KANSAS CITY SOUTHERN
Form 10-K
January 26, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K
ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2017
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: 1-4717
KANSAS CITY SOUTHERN
(Exact name of registrant as specified in its charter)

Delaware	44-0663509
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
427 West 12th Street, Kansas City, Missouri	64105
(Address of principal executive offices)	(Zip Code)

816.983.1303
(Registrant's telephone number, including area code)
None
(Former name, former address and former fiscal year, if changed since last report)
Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Preferred Stock, Par Value $25 Per Share, 4%, Noncumulative	New York Stock Exchange
Common Stock, $.01 Per Share Par Value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:
None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ý No ¨
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No ý
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 ý 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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No ¨
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting

company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer ý Accelerated filer o Non-accelerated filer o Smaller reporting company o
(Do not check if a smaller reporting company)
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No ý
The aggregate market value of common stock held by non-affiliates of the registrant was $10.75 billion at June 30, 2017. There were 103,053,604 shares of $.01 par common stock outstanding at January 19, 2018.
DOCUMENTS INCORPORATED BY REFERENCE
Kansas City Southern's Definitive Proxy Statement for the 2018 Annual Meeting of Stockholders which will be filed no later than 120 days after December 31, 2017, is incorporated by reference in Part III.

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KANSAS CITY SOUTHERN
2017 FORM 10-K ANNUAL REPORT
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Item 1. Business

COMPANY OVERVIEW

Kansas City Southern, a Delaware corporation, is a holding company with domestic and international rail operations in North America that are strategically focused on the growing north/south freight corridor connecting key commercial and industrial markets in the central United States with major industrial cities in Mexico. As used herein, "KCS" or the "Company" may refer to Kansas City Southern or, as the context requires, to one or more subsidiaries of Kansas City Southern. KCS and its subsidiaries had approximately 7,130 employees on December 31, 2017.

KCS controls and owns all of the stock of The Kansas City Southern Railway Company ("KCSR"), a U.S. Class I railroad founded in 1887. KCSR serves a ten-state region in the midwest and southeast regions of the United States and has the shortest north/south rail route between Kansas City, Missouri and several key ports along the Gulf of Mexico in Alabama, Louisiana, Mississippi and Texas.

KCS controls and owns all of the stock of Kansas City Southern de México, S.A. de C.V. ("KCSM"). Through its 50-year concession from the Mexican government (the "Concession"), which could expire in 2047 unless extended, KCSM operates a key commercial corridor of the Mexican railroad system and has as its core route the most strategic portion of the shortest, most direct rail passageway between Mexico City and Laredo, Texas. Laredo is a principal international gateway through which a substantial portion of rail and truck traffic between the United States and Mexico crosses the border. KCSM serves most of Mexico's principal industrial cities and three of its major seaports. KCSM's rail lines provide exclusive rail access to the United States and Mexico border crossing at Nuevo Laredo, Tamaulipas, the largest rail freight interchange point between the United States and Mexico. Under the Concession, KCSM has the right to control and operate the southern half of the rail bridge at Laredo, Texas, which spans the Rio Grande River between the United States and Mexico. The Company also controls the northern half of this bridge through its ownership of Mexrail, Inc. ("Mexrail").

KCSM also provides exclusive rail access to the port of Lazaro Cardenas on the Pacific Ocean. The Mexican government developed the port at Lazaro Cardenas principally to serve Mexican markets and as an alternative to the U.S. west coast ports for Asian and South American traffic bound for North America.

The Company wholly owns Mexrail which, in turn, wholly owns The Texas Mexican Railway Company ("Tex-Mex"). Tex-Mex owns a 157-mile rail line extending from Laredo, Texas to the port city of Corpus Christi, Texas, which connects the operations of KCSR with KCSM.

The KCS coordinated rail network (KCSR, KCSM and Tex-Mex) comprises approximately 6,700 route miles extending from the midwest and southeast portions of the United States south into Mexico and connects with all other Class I railroads, providing shippers with an effective alternative to other railroad routes and giving direct access to Mexico and the southeast and southwest United States through alternate interchange hubs.

Panama Canal Railway Company ("PCRC"), an unconsolidated joint venture company owned equally by KCS and Mi-Jack Products, Inc. ("Mi-Jack"), was awarded a concession from the Republic of Panama to reconstruct and operate the Panama Canal Railway, a 47-mile railroad located adjacent to the Panama Canal that provides international container shipping companies with a railway transportation alternative to the Panama Canal. The concession was awarded in 1998 for an initial term of 25 years with an automatic renewal for an additional 25-year term. The Panama Canal Railway is a north-south railroad traversing the isthmus of Panama between the Atlantic and Pacific oceans.

Other subsidiaries and affiliates of KCS include the following:

- KCSM Servicios, S.A. de C.V. ("KCSM Servicios"), a wholly-owned and consolidated subsidiary that provides employee services to KCSM;
- Meridian Speedway, LLC ("MSLLC"), a seventy percent-owned consolidated affiliate that owns the former KCSR rail line between Meridian, Mississippi and Shreveport, Louisiana, which is the portion of the rail line between Dallas, Texas and Meridian known as the "Meridian Speedway." Norfolk Southern Corporation, through its wholly-owned subsidiary, The Alabama Great Southern Railroad Company, owns the remaining thirty percent of MSLLC;
- TFCM, S. de R.L. de C.V. ("TCM"), a forty-five percent-owned unconsolidated affiliate that operates a bulk liquid terminal in San Luis Potosí, Mexico;

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- Ferrocarril y Terminal del Valle de México, S.A. de C.V. (“FTVM”), a twenty-five percent-owned unconsolidated affiliate that provides railroad services as well as ancillary services in the greater Mexico City area; and
- PTC-220, LLC (“PTC-220”), a fourteen percent-owned unconsolidated affiliate that holds the licenses to large blocks of radio spectrum and other assets for the deployment of Positive Train Control (“PTC”). See Government Regulation section for further information regarding PTC.

MARKETS SERVED

2017 Revenues Business Mix

Chemical and petroleum. This sector includes products such as plastics, other petroleum refined products and miscellaneous chemicals. KCS transports these products to markets in the midwest, southeast and northeast United States and throughout Mexico through interchanges with other rail carriers. The products within the chemicals and plastics channels are used in the automotive, housing and packaging industries as well as in general manufacturing. KCS hauls petroleum products across its network and as petroleum refineries have continued to increase their refining capacity, they have coordinated with KCS to develop additional long-term storage opportunities which complement a fluid freight railroad operation.

Industrial and consumer products. This sector includes metals and ores such as iron, steel, zinc and copper. The majority of metals, minerals and ores mined, and steel produced in Mexico is consumed within Mexico. The volume of Mexican steel domestic consumption and exports fluctuates based on global market prices. Higher-end finished products such as steel coils are used by Mexican manufacturers in automobiles, household appliances, the oil and gas industry, and other consumer goods which are imported from the United States through land borders and through the seaports served by KCS’s rail network. KCS also transports steel coils, plates and pipe from U.S. and Mexican-based mini-mills to locations in the U.S. and Mexico for oil drilling, appliance and automotive applications.

This sector also serves paper mills directly and indirectly through its various short-line connections. KCS’s rail lines run through the heart of the southeast United States timber-producing region. Additionally, KCS is uniquely positioned to serve many paper mills in the southeast United States whose products are increasing in demand due to a general growth of consumer goods and industrial production in central Mexico.

Agriculture and minerals. The agriculture and minerals sector consists primarily of grain and food products. Shipper demand for agriculture products is affected by competition among sources of grain and grain products, as well as price fluctuations in international markets for key commodities. In the United States, KCS’s rail lines receive and originate shipments of grain and grain products for delivery to feed mills, food and industrial consumers in the U.S. and Mexico. United States export grain shipments and Mexico import grain shipments include primarily corn, wheat, and soybeans. Over the long term, export grain shipments to Mexico are expected to increase as a result of Mexico’s reliance on grain imports and KCS’s coordinated rail network is well-positioned to meet these increases in demand. Food products consist mainly of soybean meal, grain meal, oils, canned goods, distillers dried grains, corn syrup and sugar. Other shipments consist of a variety of products including ores, minerals, clay and glass used across North America.

Energy. The energy sector includes coal, frac sand, petroleum coke and crude oil. KCS hauls unit trains (trains transporting a single commodity from one source to one destination) of coal for eight electric generating plants in the central United States. The coal originates from the Powder River Basin in Wyoming and is interchanged to KCS at Kansas City, Missouri. Coal mined in the midwest United States is transported in non-unit trains to industrial consumers such as paper mills, steel mills, and cement companies. Frac sand originating primarily in Wisconsin, Illinois or Iowa is delivered to transloads located in northeast Texas, northern Louisiana and south Texas for distribution to gas and oil wells in the region. KCS transports petroleum coke from refineries in the United States to cement companies in Mexico as well as to vessels for international distribution through the Pabtex export terminal located in Port Arthur, Texas. The majority of crude by rail business originates in Canada, with spot shipments coming from west Texas, and is delivered to U.S. Gulf Coast refineries and tank farms in Texas, Louisiana, and Alabama.

Intermodal. The intermodal freight sector consists primarily of hauling freight containers or truck trailers on behalf of steamship lines, motor carriers, and intermodal marketing companies with rail carriers serving as long-distance haulers. KCS serves and supports the U.S. and Mexican markets, as well as cross-border traffic between the U.S. and Mexico. In light of the importance of trade between Asia and North America, the Company believes the Port of Lazaro Cardenas continues to be a strategically beneficial location for ocean carriers, manufacturers and retailers. Equally important, the increase in foreign direct investment in Mexico has caused the KCS Mexico/U.S. cross border corridor to emerge as an increasingly important tool for the North American Free Trade Agreement ("NAFTA") freight flow. The Company also provides premium service to customers over its line from Dallas through the Meridian Speedway — a critical link in creating the most direct route between the southwest and southeast/northeast U.S.

Automotive. KCS provides rail transportation to every facet of the automotive industry supply chain, including automotive manufacturers, assembly plants and distribution centers throughout North America. Several U.S., European and Asian automakers have built or intend to build assembly plants in central Mexico to take advantage of access to lower costs, which has driven a shift in production and distribution patterns from various countries to Mexico. In addition, KCS transports finished vehicles imported and exported to and from various countries through a distribution facility at the Port of Lazaro Cardenas. As the automotive industry shifts production and distribution patterns, KCS is poised to serve the automotive industry's evolving transportation requirements.

GOVERNMENT REGULATION

The Company's United States operations are subject to federal, state and local laws and regulations generally applicable to all businesses subject to federal preemption under certain circumstances. Rail operations are also subject to the regulatory jurisdiction of the Surface Transportation Board ("STB"), the Federal Railroad Administration ("FRA") of the U.S. Department of Transportation ("DOT"), the Occupational Safety and Health Administration ("OSHA"), as well as other federal and state regulatory agencies. The STB has jurisdiction over disputes and complaints involving certain rates, routes and services, the sale or abandonment of rail lines, applications for line extensions and construction, and consolidation or merger with, or acquisition of control of, rail common carriers. DOT and OSHA each has jurisdiction under several federal statutes over a number of safety and health aspects of rail operations, including the transportation of hazardous materials. In 2008, the President of the United States signed the Rail Safety Improvement Act of 2008 into law, which, among other things, revised hours of service for train and certain other employees and mandated implementation of PTC at certain locations by the end of 2015. PTC is a technology designed to help prevent train-to-train collisions, overspeed derailments, incursions into rail work zones, and entry into main line track if a switch is misaligned at certain locations, including main line track where toxic inhalation hazard or poison inhalation hazard movements occur or where passenger operations occur. The Surface Transportation Extension Act of 2015 extended the PTC implementation deadline from the end of 2015 to the end of 2018, conditioned upon the filing of revised PTC Implementation Plans, with a further two-year extension possible subject to review by the DOT. KCS filed a revised PTC Implementation Plan by the statutory due date. PTC will add to operating costs, increase the number of employees the Company employs and require KCS to make significant investments in new safety technology.

KCS's U.S. subsidiaries are subject to extensive federal, state and local environmental regulations. These laws cover discharges to water, air emissions, toxic substances, and the generation, handling, storage, transportation and disposal of waste and hazardous materials. These regulations have the effect of increasing the costs, risks and liabilities associated with rail operations. Environmental risks are also inherent in rail operations, which frequently involve transporting chemicals and other hazardous materials.

Primary regulatory jurisdiction for the Company's Mexican operations is overseen by the new Mexican Agencia Reguladora del Transporte Ferroviario ("Regulatory Agency of Rail Transportation" or "ARTF"). The ARTF establishes regulations concerning railway safety and operations, and is responsible for resolving disputes between railways and between railways and customers. KCSM must register its maximum rates with the ARTF and make regular reports to the ARTF and the Secretaría de Comunicaciones y Transportes (“Secretary of Communications and Transportation” or “SCT”). KCSM must provide reports on investments, traffic volumes, theft and vandalism on the general right of way, customer complaints, fuel

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consumption, number of locomotives, railcars and employees, and activities around maintenance of way, sidings and spurs, among other financial information and reports. The Company may freely set rates on a non-discriminatory basis. At any time, the ARTF may request additional information regarding the determination of such rates and may issue recommendations with respect to proposed rate increases. If the ARTF or another party considers there to be no effective competition, they can request an opinion from the Comisión Federal de Competencia Económica ("Mexican Antitrust Commission" or "COFECE") regarding market conditions. If the COFECE determines that there is no effective competition for particular movements, the ARTF could set fixed maximum rates for those movements or grant limited trackage rights to another railroad while the condition of no effective competition remains.

KCSM holds a concession from the Mexican government until June 2047 (exclusively through 2027, subject to certain trackage and haulage rights granted to other concessionaires), which is renewable under certain conditions for an additional period of up to 50 years. The Concession authorizes KCSM to provide freight transportation services over north-east rail lines which are a primary commercial corridor of the Mexican railroad system. KCSM is required to provide railroad services to all users on a fair and non-discriminatory basis and in accordance with efficiency and safety standards approved periodically by the Mexican government. KCSM has the right to use, but does not own, all track and buildings that are necessary for the rail lines' operation. KCSM is obligated to maintain the right of way, track structure, buildings and related maintenance facilities to the operational standards specified in the Concession agreement and to return the assets in that condition at the end of the Concession period. During the remainder of the Concession period, KCSM is required to pay the Mexican government an annual concession duty equal to 1.25% of gross revenues. The ARTF may request information to verify KCSM´s compliance with the Concession and any applicable regulatory framework.

The Company's Mexican operations are subject to Mexican federal and state laws and regulations relating to the protection of the environment through the establishment of standards for water discharge, water supply, emissions, noise pollution, hazardous substances and transportation and handling of hazardous and solid waste. The Mexican government may bring administrative and criminal proceedings and impose economic sanctions against companies that violate environmental laws, and temporarily or even permanently close non-complying facilities.

Noncompliance with applicable legal provisions may result in the imposition of fines, temporary or permanent shutdown of operations or other injunctive relief, criminal prosecution or, with respect to KCSM, the termination of the Concession. KCS maintains environmental provisions that are believed by management to be appropriate with respect to known and existing environmental contamination of its properties that KCS may be responsible to remedy. In addition, KCS's subsidiaries are party to contracts and other legally binding obligations by which previous owners of certain facilities now owned by KCS are responsible to remedy contamination of such sites remaining from their previous ownership.

Government regulations are further discussed within Item 7, "Management's Discussion and Analysis" under "Other Matters."

COMPETITION

The Company competes against other railroads, many of which are much larger and have significantly greater financial and other resources. The railroad industry in North America is dominated by a few very large carriers. The larger U.S. western railroads (BNSF Railway Company and Union Pacific Railroad Company), in particular, are significant competitors of KCS because of their substantial resources and competitive routes.

In Mexico, KCSM's operations are subject to competition from other railroads, particularly Ferrocarril Mexicano, S.A. de C.V. ("Ferromex") and Ferrosur, S.A. de C.V. ("Ferrosur"), both controlled by Grupo Mexico S.A.B. de C.V. Ferromex and Ferrosur together are much larger and have significantly greater financial and other resources than KCSM, serving most of the major ports and cities in Mexico and together owning fifty percent of FTVM, which serves industries located within Mexico City.

The ongoing impact of past and future rail consolidation is uncertain. However, KCS believes that its investments and strategic alliances continue to competitively position the Company to attract additional rail traffic throughout its rail network.

The Company is subject to competition from motor carriers, barge lines and other maritime shipping, which compete across certain routes in KCS's operating areas. In the past, truck carriers have generally eroded the railroad industry's share of total transportation revenues. Intermodal traffic and certain other traffic face highly price sensitive competition, particularly

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from motor carriers. However, rail carriers, including KCS, have placed an emphasis on competing in the intermodal marketplace and working with motor carriers to provide end-to-end transportation of products.

While deregulation of U.S. freight rates has enhanced the ability of railroads to compete with each other and with alternative modes of transportation, this increased competition has generally resulted in downward pressure on freight rates since deregulation. Competition with other railroads and other modes of transportation is generally based on the rates charged, the quality and reliability of the service provided and the quality of the carrier's equipment for certain commodities.

RAIL SECURITY

The Company and its rail subsidiaries have continued to research, develop and implement multidisciplinary approaches to secure the Company's assets and personnel against transnational criminal organizations that actively target transportation networks. In addition, the Company has developed a variety of vertically integrated strategies to mitigate the risk terrorist attacks could pose to the Company, its personnel and assets. Many of the specific measures the Company utilizes for these efforts are required to be kept confidential through arrangements with government agencies, such as the Department of Homeland Security ("DHS"), or through jointly-developed and implemented strategies and plans with connecting carriers.

KCSR and KCSM developed a proprietary security plan based on an industry-wide plan developed by the Association of American Railroads ("AAR") members which focuses on comprehensive risk assessments in five areas — hazardous materials; train operations; critical physical assets; military traffic; and information technology and communications. The security plan is kept confidential, with access to the plan tightly limited to members of management with direct security and anti-terrorism implementation responsibilities. The Company participates with other AAR members in periodic drills under the industry plan to test and refine its various provisions.

To protect the confidentiality and sensitivity of both the AAR plans and the proprietary strategies the Company has developed to safeguard against criminal enterprises, terrorism, and other security and safety threats, the following paragraphs will provide only a general overview of some of these efforts.

The Company's security activities range from periodically providing security awareness updates to KCS employees and including safety and security information on the Company's internet website (which can be found under the "Corporate Responsibility" tab at www.kcsouthern.com) to its ongoing implementation of security plans for rail facilities in areas labeled by the DHS as High Threat Urban Areas ("HTUAs"). The Company's other activities to bolster security against terrorism include, but are not limited to, the following:

- Conferring regularly with other railroads' security personnel and with industry experts on security issues;
- Routing shipments of certain chemicals, which might be toxic if inhaled, pursuant to federal regulations;
- Initiating a series of over 20 voluntary action items agreed to between AAR and DHS as enhancing security in the rail industry;
- Conducting constant and targeted security training as part of the scheduled training for operating employees and managers;
- Developing smartphone applications to ensure immediate information, live video and pictures from security supervisors and protection assets pertaining to potential operational risks;
- Developing a multi-layered security model using high-speed digital imaging, system velocity and covert and overt security filters to mitigate the risk of illicit activity;
- Measuring key security metrics to ensure positive risk mitigation and product integrity trends;
- Performing constant due diligence with the existing security model and by benchmarking rail security on a world-wide basis to monitor threat streams related to rail incidents;
- Implementing a Tactical Intelligence Center by KCSM, which provides constant training with core members in new technology helping to prevent, detect, deter, deny and respond to potentially illicit activities; and
- Deploying an array of non-intrusive technologies including, but not limited to, digital video surveillance and analytics as part of an intelligent video security solution, including a closed circuit television platform with geo-fencing for intrusion detection, to allow for remote viewing access to monitor ports of entry, intermodal and rail yards.

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In addition, the Company utilizes dedicated security personnel with extensive special operations forces, intelligence, and law enforcement backgrounds to oversee the ongoing and increasingly complex security efforts of the Company in both the United States and Mexico. While the risk of theft and vandalism is higher in Mexico, KCSM remains among the safest methods of transportation for freight shipments in Mexico. KCSM's record in rail safety is due in large part to the implementation of a multi-layered safety and security process throughout the KCSM network. In addition to having its own internal system, the process is connected to, and supported by a high level of federal, state and local law enforcement. A primary focus of this effort involves maintaining constant due diligence, intelligence and counterintelligence operations, technology-reporting applications and active vigilance while enhancing overall system velocity, which reduces the residual risk for incidents to occur.

RAILWAY LABOR ACT

Labor relations in the U.S. railroad industry are subject to extensive governmental regulation under the Railway Labor Act ("RLA"). Under the RLA, national labor agreements are renegotiated on an industry-wide scale when they become open for modification, but their terms remain in effect until new agreements are reached or the RLA's procedures (which include mediation, cooling-off periods, and the possibility of presidential intervention) are exhausted. Contract negotiations with the various unions generally take place over an extended period of time and the Company rarely experiences work stoppages during negotiations. Wages, health and welfare benefits, work rules and other issues have traditionally been addressed during these negotiations.

COLLECTIVE BARGAINING

Approximately 75% of KCSR employees are covered by collective bargaining agreements. These agreements do not have expiration dates, but rather remain in place until modified by subsequent agreements. KCSR participates in industry-wide multi-employer bargaining as a member of the National Carriers' Conference Committee (the "NCCC"), as well as local bargaining for agreements that are limited to KCSR's property. Multi-employer agreements are subject to a procedure that allows requests for changes to be served every five years. The last amendments to the collective bargaining agreements with all of the participating unions were reached and ratified during 2011 and the first half of 2012, and were retroactive to January 1, 2010. The current round of multi-employer bargaining began on January 1, 2015. The subjects of bargaining primarily concern salary and benefits payable to the various union employees. On October 5, 2017, the NCCC, as representatives of KCSR and the railroad industry, reached a tentative agreement with the Collective Bargaining Group (the "CBG"), a coalition comprised of multiple unions that represent approximately 60% of KCSR's unionized workforce. The unions in the CBG coalition have now ratified the tentative agreement by its members. The ratification concludes this round of bargaining for those unions, and the revised agreement will be in effect through December 2019. In December 2017, the NCCC reached a tentative agreement with the TCU Bargaining Group, a coalition comprised of four unions that represent approximately 20% of KCSR's unionized workforce. The terms of this tentative agreement are substantially identical to the agreement with the CBG. The unions in the TCU Bargaining Group coalition are ratifying this agreement. The NCCC is still in mediation with the other union coalition (BMWE/Smart Mechanical) regarding proposed amendments to their agreements. The union labor negotiation has not historically resulted in any strike, lock-out, or other disruption in the Company's business operations. The Company does not believe the expected settlements will have a material impact on the consolidated financial statements.

KCSM Servicios union employees are covered by one labor agreement, which was signed on April 16, 2012, between KCSM Servicios and the Sindicato de Trabajadores Ferrocarrileros de la República Mexicana ("Mexican Railroad Union"), for an indefinite period of time, for the purpose of regulating the relationship between the parties. Approximately 80% of KCSM Servicios employees are covered by this labor agreement. The compensation terms under this labor agreement are subject to renegotiation on an annual basis and all other benefits are subject to negotiation every two years. The union labor negotiations with the Mexican Railroad Union have not historically resulted in any strike, boycott or other disruption in KCSM's business operations. KCSM Servicios has started negotiations of compensation and all other benefits terms with the Mexican Railroad Union for the period covering July 1, 2017 to June 30, 2018. The anticipated resolution of this negotiation is not expected to have a material impact to the consolidated financial statements.

EXECUTIVE OFFICERS OF KCS AND SUBSIDIARIES

All executive officers are elected annually and serve at the discretion of the Board of Directors. All of the executive officers have employment agreements with KCS and/or its subsidiaries. The mailing address of the principal executive officers other than Mr. Zozaya is 427 W. 12th Street, Kansas City, Missouri 64105. Mr. Zozaya's mailing address is Montes Urales No. 625, Col. Lomas de Chapultepec, C.P. 11000, Mexico D.F.

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Patrick J. Ottensmeyer — President and Chief Executive Officer— 60 — Served in this capacity since July 1, 2016. Mr. Ottensmeyer has been a director of KCS since July 1, 2016 and served as President of KCS since March 1, 2015. He served as Executive Vice President Sales and Marketing of KCS from October 16, 2008 through March 1, 2015. Mr. Ottensmeyer joined KCS in May 2006 as Executive Vice President and Chief Financial Officer.

Warren K. Erdman — Executive Vice President — Administration and Corporate Affairs — 59 — Served in this capacity since April 2010. Mr. Erdman served as Executive Vice President — Corporate Affairs from October 2007 until April 2010. He served as Senior Vice President — Corporate Affairs of KCS and KCSR from January 2006 to September 2007. Mr. Erdman served as Vice President — Corporate Affairs of KCS from April 15, 1997 to December 31, 2005 and as Vice President — Corporate Affairs of KCSR from May 1997 to December 31, 2005. Prior to joining KCS, Mr. Erdman served as Chief of Staff to United States Senator Kit Bond of Missouri from 1987 to 1997.

