in net income. Net cash used by investing activities increased to $99.0 million in the first three months of fiscal 2007 from $59.4 million in the first three months of fiscal 2006 primarily due to increased multi-client library and capital

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expenditures. Our currently projected cash investments for fiscal 2007 include capital expenditures to replace and upgrade existing equipment of approximately $230 to $250 million and investment in our data library of approximately $270 to $300 million. We expect to fund the remainder of these investments from our current cash on hand and from internally generated funds.

As of the beginning of the second fiscal quarter of fiscal 2006, our convertible senior notes were convertible. See further discussion on the convertibility of the notes below. The notes continued to be convertible as of October 31, 2006. As of October 31, 2006, we had an adequate amount of cash to fund the conversion of the notes which would require a payment of the entire principal amount had all of the notes been converted on that date.

While we believe that we have adequate sources of funds to meet our liquidity needs even if we were required to fund the conversion of the notes, our ability to meet our obligations depends on our future performance, which is subject to many factors beyond our control. Key factors affecting future results include utilization levels of acquisition and processing assets and demand for multi-client library surveys, all of which are driven by exploration spending and, ultimately, the underlying commodity prices.

Debt structure

As of October 31, 2006, our notes payable consisted of $155.0 million of Convertible Senior Notes due 2024. These notes are classified as a current liability as of October 31, 2006 because the conversion feature discussed below results in the notes being convertible at the option of the holders.

The Convertible Senior Notes bear interest at a per annum rate which equals the three-month LIBOR rate, adjusted quarterly, minus a spread of 0.75%. The interest rate of the notes, from September 15, 2006 through December 14, 2006, is 4.64%, based on a LIBOR rate of 5.39%. For the first quarter of fiscal 2007, the weighted average interest rate on the notes was 4.61%. The notes will mature on March 15, 2024 and may not be redeemed by us prior to March 20, 2009. Holders of the notes may require us to repurchase some, or all, of the notes on March 15, 2009, 2014 and 2019. They could also require repurchase upon a change of control (as defined in the indenture under which the Convertible Senior Notes were issued).

Under certain circumstances and at the option of the holder, the Convertible Senior Notes are convertible prior to the maturity date into cash and shares of our common stock. Certain of these circumstances may result in classification of the Convertible Senior Notes as current on our balance sheet. These circumstances include:

1. the closing sale price of our common stock is over 120% of the conversion price, which is currently $24.03 (with 120% being $28.84) for 20 trading days in the period of 30 consecutive trading days ending on the last trading day of the fiscal quarter preceding the quarter in which the conversion occurs;

2. if we called the notes for redemption and the redemption has not occurred;

3. the occurrence of a five consecutive trading day period in which the trading price of the notes was less than 95% of the closing sale price of our common stock on such day multiplied by the conversion ratio; or

4. the occurrence of specified corporate transactions.

Should any of these circumstances occur, the Convertible Senior Notes would be convertible at the then current stock price times the conversion ratio of 41.6146. This amount would be payable in cash equal to the principal amount of the notes, the par value adjusted for dividends or other equity transactions, and the additional amount payable in shares of our common stock. Currently, the maximum amount payable by us on conversion is $155 million in cash plus approximately 6.5 million shares. This settlement method is prescribed in the indenture and is not at the discretion of any party. The shares issuable from such conversion are considered in the calculation of diluted earnings per share.

As of the beginning of the second fiscal quarter of 2006, the Convertible Senior Notes were convertible as the stock price remained greater than 120% of the Conversion Price for at least 20 trading days in the period of 30 consecutive trading days ending on October 31, 2005. The notes continued to be convertible as of October 31, 2006. Because of the convertibility, the notes have been classified as a current liability on our consolidated balance sheet as of October 31, 2006. The determination of the convertibility of the notes occurs quarterly. Depending upon the common stock price in the future, the notes may not be convertible in future quarters and therefore would not be classified as current on our consolidated balance sheet. Assuming a stock price of $72.01 (which was the closing stock price at October 31, 2006), conversion of all the notes would result in our payment of $155 million in cash and 4.3 million shares of common stock.

In connection with our issuance of the Convertible Senior Notes, we entered into a registration rights agreement pursuant to which we agreed to register the resale of the notes and underlying common stock by the holders thereof. If we failed to keep the shelf registration statement related to this debt effective or usable in accordance with the registration rights agreement, then we were required to pay liquidated damages to all holders of notes and all holders of our common stock issued upon conversion of the notes. The liquidated damages to be paid were equal to an annual rate of 0.50% of the principal amount. In November 2005, the shelf registration statement became no longer effective and, accordingly, we began accruing liquidated damages at approximately $2,100 per day. We were not required to register the resale of the notes and underlying common stock after March 10, 2006 and therefore, our liability for the payment of liquidated damages ended on that date.

In addition to the notes, we also have a five-year $85 million revolving loan agreement with a syndicate of banks. The facility provides for revolving loans and the issuance of letters of credit to Veritas DGC Inc. and certain of its subsidiaries of up to $45 million in the United States, $15 million in Canada, $15 million in Singapore and $10 million in the United Kingdom. As of October 31, 2006, there were no borrowings and $5.9 million of outstanding letters of credit, leaving $79.1 million available under the revolving loan facility.

