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NSC - Q1 2015 Norfolk Southern Corp Earnings Call

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OVERVIEW:

Co. reported 1Q15 operating revenue of \$2.6b and diluted EPS of \$1.00.



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Jim Squires *Norfolk Southern Corporation - President*

Mark Manion *Norfolk Southern Corporation - COO*

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Rob Salmon *Deutsche Bank - Analyst*

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PRESENTATION

Operator

Greetings, welcome to the Norfolk Southern first-quarter 2015 earnings call.

(Operator Instructions)

As a reminder, this conference is being recorded. I would now like to turn the conference over to your host, Katie Cook, director of investor relations. Thank you, Ms. Cook. You may now begin.



Katie Cook - *Norfolk Southern Corporation - Director of IR*

Thank you, and good morning. Before we begin today's call, I would like to mention a few items. First, the slides of the presenters are available on our website at NorfolkSouthern.com in the investor section. Additionally, transcripts and downloads of today's call will be posted on our website.

Please be advised that during this call, we may make certain forward-looking statements. These forward-looking statements are subject to a number of risks and uncertainties and our actual results may differ materially from those projected. Please refer to our annual and quarterly reports filed with the SEC for a full discussion of those risks and uncertainties we view as most important.

Additionally, keep in mind that all references to reported results, excluding certain adjustments, that is non-GAAP numbers, have been reconciled on our website in the investor section. Now, it is my pleasure to introduce Norfolk Southern Chairman, CEO, Wick Moorman.

Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

Thank you, Katie, and good morning everyone. It's my pleasure to welcome you to our first-quarter 2015 earnings conference call. With me today are several members of our senior team including our President, Jim Squires; our Chief Operating Officer, Mark Manion; and our Chief Financial Officer, Marta Stewart.

As all of you know, earlier this month, we announced first-quarter earnings of \$1 per share, 15% lower than last year. These results reflected lower fuel surcharges on the top line as well as continued weakness in our coal franchise, which restricted growth in revenue and revenue per unit. Additionally, very severe weather in our service territory slowed our operations, increased our expenses, and impacted our volumes. With the exception of the ongoing affect of lower fuel surcharges and continued pressure in our coal markets, we believe that most of our issues will be largely resolved by the second half of the year.

Having said that, we will be up against strong comps, particularly in the second and third quarters as last year's results were record-setting quarters for us. Jim will share with you more detail on the revenue trends and the outlook for the remainder of the year. With respect to service, we have already seen steady improvement in our network, and we expect to reach our strong 2012- 2013 velocity and service levels in the second half of this year. Mark will provide you with the latest on the relevant service metrics and our operations outlook, and Marta will round it all out providing you with details of our full financial results.

Before getting down to the details, I'll just reiterate what I told all of you on our earlier call. We have a great team at Norfolk Southern, and while there are always uncertainties around our markets, all of us are confident in the long-term strength of our franchise and our prospects for future success. On that note, I will turn the program over to Jim, Mark, and Marta, and then I'll return with some closing comments before taking your questions. Jim?

Jim Squires - *Norfolk Southern Corporation - President*

Thank you, Wick, and good morning, everyone. First-quarter 2015 operating revenue declined 5% to \$2.6 billion primarily due to a \$102 million reduction in fuel surcharge revenues as a result of lower fuel prices. Growth in intermodal and merchandise volumes offset coal declines, increasing first quarter volume 2% to 1.8 million units. Revenue per unit declined 7% but without the impact of declining fuel surcharges, revenue per unit declined only 2%. Mix shifts between increased volumes of intermodal and decreased volumes of coal offset strong pricing across most of our business segments.

We will discuss the mix impact as we review each commodity group. Overall volume growth of 2% for the quarter was driven by a 5% gain in intermodal and a 3% gain in merchandise markets partially offset by a 7% decline in coal volumes. After a strong start to the year, volume in the first quarter was again impacted by winter weather conditions and accompanying service disruptions particularly throughout February, but similar to first-quarter 2014, we achieved strong volume and improved service levels in March.



Breaking up the market segments starting with coal, first quarter volume decreased 7%. Coal burn at eastern utilities was down 14.5% in the first quarter due to lowered national and regional natural gas prices causing our utility volumes to decline 6%. Volumes to northern utilities were down nearly 9% while volumes to southern utilities were down 2%. Though handling a greater percentage of utility volume to our southern utilities generally increases our coal revenue per unit, this positive mix impact was more than offset by a 20% decline in export coal volumes in the first quarter.