Brian D. Hancock — Executive Vice President and Chief Marketing Officer — 52 — Served in this capacity since joining KCS in August 2015. Prior to joining KCS, Mr. Hancock served as Senior Vice President of Supply Chain for Family Dollar Stores, Inc. from 2013 to July 2015. From 2011 to 2013, Mr. Hancock served as President – North America for The Martin – Brower Company, L.L.C. From 2005 to 2011, he served as Vice President – Global Supply Chain for Whirlpool Corporation.

Jeffrey M. Songer — Executive Vice President and Chief Operating Officer — 48 — Served in this capacity since March 2016. Mr. Songer served as Senior Vice President Engineering and Chief Transportation Officer of the Company from August 2014 to February 2016 and as Vice President and Chief Engineer for KCSR from June 2012 to July 2014. Prior to serving as KCSR’s Vice President and Chief Engineer, Mr. Songer served as Assistant Vice President — Engineering and Planning from March 2011 to June 2012, and as its General Director — Planning, Scheduling & Administration from January 2007 to March 2011.

Michael W. Upchurch — Executive Vice President and Chief Financial Officer — 57 — Served in this capacity since October 16, 2008. Mr. Upchurch joined KCS in March 2008 as Senior Vice President Purchasing and Financial Management. From 1990 through September 2006, Mr. Upchurch served in various senior financial leadership positions at Sprint Corporation, including Senior Vice President Financial Operations, Senior Vice President Finance Sprint Business Solutions and Senior Vice President Finance Long Distance Division.

José Guillermo Zozaya Delano — President and Executive Representative — KCSM — 65 — Served in this position since April 20, 2006. Mr. Zozaya has 35 years of experience in law and government relations, most recently as the Legal and Government Relations Director for ExxonMobil México, S.A. de C.V., where he spent nine years prior to joining KCSM.

Lora S. Cheatum — Senior Vice President — Human Resources — 61 — Served in this capacity since joining KCS in October 2014. Ms. Cheatum previously served as Senior Vice President Global Human Resources of Layne Christensen from 2012 to October 2014. From 2010 to 2012, she served as Director — Field Operations at Fitness Together Holdings, Inc. Ms. Cheatum spent nine years with Kansas City Power & Light, from 2001 to 2010, where she was Vice President of Procurement and previously as Vice President Human Resources.

Michael J. Naatz — Senior Vice President Operations Support and Chief Information Officer — 52 — Served in this capacity since August 2014. Mr. Naatz served as Senior Vice President and Chief Information Officer of the Company from May 2012 to July 2014. Prior to joining KCS, Mr. Naatz served as President of USF Holland, a YRC Worldwide, Inc. (“YRCW”) company, from 2011 to May 2012. From 2010 to 2011, Mr. Naatz served as President and Chief Customer Officer - Customer Care Division at YRCW. From 2008 to 2010, he served as Executive Vice President and Chief Information & Service Officer at YRCW. From 2005 to 2007, he served as President — Enterprise Services Division at YRCW. From 1994 to 2005, he held various leadership positions with USF Corporation.

Suzanne M. Grafton — Vice President and Chief Accounting Officer — 42 — Served in this capacity since July 24, 2017. Ms. Grafton served as Vice President of Audit and Enterprise Risk Management of the Company from April 2016 to July 2017 and as Vice President of Accounting from May 2014 to March 2016. From September 2006 to May 2014, Ms. Grafton served in various accounting leadership positions at KCS.

William J. Wochner — Senior Vice President and Chief Legal Officer — 70 — Served in this capacity since February 2007. He served as Vice President and Interim General Counsel from December 2006 to January 2007. From September 2006 to December 2006, Mr. Wochner served as Vice President and Associate General Counsel. From March 2005 to

September 2006, Mr. Wochner served as Vice President Sales and Marketing/Contracts for KCSR. From February 1993 to March 2005, Mr. Wochner served as Vice President and General Solicitor of KCSR.

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There are no arrangements or understandings between the executive officers and any other person pursuant to which the executive officer was or is to be selected as an officer of KCS, except with respect to the executive officers who have entered into employment agreements designating the position(s) to be held by the executive officer.

None of the above officers is related to another, or to any of the directors of KCS.

AVAILABLE INFORMATION

KCS's website (www.kcsouthern.com) provides at no cost KCS's Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and Current Reports on Form 8-K, and amendments to those reports, as soon as reasonably practicable after the electronic filing of these reports is made with the Securities and Exchange Commission. In addition, KCS's corporate governance guidelines, ethics and legal compliance policy, and the charters of the Audit Committee, the Finance Committee, the Nominating and Corporate Governance Committee and the Compensation and Organization Committee of the Board of Directors are available on KCS's website. These guidelines, policies and charters are available in print without charge to any stockholder requesting them. Written requests for these materials may be made to the Corporate Secretary, P.O. Box 219335, Kansas City, Missouri 64121-9335 (or if by express delivery to 427 West 12th Street, Kansas City, Missouri 64105). From time to time, KCS publicly designates material information by posting it on the website, investors.kcsouthern.com, in lieu of press releases.

See Item 8, Financial Statements and Supplementary Data — Note 1 "Description of the Business" and Note 17 "Geographic Information" for more information on the description and general development of the Company's business and financial information about geographic areas.

Item 1A. Risk Factors

KCS U.S. and Mexico rail common carrier subsidiaries are required by United States and Mexican laws, respectively, to transport hazardous materials, which could expose KCS to significant costs and claims.

Under United States federal statutes and applicable Mexican laws, KCS's common carrier responsibility requires it to transport hazardous materials. Any rail accident or other incident or accident on KCS's network, facilities, or at the facilities of KCS's customers involving the release of hazardous materials, including toxic inhalation hazard materials, could involve significant costs and claims for personal injury, property damage, and environmental penalties and remediation in excess of the Company's insurance coverage for these risks, which could have a material adverse effect on KCS's consolidated financial statements.

KCS's business is subject to regulation by federal, state and local legislatures and agencies that could impose significant cost on the Company's business operations.

KCS rail subsidiaries are subject to legislation and regulation enacted by federal, state and local legislatures and agencies in the U.S. and Mexico with respect to railroad operations. Government regulation of the railroad industry is a significant determinant of the competitiveness and profitability of railroads. Changes in legislation or regulation could have a negative impact on KCS's ability to negotiate prices for rail services, could negatively affect competition among rail carriers, or could negatively impact operating practices, resulting in reduced efficiency, increased operating costs or increased capital investment, all of which could result in a material adverse effect on KCS's consolidated financial statements.

New economic regulation in the U.S. or Mexico in current or future proceedings could change the regulatory framework within which the Company operates which could materially change the Company's business and have an adverse effect on the Company's consolidated financial statements.

Pursuant to the Mexican Antitrust Law and the Regulatory Railroad Service Law, the COFECE announced that it would review competitive conditions in the Mexican railroad industry, with respect to the existence of effective competition in the provision of interconnection services, trackage rights, switching rights and interline services used to render public freight transport in Mexico. The COFECE review includes the entire freight rail transportation market in Mexico and is not targeted to any single rail carrier. If the COFECE determines there is a lack of effective competition, the COFECE could request the ARTF, which has primary regulatory jurisdiction over the Company's Mexican operations, to conduct proceedings to determine whether to establish new limited mandatory trackage rights and/or rate regulation under the Amendments to the Mexican Regulatory Railroad Service Law. Such proceedings could have a material adverse effect on the Company's consolidated financial statements.

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As part of the Rail Safety Improvement Act of 2008 in the United States, Class I railroad carriers and passenger and commuter rail operators must implement PTC, a technology designed to help prevent train-to-train collisions, overspeed derailments, incursions into rail work zones, and entry into main line track if a switch is misaligned. PTC is required to be implemented at certain locations, including main line track where toxic inhalation hazard movements regularly occur or where passenger operations occur. The Surface Transportation Extension Act of 2015 extended the PTC implementation deadline from the end of 2015 to the end of 2018, conditioned upon the filing of revised PTC Implementation Plans, with a further two-year extension possible subject to review by the Department of Transportation. KCS filed a revised PTC Implementation Plan by the statutory due date. PTC will add to operating costs, increase the number of employees the Company employs and require KCS to make significant investments in new safety technology. KCS's failure to meet deadlines, including any extension, could result in fines, service interruptions or penalties and could have a material adverse effect on the Company's consolidated financial statements.
KCS's inadvertent failure or inability to comply with applicable laws and regulations could have a material adverse effect on the Company's consolidated financial statements and operations, including fines, penalties, or limitations on operating activities until compliance with applicable requirements is achieved. Congress and government agencies may change the legislative or regulatory framework within which the Company operates without providing any recourse for any adverse effects on the Company's business that occur as a result of such change. Additionally, some of the regulations require KCS to obtain and maintain various licenses, permits and other authorizations. Any failure to obtain or maintain these licenses, permits, and other authorizations could adversely affect KCS's business operations.

KCSM's Mexican Concession is subject to revocation or termination in certain circumstances which would prevent KCSM from conducting rail operations over the Concession and would have a material adverse effect on the Company's consolidated financial statements.

KCSM operates under the Concession granted by the Mexican government until June 2047, which is renewable for an additional period of up to 50 years, subject to certain conditions. The Concession gives KCSM exclusive rights to provide freight transportation services over its rail lines for the first 30 years of the 50-year Concession, subject to certain trackage and haulage rights granted to other concessionaires. The SCT and ARTF, which are principally responsible for regulating railroad services in Mexico, have broad powers to monitor KCSM's compliance with the Concession, and they can require KCSM to supply them with any technical, administrative and financial information they request. Among other obligations, KCSM must comply with the investment commitments established in its business plan, which forms an integral part of the Concession, and must update the plan every three years. The SCT treats KCSM's business plans confidentially. The SCT and ARTF also monitor KCSM's compliance with efficiency and safety standards established in the Concession. The SCT and ARTF review, and may amend, these standards from time to time.

Under the Concession, KCSM has the right to operate its rail lines, but it does not own the land, roadway or associated structures. If the Mexican government legally terminates the Concession, it would own, control, and manage such public domain assets used in the operation of KCSM's rail lines. All other property not covered by the Concession, including all locomotives and railcars otherwise acquired, would remain KCSM's property. In the event of early termination, or total or partial revocation of the Concession, the Mexican government would have the right to cause the Company to lease all service-related assets to it for a term of at least one year, automatically renewable for additional one-year terms up to five years. The amount of rent would be determined by experts appointed by KCSM and the Mexican government. The Mexican government must exercise this right within four months after early termination or revocation of the Concession. In addition, the Mexican government would also have a right of first refusal with respect to certain transfers by KCSM of railroad equipment within 90 days after revocation of the Concession.

The Mexican government may also temporarily seize control of KCSM's rail lines and its assets in the event of a natural disaster, war, significant public disturbance or imminent danger to the domestic peace or economy. In such a case, the SCT may restrict KCSM's ability to exploit the Concession in such manner as the SCT deems necessary under the circumstances, but only for the duration of any of the foregoing events. Mexican law requires that the Mexican government pay compensation if it effects a statutory appropriation for reasons of the public interest. With respect to a temporary seizure due to any cause other than international war, the Mexican Regulatory Railroad Service Law and regulations provide that the Mexican government will indemnify an affected concessionaire for an amount equal to damages caused and losses suffered. However, these payments may not be sufficient to compensate KCSM for its losses and may not be made timely.

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The SCT may revoke the Concession if KCSM is sanctioned at least three times within a period of five years for any of the following: unjustly interrupting the operation of its rail lines or for charging rates higher than those it has registered with the ARTF; unlawfully restricting the ability of other Mexican rail operators to use its rail lines; failing to make payments for damages caused during the performance of services; failing to comply with any term or condition of the Mexican Regulatory Railroad Service Law and regulations or the Concession; failing to make the capital investments required under its three-year business plan filed with the SCT; or failing to maintain an obligations compliance bond and insurance coverage as specified in the Mexican Regulatory Railroad Service Law and regulations. In addition, the Concession would terminate automatically if KCSM changes its nationality or assigns or creates any lien on the Concession, or if there is a change in control of KCSM without the SCT's approval. The SCT may also terminate the Concession as a result of KCSM's surrender of its rights under the Concession, or for reasons of public interest or upon KCSM's liquidation or bankruptcy. If the Concession is terminated or revoked by the SCT for any reason, KCSM would receive no compensation and its interest in its rail lines, and all other fixtures covered by the Concession, as well as all improvements made by it, would revert to the Mexican government. Revocation or termination of the Concession could adversely affect the Company's consolidated financial statements.

KCS's ownership of KCSM and operations in Mexico subject it to economic and political risks.

The Mexican government has exercised, and continues to exercise, significant influence over the Mexican economy. Accordingly, Mexican governmental actions concerning the economy and state-owned enterprises could have a significant impact on Mexican private sector entities in general and on KCSM's operations in particular. KCS cannot predict the impact that the political landscape, including multiparty rule and civil disobedience, will have on the Mexican economy. Furthermore, KCS's consolidated financial statements and prospects may be affected by currency fluctuations, inflation, interest rates, regulation, taxation and other political, social and economic developments in or affecting Mexico.

The Mexican economy in the past has suffered balance of payment deficits and shortages in foreign exchange reserves. Although Mexico has imposed foreign exchange controls in the past, there are currently no exchange controls in Mexico. Pursuant to the provisions of NAFTA, if Mexico experiences serious balance of payment difficulties or the threat of such difficulties in the future, Mexico would have the right to impose foreign exchange controls on investments made in Mexico, including those made by United States and Canadian investors. Any restrictive exchange control policy could adversely affect KCS's ability to obtain U.S. dollars or to convert Mexican pesos ("pesos" or "Ps.") into dollars for purposes of making payments. This could have a material adverse effect on KCS's consolidated financial statements.

The social and political situation in Mexico could adversely affect the Mexican economy and changes in laws, public policies and government programs could be enacted, which could have an adverse effect on KCS's consolidated financial statements.

Downturns in the United States economy or in trade between the United States and Asia or Mexico and fluctuations in the peso-dollar exchange rates would likely have adverse effects on KCS's consolidated financial statements.

The level and timing of KCS's Mexican business activity is heavily dependent upon the level of United States-Mexican trade and the effects of NAFTA on such trade. The Mexican operations depend on the United States and Mexican markets for the products KCSM transports, the relative position of Mexico and the United States in these markets at any given time, and tariffs or other barriers to trade. Failure to preserve NAFTA free trade provisions, or any other action imposing import duties or border taxes, could negatively impact KCS customers and the volume of rail shipments, and could have a material adverse effect on KCS's consolidated financial statements.

Downturns in the United States or Mexican economies or in trade between the United States and Mexico would likely have adverse effects on KCS's consolidated financial statements and the Company's ability to meet debt service obligations. In addition, KCS has invested significant amounts in developing its intermodal operations, including the Port of Lazaro Cardenas, in part to provide Asian importers with an alternative to the west coast ports of the United States, and the level of intermodal traffic depends, to an extent, on the volume of Asian shipments routed through Lazaro Cardenas. Reduction in trading volumes, which may be caused by factors beyond KCS's control, including increased government regulations regarding the safety and quality of Asian-manufactured products, may adversely affect KCS's consolidated financial statements.

Additionally, fluctuations in the peso-dollar exchange rates could lead to shifts in the types and volumes of Mexican imports and exports. Although a decrease in the level of exports of some of the commodities that KCSM transports to the United States may be offset by a subsequent increase in imports of other commodities KCSM hauls into Mexico and vice versa, any offsetting increase might not occur on a timely basis, if at all. Future developments in United States-Mexican trade beyond

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the Company's control may result in a reduction of freight volumes or in an unfavorable shift in the mix of products and commodities KCSM carries.

Severe weakening of the peso against the U.S. dollar may result in disruption of the international foreign exchange markets and may limit the ability to transfer pesos or to convert pesos into U.S. dollars for the purpose of making timely payments of interest and principal on the non-peso denominated indebtedness. Although the Mexican government currently does not restrict, and for many years has not restricted, the right or ability of Mexican or foreign persons or entities to convert pesos into U.S. dollars or to transfer foreign currencies out of Mexico, the Mexican government could, as in the past, institute restrictive exchange rate policies that could limit the ability to transfer or convert pesos into U.S. dollars or other currencies for the purpose of making timely payments and contractual commitments. Devaluation or depreciation of the peso against the U.S. dollar may also adversely affect U.S. dollar prices for KCS's securities.

Fluctuations in the peso-dollar exchange rates also have an effect on KCS's consolidated financial statements. A weakening of the peso against the U.S. dollar would cause reported peso-denominated revenues and expenses to decrease, and would increase reported foreign exchange loss due to the Company's net monetary assets that are peso-denominated. Exchange rate variations also affect the calculation of taxes under Mexican income tax law, and a strengthening of the peso against the U.S. dollar would cause an increase in the Company's cash tax obligation and effective income tax rate.

Severe weather or other natural disasters could result in significant business interruptions and expenditures.

The Company's operations may be affected by severe weather or other natural disasters. The Company operates in and along the Gulf of Mexico, and its facilities may be adversely affected by hurricanes, floods and other extreme weather conditions that could also adversely affect KCS's shipping, agricultural, chemical and other customers. Severe weather or other natural disasters could result in significant business interruption and could have a material adverse effect on KCS's consolidated financial statements.

KCS's business may be adversely affected by changes in general economic or other conditions.

KCS's operations may be adversely affected by changes in the economic conditions of the industries and geographic areas that produce and consume the freight that KCS transports. The relative strength or weakness of the United States and Mexican economies affects the businesses served by KCS. A significant and sustained decrease in crude oil prices could adversely affect the transport of crude oil by rail to the U.S. Gulf region as well as negatively impact railroad volumes related to equipment and other materials that support crude oil production. Prolonged negative changes in domestic and global economic conditions or disruptions of either or both of the financial and credit markets, including the availability of short and long-term debt financing, may affect KCS, as well as the producers and consumers of the commodities that KCS transports and may have a material adverse effect on KCS's consolidated financial statements.

The transportation industry is highly cyclical, generally tracking the cycles of the world economy. Although transportation markets are affected by general economic conditions, there are numerous specific factors within each particular market that may influence operating results. Some of KCS's customers do business in industries that are highly cyclical, including the energy, automotive, housing and agriculture industries. Any downturn or change in government policy in these industries could have a material adverse effect on operating results. Also, some of the products transported have had a historical pattern of price cyclicality which has typically been influenced by the general economic environment and by industry capacity and demand. KCS cannot assure that prices and demand for these products will not decline in the future, adversely affecting those industries and, in turn, the Company's consolidated financial statements.

Significant reductions in the volume of rail shipments due to economic or other conditions could have a material adverse effect on KCS's consolidated financial statements.

KCS depends on the stability, availability and security of its information technology systems to operate its business.

KCS relies on information technology in all aspects of its business. A significant disruption or failure of its information technology systems, including its computer hardware, software, communications equipment, wayside equipment or locomotive onboard equipment could result in service interruptions, safety failures, security failures, regulatory compliance failures or other operational difficulties.

The security risks associated with information technology systems have increased in recent years because of the increased sophistication, activities and evolving techniques of perpetrators of cyber attacks. A failure in or breach of KCS's information technology security systems, or those of its third party service providers, as a result of cyber attacks or unauthorized access to its network could disrupt KCS's business, result in the disclosure or misuse of confidential or proprietary information, increase its costs and/or cause losses and reputational damage. KCS also confronts the risk that a terrorist or nation-state sponsored group may seek to use its property, including KCS's information technology systems, to inflict major harm.

A significant disruption, failure or unauthorized access of KCS's information technology system could have a material adverse effect on KCS's consolidated financial statements.

Capacity constraints could adversely affect service and operating efficiency.

KCS may experience capacity constraints due to increased demand for rail services, unavailability of equipment, crew shortages, or extreme weather. Also, due to the interconnectivity between all railroads, especially in the U.S., congestion on other railroads could result in operational inefficiencies for KCS.

Traffic congestion experienced in the U.S. or Mexican railroad system may result in overall traffic congestion which would impact the ability to move traffic to and from Mexico. In addition, the growth of cross border traffic in recent years has contributed to congestion on the international bridge at the Nuevo Laredo-Laredo border gateway, which is expected to continue in the near future. This could also result in operational inefficiencies for KCS and adversely affect KCS's operations.

Significant expansions in the capacity of the Company's network can require a substantial amount of time and investment. Although KCS constantly monitors its network in an effort to optimize its rail services, there can be no assurance that such measures will adequately address capacity constraints on a timely basis.

KCS may be subject to various claims and litigation that could have a material adverse effect on KCS's consolidated financial statements.

The Company may be exposed to the potential of various claims and litigation related to labor and employment, personal injury, commercial disputes, freight loss and other property damage, and other matters that arise in the normal course of business. Any material changes to litigation trends or a catastrophic rail accident or series of accidents involving any or all of property damage, personal injury, and environmental liability could have a material adverse effect on KCS's consolidated financial statements.

KCS competes against other railroads and other transportation providers.

The Company's domestic and international operations are subject to competition from other railroads, as well as from truck carriers, barge lines, and other maritime shippers. Many of KCS's rail competitors are much larger and have significantly greater financial and other resources than KCS, which may enable rail competitors to reduce rates and make KCS's freight services less competitive. KCS's ability to respond to competitive pressures by matching rate reductions and decreasing rates without adversely affecting gross margins and operating results will depend on, among other things, the ability to reduce operating costs. KCS's failure to respond to competitive pressures, and particularly rate competition, in a timely manner could have a material adverse effect on the Company's consolidated financial statements.

The railroad industry is dominated by a few large carriers. These larger railroads could attempt to use their size and pricing power to block other railroads' access to gateways and routing options that are currently and have historically been available. In addition, if there is future consolidation in the railroad industry in the United States or Mexico, there can be no assurance that it will not have an adverse effect on the Company's consolidated financial statements.

Trucking, maritime, and barge competitors, while able to provide rate and service competition to the railroad industry, are able to use public rights-of-way, require substantially smaller capital investment and maintenance expenditures than railroads and allow for more frequent and flexible scheduling. Continuing competitive pressures, any reduction in margins due to competitive pressures, developments that increase the quality or decrease the cost of alternative modes of transportation in the locations in which the Company operates, or legislation or regulations that provide motor carriers with additional advantages, such as increased size of vehicles and reduced weight restrictions, could result in downward pressure on freight rates, which in turn could have a material adverse effect on the Company's consolidated financial statements.

A key part of KCS's growth strategy is based upon the conversion of truck traffic to rail. There can be no assurance the Company will succeed in its efforts to convert traffic from truck to rail transport or that the customers already converted will be retained. If the railroad industry in general is unable to preserve its competitive advantages vis-à-vis the trucking industry,

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revenue growth could be adversely affected. Additionally, revenue growth could be affected by, among other factors, an expansion in the availability, or an improvement in the quality, of the trucking services offered by carriers resulting from regulatory and administrative interpretations and implementation of certain provisions of NAFTA, and KCS's inability to grow its existing customer base and capture additional cargo transport market share because of competition from the shipping industry and other railroads.

KCS's business strategy, operations and growth rely significantly on agreements with other railroads and third parties.

Operation of KCS's rail network and its plans for growth and expansion rely significantly on agreements with other railroads and third parties, including joint ventures and other strategic alliances, as well as interchange, trackage rights, haulage rights and marketing agreements with other railroads and third parties that enable KCS to exchange traffic and utilize trackage the Company does not own. KCS's ability to provide comprehensive rail service to its customers depends in large part upon its ability to maintain these agreements with other railroads and third parties, and upon the performance of the obligations under the agreements by the other railroads and third parties. The termination of, or the failure to renew, these agreements could adversely affect KCS's consolidated financial statements. KCS is also dependent in part upon the financial strength and efficient performance of other railroads. There can be no assurance that KCS will not be materially adversely affected by operational or financial difficulties of other railroads.

KCS is subject to environmental regulations, which may impose significant costs on the Company's business operations.

KCS subsidiaries' operations are subject to environmental regulation enacted by federal, state and local legislatures in the U.S. and Mexico. From time to time, certain KCS facilities have not been in compliance with environmental health and safety laws and regulations and there can be no assurance that KCS will always be in compliance with such laws and regulations in the future. Environmental liability under federal and state law in the United States can also extend to previously owned or operated properties, leased properties and properties owned by third parties, as well as to properties currently owned and used by the Company. Environmental liabilities may also arise from claims asserted by adjacent landowners or other third parties. Given the nature of its business, the Company incurs, and expects to continue to incur, environmental compliance costs, including, in particular, costs necessary to maintain compliance with requirements governing chemical and hazardous material shipping operations, refueling operations and repair facilities. KCS presently has environmental investigation and remediation obligations at certain sites, and will likely incur such obligations at additional sites in the future.