The facility is secured by pledges of accounts receivable and the U.S. land data library, which, when added together, have a carrying amount of approximately $268 million as of October 31, 2006. The facility is also secured by certain intercompany notes and stock in certain Veritas subsidiaries. Veritas and certain of its subsidiaries have also issued loan guarantees with respect to certain borrowings. Interest rates on borrowings under the facility are selected by the borrower at the time of any advance and the rates so selected may be either at LIBOR plus 1.00% or the Base Rate (defined as the lesser of the applicable prime rate or the federal funds rate). These rates may be adjusted upward depending upon our leverage ratio (calculated as a ratio of funded debt versus EBITDA for the previous four quarters) to a maximum of LIBOR plus 1.50% or the base rate plus 0.50%. The loan agreement and related documents contain customary financial covenants and default provisions, including a limit on the amount of cash dividends. These covenants contain certain financial measurements as of quarter ending dates, and, as of October 31, 2006, we were in compliance with these covenants.

We also have various unsecured lines of credit, with lending institutions that operate in geographic areas not covered by the lending institutions in our credit facility, totaling $8.5 million that may be used exclusively for the issuance of letters of credit and bank guarantees. As of October 31, 2006, $0.4 million in letters of credit were outstanding under these lines.

Recent Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior periods financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate effected by a change in accounting principle. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The implementation of SFAS No. 154 did not have a material impact on the company s financial statements.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 150. SFAS No. 155 (a) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (b)

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clarifies that certain instruments are not subject to the requirements of SFAS 133, (c) establishes a requirement to evaluate interests in securitized financial assets to identify interests that may contain an embedded derivative requiring bifurcation, (d) clarifies what may be an embedded derivative for certain concentrations of credit risk and (e) amends SFAS 140 to eliminate certain prohibitions related to derivatives on a qualifying special-purpose entity. SFAS 155 is effective for us for the fiscal year beginning August 1, 2007. The implementation of SFAS No. 155 is not expected to have a material impact on the company s financial statements.

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The new standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. The provisions of FIN No. 48 are effective for years beginning after December 15, 2006, which is our fiscal year beginning August 1, 2007. We are currently evaluating the provisions of FIN No. 48 to determine the impact on our consolidated financial statements.

In September 2006, the FASB issued FASB Staff Position No. AUG AIR-1, Accounting for Planned Major Maintenance Activities. This guidance prohibits the use of the accrue-in-advance method of accounting for planned major activities because an obligation has not occurred and therefore a liability should not be recognized. The provisions of this guidance will be effective for us for the fiscal year beginning August 1, 2007. We are currently evaluating the provisions of this guidance to determine the impact on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements, and accordingly, does not require any new fair value measurements. SFAS No. 157 is effective for our financial statements issued related to the fiscal year beginning August 1, 2008, and interim periods within that year. We are currently evaluating the effect, if any, that the adoption of this standard will have on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R). SFAS No. 158 requires an employer to: (a) Recognize in its statement of financial position an asset for a plan s overfunded status or a liability for a plan s underfunded status; (b) Measure a plan s assets and its obligations that determine its funded status as of the end of the employer s fiscal year (with limited exceptions); (c) Recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective for us as of the end of the fiscal year ending on July 31, 2007. The requirement to measure plan assets and benefit obligations as of the date of our fiscal year-end balance sheet is effective for us for the fiscal year ending July 31, 2009. We are currently evaluating the provisions of this guidance to determine the impact on our consolidated financial statements. Had we adopted SFAS No. 158 as of July 31, 2006, the impact would have been an increase to liabilities and a decrease to stockholders equity of approximately $10 million.

In September 2006, the SEC issued SEC Staff Accounting Bulletin (SAB) No. 108, Financial Statements Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements. SAB No. 108 addresses how a registrant should quantify the effect of an error in the financial statements for purposes of assessing materiality and requires that the effect be computed using both the current year income statement perspective (rollover) and the year end balance sheet perspective (iron curtain) methods for fiscal years ending after November 15, 2006. If a change in the method of quantifying errors is required under SAB No. 108, this represents a change in accounting policy; therefore, if the use of both methods results in a larger, material misstatement than the previously applied method, the financial statements must be adjusted. SAB No. 108 allows the cumulative effect of such adjustments to be made to opening retained earnings upon adoption. The adoption of SAB No. 108 did not have an effect on our consolidated financial statements.

Critical accounting policies

While all of our accounting policies are important in assuring that we adhere to current accounting standards, certain policies are particularly important due to their impact on our financial statements. Our critical accounting policies are described in detail in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations - Significant Accounting Policies included in our Annual Report on Form 10-K for the fiscal year ended July 31, 2006, which description is incorporated herein by reference.

Item 3. Quantitative and Qualitative Disclosures Regarding Market Risk

As of October 31, 2006, we had $155.0 million Convertible Senior Notes bearing interest at LIBOR less 0.75% with a fair value of $465 million, based upon the bid price of 300.29 on October 31, 2006. These notes are not hedged and represent our total exposure to interest rate risk. Each 100 basis point increase in the LIBOR rate will increase our interest expense by $1.6 million per year.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We carried out an evaluation, under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, as to the effectiveness, design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities and Exchange Act of 1934) as of October 31, 2006. Our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of our disclosure controls and procedures were effective as of October 31, 2006.

Changes in Internal Control over Financial Reporting

During the first quarter of fiscal 2007, we did not make any change to our internal control over financial reporting that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 6. Exhibits

Exhibits filed with this report:

Exhibit No.	Description
*31.1	Certification pursuant to Section 302 of the Sarbanes- Oxley Act of 2002 by Chief Executive Officer.
*31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 by Chief Financial Officer.
*32.1	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by Chief Executive Officer.
*32.2	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 by Chief Financial Officer.

*** filed herewith**

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 6th day of December 2006.

VERITAS DGC INC.

By: /s/ Mark E. Baldwin
Mark E. Baldwin
Executive Vice President, Chief Financial Officer and Treasurer
(Principal Financial Officer)

/s/ Dennis S. Baldwin
Dennis S. Baldwin
Vice President, Corporate Controller

(Chief Accounting Officer)

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