Persistent weak conditions in the global marketplace, soft prices, and a strong US dollar made it very difficult for US coals to compete in this over-supplied environment. Domestic metallurgical volumes were down 1% with weaker demand for met coals related to softer steel production and sourcing shifts partially offset by market share gains of coke shipments. This decrease in volume and lower fuel surcharges reduced revenue by \$86 million to \$455 million, a 16% decline versus first-quarter 2014. In addition to the previously discussed mix changes, lower fuel charges also negatively impacted RPU.

Turning to our intermodal market, we continued to see strong volume growth of 5% to nearly 927,000 units. Intermodal pricing gains outpaced our other business units with continued growth expected the rest of the year. Despite these positive trends, the decrease in fuel surcharge revenues drove the decrease in overall revenue and revenue per unit. The effects of lower fuel surcharge revenues more than offset a 2% increase in average revenue per unit already dampened by negative mix resulting from higher volume increase in international freight. As we've discussed before, international intermodal freight has a lower revenue per unit.

Merchandise revenue of \$1.5 billion was \$32 million or 2% -- was down \$32 million or 2% for the quarter with a 5% decline in revenue per unit. More than 80% of this RPU decline was due to fuel surcharges. We also experienced negative mix associated with increased volumes in lower rated sand, gravel, and aggregates while higher rated iron and steel volumes declined. Our automotive sector was also impacted by negative mix with decreased auto parts shipments and increased by level traffic.

Volume for the merchandise book was up 3% overall with the strongest gain in our chemicals market due largely to increased shipments of crude oil from the Bakken and Canadian oil fields to East Coast refineries, as well as increased natural gas liquids from the Marcellus Utica Shale plays. Automotive volumes increased 4% in the quarter with increased vehicle production at several key NS-served plants. Our metals and construction markets benefited from increased volumes of aggregates for construction projects in the Southeast as well as increased frac sand volume into the Marcellus Utica region to support natural gas drilling efforts.

These increases were partially offset by reduced shipments of steel pipe and steel coil driven by a softening of the pipe market and reduced steel production in the quarter. Agriculture shipments were up 2% with increased volumes of corn moving to Southeast poultry producers as well as increased volumes of feed products and fertilizers. These gains offset reduced volumes of export soybeans resulting from a record South American crop, the strength of the US dollar, and limited railcar availability.

Finally, paper and forest products volumes were flat in the quarter with strength in lumber related to the continuing housing recovery offset by reduced volumes of wood chips and waste materials. Let close with expected trends in volume and revenue for the balance of the year. First, we expect solid volume growth in many parts of our franchise throughout the year. Highway conversions and quarter investments should continue to drive domestic intermodal growth while international intermodal shipments will benefit from the recovery following the West Coast port disruptions earlier in the year.

We expect growth in natural gas liquids and despite lower oil prices, crude by rail volumes. Double-digit growth in housing starts and increases in construction activity should generate more lumber, plastics, soda ash, and aggregates traffic. Automotive volumes should grow at a rate better than North American vehicle production driven by output at key NS-served plants. Ethanol shipments should increase due to rising gasoline consumption and project related growth while a stronger crop should push export soybean volumes up later in the year.

However, lower oil prices are expected to cause declines in our metals and construction group as drilling activity slows reducing shipments of pipe, frac sand, and other drilling inputs. Further, production curtailments by major steel producers and high inventories will likely dampen shipments of iron and steel products.



Lastly, low natural gas prices, utility stockpiles at or above target levels, a strong US dollar, and global oversupply will make this a challenging year for coal. We continue to obtain price increases at or above the rate of real inflation in most areas of our business and should see negative price mix effects abate in the second half.

However, high fuel surcharge recoveries in the comparable periods last year are likely to result in lower revenue in the second and third quarters and for the full year. By the final quarter of 2015, however, we expect top-line growth to resume. Thank you for your attention, and I will now turn the presentation over to Mark, who will provide an update on our first-quarter operations.

Mark Manion - *Norfolk Southern Corporation - COO*

Thank you, Jim. Restoring our service levels remains our primary focus, however, safety is at the heart of everything we do so let's take a look at our safety numbers. Turning to slide 2, our reportable injury ratio was 1.08 for the first quarter of 2015 as compared to 1.49 for the first quarter of 2014. The train incidents through March 2015 were 71 versus 61 over the same period last year. Grade crossing accidents through March were 76 down from 88 over the same period in 2014.

Now let's take a look at our service. While our service composite in the first quarter was lower than 2014 as a whole, we are operating at a higher level than we were in the fourth quarter even with the more challenging operating conditions that existed in the first quarter. In addition, as you can see on the right, our service has been trending upward since the end of February. The timeline and trajectory of our service recovery I have provided on our last call, which outlined incremental improvement in the second quarter with more significant improvement in the second half of this year, has not changed.