The Company's Mexican subsidiaries' operations are subject to Mexican federal and state laws and regulations relating to the protection of the environment, including standards for, among other things, water discharge, water supply, emissions, noise pollution, hazardous substances and transportation and handling of hazardous and solid waste. Under applicable Mexican law and regulations, administrative and criminal proceedings may be brought and economic sanctions imposed against companies that violate environmental laws, and non-complying facilities may be temporarily or permanently closed. KCSM is also subject to the laws of various jurisdictions with respect to the discharge of materials into the environment and to environmental laws and regulations issued by the governments of each of the Mexican states in which KCSM's facilities are located. The terms of KCSM's Concession from the Mexican government also impose environmental compliance obligations on KCSM. Failure to comply with any environmental laws or regulations may result in the termination of KCSM's Concession or in fines or penalties that may affect profitability.

Liabilities accrued for environmental costs represent the Company's best estimate of the probable future obligation for the remediation and settlement of matters related to these sites. However, remediation costs may exceed such estimates, due to various factors such as evolving environmental laws and regulations, changes in technology, the extent of other parties' participation, developments in environmental surveys and studies, and the extent of corrective action that may ultimately be required. The Company cannot predict the effect, if any, that unidentified environmental matters or the adoption of additional or more stringent environmental laws and regulations would have on KCS's consolidated financial statements.

KCS's inadvertent failure or inability to comply with applicable environmental laws and regulations could have a material adverse effect on the Company's consolidated financial statements and operations, including fines, penalties, or limitations on operating activities until compliance with applicable requirements is achieved. Government entities may change the legislative or regulatory framework within which the Company operates without providing any recourse for any adverse effects on the Company's business that occur as a result of such change. Additionally, some of the regulations require KCS to obtain and maintain various licenses, permits and other authorizations. Any failure to obtain or maintain these licenses, permits, and other authorizations could adversely affect KCS's business operations.

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KCS's business is vulnerable to fluctuations in fuel costs and disruptions in fuel supplies.

KCS incurs substantial fuel costs in its railroad operations and these costs represent a significant portion of its transportation expenses. Significant price increases for fuel may have a material adverse effect on operating results. If KCS is unable to recapture its costs of fuel from its customers, operating results could be materially adversely affected. In addition, a severe disruption of fuel supplies resulting from supply shortages, political unrest, a disruption of oil imports, weather events, war, or otherwise, and the resulting impact on fuel prices could materially adversely affect KCS's consolidated financial statements.

KCSM currently meets the majority of its fuel requirements through purchases from PEMEX Transformación Industrial ("PEMEX"), the national oil company of Mexico, and other authorized fuel distributors of PEMEX fuel around the country. If PEMEX were to experience significant operational difficulties not quickly resolved, the KCSM operations could be materially adversely affected.

Weaknesses in the short and long-term debt markets could negatively impact the Company's access to capital.

Due to the significant capital expenditures required to operate and maintain a safe and efficient railroad, the Company regularly relies on debt markets for the issuance of long-term debt instruments, bank financing and commercial paper. Instability or disruptions of the capital markets, including debt markets, or the deterioration of the Company's financial condition due to internal or external factors, could restrict or prohibit access and could increase the cost of financing sources. A significant deterioration of the Company's financial condition could also reduce credit ratings to below investment grade, limiting its access to external sources of capital, and increasing the costs of short and long-term debt financing, and could have a material adverse effect on KCS's consolidated financial statements.

KCS's business may be affected by market and regulatory responses to climate change.

KCS's operations may be adversely affected by restrictions, caps, taxes, or other controls on emissions of greenhouse gases, including diesel exhaust. Restrictions on emissions could also affect KCS's customers that use commodities that KCS transports to produce energy, use significant amounts of energy in producing or delivering the commodities KCS transports, or manufacture or produce goods that consume significant amounts of energy or burn fossil fuels, including coal-fired power plants, chemical producers, farmers and food producers, and automakers and other manufacturers. Significant cost increases, government regulation, or changes of consumer preferences for goods or services relating to alternative sources of energy or emissions reductions could materially affect the markets for the commodities KCS transports, which in turn could have a material adverse effect on KCS's consolidated financial statements. Government incentives encouraging the use of alternative sources of energy could also affect certain customers and their respective markets for certain commodities KCS transports in an unpredictable manner that could alter traffic patterns, including, for example, the impacts of ethanol incentives on farming and ethanol producers. Any of these factors, individually or in conjunction with one or more of the other factors, or other unforeseen impacts of climate change could have a material adverse effect on KCS's consolidated financial statements.

A majority of KCS's employees belong to labor unions. Strikes or work stoppages could adversely affect operations.

The Company is a party to collective bargaining agreements with various labor unions in the United States and Mexico. As of December 31, 2017, approximately 75% and 80% of KCSR and KCSM Servicios employees, respectively, were covered by labor contracts subject to collective bargaining. The Company may be subject to, among other things, strikes, work stoppages or work slowdowns as a result of disputes under these collective bargaining agreements and labor contracts or KCS's potential inability to negotiate acceptable contracts with these unions. In the United States, because such agreements are generally negotiated on an industry-wide basis, determination of the terms and conditions of labor agreements have been and could continue to be beyond KCS's control. KCS may, therefore, be subject to terms and conditions in industry-wide labor agreements that could have a material adverse effect on its consolidated financial statements. If the unionized workers in the United States or Mexico were to engage in a strike, work stoppage or other slowdown; if other employees were to become unionized or if the terms and conditions in future labor agreements were renegotiated, KCS could experience a significant disruption of its operations and higher ongoing labor costs. Although the U.S. Railway Labor Act imposes restrictions on the right of United States railway workers to strike, there is no law in Mexico imposing similar restrictions on the right of railway workers in that country to strike.

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KCS is dependent on certain key suppliers of core rail equipment.

KCS relies on a limited number of suppliers of core rail equipment (including locomotives, rolling stock equipment, rail and ties). The capital intensive nature and complexity of such equipment creates high barriers of entry for any potential new suppliers. If any of KCS's suppliers discontinue production or experience capacity or supply shortages, this could result in increased costs or difficulty in obtaining rail equipment and materials, which could have a material adverse effect on KCS's consolidated financial statements.

The unavailability of qualified personnel could adversely affect KCS's operations.

Changes in demographics, training requirements and the unavailability of qualified personnel could negatively affect KCS's ability to meet demand for rail service. Unforeseen increases in demand for rail services may exacerbate such risks, which could have a negative impact on KCS's operational efficiency and otherwise have a material adverse effect on KCS's consolidated financial statements.

KCS's business may be affected by future acts of terrorism, war or other acts of violence or crime.

Terrorist attacks, such as an attack on the Company's chemical transportation activities, any government response thereto and war or risk of war may adversely affect KCS's consolidated financial statements. These acts may also impact the Company's ability to raise capital or its future business opportunities. KCS's rail lines and facilities could be direct targets or indirect casualties of acts of terror, which could cause significant business interruption and damage to KCS's property. In recent years, there have been reported incidents of train-related robberies in Mexico, including incidents involving KCSM's trains and infrastructure. Other acts of violence or crime could also adversely affect the Company's business.

As a result, acts of terrorism or war or acts of crime or violence could result in increased costs and liabilities and decreased revenues for KCS. In addition, insurance premiums charged for some or all of the applicable coverage currently maintained by KCS could increase dramatically or certain coverage may not be adequate to cover losses or may not be available in the future.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Track Configuration

The Kansas City Southern Railway Company ("KCSR") operates over a railroad system consisting of approximately 3,400 route miles in ten states extending from the midwest and southeast portions of the United States south to the Mexican border, which includes approximately 635 miles of trackage rights that permit KCSR to operate its trains with its crews over other railroads' tracks.

Under its concession from the Mexican government (the "Concession"), Kansas City Southern de México, S.A. de C.V. ("KCSM") has the right to operate approximately 3,300 route miles, but does not own the land, roadway, or associated structures, and additionally has approximately 550 miles of trackage rights. The Concession requires KCSM to make investments as described in a business plan filed every three years with the Mexican government. See Item 1A, "Risk Factors — KCSM's Mexican Concession is subject to revocation or termination in certain circumstances which would prevent KCSM from operating its railroad and would have a material adverse effect on the Company's consolidated financial statements."

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Kansas City Southern Rail Network

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Equipment Configuration

As of December 31, 2017 and 2016, KCS owned and leased the following units of equipment:

	2017			2016		
	Owned	Leased	Total	Owned	Leased	Total
Freight Cars:						
Box cars	3,205	1,212	4,417	3,212	2,105	5,317
Hoppers (covered and open top)	4,735	2,107	6,842	4,333	2,030	6,363
Gondolas	2,619	1,267	3,886	2,993	1,295	4,288
Automotive	2,731	1,142	3,873	2,483	768	3,251
Flat cars (intermodal and other)	850	98	948	851	97	948
Tank cars	4	568	572	4	645	649
Total	14,144	6,394	20,538	13,876	6,940	20,816
Locomotives:						
Freight	736	146	882	736	121	857
Switching	187	—	187	187	—	187
Total	923	146	1,069	923	121	1,044

Average Age (in Years) of Owned and Leased Locomotives:	2017	2016
Freight	16.2	15.0
Switching	42.0	41.0
All locomotives	20.2	19.7

Property and Facilities

KCS operates numerous facilities, including terminals for intermodal and other freight, rail yards for train-building, switching, storage-in-transit (the temporary storage of customer goods in rail cars prior to shipment) and other activities; offices to administer and manage operations; dispatch centers to direct traffic on the rail network; crew quarters to house train crews along the rail line; and shops and other facilities for fueling and maintenance and repair of locomotives, freight cars and other equipment.

Capital Expenditures

The Company's cash capital expenditures for the three years ended December 31, 2017, 2016, and 2015, and planned 2018 capital expenditures are included in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources — Capital Expenditures". See also Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations — Critical Accounting Policies and Estimates — Capitalization, Depreciation and Amortization of Property and Equipment (including Concession Assets)" regarding the Company's policies and guidelines related to capital expenditures.

Item 3. Legal Proceedings

The Company is subject to various legal proceedings and claims that arise in the ordinary course of business. For more information on legal proceedings, see Item 1A, "Risk Factors — KCS may be subject to various claims and litigation that could have a material adverse effect on KCS's consolidated financial statements," Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations — "Other Matters — Litigation," and Item 8, "Financial Statements and Supplementary Data — Note 15 Commitments and Contingencies."

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Item 4. Mine Safety Disclosures
Not applicable.

Part II

Item 5. Market for KCS's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities
Market Information
The Company's common stock is traded on the New York Stock Exchange under the ticker symbol "KSU". The following table presents for the quarters indicated the dividends declared and the high and low sales price of the Company's common and preferred stock.

	Fourth	Third	Second	First
2017				
Dividends per share:				
Common stock	$0.36	$0.36	$0.33	$0.33
$25 par preferred stock	0.25	0.25	0.25	0.25
Stock price ranges:				
$25 par preferred:				
— High	$28.91	$29.14	$29.50	$29.35
— Low	26.96	27.35	25.45	26.75
Common:				
— High	$114.85	$109.13	$105.15	$90.82
— Low	99.70	100.17	84.92	79.05
2016				
Dividends per share:				
Common stock	$0.33	$0.33	$0.33	$0.33
$25 par preferred stock	0.25	0.25	0.25	0.25
Stock price ranges:				
$25 par preferred:				
— High	$31.10	$29.54	$29.00	$27.30
— Low	25.52	26.40	25.70	25.31
Common:				
— High	$96.83	$100.69	$98.99	$88.84
— Low	79.30	86.52	83.00	62.20

Dividend Policy
Common Stock. Any declarations and payments of dividends to holders of the Company's common stock are at the discretion of the Board of Directors, and are based on many factors, including the Company's financial condition, earnings, capital requirements and other factors that the Board of Directors deems relevant. Subject to these qualifications, the Company expects to continue to pay dividends on an ongoing basis.
Holders
There were 2,138 record holders of KCS common stock on January 19, 2018; however, the number of actual holders of KCS common stock is greater due to the practice of brokerage firms registering many shares for clients in the brokerage firm's name.

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Securities Authorized for Issuance Under Equity Compensation Plans

See Part III, Item 12, "Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters" for information about securities authorized for issuance under KCS's equity compensation plans.

Performance Graph

The following graph shows the changes in value over the five years ended December 31, 2017, of an assumed investment of $100 in: (i) KCS's common stock; (ii) the stocks that comprise the Dow Jones U.S. Industrial Transportation Index; and (iii) the stocks that comprise the S&P 500 Index. The table following the graph shows the value of those investments on December 31 for each of the years indicated. The values for the assumed investments depicted on the graph and in the table have been calculated assuming that any cash dividends are reinvested.

COMPARISON OF FIVE YEAR CUMULATIVE TOTAL RETURN
Among Kansas City Southern, the S&P 500 Index
and the Dow Jones U.S. Industrial Transportation Index

	2012	2013	2014	2015	2016	2017
Kansas City Southern	$100.00	$149.50	$148.83	$92.38	$106.56	$133.99
S&P 500 [1]	100.00	132.39	150.51	152.59	170.84	208.14
Dow Jones U.S. Industrial Transportation [2]	100.00	140.91	171.45	133.47	172.86	221.67

(1) The S&P 500 is a registered trademark of the McGraw-Hill Companies, Inc. The S&P 500 Index reflects the weighted average market value for 500 companies whose shares are traded on the New York Stock Exchange, American Stock Exchange and the Nasdaq Stock Market.

(2) The Dow Jones U.S. Industrial Transportation Index is a registered trademark of Dow Jones & Co., Inc., an independent company.

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Purchases of Equity Securities

During the first half of 2017, KCS concluded its $500.0 million share repurchase program, announced on May 14, 2015 (the "2015 Program"). On August 15, 2017, the Company announced that the Board of Directors approved a new share repurchase program, pursuant to which up to $800.0 million in shares of common stock could be repurchased through June 30, 2020 (the "2017 Program"). The authorization included a $200.0 million Accelerated Share Repurchase program and a $600.0 million open market share repurchase program.

During 2017, KCS repurchased 1,340,209 shares of common stock for $120.4 million at an average price of $89.83 per share under the 2015 Program, and 2,419,469 shares of common stock for $255.2 million at an average price of $105.48 per share under the 2017 Program. In total during 2017, KCS repurchased 3,759,678 shares of common stock for $375.6 million at an average price of $99.90 per share under both the 2015 Program and the 2017 Program. The following table presents common stock repurchases during each month for the fourth quarter of 2017:

Period	(a) Total Number of Shares (or Units) Purchased		(b) Average Price Paid per Share (or Unit)		(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs		(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that may yet be purchased under the Plans or Programs
October 1-31, 2017	254,792	(i)	$101.10	(i)	254,792	(i)	$589,239,305
November 1-30, 2017	299,724		$105.46		299,724		$557,631,058
December 1-31, 2017	114,676		$111.86		114,676		$544,803,013
Total	669,192				669,192		

(i) In the third quarter of 2017, the Company paid $200.0 million under two ASR agreements and received an aggregate of initial delivery of 1,598,796 shares. One of the ASR agreements was settled in the third quarter of 2017, with the Company receiving 151,481 additional shares for a total of 1,750,277 and a value of $185.0 million. In October 2017, the second ASR agreement was settled with the Company receiving 151,492 additional shares and a value of $15.0 million, which is included in the number of shares and the average price paid per share in the table above. The average price paid per share upon completion of the ASR agreements was $105.17. See Note 13 to the consolidated financial statements included in Item 8.

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Item 6. Selected Financial Data

The selected financial data below (in millions, except per share amounts) should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" included under Item 7 of this Form 10-K as well as the consolidated financial statements and the related notes.

	2017	2016	2015	2014	2013
Earnings From Continuing Operations					
Revenues	$2,582.9	$2,334.2	$2,418.8	$2,577.1	$2,369.3
Operating expenses (i) (ii)	1,661.3	1,515.7	1,615.0	1,768.0	1,630.7
Operating income	$921.6	$818.5	$803.8	$809.1	$738.6
Net income (iii) (iv)	$963.9	$479.9	$485.3	$504.3	$353.3
Earnings per common share:					
Basic	$9.18	$4.44	$4.41	$4.56	$3.19
Diluted	9.16	4.43	4.40	4.55	3.18
Financial Position					
Total assets	$9,198.7	$8,817.5	$8,341.0	$7,976.4	$7,283.7
Total long-term debt obligations, including current portion and short-term borrowings	2,619.4	2,478.2	2,401.1	2,301.4	2,168.8
Total stockholders' equity	4,548.9	4,089.9	3,914.3	3,755.5	3,370.6
Total equity	4,865.4	4,404.5	4,224.7	4,064.1	3,676.6
Other Data Per Common Share					
Cash dividends declared per common share	$1.38	$1.32	$1.32	$1.12	$0.86

(i) During 2017 and 2016, the Company recognized a benefit of $44.1 million and $62.8 million, respectively, related to a credit available for the excise tax included in the price of fuel that is purchased and consumed in locomotives and certain work equipment in Mexico.

(ii) During 2015 and 2014, the Company recognized pre-tax lease termination costs of $9.6 million and $38.3 million, respectively, within operating expenses due to the early termination of certain operating leases and the related purchase of equipment.

(iii) During 2017, the Company recognized a $413.0 million net tax benefit as a result of the Tax Cuts and Jobs Act (the "Tax Reform Act"), which was signed into law December 22, 2017. Further information on the tax impacts of the Tax Reform Act is presented in Note 12 to the consolidated financial statements in Item 8.

(iv) During 2015, 2014 and 2013, the Company recognized pre-tax debt retirement and exchange costs of $7.6 million, $6.6 million and $119.2 million, respectively, related to debt restructuring activities that occurred during the periods.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following is a discussion of Kansas City Southern's results of operations, certain changes in its financial position, liquidity, capital structure and business developments for the periods covered by the consolidated financial statements included under Item 8 of this Form 10-K. This discussion should be read in conjunction with the included consolidated financial statements, the related notes, and other information included in this report.

CAUTIONARY INFORMATION

The discussions set forth in this Annual Report on Form 10-K may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. In addition, management may make forward-looking statements orally or in other writings, including, but not limited to, in press releases, quarterly earnings calls, executive presentations, in the annual report to stockholders and in other filings with the Securities and Exchange Commission. Readers can usually identify these forward-looking statements by the use of such verbs as "expects," "anticipates," "believes" or similar verbs or conjugations of such verbs. These statements involve a number of risks and uncertainties. Actual results could materially differ from those anticipated by such forward-looking statements. Such differences could be caused by a number of factors or combination of factors including, but not limited to, the factors identified below and those discussed under Item 1A of this Form 10-K, "Risk Factors." Readers are strongly encouraged to consider these factors and the following factors when evaluating any forward-looking statements concerning the Company:

- the outcome of claims and litigation, including those related to environmental contamination, personal injuries and property damage;
- changes in legislation and regulations or revisions of controlling authority;
- the adverse impact of any termination or revocation of Kansas City Southern de México, S.A. de C.V. ("KCSM")'s concession by the Mexican government;
- United States, Mexican and global economic, political and social conditions;
- the effects of the North American Free Trade Agreement ("NAFTA"), on the level of trade among the United States, Mexico and Canada;
- the level of trade between the United States and Asia or Mexico;
- the effects of fluctuations in the peso-dollar exchange rate;
- natural events such as severe weather, fire, floods, hurricanes, earthquakes or other disruptions to the Company's operating systems, structures and equipment or the ability of customers to produce or deliver their products;
- the effects of adverse general economic conditions affecting customer demand and the industries and geographic areas that produce and consume the commodities KCS carries;
- the dependence on the stability, availability and security of the information technology systems to operate its business;
- the effect of demand for KCS's services exceeding network capacity or traffic congestion on operating efficiencies and service reliability;
- uncertainties regarding the litigation KCS faces and any future claims and litigation;
- the impact of competition, including competition from other rail carriers, trucking companies and maritime shippers in the United States and Mexico;
- KCS's reliance on agreements with other railroads and third parties to successfully implement its business strategy, operations and growth and expansion plans, including the strategy to convert customers from using trucking services to rail transportation services;
- compliance with environmental regulations;
- disruption in fuel supplies, changes in fuel prices and the Company's ability to recapture its costs of fuel from customers;
- material adverse changes in economic and industry conditions, including the availability of short and long-term financing, both within the United States and Mexico and globally;
- market and regulatory responses to climate change;

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- changes in labor costs and labor difficulties, including strikes and work stoppages affecting either operations or customers' abilities to deliver goods for shipment;
- KCS's reliance on certain key suppliers of core rail equipment;
- availability of qualified personnel; and
- acts of terrorism, war or other acts of violence or crime or risk of such activities.

Forward-looking statements reflect the information only as of the date on which they are made. The Company does not undertake any obligation to update any forward-looking statements to reflect future events, developments, or other information. If KCS does update one or more forward-looking statements, no inference should be drawn that additional updates will be made regarding that statement or any other forward-looking statements.

CORPORATE OVERVIEW

Kansas City Southern, a Delaware corporation, is a transportation holding company that has railroad investments in the U.S., Mexico and Panama. In the U.S., the Company serves the central and south central U.S. Its international holdings serve northeastern and central Mexico and the port cities of Lazaro Cardenas, Tampico and Veracruz, and a fifty percent interest in Panama Canal Railway Company provides ocean-to-ocean freight and passenger service along the Panama Canal. KCS's North American rail holdings and strategic alliances are primary components of a NAFTA railway system, linking the commercial and industrial centers of the U.S., Canada and Mexico. Its principal subsidiaries and affiliates include the following:

- The Kansas City Southern Railway Company ("KCSR"), a wholly-owned subsidiary;
- KCSM, a wholly-owned subsidiary;
- Mexrail, Inc. ("Mexrail"), a wholly-owned consolidated subsidiary; which, in turn, wholly owns The Texas Mexican Railway Company ("Tex-Mex");
- KCSM Servicios, S.A. de C.V. ("KCSM Servicios"), a wholly-owned subsidiary;
- Meridian Speedway, LLC ("MSLLC"), a seventy percent-owned consolidated affiliate;
- Panama Canal Railway Company ("PCRC"), a fifty percent-owned unconsolidated affiliate;
- TFCM, S. de R.L. de C.V. ("TCM"), a forty-five percent-owned unconsolidated affiliate;
- Ferrocarril y Terminal del Valle de México, S.A. de C.V. ("FTVM"), a twenty-five percent-owned unconsolidated affiliate; and
- PTC-220, LLC ("PTC-220"), a fourteen percent-owned unconsolidated affiliate.

EXECUTIVE SUMMARY

2017 Financial Overview

Revenues in 2017 increased 11% from 2016, due to 6% and 5% increases in revenue per carload/unit and carload/unit volumes, respectively. Revenue per carload/unit increased due to mix, increased average length of haul, positive pricing impacts and higher fuel surcharge. Energy revenue increased $81.1 million, primarily due to an increase in utility coal volumes due to higher natural gas prices and lower coal inventory levels. In addition, frac sand volumes increased due to strong demand as a result of higher crude oil prices.

Operating expenses increased 10% compared to 2016, primarily due to higher fuel prices and consumption, and compensation and benefits. Expense fluctuations resulting from higher fuel prices largely offset the revenue fluctuations driven by these same macroeconomic factors. Operating expenses as a percentage of revenues decreased to 64.3% in 2017 from 64.9% in 2016.

In 2017, the Company invested $559.5 million in capital expenditures. In addition, the Company purchased $42.6 million of equipment under existing operating leases or replacement equipment as certain operating leases expired, which was primarily funded with internally generated cash flows and short-term borrowings.

The Company reported 2017 earnings of $9.16 per diluted share on consolidated net income attributable to Kansas City Southern and subsidiaries of $962.0 million for the year ended December 31, 2017, compared to annual earnings of $4.43 per

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diluted share on consolidated net income attributable to Kansas City Southern and subsidiaries of $478.1 million for 2016, due to increased net income, largely resulting from the recognition of a $413.0 million net tax benefit as a result of the Tax Cuts and Jobs Act (the “Tax Reform Act”), and the accelerated share repurchase program that was implemented during the third quarter of 2017, which reduced the weighted-average shares outstanding. Further information on the tax impacts of the Tax Reform Act is included in the Company’s consolidated financial statements presented in Note 12 to the consolidated financial statements in Item 8.

RESULTS OF OPERATIONS

Year Ended December 31, 2017, compared with the Year Ended December 31, 2016

The following summarizes KCS’s consolidated income statement components (in millions):

	2017	2016	Change
Revenues	$2,582.9	$2,334.2	$248.7
Operating expenses	1,661.3	1,515.7	145.6
Operating income	921.6	818.5	103.1
Equity in net earnings of affiliates	11.5	14.6	(3.1)
Interest expense	(100.2)	(97.7)	(2.5)
Foreign exchange gain (loss)	41.7	(72.0)	113.7
Other expense, net	(0.3)	(0.7)	0.4
Income before income taxes	874.3	662.7	211.6
Income tax expense (benefit)	(89.6)	182.8	(272.4)
Net income	963.9	479.9	484.0
Less: Net income attributable to noncontrolling interest	1.9	1.8	0.1
Net income attributable to Kansas City Southern and subsidiaries	$962.0	$478.1	$483.9

Revenues

The following summarizes revenues (in millions), carload/unit statistics (in thousands) and revenue per carload/unit:

	Revenues			Carloads and Units			Revenue per Carload/Unit		
	2017	2016	% Change	2017	2016	% Change	2017	2016	% Change
Chemical and petroleum	$539.9	$475.4	14 %	273.5	258.5	6 %	$1,974	$1,839	7 %
Industrial and consumer products	588.3	554.0	6 %	329.9	317.0	4 %	1,783	1,748	2 %
Agriculture and minerals	477.4	461.0	4 %	244.3	251.4	(3 %)	1,954	1,834	7 %
Energy	283.8	202.7	40 %	291.7	253.9	15 %	973	798	22 %
Intermodal	363.8	357.6	2 %	975.1	952.8	2 %	373	375	(1 %)
Automotive	230.8	189.9	22 %	155.5	133.3	17 %	1,484	1,425	4 %
Carload revenues, carloads and units	2,484.0	2,240.6	11 %	2,270.0	2,166.9	5 %	$1,094	$1,034	6 %
Other revenue	98.9	93.6	6 %						
Total revenues (i)	$2,582.9	$2,334.2	11 %						

(i) Included in revenues:		
Fuel surcharge	$169.5	$103.8

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Revenues include revenue for transportation services and fuel surcharges. Notwithstanding the impacts of Hurricane Harvey, revenues and carload/unit volumes increased 11% and 5%, respectively, for the year ended December 31, 2017, compared to the prior year. Revenue per carload/unit increased by 6% due to mix, increased average length of haul, positive pricing impacts, and higher fuel surcharge. Energy revenues increased $81.1 million, primarily due to an increase in utility coal volumes due to higher natural gas prices and lower coal inventory levels. In addition, frac sand volumes increased due to strong demand as a result of higher crude oil prices. Chemical and petroleum revenues increased $64.5 million, primarily due to increased refined product and liquefied petroleum gas shipments to Mexico. The increase in revenue per carload/unit was partially offset by the weakening of the Mexican peso against the U.S. dollar of approximately $8.0 million, compared to the prior year, for revenue transactions denominated in Mexican pesos. The average exchange rate of Mexican pesos per U.S. dollar was Ps.18.9 for 2017 compared to Ps.18.7 for 2016.

KCS’s fuel surcharges are a mechanism to adjust revenue based upon changes in fuel prices above fuel price thresholds set in KCS’s tariffs or contracts. Fuel surcharge revenue is calculated using a fuel price from a prior time period that can be up to 60 days earlier. In a period of volatile fuel prices or changing customer business mix, changes in fuel expense and fuel surcharge revenue may differ.

Fuel surcharge revenue increased $65.7 million for the year ended December 31, 2017, compared to the prior year, due to higher fuel prices and the impact of fuel prices increasing above the fuel price thresholds for certain of KCS’s tariffs and contracts. Additionally, fuel surcharge increased due to separating the fuel surcharge for certain customers from the line haul rate, as well as increased volumes.

The following discussion provides an analysis of revenues by commodity group:

Revenues by commodity
group for 2017

Chemical and petroleum. Revenues increased $64.5 million for the year ended December 31, 2017, compared to 2016, due to a 7% increase in revenue per carload/unit and a 6% increase in carload/unit volumes. Revenue per carload/unit increased due to longer average length of haul and positive pricing impacts. Petroleum volumes increased due to refined product and liquefied petroleum gas shipments to Mexico.

Industrial and consumer products. Revenues increased $34.3 million for the year ended December 31, 2017, compared to 2016, due to a 4% increase in carload/unit volumes and a 2% increase in revenue per carload/unit. Other carloads’ volumes increased due to strong military movements. Revenue per carload/unit increased due to higher fuel surcharge, metals and scrap longer average length of haul, and positive pricing impacts.

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Revenues by commodity
group for 2017

Agriculture and minerals. Revenues increased $16.4 million for the year ended December 31, 2017 compared to 2016, due to a 7% increase in revenue per carload/unit, partially offset by a 3% decrease in carload/unit volumes. Revenue per carload/unit increased due to positive pricing impacts, longer average length of haul, and higher fuel surcharge. Food products volumes decreased due to change in market demand.

Energy. Revenues increased $81.1 million for the year ended December 31, 2017, compared to 2016, due to a 22% increase in revenue per carload/unit and a 15% increase in carload/unit volumes. Revenues per carload/unit increased due to longer average length of haul, positive pricing impacts, mix, and higher fuel surcharge. Utility coal volumes increased due to higher natural gas prices and lower coal inventory levels. Additionally, frac sand volumes increased due to strong demand as a result of higher crude oil prices.

Intermodal. Revenues increased $6.2 million for the year ended December 31, 2017, compared to 2016, due to a 2% increase in carload/unit volumes, partially offset by a 1% decrease in revenue per carload/unit. The volume increase was attributable to new business and lower volumes in second half of 2016 due to service disruptions from protests, partially offset by truck capacity in the U.S. and Mexico. Revenue per carload/unit decreased due to shorter average length of haul and mix.

Automotive. Revenues increased $40.9 million for the year ended December 31, 2017, compared to 2016, due to 17% increase in carload/unit volumes and a 4% increase in revenue per carload/unit. Volumes increased due to customers' temporary plant shutdowns in the first half of 2016, the introduction of new automobile models, and new plant openings. Revenue per carload/unit increased due to higher fuel surcharge and positive pricing impacts, partially offset by the weakening of the Mexican peso against the U.S. dollar.

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Operating Expenses

Operating expenses, as shown below (in millions), increased $145.6 million for the year ended December 31, 2017, compared to 2016, primarily due to higher fuel prices and consumption, and compensation and benefits. The weakening of the Mexican peso against the U.S. dollar resulted in an expense reduction of approximately $5.0 million for expense transactions denominated in Mexican pesos. The average exchange rate of Mexican pesos per U.S. dollar was Ps.18.9 for 2017 compared to Ps.18.7 for 2016.

			Change	
	2017	2016	Dollars	Percent
Compensation and benefits	$493.8	$462.4	$31.4	7 %
Purchased services	193.7	208.5	(14.8)	(7 %)
Fuel	316.1	253.8	62.3	25 %
Mexican fuel excise tax credit	(44.1)	(62.8)	18.7	(30 %)
Equipment costs	129.2	120.0	9.2	8 %
Depreciation and amortization	320.9	305.0	15.9	5 %
Materials and other	251.7	228.8	22.9	10 %
Total operating expenses	$1,661.3	$1,515.7	$145.6	10 %

Compensation and benefits. Compensation and benefits increased $31.4 million for the year ended December 31, 2017, compared to 2016, due to increases in annual wages and benefits of approximately $16.0 million. In addition, compensation and benefits increased by approximately $12.0 million due to increased headcount as a result of higher carloads and car repair in Mexico being performed in-house starting in October 2016.

Purchased services. Purchased services expense decreased $14.8 million for the year ended December 31, 2017, compared to 2016, due to car repair in Mexico being performed in-house starting in October 2016, partially offset by increases in repairs and maintenance, joint facilities expenses, computer software expenses, and detours.

Fuel. Fuel expense increased $62.3 million for the year ended December 31, 2017, compared to 2016, due to higher diesel fuel prices of approximately $30.0 million and $21.0 million in Mexico and the U.S., respectively, and higher consumption of approximately $19.0 million, partially offset by the weakening of the Mexican peso of approximately $4.0 million and improved efficiency of approximately $4.0 million. The average price per gallon, inclusive of the impact from the weakening of the Mexican peso, was $2.27 in 2017, compared to $1.95 in 2016.

Mexican fuel excise tax credit. Fuel purchases made in Mexico are subject to an excise tax that is included in the price of fuel. The Company is eligible for and utilizes an available credit for the excise tax included in the price of fuel that is purchased and consumed in locomotives and certain work equipment in Mexico. For the year ended December 31, 2017, the Company recognized a $44.1 million benefit, compared to a $62.8 million benefit recognized in 2016. The reduced benefit is due to a lower excise tax rate in effect for 2017 as compared to 2016. The Mexican fuel excise tax credit is realized through the offset of the total annual Mexico income tax liability and income tax withholding payment obligations of KCSM, with no carryforward to future periods.

Equipment costs. Equipment costs increased $9.2 million for the year ended December 31, 2017, compared to 2016, due to higher car hire expense resulting from increased automotive business impacting rates and volumes, partially offset by improved efficiency.

Depreciation and amortization. Depreciation and amortization expense increased $15.9 million for the year ended December 31, 2017, compared to 2016, due to a larger asset base.

Materials and other. Materials and other expense increased $22.9 million for the year ended December 31, 2017, compared to 2016, due to car repair in Mexico being performed in-house starting in October 2016, which resulted in additional materials purchased, and in an increase in casualty derailment expense.

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Non-Operating Expenses

Equity in net earnings of affiliates. Equity in net earnings from affiliates decreased $3.1 million for the year ended December 31, 2017, compared to 2016, as a result of lower equity in net earnings from the operations of PCRC due to a decrease in container volumes.

Interest expense. Interest expense increased $2.5 million for the year ended December 31, 2017, compared to 2016, due to higher average debt balances, partially offset by lower average interest rates as a result of an increased proportion of commercial paper in the overall debt mix. For the year ended December 31, 2017, the average debt balance (including commercial paper) was $2,603.6 million, compared to $2,492.7 million in 2016. The average interest rate for the year ended December 31, 2017 was 3.9%, compared to 4.0% in 2016.

Foreign exchange gain (loss). For the year ended December 31, 2017 foreign exchange gain was $41.7 million, compared to a loss of $72.0 million in 2016. Foreign exchange gain (loss) includes the re-measurement and settlement of net monetary assets denominated in Mexican pesos and the gain (loss) on foreign currency derivative contracts. For the year ended December 31, 2017, the re-measurement and settlement of net monetary assets denominated in Mexican pesos resulted in a foreign exchange gain of $3.5 million, compared to a loss of $18.5 million in 2016.

The Company enters into foreign currency derivative contracts to hedge its net exposure to fluctuations in the Mexican cash tax obligation due to changes in the value of the Mexican peso against the U.S. dollar. For the year ended December 31, 2017, foreign exchange gain on foreign currency derivative contracts was $38.2 million compared to a loss of $53.5 million in 2016.

Other expense, net. Other expense, net, decreased $0.4 million for the year ended December 31, 2017, compared to 2016, due to an increase in miscellaneous income.

Income tax expense (benefit). Income tax expense (benefit) decreased $272.4 million for the year ended December 31, 2017, compared to 2016, due to the impact of the Tax Reform Act enacted on December 22, 2017. The Company recognized a $487.6 million tax benefit as a result of revaluing the U.S. ending net deferred tax liabilities from 35% to the newly enacted U.S. corporate income tax rate of 21%. The tax benefit was partially offset by tax expense of $74.6 million for the deemed mandatory repatriation of undistributed earnings. The effective tax rate was (10.2%) and 27.6% for the years ended December 31, 2017 and 2016, respectively. The decrease in the effective tax rate was due to impact of the Tax Reform Act.

The strengthening of the Mexican peso as of December 31, 2017 as compared to December 31, 2016 increased the Company’s Mexican cash tax obligation by $18.8 million for the year ended December 31, 2017, whereas the weakening of the Mexican peso as of December 31, 2016 decreased the Company’s Mexican cash tax obligation by $49.2 million for the year ended December 31, 2016. The Company enters into foreign currency derivative contracts to hedge its net exposure to fluctuations in the Mexican cash tax obligation due to changes in the value of the Mexican peso against the U.S. dollar, and gains and losses on these foreign currency derivative contracts are recorded in foreign exchange gain (loss).

Further information on the components of the effective tax rates for the years ended December 31, 2017 and 2016, is presented in Note 12 to the consolidated financial statements in Item 8.

Beginning in 2018, the Company’s effective tax rate is expected to be reduced to 29%-30%, assuming a constant exchange rate of the Mexican peso against the U.S. dollar. The Company expects U.S. tax reform to reduce U.S. cash taxes by approximately $90.0 million over 2018 through 2020.

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Year Ended December 31, 2016, compared with the Year Ended December 31, 2015

The following summarizes KCS's consolidated income statement components (in millions):

	2016	2015	Change
Revenues	$2,334.2	$2,418.8	$(84.6)
Operating expenses	1,515.7	1,615.0	(99.3)
Operating income	818.5	803.8	14.7
Equity in net earnings of affiliates	14.6	18.3	(3.7)
Interest expense	(97.7)	(81.9)	(15.8)
Debt retirement and exchange costs	—	(7.6)	7.6
Foreign exchange loss	(72.0)	(56.6)	(15.4)
Other expense, net	(0.7)	(3.4)	2.7
Income before income taxes	662.7	672.6	(9.9)
Income tax expense	182.8	187.3	(4.5)
Net income	479.9	485.3	(5.4)
Less: Net income attributable to noncontrolling interest	1.8	1.8	—
Net income attributable to Kansas City Southern and subsidiaries	$478.1	$483.5	$(5.4)

Revenues

The following summarizes revenues (in millions), carload/unit statistics (in thousands) and revenue per carload/unit:

	Revenues			Carloads and Units			Revenue per Carload/Unit		
	2016	2015	% Change	2016	2015	% Change	2016	2015	% Change
Chemical and petroleum	$475.4	$474.2	—	258.5	259.7	—	$1,839	$1,826	1 %
Industrial and consumer products	554.0	570.4	(3 %)	317.0	320.5	(1 %)	1,748	1,780	(2 %)
Agriculture and minerals	461.0	429.3	7 %	251.4	238.8	5 %	1,834	1,798	2 %
Energy	202.7	252.3	(20 %)	253.9	280.8	(10 %)	798	899	(11 %)
Intermodal	357.6	381.5	(6 %)	952.8	990.3	(4 %)	375	385	(3 %)
Automotive	189.9	218.7	(13 %)	133.3	126.5	5 %	1,425	1,729	(18 %)
Carload revenues, carloads and units	2,240.6	2,326.4	(4 %)	2,166.9	2,216.6	(2 %)	$1,034	$1,050	(2 %)
Other revenue	93.6	92.4	1 %						
Total revenues (i)	$2,334.2	$2,418.8	(3 %)						

(i) Included in revenues:		
Fuel surcharge	$103.8	$230.1

Revenues include both revenue for transportation services and fuel surcharges. For the year ended December 31, 2016, revenues and carload/unit volumes decreased 3% and 2%, respectively, compared to the prior year. Revenue decreased by $66.0 million or approximately 3%, compared to the prior year, due to the weakening of the Mexican peso against the U.S. dollar for revenue transactions denominated in Mexican pesos. The average exchange rate of Mexican pesos per U.S. dollar was Ps.18.7 for 2016 compared to Ps.15.8 for 2015.

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Revenue per carload/unit decreased by 2% for the year ended December 31, 2016, compared to the prior year, due to the weakening of the Mexican peso against the U.S. dollar and lower fuel surcharge, partially offset by positive pricing impacts.

KCS's fuel surcharges are a mechanism to adjust revenue based upon changes in fuel prices above fuel price thresholds set in KCS's tariffs or contracts. Fuel surcharge revenue is calculated using a fuel price from a prior time period that can be up to 60 days earlier. In a period of volatile fuel prices or changing customer business mix, changes in fuel expense and fuel surcharge revenue may differ.

Fuel surcharge revenue decreased $126.3 million for the year ended December 31, 2016, compared to the prior year, due in part to combining the fuel surcharge for certain customers with the line haul rate. In addition, fuel surcharge revenue decreased due to lower U.S. fuel prices and the impact of fuel prices falling below fuel price thresholds for certain of KCS's tariffs and contracts during 2016.

The following discussion provides an analysis of revenues by commodity group:

Revenues by commodity
group for 2016

Chemical and petroleum. Revenues increased $1.2 million for the year ended December 31, 2016, compared to 2015, due to a 1% increase in revenue per carload/unit. Revenue per carload/unit increased due to positive pricing impacts and mix, partially offset by lower fuel surcharge and the weakening of the Mexican peso against the U.S. dollar. Plastic volumes increased due to strong market demand and low commodity pricing environment and petroleum volumes increased as a result of several customers' business expansion. These increases were partially offset by a decrease in chemical volumes due to oversupply caused by low natural gas prices that drove fertilizer prices down and a customer's lost business.

Industrial and consumer products. Revenues decreased $16.4 million for the year ended December 31, 2016, compared to 2015, due to a 2% decrease in revenue per carload/unit and a 1% decrease in carload/unit volumes. Revenue per carload/unit decreased due to the weakening of the Mexican peso against the U.S. dollar and lower fuel surcharge, partially offset by positive pricing impacts. Paper volumes decreased due to competitive trucking market, global softness in the market, and high inventory levels.

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Revenues by commodity
group for 2016

Agriculture and minerals. Revenues increased $31.7 million for the year ended December 31, 2016 compared to 2015, due to a 5% increase in carload/unit volumes and a 2% increase in revenue per carload/unit. Grain and food product volumes increased due to improved cycle times. In addition, grain volumes increased due to additional equipment capacity, partially offset by a decrease in ores and minerals volumes due to weather related issues in the southeast region of the United States. Revenue per carload/unit increased due to longer average length of haul and mix, partially offset by lower fuel surcharge and the weakening of the Mexican peso against the U.S. dollar.
Energy. Revenues decreased $49.6 million for the year ended December 31, 2016, compared to 2015, due to an 11% decrease in revenue per carload/unit and a 10% decrease in carload/unit volumes. Revenue per carload/unit decreased due to shorter average length of haul and lower fuel surcharge. Volumes decreased as low natural gas prices and high coal inventory levels reduced the demand for utility coal in 2016. In addition, crude oil volumes decreased as result of low crude oil spreads and increased pipeline capacity, and the decline in new crude drilling operations in the U.S. has reduced the demand for frac sand.
Intermodal. Revenues decreased $23.9 million for the year ended December 31, 2016, compared to 2015, due to a 4% decrease in carload/unit volumes and a 3% decrease in revenue per carload/unit. Volumes decreased due to service disruptions related to the flooding in the southeastern United States earlier in the year and protests in Mexico during July of 2016, increased truck conversion, and high retail inventory levels. Revenue per carload/unit decreased as a result of pricing impacts and shorter average length of haul.
Automotive. Revenues decreased $28.8 million for the year ended December 31, 2016, compared to 2015, due to an 18% decrease in revenue per carload/unit, partially offset by a 5% increase in carload/unit volumes. Revenue per carload/unit decreased due to the weakening of the Mexican peso against the U.S. dollar and lower fuel surcharge. Volumes increased due to 2015 service-related issues and new customers in 2016, partially offset by customers' temporary plant shutdowns in the first half of 2016.

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Operating Expenses

Operating expenses, as shown below (in millions), decreased $99.3 million for the year ended December 31, 2016, compared to 2015, primarily due to the Mexican fuel excise tax credit, the weakening of the Mexican peso against the U.S. dollar, and lower fuel prices. The weakening of the Mexican peso against the U.S. dollar resulted in an expense reduction of approximately $63.0 million or 4% for expense transactions denominated in Mexican pesos. The average exchange rate of Mexican pesos per U.S. dollar was Ps.18.7 for 2016 compared to Ps.15.8 for 2015.

			Change	
	2016	2015	Dollars	Percent
Compensation and benefits	$462.4	$442.2	$20.2	5 %
Purchased services	208.5	223.0	(14.5)	(7 %)
Fuel	253.8	306.9	(53.1)	(17 %)
Mexican fuel excise tax credit	(62.8)	—	(62.8)	100 %
Equipment costs	120.0	119.4	0.6	1 %
Depreciation and amortization	305.0	284.6	20.4	7 %
Materials and other	228.8	229.3	(0.5)	—
Lease termination costs	—	9.6	(9.6)	(100%)
Total operating expenses	$1,515.7	$1,615.0	$(99.3)	(6 %)

Compensation and benefits. Compensation and benefits increased $20.2 million for the year ended December 31, 2016, compared to 2015, due to higher incentive compensation of approximately $34.0 million and annual wage increases of approximately $14.0 million. Incentive compensation increased due to higher expected achievement of short and long-term incentive performance targets in 2016, as compared to 2015. These increases were partially offset by the weakening of the Mexican peso of approximately $19.0 million compared to 2015, and lower U.S. labor costs of approximately $15.0 million due to reduced volumes and increased productivity.

Purchased services. Purchased services expense decreased $14.5 million for the year ended December 31, 2016, compared to 2015, due to car repair in Mexico being performed in-house starting in October 2016 and the weakening of the Mexican peso.

Fuel. Fuel expense decreased $53.1 million for the year ended December 31, 2016, compared to 2015, due to the weakening of the Mexican peso of approximately $28.0 million and lower diesel fuel prices of approximately $18.0 million and $4.0 million in the U.S. and Mexico, respectively. The average price per gallon, inclusive of the impact from the weakening of the Mexican peso, was $1.95 in 2016, compared to $2.32 in 2015. In addition, fuel expense decreased due to improved fuel efficiency and lower fuel consumption.

Mexican fuel excise tax credit. Fuel purchases made in Mexico are subject to an excise tax that is included in the price of fuel. In 2016, the Company determined it was eligible for and could utilize an available credit for the excise tax included in the price of fuel that is purchased and consumed in locomotives and certain work equipment in Mexico and recognized a $62.8 million benefit. The Mexican fuel excise tax credit is realized through the offset of the total annual 2016 Mexico income tax liability and income tax withholding payment obligations of KCSM, with no carryforward to future periods.

Equipment costs. Equipment costs increased $0.6 million for the year ended December 31, 2016, compared to 2015, due to higher car hire expense due to volume mix, partially offset by lower lease expense as a result of the purchase of equipment under existing operating leases and replacement equipment as certain operating leases expired.

Depreciation and amortization. Depreciation and amortization increased $20.4 million for the year ended December 31, 2016, compared to 2015, due to a larger asset base.

Materials and other. Materials and other expense was flat for the year ended December 31, 2016, compared to 2015.

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Lease termination costs. Lease termination costs were $9.6 million for the year ended December 31, 2015, due to the early termination of certain operating leases and the related purchase of the equipment. The Company did not incur lease termination costs for the year ended December 31, 2016.

Non-Operating Expenses

Equity in net earnings of affiliates. Equity in net earnings from affiliates decreased $3.7 million for the year ended December 31, 2016, compared to 2015, due to lower net earnings from the operations of PCRC and FTVM as a result of lower volumes.

Interest expense. Interest expense increased $15.8 million for the year ended December 31, 2016, compared to 2015, due to higher average debt balances and average interest rates as a result of the Company's issuance of debt during the third quarter of 2015 and the second quarter of 2016. For the year ended December 31, 2016, the average debt balance (including short-term borrowings) was $2,492.7 million, compared to $2,257.8 million in 2015. The average interest rate for the year ended December 31, 2016 was 4.0%, compared to 3.7% in 2015.

Debt retirement and exchange costs. The Company did not incur debt retirement and exchange costs during 2016. For the year ended December 31, 2015, debt retirement and exchange costs were $7.6 million, related to costs that were payable to parties other than the debt holders as a result of the KCSR and KCSM senior notes exchanged for KCS senior notes.

Foreign exchange loss. For the years ended December 31, 2016 and 2015, foreign exchange loss was $72.0 million and $56.6 million, respectively. Foreign exchange loss includes the re-measurement and settlement of net monetary assets denominated in Mexican pesos and the loss on foreign currency derivative contracts.

For the years ended December 31, 2016 and 2015, the re-measurement and settlement of net monetary assets denominated in Mexican pesos resulted in a foreign exchange loss of $18.5 million and $9.4 million, respectively.

The Company enters into foreign currency derivative contracts to hedge its net exposure to fluctuations in the Mexican cash tax obligation due to changes in the value of the Mexican peso against the U.S. dollar. For the years ended December 31, 2016 and 2015, foreign exchange loss on foreign currency derivative contracts was $53.5 million and $47.2 million, respectively.

Other expense, net. Other expense, net, decreased $2.7 million for the year ended December 31, 2016, compared to 2015, due to lower miscellaneous expenses.

Income tax expense. Income tax expense decreased $4.5 million for the year ended December 31, 2016, compared to 2015, due to lower pre-tax income and a lower effective tax rate. The effective tax rate was 27.6% and 27.8% for the years ended December 31, 2016 and 2015, respectively. The decrease in the effective tax rate was primarily due to the more significant weakening of the Mexican peso against the U.S. dollar in 2016 as compared to 2015.

The weakening of the Mexican peso as of December 31, 2016 and 2015 decreased the Company's Mexican cash tax obligation by $49.2 million and $46.4 million for the years ended December 31, 2016 and 2015, respectively. The Company enters into foreign currency derivative contracts to hedge its net exposure to fluctuations in the Mexican cash tax obligation due to changes in the value of the Mexican peso against the U.S. dollar, and gains and losses on these foreign currency derivative contracts are recorded in foreign exchange gain (loss).

Further information on the components of the effective tax rates for the years ended December 31, 2016 and 2015, is presented in Note 12 to the consolidated financial statements in Item 8.

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LIQUIDITY AND CAPITAL RESOURCES

Overview

The Company focuses its cash and capital resources on investing in the business, shareholder returns and optimizing its capital structure.

The Company believes, based on current expectations, that cash and other liquid assets, operating cash flows, access to debt and equity capital markets, and other available financing resources will be sufficient to fund anticipated operating expenses, capital expenditures, debt service costs, dividends, share repurchases and other commitments in the foreseeable future. The Company may, from time to time, incur debt to refinance existing indebtedness, purchase equipment under operating leases, repurchase shares or fund equipment additions or new investments.

During 2017, the Company invested $559.5 million in capital expenditures. See Capital Expenditures section for further details.

During the first half of 2017, KCS concluded its $500.0 million share repurchase program, announced in May 2015 (the “2015 Program”). In August 2017, the Company announced a new share repurchase program of up to $800.0 million, which expires on June 30, 2020 (the “2017 Program”). Included within the 2017 Program was authorization for an accelerated share repurchase (“ASR”) program limited to $200.0 million. The Company entered into an ASR program of $200.0 million in the third quarter of 2017, and settled the program in the fourth quarter of 2017. The Company’s 2017 repurchases of common stock, which include shares repurchased through the 2015 Program and the 2017 Program, totaled 3,759,678 shares at an average price of $99.90 per share and a total cost of $375.6 million. Remaining share repurchases are expected to be funded by cash on hand, cash generated from operations and debt. Management's assessment of market conditions, available liquidity and other factors will determine the timing and volume of any future repurchases. Refer to Note 13, Stockholders’ Equity in the notes to the consolidated financial statements in Item 8 for additional detail on the Company’s share repurchase activity.

The Company’s financing instruments contain restrictive covenants which limit or preclude certain actions; however, the covenants are structured such that the Company expects to have sufficient flexibility to conduct its operations. The Company was in compliance with all of its debt covenants as of December 31, 2017.

For discussion regarding the agreements representing the indebtedness of KCS, see Note 10, Short-Term Borrowings and Note 11, Long-Term Debt in the notes to the consolidated financial statements section in Item 8.

During the first half of 2017, the Company’s Board of Directors declared quarterly cash dividends of $0.33 per share or $69.9 million on its common stock. During the second half of 2017, the Company’s Board of Directors declared quarterly cash dividends of $0.36 per share or $74.3 million on its common stock. On January 23, 2018, the Company’s Board of Directors declared a cash dividend of $0.36 per share payable on April 4, 2018, to common stockholders of record as of March 12, 2018. Subject to the discretion of the Board of Directors, capital availability and a determination that cash dividends continue to be in the best interest of its stockholders, the Company intends to pay a quarterly dividend on an ongoing basis.

On December 31, 2017, total available liquidity (the cash balance plus revolving credit facility availability) was $588.9 million, compared to available liquidity at December 31, 2016 of $789.2 million. This decrease was primarily due to an increase in commercial paper and reduction in cash on hand to fund share repurchases made during 2017.

As of December 31, 2017, the total cash and cash equivalents held outside of the U.S. in foreign subsidiaries was $113.7 million. The Company expects that this cash will be available to fund company operations without incurring significant additional taxes.

KCS’s operating results and financing alternatives can be impacted by various factors, some of which are outside of its control. For example, if KCS were to experience a reduction in revenues or a substantial increase in operating costs or other liabilities, its earnings could be significantly reduced, increasing the risk of non-compliance with debt covenants. Additionally, the Company is subject to external factors impacting debt and equity capital markets and its ability to obtain financing under reasonable terms is subject to market conditions. Volatility in capital markets and the tightening of market liquidity could impact KCS’s access to capital. Further, KCS’s cost of debt can be impacted by independent rating agencies which assign debt ratings based on certain factors including competitive position, credit measurements such as interest coverage and leverage ratios, and liquidity.

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Cash Flow Information and Contractual Obligations

Summary cash flow data follows (in millions):

	2017	2016	2015
Cash flows provided by (used for):			
Operating activities	$1,028.4	$919.0	$909.2
Investing activities	(681.1)	(628.2)	(873.0)
Financing activities	(383.8)	(256.8)	(247.6)
Net increase (decrease) in cash and cash equivalents	(36.5)	34.0	(211.4)
Cash and cash equivalents beginning of year	170.6	136.6	348.0
Cash and cash equivalents end of year	$134.1	$170.6	$136.6

During 2017, cash and cash equivalents decreased $36.5 million as a result of the impacts discussed in the paragraphs below. During 2016, cash and cash equivalents increased $34.0 million as a result of the impacts discussed in the paragraphs below.

Operating Cash Flows. Net cash provided by operating activities increased $109.4 million for 2017, as compared to 2016, primarily due to increased operating income of $103.1 million. Net cash provided by operating activities increased $9.8 million for 2016, as compared to 2015, due to an increase in cash inflows from working capital items resulting mainly from the timing of certain payments, partially offset by the 2016 Mexican fuel excise tax credit, which reduced cash taxes paid during 2017.

Investing Cash Flows. Net cash used for investing activities increased $52.9 million for 2017, as compared to 2016, due to a a $21.8 million increase in capital expenditures, $19.5 million increase in investments in and advances to affiliates, and a $16.0 million increase in expenditures for the purchase or replacement of equipment under existing operating leases. Net cash used for investing activities decreased $244.8 million for 2016, as compared to 2015, due to a $124.4 million decrease in capital expenditures and a $117.6 million decrease in expenditures for the purchase or replacement of equipment under existing operating leases. Additional capital expenditure information is included within the Capital Expenditure section of Liquidity and Capital Resources.

Financing Cash Flows. Net cash used for financing activities increased $127.0 million for 2017, as compared to 2016, due to an increase in the repurchase of common stock of $190.2 million, partially offset by an increase in net proceeds from short-term borrowings of $58.2 million. Net cash used for financing activities increased $9.2 million for 2016, as compared to 2015, due to a decrease in net proceeds from long-term debt and short-term borrowings of $29.7 million, partially offset by a decrease in debt cost payments of $17.7 million.

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Contractual Obligations. The following table outlines the material obligations and commitments as of December 31, 2017 (in millions):

	Payments Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 years
Long-term debt and short-term borrowings (including interest and capital lease obligations) (i)	$4,083.4	$ 474.5	$491.1	$ 182.5	$ 2,935.3
Operating leases	281.7	60.9	93.9	49.7	77.2
Deemed mandatory repatriation tax (ii)	44.9	3.6	7.2	7.2	26.9
Capital expenditure obligations (iii)	400.3	149.8	250.5	—	—
Other contractual obligations (iv)	547.5	105.3	143.4	89.6	209.2
Total	$5,357.8	$ 794.1	$986.1	$ 329.0	$ 3,248.6

(i) For variable rate obligations, interest payments were calculated using the December 31, 2017 rate. For fixed rate obligations, interest payments were calculated based on the applicable rates and payment dates.

(ii) U.S. federal income tax on deemed mandatory repatriation is payable over 8 years pursuant to the Tax Reform Act.

(iii) Capital expenditure obligations include minimum capital expenditures under the KCSM Concession agreement and other regulatory requirements.

(iv) Other contractual obligations include purchase commitments and certain maintenance agreements.

In the normal course of business, the Company enters into long-term contractual commitments for future goods and services needed for the operations of the business. Such commitments are not in excess of expected requirements and are not reasonably likely to result in performance penalties or payments that would have a material adverse effect on the Company's liquidity. Such commitments are not included in the above table.

The Company is party to three utilization leases covering 571 railcars in which car hire revenue as defined in the lease agreements is shared between the lessor and the Company. The leases expire at various times through 2024. Amounts that may be due to lessors under these utilization leases vary from month to month based on car hire rental with the minimum monthly cost to the Company being zero. Accordingly, the utilization leases have been excluded from contractual obligations above.

The SCT requires KCSM to submit a three-year capital expenditures plan every three years. The most recent three-year plan was submitted in December 2017 for the years 2018 — 2020, and has not yet been approved by the SCT. KCSM expects to continue capital spending at current levels in future years and will continue to have capital expenditure obligations past 2020, which are not included in the table above.

Off-Balance Sheet Arrangements

On November 2, 2007, PCRC completed an offering of $100.0 million of 7.0% senior secured notes due November 1, 2026 (the "Notes"). The Notes are senior obligations of PCRC, secured by certain assets of PCRC. KCS has pledged its shares of PCRC as security for the Notes. The Notes are otherwise non-recourse to KCS. The Company has agreed, along with Mi-Jack Products, Inc. ("Mi-Jack"), the other 50% owner of PCRC, to each fund 50% of any debt service reserve and liquidity reserve (reserves which are required to be established by PCRC in connection with the issuance of the Notes). As of December 31, 2017, the Company's portion of these reserves was $5.5 million. The Company has issued a standby letter of credit in the amount of $5.5 million to fund its share of these reserves.

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Capital Expenditures

KCS has funded, and expects to continue to fund, capital expenditures with operating cash flows and short and long-term debt.

The following table summarizes capital expenditures by type for the years ended December 31, 2017, 2016, and 2015, respectively (in millions):

	2017	2016	2015
Roadway capital program	$269.3	$271.8	$294.0
Locomotives and freight cars	75.7	112.6	201.2
Capacity	111.4	109.6	86.6
Positive train control	51.7	49.6	34.0
Information technology	33.7	29.3	21.9
Other	17.7	11.1	11.0
Total capital expenditures (accrual basis)	559.5	584.0	648.7
Change in capital accruals	25.9	(20.4)	39.3
Total cash capital expenditures	$585.4	$563.6	$688.0
Purchase or replacement of equipment under operating leases (accrual basis)	$42.6	$26.6	$144.2
Change in capital accruals	—	—	—
Total cash purchase or replacement of equipment under operating leases	$42.6	$26.6	$144.2

Generally, the Company’s capital program consists of capital replacement and equipment. For 2018, internally generated cash flows and short-term borrowings are expected to fund cash capital expenditures, which are currently estimated to be between $530.0 million and $550.0 million. In addition, the Company periodically reviews its equipment under operating leases. Any additional purchase or replacement of equipment under operating leases during 2018 is expected to be funded with internally generated cash flows and/or short-term debt.

Property Statistics

The following table summarizes certain property statistics as of December 31:

	2017	2016	2015
Track miles of rail installed	174	146	177
Cross ties installed (thousands)	699	711	829

Shelf Registration Statements and Public Securities Offerings

KCS has one current, universal shelf registration statement on file with the SEC (the “Universal Shelf” — Registration No. 333-221537). The Universal Shelf was filed on November 13, 2017 in accordance with the securities offering reform rules of the SEC that allow “well-known seasoned issuers” to register an unspecified amount of different types of securities on an immediately effective Form S-3 registration statement. The Universal Shelf will expire on November 13, 2020.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

KCS's accounting and financial reporting policies are in conformity with U.S. generally accepted accounting principles ("U.S. GAAP"). The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Management believes that the following accounting policies and estimates are critical to an understanding of KCS's historical and future performance. Management has discussed the development and selection of the following critical accounting estimates with the Audit Committee of KCS's Board of Directors and the Audit Committee has reviewed the selection, application and disclosure of the Company's critical accounting policies and estimates.

Capitalization, Depreciation and Amortization of Property and Equipment (including Concession Assets)

Due to the highly capital intensive nature of the railroad industry, capitalization and depreciation of property and equipment are a substantial portion of the Company's consolidated financial statements. Net property and equipment, including concession assets, comprised approximately 91% of the Company's total assets as of December 31, 2017, and related depreciation and amortization comprised approximately 19% of total operating expenses for the year ended December 31, 2017.

KCS capitalizes costs for self-constructed additions and improvements to property including direct labor and material, indirect overhead costs, and interest during long-term construction projects. Direct costs are charged to capital projects based on the work performed and the material used. Indirect overhead costs are allocated to capital projects as a standard percentage, which is evaluated annually, and applied to direct labor and material costs. Asset removal activities are performed in conjunction with replacement activities; therefore, removal costs are estimated based on a standard percentage of direct labor and indirect overhead costs related to capital replacement projects. For purchased assets, all costs necessary to make the asset ready for its intended use are capitalized. Expenditures that significantly increase asset values, productive capacity, efficiency, safety or extend useful lives are capitalized. Repair and maintenance costs are expensed as incurred.

Property and equipment are carried at cost and are depreciated primarily on the group method of depreciation, which the Company believes closely approximates a straight line basis over the estimated useful lives of the assets measured in years. The group method of depreciation applies a composite rate to classes of similar assets rather than to individual assets. Composite depreciation rates are based upon the Company's estimates of the expected average useful lives of assets as well as expected net salvage value at the end of their useful lives. In developing these estimates, the Company utilizes periodic depreciation studies performed by an independent engineering firm. Depreciation rate studies are performed at least every three years for equipment and at least every six years for road property (rail, ties, ballast, etc.). The depreciation studies take into account factors such as:

- Statistical analysis of historical patterns of use and retirements of each asset class;
- Evaluation of any expected changes in current operations and the outlook for the continued use of the assets;
- Evaluation of technological advances and changes to maintenance practices; and
- Historical and expected salvage to be received upon retirement.

The depreciation studies may also indicate that the recorded amount of accumulated depreciation is deficient or in excess of the amount indicated by the study. Any such deficiency or excess is amortized as a component of depreciation expense over the remaining useful lives of the affected asset class, as determined by the study. The Company also monitors these factors in non-study years to determine if adjustments should be made to depreciation rates. The Company completed depreciation studies for KCSM in 2016 and KCSR in 2015. The impacts of the studies were immaterial to the consolidated financial results for all periods.

Also under the group method of depreciation, the cost of railroad property and equipment (net of salvage or sales proceeds) retired or replaced in the normal course of business is charged to accumulated depreciation with no gain or loss recognized. Actual historical costs are retired when available, such as with equipment costs. The use of estimates in recognizing the retirement of roadway assets is necessary as it is impractical to track individual, homogeneous network-type assets. Certain types of roadway assets are retired using statistical curves derived from the depreciation studies that indicate the relative distribution of the age of the assets retired. For other roadway assets, historical costs are estimated by (1) deflating current costs

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using inflation indices published by the U.S. Bureau of Labor Statistics and (2) the estimated useful life of the assets as determined by the depreciation studies. The indices applied to the replacement value are selected because they closely correlate with the major costs of the items comprising the roadway assets. Because of the number of estimates inherent in the depreciation and retirement processes and because it is impossible to precisely estimate each of these variables until a group of assets is completely retired, the Company continually monitors the estimated useful lives of its assets and the accumulated depreciation associated with each asset group to ensure the depreciation rates are appropriate.

Estimation of the average useful lives of assets and net salvage values requires management judgment. Estimated average useful lives may vary over time due to changes in physical use, technology, asset strategies and other factors that could have an impact on the retirement experience of the asset classes. Accordingly, changes in the assets' estimated useful lives could significantly impact future periods' depreciation expense. Depreciation and amortization expense for the year ended December 31, 2017 was $320.9 million. If the weighted average useful lives of assets were changed by one year, annual depreciation and amortization expense would change approximately $10.0 million.

Gains or losses on dispositions of land or non-group property and abnormal retirements of railroad property are recognized through income. A retirement of railroad property would be considered abnormal if the cause of the retirement is unusual in nature and its actual life is significantly shorter than what would be expected for that group based on the depreciation studies. An abnormal retirement could cause the Company to re-evaluate the estimated useful life of the impacted asset class. There were no significant gains or losses from abnormal retirements of property or equipment for any of the three years ended December 31, 2017.

Costs incurred by the Company to acquire the concession rights and related assets, as well as subsequent improvements to the concession assets, are capitalized and amortized using the group method of depreciation over the lesser of the current expected Concession term, including probable renewal of an additional 50-year term, or the estimated useful lives of the assets and rights. The Company's ongoing evaluation of the useful lives of concession assets and rights considers the aggregation of the following facts and circumstances:

- The Company's executive management is dedicated to ensuring compliance with the various provisions of the Concession and to maintaining positive relationships with the SCT and other Mexican federal, state, and municipal governmental authorities;
- During the time since the Concession was granted, the relationships between KCSM and the various Mexican governmental authorities have matured and the guidelines for operating under the Concession have become more defined with experience;
- There are no known supportable sanctions or compliance issues that would cause the SCT to revoke the Concession or prevent KCSM from renewing the Concession; and
- KCSM operations are an integral part of the KCS operations strategy, and related investment analyses and operational decisions assume that the Company's cross border rail business operates into perpetuity, and do not assume that Mexico operations terminate at the end of the current Concession term.

Based on the above factors, as of December 31, 2017, the Company continues to believe that it is probable that the Concession will be renewed for an additional 50-year term beyond the current term.

Long-lived assets are reviewed for impairment when events or circumstances indicate that the carrying amount of an asset may not be recoverable. If impairment indicators are present and the estimated future undiscounted cash flows are less than the carrying value of the long-lived assets, the carrying value would be reduced to the estimated fair value. Future cash flow estimates for an impairment review would be based on the lowest level of identifiable cash flows, which are the Company's U.S. and Mexican operations. During the years ended December 31, 2017 and 2016, management did not identify any indicators of impairment.

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Income Taxes

Deferred income taxes represent a net asset or liability of the Company. For financial reporting purposes, management determines the current tax liability, as well as deferred tax assets and liabilities, in accordance with the asset and liability method of accounting for income taxes. The provision for income taxes is the sum of income taxes both currently payable and deferred into the future. Currently payable income taxes represent the liability related to the Company’s U.S., state and foreign income tax returns for the current year and anticipated tax payments resulting from income tax audits, while the net deferred tax expense or benefit represents the change in the balance of net deferred tax assets or liabilities as reported on the balance sheet. The changes in deferred tax assets and liabilities are determined based upon the estimated timing of reversal of differences between the carrying amount of assets and liabilities for financial reporting purposes and the basis of assets and liabilities for tax purposes as measured using the currently enacted tax rates that will be in effect at the time these differences are expected to reverse. Additionally, management estimates whether taxable operating income in future periods will be sufficient to fully recognize any deferred tax assets. Valuation allowances are recorded as appropriate to reduce deferred tax assets to the amount considered likely to be realized.

On December 22, 2017, the President of the United States signed into law the Tax Reform Act. The legislation significantly changes U.S. tax law by, among other things, lowering corporate income tax rates, implementing a territorial tax system and imposing a repatriation tax on deemed repatriated earnings of foreign subsidiaries. The Tax Reform Act permanently reduces the U.S. corporate income tax rate from a maximum of 35% to a flat 21% rate, effective January 1, 2018. The SEC staff issued Staff Accounting Bulletin No. 118 (“SAB 118”) to address the application of U.S. GAAP in situations when a registrant does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Tax Reform Act. The Company has recognized the provisional tax impacts related to deemed repatriated earnings and the revaluation of deferred tax assets and liabilities and included these amounts in its consolidated financial statements for the year ended December 31, 2017. The ultimate impact may differ from these provisional amounts, possibly materially, due to, among other things, additional analysis, changes in interpretations and assumptions the Company has made, additional regulatory guidance that may be issued, and actions the Company may take as a result of the Tax Reform Act. The accounting is expected to be complete when the 2017 U.S. corporate income tax return is filed in 2018.

Income tax expense related to Mexican operations has additional complexities such as the impact of exchange rate variations, which can have a significant impact on the effective income tax rate.

Management believes that the assumptions and estimates related to the provision for income taxes are critical to the Company’s results of operations. For the year ended December 31, 2017, income tax benefit totaled $89.6 million. For every 1% change in the 2017 effective rate, income tax expense would have changed by approximately $8.7 million. For further information on the impact of foreign exchange fluctuation on income taxes, refer to Foreign Exchange Sensitivity in Item 7A.

OTHER MATTERS

Litigation. The Company is a party to various legal proceedings and administrative actions, all of which are of an ordinary, routine nature and incidental to its operations. Included in these proceedings are various tort claims brought by current and former employees for job-related injuries and by third parties for injuries related to railroad operations. KCS aggressively defends these matters and has established liability provisions that management believes are adequate to cover expected costs. Although it is not possible to predict the outcome of any legal proceeding, in the opinion of the Company’s management, other than those proceedings described in Note 15 to the consolidated financial statements in Item 8 of this Form 10-K, such proceedings and actions should not, individually or in the aggregate, have a material adverse effect on the Company’s consolidated financial statements.

Inflation. U.S. generally accepted accounting principles require the use of historical cost, which does not reflect the effects of inflation on the replacement cost of property. Due to the capital intensive nature of KCS’s business, the replacement cost of these assets would be significantly higher than the amounts reported under the historical cost basis.

Recent Accounting Pronouncements. Refer to Note 2 to the consolidated financial statements in Item 8 of this Form 10-K for information relative to recent accounting pronouncements.

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Regulatory Updates

Mexican Antitrust Law. Pursuant to the Mexican Antitrust Law and the Regulatory Railroad Service Law, the COFECE announced that it would review competitive conditions in the Mexican railroad industry, with respect to the existence of effective competition in the provision of interconnection services, trackage rights, switching rights and interline services used to render public freight transport in Mexico. The COFECE review includes the entire freight rail transportation market in Mexico and is not targeted to any single rail carrier.

On March 15, 2017, the COFECE published an executive summary of its preliminary report in the Diario Oficial de la Federación. The COFECE's preliminary report concluded that there was a lack of effective competition in the market for trackage rights ("Relevant Market") throughout the entire networks of KCSM, Ferrocarril Mexicano, S.A. de C.V., Ferrosur, S.A. de C.V., and Ferrocarril y Terminal del Valle de Mexico, S.A. de C.V.

The Company disagrees with the COFECE's reasoning and preliminary conclusions, and responded on April 20, 2017, with its evidence and arguments to support its position, as provided in the Mexican antitrust law. The Company's response argues that the investigation which supports the conclusions in the preliminary report was conducted contrary to the rule of law, the rules of procedure, and relied upon faulty economic analysis.

On April 27, 2017, the COFECE initiated the incidental procedure to analyze the recusal of two of its commissioners from ongoing proceedings ("Motion to Recuse"). On June 6, 2017, KCSM presented arguments in connection with the Motion to Recuse. On July 7, 2017, KCSM was served with rulings dated June 22, 2017 and June 2, 2017, regarding the Motion to Recuse. Consequently, the two commissioners excluded themselves from further participation in the investigation.

It is expected a final ruling will be issued around April 2018. It is too early to determine what, if any, impact this review may have on Mexican rail operations in the future. If the COFECE determines there is a lack of effective competition, the COFECE could request the ARTF, which has primary regulatory jurisdiction over the Company's Mexican operations, to conduct proceedings to determine whether to establish new limited mandatory trackage rights and/or rate regulation under the Amendments to the Mexican Regulatory Railroad Service Law.

Surface Transportation Board. On July 27, 2016, the Surface Transportation Board issued a Notice of Proposed Rulemaking in Ex Parte 711 (Sub-No.1) Reciprocal Switching, proposing rules related to reciprocal switching. Initial comments on the proposed rule were due by October 26, 2016, and replies to the initial comments were due by January 13, 2017. On December 27, 2016, the agency suspended the procedural deadline following submission of reply comments, pending anticipated changes in the agency's membership.

NAFTA. NAFTA is currently being renegotiated. Negotiations will continue in late January with no certainty of progress or continuation. In addition, U.S. President Donald J. Trump, some members of Congress, and key U.S. administration officials and policy makers have suggested the implementation of tariffs, border taxes or other measures that could impact the level of trade between the U.S. and Mexico. Any notice of U.S. withdrawal from NAFTA could be for negotiating position and may be challenged in courts. KCS believes North American trade will continue due to its economic importance and the economic realties that already exist in the North American marketplace.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

KCS utilizes various financial instruments that have certain inherent market risks. These instruments have been entered into for hedging rather than trading purposes. The following information, together with information included in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, and Note 9 to the consolidated financial statements in Item 8 of this Form 10-K, describe the key aspects of certain financial instruments that have market risk to KCS.

Interest Rate Sensitivity. Floating-rate indebtedness includes commercial paper borrowings and revolving credit facilities which totaled $345.2 million and $181.4 million at December 31, 2017 and 2016, respectively. Considering the balance of $345.2 million of variable rate debt at December 31, 2017, KCS is sensitive to fluctuations in interest rates. For example, a hypothetical 100 basis points increase in interest rates would result in additional interest expense of $3.5 million on an annualized basis for the floating-rate instruments issued by the Company as of December 31, 2017.

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Based upon the borrowing rates available to KCS and its subsidiaries for indebtedness with similar terms and average maturities, the fair value of long-term debt was approximately $2,377.8 million and $2,303.8 million at December 31, 2017 and 2016, respectively, compared with a carrying value of $2,274.3 million and $2,296.9 million at December 31, 2017 and 2016, respectively.

In May 2017, the Company executed four treasury lock agreements with an aggregate notional value of $275.0 million and a weighted-average interest rate of 2.85%. The purpose of the treasury locks is to hedge the U.S. Treasury benchmark interest rate associated with future interest payments related to the anticipated refinancing of the $275.0 million of 2.35% senior notes due May 15, 2020.

Commodity Price Sensitivity. KCS periodically participates in diesel fuel purchase commitments and derivative financial instruments. At December 31, 2017 and 2016, KCS did not have any outstanding fuel derivative financial instruments. The Company also holds fuel inventories for use in operations. These inventories are not material to KCS's overall financial position. Fuel costs are expected to reflect market conditions in 2018; however, fuel costs are unpredictable and subject to a variety of factors outside the Company's control. Assuming annual consumption of 140 million gallons, a 10 cent change in the price per gallon of fuel would cause a $14.0 million change in operating expenses. KCS mitigates the impact of increased fuel costs through fuel surcharge revenues from customers; however, in a period of volatile fuel prices or changing customer business mix, changes in fuel expense and fuel surcharge revenue may differ.

Foreign Exchange Sensitivity. KCS's foreign subsidiaries use the U.S. dollar as their functional currency; however, a portion of the foreign subsidiaries' revenues and expenses is denominated in Mexican pesos. Based on the volume of revenue and expense transactions denominated in Mexican pesos, revenue and expense fluctuations have historically offset.

The Company has exposure to fluctuations in the value of the Mexican peso against the U.S. dollar due to its net monetary assets that are denominated in Mexican pesos. The Company had Ps.2,389.1 million of net monetary assets at December 31, 2017.

The following table presents an estimate of the impact to the consolidated statements of income that would result from a hypothetical change in the exchange rate of one Mexican peso at December 31, 2017:

	Hypothetical Change in Exchange Rate	Amount of Gain (Loss)	Affected Line Item in the Consolidated Statements of Income
Net monetary assets denominated in Mexican pesos at December 31, 2017:			
Ps.2,389.1 million	From Ps.19.7 to Ps.20.7	($5.8 million)	Foreign exchange gain (loss)
Ps.2,389.1 million	From Ps.19.7 to Ps.18.7	$6.5 million	Foreign exchange gain (loss)

Mexican income taxes are paid in Mexican pesos, and as a result, the effective income tax rate reflects fluctuations in the value of the Mexican peso against the U.S. dollar. Most significantly, any gain or loss from the revaluation of the Company's net U.S. dollar-denominated monetary liabilities into Mexican pesos is included in Mexican taxable income under Mexican tax law. As a result, a strengthening of the Mexican peso against the U.S. dollar for the reporting period will generally increase the Mexican cash tax obligation and the effective income tax rate, and a weakening of the Mexican peso against the U.S. dollar for the reporting period will generally decrease the Mexican cash tax obligation and the effective tax rate.

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The following table presents an estimate of the impact to the effective income tax rate and income tax expense that would result from a hypothetical change in the exchange rate of one Mexican peso at December 31, 2017:

Hypothetical Change in Exchange Rate	Increase (Decrease) in Effective Income Tax Rate	Amount of Expense (Benefit)	Affected Line Item in the Consolidated Statements of Income
From Ps.19.7 to Ps.20.7	(1.9%)	($16.6 million)	Income tax expense (benefit)
From Ps.19.7 to Ps.18.7	2.1%	$18.3 million	Income tax expense (benefit)

The Company has executed, and expects to continue to execute foreign currency derivative instruments to hedge its exposure to fluctuations in the Mexican cash tax obligation due to changes in the value of the Mexican peso against the U.S. dollar.

At December 31, 2017, the Company had outstanding foreign currency option contracts known as zero-cost collars with an aggregate notional amount of $80.0 million, which matured during January 2018 and resulted in cash received of $10.0 million. During January 2018, the Company entered into several zero-cost collar contracts with an aggregate notional amount of $340.0 million and maturity dates throughout 2018 and in January 2019. The zero-cost collar contracts have a weighted-average rate of Ps.19.23 to each U.S. dollar for the Mexican peso call options purchased by KCS and a weighted-average rate of Ps.21.45 to each U.S. dollar for the Mexican peso put options sold by KCS.

The Company has not designated these foreign currency derivative instruments as hedging instruments for accounting purposes. The foreign currency derivative instruments will be measured at fair value each period and any change in fair value will be recognized in foreign exchange gain (loss) within the consolidated statements of income.

Item 8. Financial Statements and Supplementary Data
Index to Consolidated Financial Statements

All schedules are omitted because they are not applicable, are insignificant, or the required information is shown in the consolidated financial statements or notes thereto.

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Management’s Report on Internal Control over Financial Reporting

The management of Kansas City Southern is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). KCS’s internal control over financial reporting was designed to provide reasonable assurance to the Company’s management and Board of Directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Under the supervision and with the participation of the Company’s Chief Executive Officer and Chief Financial Officer, management conducted an evaluation of the effectiveness of the Company’s internal control over financial reporting as of December 31, 2017, based on the framework established by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control — Integrated Framework (2013) (commonly referred to as the COSO Framework). Based on its evaluation, management concluded that the Company’s internal control over financial reporting was effective as of December 31, 2017, based on the criteria outlined in the COSO Framework.

The effectiveness of the Company’s internal control over financial reporting as of December 31, 2017, has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their attestation report, which immediately follows this report.

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Report of Independent Registered Public Accounting Firm
To the Stockholders and Board of Directors
Kansas City Southern:

Opinion on Internal Control over Financial Reporting

We have audited Kansas City Southern's (the Company) internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on the criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the Standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheets of the Company and its subsidiaries as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in equity, and cash flows for each of the years in the three-year period ended December 31, 2017, and the related notes, and our report dated January 26, 2018 expressed an unqualified opinion on those consolidated financial statements.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ KPMG LLP
We have served as the Company's auditor since 2001.
Kansas City, Missouri
January 26, 2018

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Report of Independent Registered Public Accounting Firm
To the Stockholders and Board of Directors
Kansas City Southern:

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Kansas City Southern and subsidiaries (the Company) as of December 31, 2017 and 2016, and the related consolidated statements of income, comprehensive income, changes in equity, and cash flows for each of the years in the three-year period ended December 31, 2017, and the related notes (collectively, the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2017, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), Kansas City Southern's internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated January 26, 2018 expressed an unqualified opinion on the effectiveness of Kansas City Southern's internal control over financial reporting.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ KPMG LLP

We have served as the Company's auditor since 2001.

Kansas City, Missouri
January 26, 2018

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Kansas City Southern and Subsidiaries
Consolidated Statements of Income
Years Ended December 31,

	2017	2016	2015
	(In millions, except share and per share amounts)		
Revenues	$2,582.9	$2,334.2	$2,418.8
Operating expenses:			
Compensation and benefits	493.8	462.4	442.2
Purchased services	193.7	208.5	223.0
Fuel	316.1	253.8	306.9
Mexican fuel excise tax credit	(44.1)	(62.8)	—
Equipment costs	129.2	120.0	119.4
Depreciation and amortization	320.9	305.0	284.6
Materials and other	251.7	228.8	229.3
Lease termination costs	—	—	9.6
Total operating expenses	1,661.3	1,515.7	1,615.0
Operating income	921.6	818.5	803.8
Equity in net earnings of affiliates	11.5	14.6	18.3
Interest expense	(100.2)	(97.7)	(81.9)
Debt retirement and exchange costs	—	—	(7.6)
Foreign exchange gain (loss)	41.7	(72.0)	(56.6)
Other expense, net	(0.3)	(0.7)	(3.4)
Income before income taxes	874.3	662.7	672.6
Income tax expense (benefit)	(89.6)	182.8	187.3
Net income	963.9	479.9	485.3
Less: Net income attributable to noncontrolling interest	1.9	1.8	1.8
Net income attributable to Kansas City Southern and subsidiaries	962.0	478.1	483.5
Preferred stock dividends	0.2	0.2	0.2
Net income available to common stockholders	$961.8	$477.9	$483.3
Earnings per share:			
Basic earnings per share	$9.18	$4.44	$4.41
Diluted earnings per share	$9.16	$4.43	$4.40
Average shares outstanding (in thousands):			
Basic	104,728	107,560	109,709
Potentially dilutive common shares	312	201	206
Diluted	105,040	107,761	109,915

See accompanying notes to consolidated financial statements.

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Kansas City Southern and Subsidiaries
Consolidated Statements of Comprehensive Income
Years Ended December 31,

	2017	2016	2015
	(In millions)		
Net income	$963.9	$479.9	$485.3
Other comprehensive loss:			
Unrealized loss on interest rate derivative instruments during the period, net of tax of $(2.2) million	(3.4)	—	—
Amortization of prior service credit, net of tax of less than $(0.1) million	—	—	(0.1)
Foreign currency translation adjustments, net of tax of $3.8 million, $(1.0) million and $(0.8) million	(3.3)	(1.5)	(1.4)
Other comprehensive loss	(6.7)	(1.5)	(1.5)
Comprehensive income	957.2	478.4	483.8
Less: comprehensive income attributable to noncontrolling interest	1.9	1.8	1.8
Comprehensive income attributable to Kansas City Southern and subsidiaries	$955.3	$476.6	$482.0

See accompanying notes to consolidated financial statements.

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Kansas City Southern and Subsidiaries
Consolidated Balance Sheets
December 31,

	2017	2016
	(In millions, except share and per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	$134.1	$170.6
Accounts receivable, net	237.8	191.0
Materials and supplies	150.8	152.6
Other current assets	157.4	133.8
Total current assets	680.1	648.0
Investments	44.6	32.9
Property and equipment (including concession assets), net	8,403.8	8,069.7
Other assets	70.2	66.9
Total assets	$9,198.7	$8,817.5
LIABILITIES AND EQUITY		
Current liabilities:		
Long-term debt due within one year	$38.8	$25.4
Short-term borrowings	345.1	181.3
Accounts payable and accrued liabilities	587.8	537.7
Total current liabilities	971.7	744.4
Long-term debt	2,235.5	2,271.5
Deferred income taxes	987.2	1,289.3
Other noncurrent liabilities and deferred credits	138.9	107.8
Total liabilities	4,333.3	4,413.0
Stockholders' equity:		
$25 par, 4% noncumulative, preferred stock, 840,000 shares authorized, 649,736 shares issued, 242,170 shares outstanding	6.1	6.1
$.01 par, common stock, 400,000,000 shares authorized, 123,352,185 shares issued; 103,036,805 and 106,606,619 shares outstanding at December 31, 2017 and 2016, respectively	1.0	1.1
Additional paid-in capital	943.3	954.8
Retained earnings	3,611.4	3,134.1
Accumulated other comprehensive loss	(12.9)	(6.2)
Total stockholders' equity	4,548.9	4,089.9
Noncontrolling interest	316.5	314.6
Total equity	4,865.4	4,404.5
Total liabilities and equity	$9,198.7	$8,817.5

See accompanying notes to consolidated financial statements.

Kansas City Southern and Subsidiaries
Consolidated Statements of Cash Flows
Years Ended December 31,

	2017	2016	2015
	(In millions)		
Operating activities:			
Net income	$963.9	$479.9	$485.3
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	320.9	305.0	284.6
Deferred income taxes	(301.3)	104.8	135.8
Equity in net earnings of affiliates	(11.5)	(14.6)	(18.3)
Share-based compensation	18.2	19.2	11.4
Distributions from unconsolidated affiliates	12.5	13.0	16.5
Debt retirement and exchange costs	—	—	7.6
Settlement of foreign currency derivative instruments	(10.8)	(58.4)	(5.5)
(Gain) loss on foreign currency derivative instruments	(38.2)	53.5	47.2
Mexican fuel excise tax credit	(44.1)	(62.8)	—
Deemed mandatory repatriation tax	41.3	—	—
Changes in working capital items:			
Accounts receivable	(46.7)	(18.3)	12.0
Materials and supplies	1.4	(14.2)	(26.2)
Other current assets	(24.5)	9.9	(10.1)
Accounts payable and accrued liabilities	160.4	101.8	(27.1)
Other, net	(13.1)	0.2	(4.0)
Net cash provided by operating activities	1,028.4	919.0	909.2
Investing activities:			
Capital expenditures	(585.4)	(563.6)	(688.0)
Purchase or replacement of equipment under operating leases	(42.6)	(26.6)	(144.2)
Property investments in MSLLC	(26.0)	(33.1)	(17.4)
Investments in and advances to affiliates	(20.4)	(0.9)	(0.7)
Proceeds from disposal of property	8.8	5.0	4.6
Other, net	(15.5)	(9.0)	(27.3)
Net cash used for investing activities	(681.1)	(628.2)	(873.0)
Financing activities:			
Proceeds from short-term borrowings	12,102.6	8,698.7	10,866.2
Repayment of short-term borrowings	(11,943.6)	(8,597.9)	(11,237.3)
Proceeds from issuance of long-term debt	—	248.7	623.7
Repayment of long-term debt	(25.4)	(276.4)	(149.8)
Dividends paid	(142.5)	(142.8)	(140.1)
Shares repurchased	(375.6)	(185.4)	(194.2)
Debt costs	—	(2.6)	(20.3)
Proceeds from employee stock plans	0.7	0.9	4.2
Net cash used for financing activities	(383.8)	(256.8)	(247.6)
Cash and cash equivalents:			
Net increase (decrease) during each year	(36.5)	34.0	(211.4)
At beginning of year	170.6	136.6	348.0
At end of year	$134.1	$170.6	$136.6
Supplemental cash flow information			
Non-cash investing and financing activities:			

Capital expenditures and purchase or replacement of equipment under operating lease accrued but not yet paid at end of year	$34.9	$60.8	$ 40.4
Other investing activities accrued but not yet paid at the end of the year	56.7	38.3	22.3
Capital lease obligations incurred	0.1	2.4	4.7
Non-cash asset acquisitions	0.1	4.8	7.6
Dividends accrued but not yet paid at end of year	37.2	35.2	35.9
Cash payments:			
Interest paid, net of amounts capitalized	$97.9	$84.3	$ 81.1
Income tax payments, net of refunds	51.1	40.5	40.3

See accompanying notes to consolidated financial statements.

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Kansas City Southern and Subsidiaries
Consolidated Statements of Changes in Equity
(in millions, except per share amounts)

	$25 Par Preferred Stock	$.01 Par Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Non-controlling Interest	Total
Balance at December 31, 2014	$6.1	$ 1.1	$ 949.8	$2,801.7	$ (3.2)	$ 308.6	$4,064.1
Net income				483.5		1.8	485.3
Other comprehensive loss					(1.5)		(1.5)
Dividends on common stock ($1.32/share)				(144.8)			(144.8)
Dividends on $25 par preferred stock ($1.00/share)				(0.2)			(0.2)
Share repurchases			(18.7)	(175.5)			(194.2)
Options exercised and stock subscribed, net of shares withheld for employee taxes			4.7				4.7
Excess tax benefit from share-based compensation			(0.1)				(0.1)
Share-based compensation			11.4				11.4
Balance at December 31, 2015	6.1	1.1	947.1	2,964.7	(4.7)	310.4	4,224.7
Net income				478.1		1.8	479.9
Other comprehensive loss					(1.5)		(1.5)
Contributions from noncontrolling interest						2.4	2.4
Dividends on common stock ($1.32/share)				(141.9)			(141.9)
Dividends on $25 par preferred stock ($1.00/share)				(0.2)			(0.2)
Share repurchases			(18.8)	(166.6)			(185.4)
Options exercised and stock subscribed, net of shares withheld for employee taxes			1.6				1.6
Excess tax benefit from share-based compensation			5.7				5.7
Share-based compensation			19.2				19.2
Balance at December 31, 2016	6.1	1.1	954.8	3,134.1	(6.2)	314.6	4,404.5
Cumulative-effect adjustment due to adoption of ASU 2016-09, Improvements to Employee Share-Based Payment Accounting			1.3	1.2			2.5
Net income				962.0		1.9	963.9
Other comprehensive loss					(6.7)		(6.7)
Dividends on common stock ($1.38/share)				(144.2)			(144.2)
Dividends on $25 par preferred stock ($1.00/share)				(0.2)			(0.2)
Share repurchases		(0.1)	(34.0)	(341.5)			(375.6)
Options exercised and stock subscribed, net of shares withheld for employee taxes			3.0				3.0
Share-based compensation			18.2				18.2
Balance at December 31, 2017	$6.1	$ 1.0	$ 943.3	$3,611.4	$ (12.9)	$ 316.5	$4,865.4

See accompanying notes to consolidated financial statements.

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Kansas City Southern and Subsidiaries
Notes to Consolidated Financial Statements

Note 1. Description of the Business

Kansas City Southern ("KCS" or the "Company"), a Delaware corporation, is a holding company with principal operations in rail transportation.

The Company is engaged in the freight rail transportation business operating through a single coordinated rail network under one reportable business segment. The Company generates revenues and cash flows by providing its customers with freight delivery services both within its regions, and throughout North America through connections with other Class I rail carriers. KCS's customers conduct business in a number of different industries, including electric-generating utilities, chemical and petroleum products, paper and forest products, agriculture and mineral products, automotive products and intermodal transportation.

The primary subsidiaries of the Company consist of the following:

- The Kansas City Southern Railway Company ("KCSR"), a wholly-owned consolidated subsidiary. KCSR is a U.S. Class I railroad that services the midwest and southeast regions of the United States;
- Kansas City Southern de México, S.A. de C.V. ("KCSM"), a wholly-owned consolidated subsidiary which operates under the rights granted by the Concession acquired from the Mexican government in 1997 (the "Concession") as described below;
- Mexrail, Inc. ("Mexrail"), a wholly-owned consolidated subsidiary; which wholly owns The Texas Mexican Railway Company ("Tex-Mex");
- KCSM Servicios, S.A. de C.V. ("KCSM Servicios"), a wholly-owned consolidated subsidiary which provides employee services to KCSM; and
- Meridian Speedway, LLC ("MSLLC"), a seventy percent-owned consolidated affiliate. MSLLC owns the former KCSR rail line between Meridian, Mississippi and Shreveport, Louisiana, which is the portion of the rail line between Dallas, Texas and Meridian known as the "Meridian Speedway".

Including equity investments in:

- Panama Canal Railway Company ("PCRC"), a fifty percent-owned unconsolidated affiliate which provides ocean to ocean freight and passenger services along the Panama Canal;
- TFCM, S. de R.L. de C.V. ("TCM"), a forty-five percent-owned unconsolidated affiliate that operates a bulk liquid terminal in San Luis Potosí, Mexico;
- Ferrocarril y Terminal del Valle de México, S.A. de C.V. ("FTVM"), a twenty-five percent-owned unconsolidated affiliate that provides railroad services as well as ancillary services in the greater Mexico City area; and
- PTC-220, LLC ("PTC-220"), a fourteen percent-owned unconsolidated affiliate that holds the licenses to large blocks of radio spectrum and other assets for the deployment of positive train control.

The KCSM Concession. KCSM holds a concession from the Mexican government until June 2047 (exclusive service through 2027, subject to certain trackage and haulage rights granted to other concessionaires), which is renewable under certain conditions for an additional period of up to 50 years (the "Concession"). The Concession is to provide freight transportation services over north-east rail lines which are a primary commercial corridor of the Mexican railroad system. KCSM has the right to use, but does not own, all track and buildings that are necessary for the rail lines' operation. KCSM is required to pay the Mexican government an annual concession duty equal to 1.25% of gross revenues during the Concession period.

Employees and Labor Relations. KCSR participates in industry-wide multi-employer bargaining as a member of the National Carriers' Conference Committee, as well as local bargaining for agreements that are limited to KCSR's property. Approximately 75% of KCSR employees are covered by collective bargaining agreements.

Kansas City Southern and Subsidiaries
Notes to Consolidated Financial Statements-(Continued)

KCSM Servicios union employees are covered by one labor agreement, which was signed on April 16, 2012, between KCSM Servicios and the Sindicato de Trabajadores Ferrocarrileros de la República Mexicana ("Mexican Railroad Union"), for an indefinite period of time, for the purpose of regulating the relationship between the parties. Approximately 80% of KCSM Servicios employees are covered by this labor agreement.
Union labor negotiations have not historically resulted in any strike, boycott, or other disruption in the Company's business operations.

Note 2. Significant Accounting Policies
Principles of Consolidation. The accompanying consolidated financial statements are presented using the accrual basis of accounting and include the Company and its majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated. Certain prior year amounts have been reclassified to conform to the current year presentation.
The equity method of accounting is used for all entities in which the Company or its subsidiaries have significant influence, but not a controlling interest. The Company evaluates less-than-majority-owned investments for consolidation pursuant to consolidation and variable interest entity guidance. The Company does not have any less-than-majority-owned investments requiring consolidation.
During the first quarter of 2017, the Company adopted Accounting Standards Update ("ASU") No. 2016-09, Improvements to Employee Share-Based Payment Accounting. The Company now recognizes forfeitures as they occur rather than estimating a forfeiture rate for the year. Excess tax benefits or deficiencies resulting from the exercise or vesting of awards are included in income tax expense in the reporting period in which they occur. Upon adoption, the Company recognized a cumulative-effect adjustment to equity at the beginning of 2017.
During the third quarter of 2017, the Company early adopted ASU No. 2017-12, Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities. The Company now asserts qualitatively, on a quarterly basis, that the hedging relationship was and continues to be highly effective as long as facts and circumstances related to the hedging relationship have not changed. If facts and circumstances have changed, the Company will perform a quantitative assessment to ensure the hedging relationship is still deemed highly effective. In addition, the ineffective portion of an effective hedge is no longer measured periodically and included in the income statement; rather, the total periodic change in fair value of an effective hedge is included in accumulated other comprehensive income on the balance sheet, until settlement occurs. The adoption of the new guidance had no impact on the Company's consolidated financial statements as there was no ineffectiveness recognized on the Company's cash flow hedges prior to adoption.
Use of Estimates. The accounting and financial reporting policies of the Company conform to accounting principles generally accepted in the United States of America ("U.S. GAAP"). The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include those related to the recoverability and useful lives of assets, litigation provisions, and income taxes. Changes in facts and circumstances may result in revised estimates and actual results could differ from those estimates.
Revenue Recognition. Freight revenue is recognized proportionally as a shipment moves from origin to destination, with the related expense recognized as incurred. Other revenues, in general, are recognized when the product is shipped, as services are performed or contractual obligations are fulfilled.
Foreign Exchange Gain (Loss). For financial reporting purposes, foreign subsidiaries maintain records in U.S. dollars, which is the functional currency. The dollar is the currency that reflects the economic substance of the underlying events and circumstances relevant to the entity. Monetary assets and liabilities denominated in pesos are remeasured

into dollars using current exchange rates. The difference between the exchange rate on the date of the transaction and the exchange rate on the settlement date, or balance sheet date if not settled, is included in the income statement as foreign exchange gain or loss.

Kansas City Southern and Subsidiaries
Notes to Consolidated Financial Statements-(Continued)

Cash Equivalents. Short-term liquid investments with an initial maturity of three months or less are classified as cash and cash equivalents.
Accounts Receivable, net. Accounts receivable are net of an allowance for uncollectible accounts as determined by historical experience and adjusted for economic uncertainties or known trends. Accounts are charged to the allowance when a customer enters bankruptcy, when an account has been transferred to a collection agent or submitted for legal action, or when a customer is significantly past due and all available means of collection have been exhausted. At December 31, 2017 and 2016, the allowance for doubtful accounts was $4.6 million and $5.3 million, respectively. For the years ended December 31, 2017, 2016 and 2015, bad debt expense was $1.6 million, $1.2 million and $1.0 million, respectively.
Materials and Supplies. Materials and supplies consisting of diesel fuel, items to be used in the maintenance of rolling stock and items to be used in the maintenance or construction of road property are valued at the lower of average cost or net realizable value.
Derivative Instruments. Derivatives are measured at fair value and recorded on the balance sheet as either assets or liabilities. Changes in the fair value of derivatives are recorded either through current earnings or as other comprehensive income, depending on hedge designation. Gains and losses on derivative instruments classified as cash flow hedges are reported in other comprehensive income and are reclassified into earnings in the periods in which earnings are impacted by the variability of the cash flow of the hedged item.
Property and Equipment (including Concession Assets). KCS capitalizes costs for self-constructed additions and improvements to property including direct labor and material, indirect overhead costs, and interest during long-term construction projects. For purchased assets, all costs necessary to make the asset ready for its intended use are capitalized. Expenditures that significantly increase asset values, productive capacity, efficiency, safety or extend useful lives are capitalized. Repair and maintenance costs are expensed as incurred.
Property and equipment are carried at cost and are depreciated primarily on the group method of depreciation, which the Company believes closely approximates a straight line basis over the estimated useful lives of the assets measured in years. The group method of depreciation applies a composite rate to classes of similar assets rather than to individual assets. Composite depreciation rates are based upon the Company’s estimates of the expected average useful lives of assets as well as expected net salvage value at the end of their useful lives. In developing these estimates, the Company utilizes periodic depreciation studies performed by an independent engineering firm. Depreciation rate studies are performed at least every three years for equipment and at least every six years for road property (rail, ties, ballast, etc.). The Company completed depreciation studies for KCSM in 2016 and KCSR in 2015. The impacts of the studies were immaterial to the consolidated financial results for all periods.
Under the group method of depreciation, the cost of railroad property and equipment (net of salvage or sales proceeds) retired or replaced in the normal course of business is charged to accumulated depreciation with no gain or loss recognized. Gains or losses on dispositions of land or non-group property and abnormal retirements of railroad property are recognized through income. A retirement of railroad property would be considered abnormal if the cause of the retirement is unusual in nature and its actual life is significantly shorter than what would be expected for that group based on the depreciation studies. An abnormal retirement could cause the Company to re-evaluate the estimated useful life of the impacted asset class.
Costs incurred by the Company to acquire the concession rights and related assets, as well as subsequent improvements to the concession assets, are capitalized and amortized using the group method of depreciation over the lesser of the current expected Concession term, including probable renewal of an additional 50-year term, or the estimated useful lives of the assets and rights.
Long-lived assets are reviewed for impairment when events or circumstances indicate that the carrying amount of an asset may not be recoverable. If impairment indicators are present and the estimated future undiscounted cash flows

are less than the carrying value of the long-lived assets, the carrying value would be reduced to the estimated fair value. Future cash flow estimates for an impairment review would be based on the lowest level of identifiable cash flows, which are the Company's

U.S. and Mexican operations. During the years ended December 31, 2017 and 2016, management did not identify any indicators of impairment.

Goodwill. Goodwill represents the excess of the purchase price over the fair value of the net identifiable assets acquired in business combinations. As of December 31, 2017 and 2016, the goodwill balance was $13.2 million, which is included in other assets in the consolidated balance sheets. Goodwill is not amortized, but is reviewed at least annually, or more frequently as indicators warrant, for impairment. An impairment loss would be recognized to the extent that the carrying amount exceeds the assets' fair values. The Company performed its annual impairment review for goodwill as of November 30, 2017 and 2016, and concluded there was no impairment.

Fair Value of Financial Instruments. Non-financial assets and liabilities are recognized at fair value on a nonrecurring basis. These assets and liabilities are measured at fair value on an ongoing basis but are subject to recognition in the financial statements only in certain circumstances. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Company determines the fair values of its financial instruments based on the fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The hierarchy is broken down into three levels based upon the observability of inputs. Fair values determined by Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy within which the fair value measurement in its entirety falls has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value in its entirety requires judgment and considers factors specific to the asset or liability.

Environmental Liabilities. The Company recognizes liabilities for remediation and restoration costs related to past activities when the Company's obligation is probable and the costs can be reasonably estimated. Costs of future expenditures for environmental remediation are not discounted to their present value. Recoveries of environmental remediation costs from other parties are recorded as assets when their receipt is deemed probable. Costs of ongoing compliance activities related to current operations are expensed as incurred.

Personal Injury Claims. Personal injury claims in excess of self-insurance levels are insured up to certain coverage amounts, depending on the type of claim and year of occurrence. The Company's personal injury liability is based on actuarial studies performed on an undiscounted basis by an independent third party actuarial firm and reviewed by management. The liability is based on claims filed and an estimate of claims incurred but not yet reported. Adjustments to the liability are reflected as operating expenses in the period in which the adjustments are known. Legal fees related to personal injury claims are recognized in operating expense in the period incurred.

Health and Welfare and Postemployment Benefits. The Company provides certain medical, life and other postemployment benefits to certain active employees and retirees. The Company uses actuaries to assist management in measuring the benefit obligation and cost based on the current plan provisions, employee demographics, and assumptions about financial and demographic factors affecting the probability, timing and amount of expected future benefit payments. Significant assumptions include the discount rate, rate of increase in compensation levels, and the health care cost trend rate. Actuarial gains and losses determined at the measurement date (December 31) are recognized immediately in the consolidated statements of income.

Share-Based Compensation. The Company accounts for all share-based compensation in accordance with fair value recognition provisions. Under this method, compensation expense is measured at grant date fair value and is recognized over the requisite service period in which the award is earned. The Company issues treasury stock to settle share-based awards.

Kansas City Southern and Subsidiaries
Notes to Consolidated Financial Statements-(Continued)

Income Taxes. Deferred income tax effects of transactions reported in different periods for financial reporting and income tax return purposes are recognized under the asset and liability method of accounting for income taxes. This method gives consideration to the future tax consequences of the deferred income tax items and immediately recognizes changes in income tax laws in the year of enactment. On December 22, 2017, the President of the United States signed into law the Tax Cuts and Jobs Act (the “Tax Reform Act”). Further information on the tax impacts of the Tax Reform Act is included in Note 12 of the Company’s consolidated financial statements.

The Company has recognized a deferred tax asset, net of a valuation allowance, for net operating loss carryovers. The Company projects sufficient future taxable income to realize the deferred tax asset recorded less the valuation allowance. These projections take into consideration assumptions about future income, future capital expenditures and inflation rates. If assumptions or actual conditions change, the deferred tax asset, net of the valuation allowance, will be adjusted to properly reflect the expected tax benefit.

Treasury Stock. The excess of repurchase price over par value of common shares held in treasury is allocated between additional paid-in capital and retained earnings.

New Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers, which requires companies to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration it expects to be entitled in exchange for those goods or services. The new standard will become effective for the Company beginning with the first quarter 2018 and the Company plans to adopt the accounting standard using the modified retrospective transition approach. The modified retrospective transition approach will recognize any changes from the beginning of the year of initial application through retained earnings with no restatement of comparative periods. The Company has completed a review of the impacts of the application of the new standard to its existing portfolio of customer contracts. Under the new standard, the Company will continue to recognize freight revenue proportionally as a shipment moves from origin to destination. Furthermore, the Company will be required to assess variable consideration included in its contracts and make judgments and estimates throughout the applicable periods. Certain additional financial statement disclosure requirements are mandated by the new standard including disclosure of contract assets and contract liabilities as well as a disaggregated view of revenue. Based on the Company’s review, the adoption of this guidance will not have a significant impact on the Company’s consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases, which requires lessees to recognize for all leases a right-to-use asset and a lease obligation in the consolidated balance sheet. Expenses are recognized in the consolidated statement of income in a manner similar to current accounting guidance. Lessees are permitted to make an accounting policy election to not recognize an asset and liability for leases with a term of twelve months or less. Lessor accounting under the new standard is substantially unchanged. Additional qualitative and quantitative disclosures, including significant judgments made by management, will be required. The new standard will become effective for the Company beginning with the first quarter 2019 and requires a modified retrospective transition approach. The Company created a cross functional team to assess the contractual arrangements that may qualify as a lease under the new standard and implement a lease management system. At December 31, 2017, KCS disclosed approximately $281.7 million of operating leases in the leases and debt maturities table within Note 11 - Long-Term Debt and will evaluate those contracts as well as other existing arrangements to determine if they qualify for lease accounting under the new standard. The Company is continuing to evaluate the impacts the adoption of this accounting guidance will have on the consolidated financial statements.

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Kansas City Southern and Subsidiaries
Notes to Consolidated Financial Statements-(Continued)

Note 3. Mexican Fuel Excise Tax Credit
Fuel purchases made in Mexico are subject to an excise tax that is included in the price of fuel. The Company is eligible for and utilizes an available credit for the excise tax included in the price of fuel that is purchased and consumed in locomotives and certain work equipment in Mexico. For the years ended December 31, 2017 and 2016, the Company recognized a $44.1 million and $62.8 million benefit, respectively. The Mexican fuel excise tax credit is realized through the offset of the total annual Mexico income tax liability and income tax withholding payment obligations of KCSM, with no carryforward to future periods.

Note 4. Hurricane Harvey
In late August 2017, Hurricane Harvey made landfall on the Texas coast and caused flood damage to the Company's track infrastructure and significantly disrupted the Company's rail service. The Company filed a claim in the fourth quarter of 2017 under its insurance program for property damage, incremental expenses, and lost profits caused by Hurricane Harvey. In the third quarter of 2017, the Company recognized a receivable for probable insurance recovery offsetting the impact of incremental expenses recognized in the quarter. The recognition of remaining probable insurance recoveries in excess of incremental expenses and self-insured retention represents a contingent gain, which will be recognized when all contingencies have been resolved, which generally occurs at the time of final settlement or when nonrefundable cash payments are received.

Note 5. Earnings Per Share
Basic earnings per common share is computed by dividing net income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share adjusts basic earnings per common share for the effects of potentially dilutive common shares, if the effect is not anti-dilutive. Potentially dilutive common shares include the dilutive effects of shares issuable under the 2008 and 2017 Equity Incentive Plans and shares issuable upon the conversion of preferred stock to common stock.
The following table reconciles the basic earnings per share computation to the diluted earnings per share computation (in millions, except share and per share amounts):

	2017	2016	2015
Net income available to common stockholders for purposes of computing basic and diluted earnings per share	$ 961.8	$ 477.9	$ 483.3
Weighted-average number of shares outstanding (in thousands):			
Basic shares	104,728	107,560	109,709
Effect of dilution	312	201	206
Diluted shares	105,040	107,761	109,915
Earnings per share:			
Basic earnings per share	$ 9.18	$ 4.44	$ 4.41
Diluted earnings per share	$ 9.16	$ 4.43	$ 4.40

Potentially dilutive shares excluded from the calculation (in thousands):	2017	2016	2015
Stock options excluded as their inclusion would be anti-dilutive	150	185	84

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Kansas City Southern and Subsidiaries
Notes to Consolidated Financial Statements-(Continued)

Note 6. Property and Equipment (including Concession Assets)
The following tables list the major categories of property and equipment, including concession assets, as well as the weighted-average composite depreciation rate for each category (in millions):

As of December 31, 2017	Cost	Accumulated Depreciation	Net Book Value	Depreciation Rates for 2017
Land	$218.6	$ —	$218.6	N/A
Concession land rights	141.2	(26.5)	114.7	1.0%
Rail and other track material	1,967.0	(425.9)	1,541.1	2.7-3.0%
Ties	1,779.6	(441.0)	1,338.6	2.0-4.8%
Grading	969.9	(162.1)	807.8	0.9%
Bridges and tunnels	775.0	(144.9)	630.1	1.1%
Ballast	795.2	(222.0)	573.2	2.3-4.2%
Other (a)	1,270.4	(363.3)	907.1	3.2%
Total road property	7,557.1	(1,759.2)	5,797.9	2.8%
Locomotives	1,527.9	(375.2)	1,152.7	4.7%
Freight cars	937.9	(168.9)	769.0	2.7%
Other equipment	69.1	(26.6)	42.5	5.9%
Total equipment	2,534.9	(570.7)	1,964.2	4.0%
Technology and other	229.1	(144.4)	84.7	17.1%
Construction in progress	223.7	—	223.7	N/A
Total property and equipment (including concession assets)	$10,904.6	$ (2,500.8)	$8,403.8	N/A

(a) Other includes signals, buildings and other road assets.

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Kansas City Southern and Subsidiaries
Notes to Consolidated Financial Statements-(Continued)

As of December 31, 2016	Cost	Accumulated Depreciation	Net Book Value	Depreciation Rates for 2016
Land	$219.2	$ —	$219.2	N/A
Concession land rights	141.2	(25.1)	116.1	1.0%
Rail and other track material	1,925.4	(445.0)	1,480.4	1.6-3.2%
Ties	1,710.1	(423.8)	1,286.3	2.0-5.0%
Grading	910.7	(153.9)	756.8	0.9%
Bridges and tunnels	739.4	(137.6)	601.8	1.1%
Ballast	748.3	(215.1)	533.2	2.5-4.7%
Other (a)	1,152.1	(332.4)	819.7	3.0%
Total road property	7,186.0	(1,707.8)	5,478.2	2.8%
Locomotives	1,485.9	(356.9)	1,129.0	4.5%
Freight cars	887.7	(152.5)	735.2	3.5%
Other equipment	66.2	(23.6)	42.6	6.4%
Total equipment	2,439.8	(533.0)	1,906.8	4.2%
Technology and other	182.2	(126.2)	56.0	17.4%
Construction in progress	293.4	—	293.4	N/A
Total property and equipment (including concession assets)	$10,461.8	$ (2,392.1)	$8,069.7	N/A

(a) Other includes signals, buildings and other road assets.

Concession assets, net of accumulated amortization of $638.2 million and $610.7 million, totaled $2,208.1 million and $2,131.6 million at December 31, 2017 and 2016, respectively.

The Company capitalized $0.3 million, $0.5 million, and $0.7 million of interest for the years ended December 31, 2017, 2016, and 2015, respectively.

Depreciation and amortization of property and equipment (including concession assets) totaled $320.9 million, $305.0 million and $284.6 million, for 2017, 2016, and 2015, respectively.

Note 7. Other Balance Sheet Captions

Other Current Assets. Other current assets included the following items at December 31 (in millions):

	2017	2016
Refundable taxes	$81.6	$64.0
Mexican fuel excise tax credit	35.1	49.2
Prepaid expenses	18.3	18.2
Other	22.4	2.4
Other current assets	$157.4	$133.8

Kansas City Southern and Subsidiaries
Notes to Consolidated Financial Statements-(Continued)

Accounts Payable and Accrued Liabilities. Accounts payable and accrued liabilities included the following items at December 31 (in millions):

	2017	2016
Accounts payable	$225.1	$247.8
Income and other taxes	111.8	36.0
Accrued wages and vacation	89.0	78.7
Derailments, personal injury and other claim provisions	48.0	39.2
Foreign currency derivative instruments	—	41.1
Dividends payable	37.2	35.2
Other	76.7	59.7
Accounts payable and accrued liabilities	$587.8	$537.7

Note 8. Fair Value Measurements
The Company's assets and liabilities recognized at fair value have been categorized based upon a fair value hierarchy as described in Note 2 — "Significant Accounting Policies." As of December 31, 2017, the Company's derivative financial instruments are measured at fair value on a recurring basis and consist of foreign currency forward and option contracts and treasury lock agreements, which are classified as Level 2 valuations. The Company determines the fair value of its derivative financial instrument positions based upon pricing models using inputs observed from actively quoted markets and also takes into consideration the contract terms as well as other inputs, including market currency exchange rates and in the case of option contracts, volatility, the risk-free interest rate and the time to expiration. The fair value of the foreign currency derivative instruments was an asset of $7.9 million and a liability of $41.1 million at December 31, 2017 and 2016, respectively, and the fair value of the forward treasury lock agreements was a liability of $5.6 million at December 31, 2017. There were no outstanding treasury lock agreements at December 31, 2016.
The Company's short-term financial instruments include cash and cash equivalents, accounts receivable, accounts payable and short-term borrowings. The carrying value of the short-term financial instruments approximates their fair value.
The fair value of the Company's debt is estimated using quoted market prices when available. When quoted market prices are not available, fair value is estimated based on current market interest rates for debt with similar maturities and credit quality. The fair value of the Company's debt was $2,377.8 million and $2,303.8 million at December 31, 2017 and 2016, respectively. The carrying value was $2,274.3 million and $2,296.9 million at December 31, 2017 and 2016, respectively. If the Company's debt were measured at fair value, the fair value measurements of the individual debt instruments would have been classified as either Level 1 or Level 2 in the fair value hierarchy.

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Kansas City Southern and Subsidiaries
Notes to Consolidated Financial Statements-(Continued)

Note 9. Derivative Instruments
The Company enters into derivative transactions in certain situations based on management's assessment of current market conditions and perceived risks. Management intends to respond to evolving business and market conditions and in doing so, may enter into such transactions as deemed appropriate.
Credit Risk. As a result of the use of derivative instruments, the Company is exposed to counterparty credit risk. The Company manages this risk by limiting its counterparties to large financial institutions which meet the Company's credit rating standards and have an established banking relationship with the Company. As of December 31, 2017, the Company did not expect any losses as a result of default of its counterparties.
Interest Rate Derivative Instruments. In May 2017, the Company executed four treasury lock agreements with an aggregate notional value of $275.0 million and a weighted-average interest rate of 2.85%. The purpose of the treasury locks is to hedge the U.S. Treasury benchmark interest rate associated with future interest payments related to the anticipated refinancing of the $275.0 million, 2.35% senior notes due May 15, 2020. The Company has designated the treasury locks as cash flow hedges and recorded unrealized gains and losses in accumulated other comprehensive income. Upon settlement, the unrealized gain or loss in accumulated other comprehensive income will be amortized to interest expense over the life of the future underlying debt issuance.
Foreign Currency Derivative Instruments. The Company's Mexican subsidiaries have net U.S. dollar-denominated monetary liabilities which, for Mexican income tax purposes, are subject to periodic revaluation based on changes in the value of the Mexican peso against the U.S. dollar. This revaluation creates fluctuations in the Company's Mexican income tax expense and the amount of income taxes paid in Mexico. The Company hedges its exposure to this cash tax risk by entering into foreign currency forward contracts and foreign currency option contracts known as zero-cost collars.
The foreign currency forward contracts involve the Company's purchase of pesos at an agreed-upon weighted-average exchange rate to each U.S dollar. The zero-cost collars involve the Company's purchase of a Mexican peso call option and a simultaneous sale of a Mexican peso put option, with equivalent U.S. dollar notional amounts for each option and no net cash premium paid by the Company. The Company does not physically exchange currencies upon maturity or expiration of its forward contracts or zero-cost collars. Instead, the Company settles the maturing/expiring transactions by entering into offsetting transactions, which results in a physical exchange of only the net gain or loss between the Company and the counterparty.

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Below is a summary of the Company's 2017, 2016 and 2015 foreign currency derivative contracts (amounts in millions, except Ps./USD):

Foreign currency forward contracts

	Contracts to purchase Ps./pay USD				Offsetting contracts to sell Ps./receive USD				
	Notional amount	Notional amount	Weighted-average exchange rate (in Ps./USD)	Maturity date	Notional amount	Notional amount	Weighted-average exchange rate (in Ps./USD)	Maturity date	Cash received/(paid) on settlement
Contracts executed in 2016 and settled in 2017	$340.0	Ps. 6,207.7	Ps. 18.3	1/17/2017	$287.0	Ps. 6,207.7	Ps. 21.6	1/17/2017	$ (53.0)
Contracts executed in 2016 and settled in 2016	$60.0	Ps. 1,057.3	Ps. 17.6	4/29/2016	$60.7	Ps. 1,057.3	Ps. 17.4	4/29/2016	$ 0.7
Contracts executed in 2015 and settled in 2016	$300.0	Ps. 4,480.4	Ps. 14.9	1/15/2016	$251.0	Ps. 4,480.4	Ps. 17.9	1/15/2016	$ (49.0)
Contracts executed in 2014 and settled in 2015	$300.0	Ps. 4,364.7	Ps. 14.6	1/15/2015	$298.8	Ps. 4,364.7	Ps. 14.6	1/15/2015	$ (1.2)

Foreign currency zero-cost collar contracts

	Notional amount	Maturity date	Weighted-average call rate outstanding options (in Ps./USD)	Weighted-average put rate outstanding options (in Ps./USD)	Cash received/(paid) on settlement
Contracts executed in 2017 and outstanding at December 31, 2017	$80.0	1/16/2018	Ps. 21.7	Ps. 24.8	—
Contracts executed in 2017 and settled in 2017	$450.0	—	—	—	$42.2
Contracts executed in 2015 and settled in	$80.0	—	—	—	$(10.1)

2016					
Contracts executed in 2015 and settled in 2015	$50.0	—	—	—	$(4.3)

The Company has not designated any of the foreign currency derivative contracts as hedging instruments for accounting purposes. The Company measures the foreign currency derivative contracts at fair value each period and recognizes any change in fair value in foreign exchange gain (loss) within the consolidated statements of income.

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The following table presents the fair value of derivative instruments included in the consolidated balance sheets at December 31 (in millions):

	Derivative Assets Balance Sheet Location	2017	2016
Derivatives not designated as hedging instruments:			
Foreign currency zero-cost collar contracts	Other current assets	$7.9	$ —
Total derivatives not designated as hedging instruments		7.9	—
Total derivative assets		$7.9	$ —

	Derivative Liabilities Balance Sheet Location	2017	2016
Derivatives designated as hedging instruments:			
Treasury lock agreements	Other noncurrent liabilities and deferred credits	$5.6	$—
Total derivatives designated as hedging instruments		5.6	—
Derivatives not designated as hedging instruments:			
Foreign currency forward contracts	Accounts payable and accrued liabilities	—	41.1
Total derivatives not designated as hedging instruments		—	41.1
Total derivative liabilities		$5.6	$41.1

The following table presents the effects of derivative instruments on the consolidated statements of income and consolidated statements of comprehensive income for the years ended December 31 (in millions):

Derivatives in Cash Flow Hedging Relationships	Amount of Gain/(Loss) Recognized in OCI on Derivative		
	2017	2016	2015
Treasury lock agreements	$(5.6)	$—	$—
Total	$(5.6)	$—	$—

Derivatives Not Designated as Hedging Instruments	Location of Gain/(Loss) Recognized in Income on Derivative	Amount of Gain/(Loss) Recognized in Income on Derivative		
		2017	2016	2015
Foreign currency forward contracts	Foreign exchange gain (loss)	$(11.9)	$(49.6)	$(36.7)
Foreign currency zero-cost collar contracts	Foreign exchange gain (loss)	50.1	(3.9)	(10.5)
Total		$38.2	$(53.5)	$(47.2)

Note 10. Short-Term Borrowings

Commercial Paper. The Company’s commercial paper program generally serves as the primary means of short-term funding. As of December 31, 2017, KCS had $345.1 million of commercial paper outstanding, net of $0.1 million discount, at a weighted-average interest rate of 1.846%. As of December 31, 2016, KCS had $181.3 million of commercial paper outstanding, net of $0.1 million discount, at a weighted-average interest rate of 1.290%.

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Note 11. Long-Term Debt
Long-term debt at December 31 (in millions):

	2017			2016		
	Principal	Unamortized Discount and Debt Issuance Costs	Net	Principal	Unamortized Discount and Debt Issuance Costs	Net
Revolving credit facilities, variable interest rate, due 2020	$—	$ —	$—	$—	$ —	$—
KCS 2.35% senior notes, due 2020	257.3	1.2	256.1	257.3	1.7	255.6
KCS 3.00% senior notes, due 2023	439.1	4.0	435.1	439.1	4.7	434.4
KCS 3.85% senior notes, due 2023	199.2	1.7	197.5	199.2	2.0	197.2
KCS 3.125% senior notes, due 2026	250.0	3.1	246.9	250.0	3.4	246.6
KCS 4.30% senior notes, due 2043	448.7	9.3	439.4	448.7	9.6	439.1
KCS 4.95% senior notes, due 2045	499.2	7.6	491.6	499.2	8.0	491.2
KCSR senior notes 3.85% to 4.95%, due through 2045	2.9	—	2.9	2.9	—	2.9
KCSM senior notes 2.35% to 3.00%, due through 2023	28.5	0.2	28.3	28.5	0.2	28.3
RRIF loans 2.96% to 4.29%, due serially through 2037	77.8	0.5	77.3	81.4	0.5	80.9
Financing agreements 5.737% to 9.310%, due serially through 2023	84.2	0.3	83.9	102.5	0.4	102.1
Capital lease obligations, due serially to 2024	15.0	—	15.0	18.3	—	18.3
Other debt obligations	0.3	—	0.3	0.3	—	0.3
Total	2,302.2	27.9	2,274.3	2,327.4	30.5	2,296.9
Less: Debt due within one year	38.8	—	38.8	25.4	—	25.4
Long-term debt	$2,263.4	$ 27.9	$2,235.5	$2,302.0	$ 30.5	$2,271.5

Revolving Credit Facility
KCS with certain of its domestic subsidiaries named therein as guarantors, has an $800.0 million revolving credit facility (the “KCS Revolving Credit Facility”), with a $25.0 million standby letter of credit facility which, if utilized, constitutes usage under the revolving facility. The KCS Revolving Credit Facility serves as a backstop for KCS’s $800.0 million commercial paper program (the “KCS Commercial Paper Program”) which generally serves as the Company’s primary means of short-term funding.
Borrowings under the KCS Revolving Credit Facility bear interest at floating rates. Depending on the Company’s credit rating, the margin that KCS pays above the London Interbank Offered Rate (“LIBOR”) at any point is between 1.125% and 2.0%. As of December 31, 2017, the margin was 1.5% based on KCS’s current credit rating.
The KCS Revolving Credit Facility is guaranteed by KCSR, together with certain domestic subsidiaries named therein as guarantors (the “Subsidiary Guarantors”) and matures on December 9, 2020. The KCS Revolving Credit Facility agreement contains representations, warranties, covenants (including financial covenants related to a leverage ratio and an interest coverage ratio) and events of default that are customary for credit agreements of this type. The

occurrence of an event of

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Notes to Consolidated Financial Statements-(Continued)

default could result in the termination of the commitments and the acceleration of the repayment of any outstanding principal balance on the KCS Revolving Credit Facility and the KCS Commercial Paper Program.
As of December 31, 2017 and 2016, KCS had no outstanding borrowings under the KCS Revolving Credit Facility.
Senior Notes
The Company's senior notes include certain covenants which are customary for these types of debt instruments issued by borrowers with similar credit ratings.
The KCS Notes are unsecured and unsubordinated obligations of the Company and are unconditionally guaranteed, jointly and severally, by KCSR and each current and future domestic subsidiary of KCS that guarantees the KCS Revolving Credit Facility or certain other debt of KCS or a Note Guarantor (collectively, the "Note Guarantors").
KCSR's senior notes are unconditionally guaranteed, jointly and severally, on an unsecured senior basis, by KCS and each current and future domestic subsidiary of KCS that guarantees the KCS Revolving Credit Facility or certain other debt of KCS or a note guarantor. KCSR's senior notes and the note guarantees rank pari passu in right of payment with KCSR's, KCS's and the Note Guarantors' existing and future unsecured, unsubordinated obligations.
KCSM's senior notes are denominated in U.S. dollars; are unsecured, unsubordinated obligations; rank pari passu in right of payment with KCSM's existing and future unsecured, unsubordinated obligations and are senior in right of payment to KCSM's future subordinated indebtedness.
Senior notes are redeemable at the issuer's option, in whole or in part, at any time, by paying the greater of either 100% of the principal amount to be redeemed and a formula price based on interest rates prevailing at the time of redemption and time remaining to maturity. In addition, KCSM senior notes are redeemable, in whole but not in part, at KCSM's option at any time at a redemption price of 100% of their principal amount, plus any accrued unpaid interest in the event of certain changes in the Mexican withholding tax rate.
RRIF Loan Agreements
The following loans were made under the Railroad Rehabilitation and Improvement Financing ("RRIF") Program administered by the Federal Railroad Administration ("FRA"):
KCSR RRIF Loan Agreement. On February 21, 2012, KCSR entered into an agreement with the FRA to borrow $54.6 million to be used to reimburse KCSR for a portion of the purchase price of thirty new locomotives (the "Locomotives") acquired by KCSR in the fourth quarter of 2011. The loan bears interest at 2.96% annually and the principal balance amortizes quarterly with a final maturity of February 24, 2037. The obligations under the financing agreement are secured by a first priority security interest in the Locomotives and certain related rights. In addition, the Company has agreed to guarantee repayment of the amounts due under the financing agreement and certain related agreements. The occurrence of an event of default could result in the acceleration of the repayment of any outstanding principal balance of the loan.
Tex-Mex RRIF Loan Agreement. On June 28, 2005, Tex-Mex entered into an agreement with the FRA to borrow $50.0 million to be used for infrastructure improvements in order to accommodate growing freight rail traffic related to the NAFTA corridor. The loan bears interest at 4.29% annually and the principal balance amortizes quarterly with a final maturity of July 13, 2030. The loan is guaranteed by Mexrail, which has issued a pledge agreement in favor of the lender equal to the gross revenues earned by Mexrail on per-car fees on traffic crossing the International Rail Bridge in Laredo, Texas. In addition, the Company has agreed to guarantee the scheduled principal payment installments due to the FRA from Tex-Mex under the loan agreement on a rolling five-year basis.
Locomotive Financing Agreements
During 2008 and 2011, KCSM entered into various financing agreements totaling $216.0 million to purchase locomotives. The agreements mature between December 2020 and September 2023, are payable on a quarterly or semi-annual basis and contain annual interest rates ranging between 5.737% and 9.310%. KCSM has either granted the lender a security interest in the locomotives to secure the loan or has secured the loans by transferring legal

ownership of the locomotives to irrevocable trusts established by KCSM to which the lender is the primary beneficiary and KCSM has a right of reversion upon satisfaction of the obligations of the loan agreements.

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KCSM's locomotive financing agreements contain representations, warranties and covenants typical of such equipment loan agreements. Events of default in the financing agreements include, but are not limited to, certain payment defaults, certain bankruptcy and liquidation proceedings and the failure to perform any covenants or agreements contained in the financing agreements. Any event of default could trigger acceleration of KCSM's payment obligations under the terms of the financing agreements.

Debt Covenants Compliance

The Company was in compliance with all of its debt covenants as of December 31, 2017.

Other Debt Provisions

Certain loan agreements and debt instruments entered into or guaranteed by the Company and its subsidiaries provide for default in the event of a specified change in control of the Company or particular subsidiaries of the Company.

Leases and Debt Maturities

The Company leases transportation equipment, as well as office and other operating facilities, under various capital and operating leases. Rental expenses under operating leases were $59.5 million, $61.0 million, and $63.9 million for the years ended December 31, 2017, 2016 and 2015, respectively. Operating leases that contain scheduled rent adjustments are recognized on a straight-line basis over the term of the lease. Contingent rentals and sublease rentals were not significant. Minimum annual payments and present value thereof under existing capital leases, other debt maturities and minimum annual rental commitments under non-cancelable operating leases are as follows (in millions):

		Capital Leases					
Years	Long-Term Debt	Minimum Lease Payments	Less Interest	Net Present Value	Total Debt	Operating Leases	Total
2018	$35.2	$4.9	$ 1.3	$ 3.6	$38.8	$ 60.9	$99.7
2019	15.5	3.6	0.9	2.7	18.2	52.1	70.3
2020	299.0	2.7	0.8	1.9	300.9	41.8	342.7
2021	12.3	2.7	0.6	2.1	14.4	28.2	42.6
2022	12.4	2.7	0.4	2.3	14.7	21.5	36.2
Thereafter	1,912.8	2.5	0.1	2.4	1,915.2	77.2	1,992.4
Total	$2,287.2	$19.1	$ 4.1	$ 15.0	$2,302.2	$ 281.7	$2,583.9

In the normal course of business, the Company enters into long-term contractual requirements for future goods and services needed for the operations of the business. Such commitments are not in excess of expected requirements and are not reasonably likely to result in performance penalties or payments that would have a material adverse effect on the Company's liquidity.

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Notes to Consolidated Financial Statements-(Continued)

Note 12. Income Taxes

Current income tax expense represents the amounts expected to be reported on the Company's income tax returns, and deferred tax expense or benefit represents the change in net deferred tax assets and liabilities. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities as measured by the enacted tax rates that will be in effect when these differences reverse. Valuation allowances are recorded as appropriate to reduce deferred tax assets to the amount considered likely to be realized.

On December 22, 2017, the President of the United States signed into law the Tax Reform Act. The legislation significantly changes U.S. tax law by, among other things, lowering corporate income tax rates, implementing a territorial tax system and imposing a repatriation tax on deemed repatriated earnings of foreign subsidiaries. The Tax Reform Act permanently reduces the U.S. corporate income tax rate from a maximum of 35% to a flat 21% rate, effective January 1, 2018.

The Company uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to reverse. As a result of the reduction in the U.S. corporate income tax rate from 35% to 21% under the Tax Reform Act, the Company revalued its ending net deferred tax liabilities at December 31, 2017 and recognized a provisional $487.6 million tax benefit in the Company's consolidated statement of income for the year ended December 31, 2017.

The Tax Reform Act provided for a one-time deemed mandatory repatriation of post-1986 undistributed foreign subsidiary earnings and profits ("E&P") through the year ended December 31, 2017. The Company had an estimated $1,479.2 million of undistributed foreign E&P subject to the deemed mandatory repatriation and recognized a provisional $74.6 million of income tax expense in the Company's consolidated statement of income for the year ended December 31, 2017. After the utilization of existing tax credits, the Company expects to pay additional U.S. federal cash taxes of approximately $44.9 million on the deemed mandatory repatriation, payable over eight years.

While the Tax Reform Act provides for a territorial tax system, beginning in 2018, it includes two new U.S. tax base erosion provisions, the global intangible low-taxed income ("GILTI") provisions and the base-erosion and anti-abuse tax ("BEAT") provisions.

The GILTI provisions require the Company to include in its U.S. income tax return foreign subsidiary earnings in excess of an allowable return on the foreign subsidiary's tangible assets. The Company expects that it will be subject to incremental U.S. tax on GILTI income beginning in 2018, due to expense allocations required by the U.S. foreign tax credit rules. The Company has elected to account for GILTI tax in the period in which it is incurred, and therefore has not provided any deferred tax impacts of GILTI in its consolidated financial statements for the year ended December 31, 2017.

The BEAT provisions in the Tax Reform Act eliminates the deduction of certain base-erosion payments made to related foreign corporations, and impose a minimum tax if greater than regular tax. The Company does not expect it will be subject to this tax and therefore has not included any tax impacts of BEAT in its consolidated financial statements for the year ended December 31, 2017.

On December 22, 2017, the SEC staff issued Staff Accounting Bulletin No. 118 ("SAB 118") to address the application of U.S. GAAP in situations when a registrant does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Tax Reform Act. The Company has recognized the provisional tax impacts related to deemed repatriated earnings and the revaluation of deferred tax assets and liabilities and included these amounts in its consolidated financial statements for the year ended December 31, 2017. The ultimate impact may differ from these provisional amounts, possibly materially, due to, among other things, additional analysis, changes in interpretations and assumptions the Company has made, additional regulatory guidance that may be issued, and actions the Company may take as a result of the Tax Reform Act. The accounting is expected to be complete when the 2017 U.S. corporate income tax return is filed in 2018.

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Tax Expense (Benefit). Income tax expense (benefit) consists of the following components (in millions):

	2017	2016	2015
Current:			
Federal	$47.3	$1.0	$—
State and local	0.6	0.6	0.3
Foreign	163.8	76.4	51.2
Total current	211.7	78.0	51.5
Deferred:			
Federal	(350.1)	92.7	109.3
State and local	11.9	13.1	15.5
Foreign	36.9	(1.0)	11.0
Total deferred	(301.3)	104.8	135.8
Total income tax expense (benefit)	$(89.6)	$182.8	$187.3

Income before income taxes consists of the following (in millions):

	2017	2016	2015
Income before income taxes:			
U.S.	$331.8	$279.9	$315.0
Foreign	542.5	382.8	357.6
Total income before income taxes	$874.3	$662.7	$672.6

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31 follow (in millions):

	2017	2016
Assets:		
Tax credit and loss carryovers	$26.9	$70.7
Reserves not currently deductible for tax	54.1	106.4
Other	25.2	31.6
Gross deferred tax assets before valuation allowance	106.2	208.7
Valuation allowance	(2.1)	(1.7)
Net deferred tax assets	104.1	207.0
Liabilities:		
Property	(1,012.7)	(1,389.0)
Investments	(48.0)	(73.8)
Other	(30.6)	(33.5)
Gross deferred tax liabilities	(1,091.3)	(1,496.3)
Net deferred tax liability	$(987.2)	$(1,289.3)

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Tax Rates. Differences between the Company's effective income tax rate and the U.S. federal statutory income tax rate of 35% follow (in millions):

	2017		2016		2015	
	Dollars	Percent	Dollars	Percent	Dollars	Percent
Income tax expense using the statutory rate in effect	$306.0	35.0 %	$231.9	35.0%	$235.4	35.0%
Tax effect of:						
Difference between U.S. and foreign tax rate	(25.1)	(2.9 %)	(17.4)	(2.6 %)	(17.8)	(2.6 %)
Foreign exchange (i)	31.6	3.6 %	(45.0)	(6.8 %)	(40.5)	(6.1 %)
State and local income tax provision, net	8.3	1.0 %	8.1	1.2 %	10.3	1.5 %
Change in U.S. tax rate	(487.6)	(55.8%)	—	—	—	—
Deemed mandatory repatriation	74.6	8.6 %	—	—	—	—
Other, net	2.6	0.3 %	5.2	0.8 %	(0.1)	—
Income tax expense (benefit)	$(89.6)	(10.2%)	$182.8	27.6%	$187.3	27.8%

(i) Mexican income taxes are paid in Mexican pesos, and as a result, the effective income tax rate reflects fluctuations in the value of the Mexican peso against the U.S. dollar. The foreign exchange impact on income taxes includes the gain or loss from the revaluation of the Company's net U.S. dollar-denominated monetary liabilities into Mexican pesos which is included in Mexican taxable income under Mexican tax law. As a result, a strengthening of the Mexican peso against the U.S. dollar for the reporting period will generally increase the Mexican cash tax obligation and the effective income tax rate, and a weakening of the Mexican peso against the U.S. dollar for the reporting period will generally decrease the Mexican cash tax obligation and the effective tax rate. To hedge its exposure to this cash tax risk, the Company enters into foreign currency derivative contracts, which are measured at fair value each period and any change in fair value is recognized in foreign exchange gain (loss) within the consolidated statements of income. Refer to Note 9 "Derivative Instruments" for further information.

Difference Attributable to Foreign Investments. As a result of the deemed mandatory repatriation provisions in the Tax Reform Act, the Company included an estimated $1,479.2 million of undistributed earnings in income subject to U.S. tax at reduced tax rates. The Company does not intend to distribute earnings in a taxable manner, and therefore intends to limit distributions to earnings previously taxed in the U.S., or earnings that would qualify for the 100 percent dividends received deduction provided for in the Tax Reform Act, and earnings that would not result in any significant foreign taxes. As a result, the Company has not recognized a deferred tax liability on its investment in foreign subsidiaries.

Tax Carryovers. The Company has U.S. state net operating losses which are carried forward from 5 to 20 years and are analyzed each year to determine the likelihood of realization. The state loss carryovers arise from both combined and separate tax filings from as early as 1999 and may expire as early as December 31, 2018 and as late as December 31, 2037. The state loss carryover at December 31, 2017, was $426.2 million.

The Mexico federal loss carryovers at December 31, 2017, were $8.4 million and, if not used, will begin to expire in 2026. A deferred tax asset was recognized in prior periods for the expected future tax benefit of these losses which will be carried forward to reduce only Mexican income tax payable in future years.

The valuation allowance for deferred tax assets as of December 31, 2017 and 2016, was $2.1 million and $1.7 million, respectively. The Company believes it is more likely than not that reversals of existing temporary differences that will produce future taxable income and the results of future operations will generate sufficient taxable income to realize the deferred tax assets, net of valuation allowances, related to loss carryovers.

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Uncertain Tax Positions. The accounting guidance for uncertainty in income taxes 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 guidance requires the Company to recognize in the consolidated financial statements the benefit of a tax position only if the impact is more likely than not of being sustained on audit based on the technical merits of the position. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in millions):

	2017	2016
Balance at January 1,	$3.8	$1.7
Additions based on tax positions related to the current year	—	1.3
Additions for tax positions of prior years	—	2.5
Reductions for tax positions of prior years	(0.1)	—
Reductions as a result of lapse of statute of limitations	(3.7)	(1.7)
Balance at December 31,	$—	$3.8

A tax benefit of $3.7 million was recognized in the third quarter of 2017 relating to a previous uncertain tax position as a result of a lapse of the statute of limitations.

Interest and penalties related to uncertain tax positions are included in income before taxes on the consolidated statements of income. Accrued interest and penalties on unrecognized tax benefits and interest and penalty expense was immaterial to the consolidated financial statements for all periods presented.

Tax Contingencies. Tax returns filed in the U.S. for periods after 2013 and in Mexico for periods after 2011 remain open to examination by the taxing authorities. The Servicio de Administración Tributaria (the "SAT"), the Mexican equivalent of the IRS, completed the examination of the KCSM 2011 Mexico tax return during the third quarter of 2017 without adjustment. An SAT examination was completed during the second quarter of 2017 without adjustment for the KCSM Servicios 2013 Mexico tax return. The Company received audit assessments from the SAT during the first quarter of 2017 for the KCSM 2009 and 2010 Mexico tax returns. The Company commenced administrative actions with the SAT and if these assessments are not nullified, the matters will be litigated. The Company believes that it has strong legal arguments in its favor and it is more likely than not that the Company will prevail in any challenge of the assessments.

The Company litigated a Value Added Tax ("VAT") audit assessment from the SAT for KCSM for the year ended December 31, 2005. In November 2016, KCSM was notified of a resolution by the Mexican tax court annulling this assessment. The SAT appealed this resolution to the Mexican circuit court. In September 2017, KCSM was notified of a resolution by the circuit court which ordered the tax court to consider an argument made by KCSM in the original tax court proceeding that was not addressed in the tax court's November 2016 resolution. In October 2017, the tax court ruled that the arguments made by KCSM asserting that the SAT unduly extended the audit process were not valid, and also annulled the assessment consistent with the tax courts earlier November 2016 ruling. In December 2017, KCSM and the SAT filed an appeal with the Federal Courts of Appeals. The Company believes it is probable that the court will continue to annul the 2005 VAT assessment. Further, the Company believes it is more likely than not that the SAT will ultimately be precluded from issuing a new 2005 VAT audit assessment. In the unexpected event that the SAT is provided the opportunity to issue a new 2005 VAT audit assessment, the Company cannot predict if the SAT would issue a new assessment or the basis of any new assessment. Accordingly, the Company is not able to estimate any related potential exposure.

KCSM has not historically assessed VAT on international import transportation services provided to its customers based on a written ruling that KCSM obtained from the SAT in 2008 stating that such services were not subject to VAT (the "2008 Ruling"). Notwithstanding the 2008 Ruling, in December 2013, the SAT unofficially informed KCSM of an intended implementation of new criteria effective as of January 1, 2014, pursuant to which VAT would be assessed on all international import transportation services on the portion of the services provided within Mexico. Additionally, in November 2013, the SAT filed an action to nullify the 2008 Ruling, potentially exposing the application of the new criteria to open tax years. In February 2014, KCSM filed an action opposing the SAT's nullification action. In December 2016, KCSM was notified of a resolution

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issued by the Mexican tax court confirming the 2008 Ruling. The SAT appealed this resolution. In October 2017, the Circuit Court resolved to not render a decision on the case but rather to send the SAT's appeal to the Supreme Court. The Supreme Court will decide whether it will hear the case and render a decision, or remand the SAT's appeal back to the Circuit Court for a decision. The Company believes it is more likely than not that it will continue to prevail in this matter. Further, as of the date of this filing, the SAT has not implemented any new criteria regarding this assessment of VAT on international import transportation services. The Company believes it is probable that any unexpected nullification of the 2008 Ruling and the implementation of any new VAT criteria would be applied on a prospective basis, in which case, due to the pass-through nature of VAT, KCSM would begin to assess its customers for VAT on international import transportation services, resulting in no material impact to the Company's consolidated financial statements.

Note 13. Stockholders' Equity

Information regarding the Company's capital stock at December 31 follows:

	Shares Authorized		Shares Issued	
	2017	2016	2017	2016
$25 par, 4% noncumulative, preferred stock	840,000	840,000	649,736	649,736
$1 par, preferred stock	2,000,000	2,000,000	—	—
$.01 par, common stock	400,000,000	400,000,000	123,352,185	123,352,185

Shares outstanding at December 31:

	2017	2016
$25 par, 4% noncumulative, preferred stock	242,170	242,170
$.01 par, common stock	103,036,805	106,606,619

Share Repurchase Programs. During the first half of 2017, KCS concluded its $500.0 million share repurchase program, announced in May 2015 (the "2015 Program"). In August 2017, the Company announced a new share repurchase program of up to $800.0 million, which expires on June 30, 2020 (the "2017 Program"). Share repurchases may be made in the open market, through privately negotiated transactions, or through an accelerated share repurchase ("ASR") program limited to $200.0 million.

Under an ASR agreement, the Company pays a specified amount to a financial institution and receives an initial delivery of shares. Upon settlement of the ASR agreement, typically the financial institution delivers additional shares, with the final aggregate number of shares delivered determined with reference to the volume weighted-average price per share of the Company's common stock over the term of the ASR agreement, less a negotiated discount. The transactions are accounted for as equity transactions with any excess of repurchase price over par value allocated between additional paid-in capital and retained earnings. At the time the shares are received, there is an immediate reduction in the weighted-average number of shares outstanding for purposes of the basic and diluted earnings per share computation.

During the second half of 2017, the Company entered into and settled two ASR agreements under its ASR program. In total, the Company repurchased 1,901,769 shares of common stock at an average price of $105.17 per share and a cost of $200.0 million.

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During 2017, KCS repurchased 1,340,209 shares of common stock for $120.4 million at an average price of $89.83 per share under the 2015 Program, and 2,419,469 shares of common stock for $255.2 million at an average price of $105.48 per share under the 2017 Program. In total during 2017, the Company repurchased 3,759,678 shares at an average price of $99.90 per share and a total cost of $375.6 million under both the 2015 Program and the 2017 Program.

Treasury Stock. Shares of common stock in treasury and related activity follow:

	2017	2016	2015
Balance at beginning of year	16,745,566	14,891,041	12,959,855
Shares repurchased	3,759,678	2,127,612	2,133,984
Shares issued to fund stock option exercises	(9,110)	(15,264)	(89,035)
Employee stock purchase plan shares issued	(76,401)	(82,372)	(52,736)
Nonvested shares issued	(124,519)	(179,309)	(62,936)
Nonvested shares forfeited	20,166	3,858	1,909
Balance at end of year	20,315,380	16,745,566	14,891,041

Change in Control Provisions. The Company and certain of its subsidiaries have entered into agreements with certain employees whereby, upon defined circumstances constituting a change in control of the Company or subsidiary, certain stock options become exercisable, certain benefit entitlements are automatically funded and such employees are entitled to specified cash payments upon termination of employment.

The Company and certain of its subsidiaries have established trusts to provide for the funding of corporate commitments and entitlements of certain officers, directors, employees and others in the event of a specified change in control of the Company or subsidiary. Assets held in such trusts on December 31, 2017 and 2016, were not material. Depending upon the circumstances at the time of any such change in control, the most significant of which would be the price paid for KCS common stock by a party seeking to control the Company, funding of the Company’s trusts could be substantial.

Cash Dividends on Common Stock. The following table presents the amount of cash dividends declared per common share by the Company’s Board of Directors:

	2017	2016	2015
Cash dividends declared per common share	$1.38	$1.32	$1.32

Note 14. Share-Based Compensation

On May 4, 2017, the Company’ stockholders approved the Kansas City Southern 2017 Equity Incentive Plan (the “2017 Plan”), which replaced the Kansas City Southern 2008 Stock Option and Performance Award Plan (the “2008 Plan”). The Board of Directors and its Compensation and Organization Committee had previously adopted the 2017 Plan, subject to stockholder approval, on January 26, 2017, and February 17, 2017, respectively. The 2017 Plan provides for the granting of up to 3,750,000 shares of the Company’s common stock to eligible persons as defined in the 2017 Plan. Outstanding equity awards granted under the 2008 Plan and the 2017 Plan (the “Plans”) are to be governed by the terms and conditions of each individual plan and the related award agreements.

Stock Options. The exercise price for options granted under the Plans equals the closing market price of the Company’s stock on the date of grant. Options generally have a 3-year vesting period and are exercisable over the 10-year contractual term, except that options outstanding become immediately exercisable upon certain defined circumstances constituting a change in control of the Company. The grant date fair value is recorded to expense on a straight-line basis over the vesting period.

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The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The weighted-average assumptions used were as follows:

	2017	2016	2015
Expected dividend yield	1.52 %	1.60 %	0.94 %
Expected volatility	30.74 %	32.29 %	37.11 %
Risk-free interest rate	2.20 %	1.51 %	1.82 %
Expected term (years)	6.0	6.0	6.0
Weighted-average grant date fair value of stock options granted	$24.49	$22.98	$41.49

The expected 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 volatility is based on the historical volatility of the Company's stock price over a term equal to the estimated life of the options. The risk-free interest rate is determined based on U.S. Treasury rates for instruments with terms approximating the expected term of the options granted, which represents the period of time the awards are expected to be outstanding and is based on the historical experience of similar awards.

A summary of stock option activity is as follows:

	Number of Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Remaining Contractual Term In years	Aggregate Intrinsic Value In millions
Options outstanding at December 31, 2016	414,803	$ 76.87		
Granted	97,090	87.11		
Exercised	(9,110)	80.32		
Forfeited or expired	(2,159)	88.35		
Options outstanding at December 31, 2017	500,624	$ 78.74	6.1	$ 14.0
Exercisable at December 31, 2017	339,711	$ 74.33	5.0	$ 11.0

The aggregate intrinsic value in the table above, which is the amount by which the market value of the underlying stock exceeded the exercise price of outstanding options, represents the amount optionees would have realized if all in-the-money options had been exercised on the last business day of the period indicated.

Compensation cost of $2.3 million, $2.5 million, and $2.0 million was recognized for stock option awards for the years ended December 31, 2017, 2016, and 2015, respectively. The total income tax benefit recognized in the consolidated statements of income was $0.8 million, $0.9 million, and $0.7 million for the years ended December 31, 2017, 2016 and 2015, respectively.

Additional information regarding stock option exercises appears in the table below (in millions):

	2017	2016	2015
Aggregate grant-date fair value of stock options vested	$2.8	$1.8	$2.0
Intrinsic value of stock options exercised	0.2	0.6	6.1
Cash received from option exercises	0.7	0.9	4.2