We expect that composite service performance will be near 80% by the end of the second quarter. And as you see the sizable improvements in train speed and dwell in December was maintained in January, and although February was challenging recovery has been evident. We expect this trend of increasing train speed and terminal dwell reduction to continue through the rest of the second quarter. We fully anticipate that our end of quarter speed and dwell metrics will be commensurate with the superior service levels we achieved in 2012 and 2013.

As you have seen, we've made solid improvements and we expect to see even larger gains in our service metrics by the end of the second quarter. Slide 5 outlines our plan that will lead to these larger gains. We have an increase of 600 conductors and 50 locomotive engineers between March 1 and July 1. We expect to take receipt of 40 additional SD90MACs during this same time period, and we're already seeing the number of bad older locomotives normalize, which will result in 160 additional locomotives available for service.

By the second half of the year, we anticipate we will be storing some of our older, higher maintenance locomotives, which will reduce our expenses and strengthen our service reliability. With regard to infrastructure, the connection track in Chicago, as well as Goshen, Siding, East Elkhart, were completed in April. Both of these projects will further improve our fluidity through the Chicago corridor. Lastly, the second phase of the Bellevue plan has begun with modification of the eastbound flows. The westbound flows will then be implemented later in the summer.

The full implementation of Bellevue will improve velocity through reduced car handling, improve asset utilization, and result in an overall reduction in cost structure. In closing, we are confident our service will continue to trend in the right direction with sequential improvements in the second quarter. In the second half of the year, we expect improved metrics consistent with strong service levels as the full effect of our investments is realized. Thank you, and now I will turn it over to Marta.

Marta Stewart - *Norfolk Southern Corporation - CFO*

Thank you, Mark. Now let's review our financial results for the first quarter. As you can see on slide 2 and as has already been noted, the weather and service challenges significantly affected our first quarter results. Jim discussed the 5% decline in revenues and while operating expenses decreased by \$61 million or 3%, it was not sufficient to offset the revenue decline resulting in a 9% reduction in income from railway operations and an operating ratio of 76.4%.

Slide 3 outlines the major cost categories affected by the weather and service recovery effort. These are estimated at \$42 million, the largest portion of which was at compensation and benefits. Additional service hours occurred in all areas of operations, including train and engine employees for field service, mechanical employees to maintain the higher number of locomotives, and maintenance and way employees related to storm cleanup and repair. Similarly, the other listed expenses reflect the increased cost of a slow network and added assets.

Purchased services and rents were primarily affected by the decreased velocity while the last two categories, materials and fuel, were principally affected by the rise in locomotive count. As we've previously stated, some of the service recovery costs are expected to continue into the second quarter. However, at a lower level currently estimated at \$25 million. Turning now to slide 4, this illustrates the year-over-year change by expense category. Fuel was the only category that declined versus the first quarter of last year, and the decrease was largely attributable to lower prices as shown on the next slide.

Breaking down the components of the fuel expense change, \$160 million of the reduction was due to price as consumption was flat on the 2% increase in traffic volume. Slide 6 depicts the \$42 million or 6% rise in compensation expenses. We have higher than usual weight rate and payable tax increases. As discussed during our January call, the union wage increase was effective January 1 versus the July 1 timeframe of recent years. This resulted in a \$26 million increase.

Payroll tax rates rose on January 1 as well, and total payroll taxes were up \$14 million. In addition, employee activity levels, including increased hours, more overtime, and more trainees, added \$14 million and signing bonuses related to our recently wrapped site agreement with the Brotherhood of Locomotive Engineers, added \$11 million. That labor agreement also calls for a lump sum bonus, which will affect fourth quarter expenses by a similar amount.

The final significant item was in the compensation area. It was a reduction in the accruals for incentive and stock comp reflective of the quarter's result. Slide 7 shows purchased services and rent expense, which increased by \$31 million or 8%. This rise is primarily due to higher volume related activities such as equipment rents and intermodal operations. As previously mentioned, lower network velocity also caused these costs to rise.

Turning to the next slide, materials and other expenses rose by \$25 million or 11%. About half of the increase was due to higher materials expenses and was associated with both locomotive and maintenance of way usage. Environmental and personal injury expenses also rose in part due to a prior-year favorable accrual. And lastly, travel costs increased largely related to our train service employees who had more overnight stays as well as temporary transfers to areas on our systems with crew needs.

Depreciation expense, displayed on slide 9, rose by \$8 million or 3% reflecting our larger capital base as we continue to invest in infrastructure and equipment. Operating expense headwinds are summarized on the next slide. In addition to the service recovery costs, the wage and payroll tax increases, and the lump sum payment, 2015 expenses will include costs associated with the previously announced closing of our Roanoke, Virginia office. Approximately 450 employees will be affected by this move going from Roanoke to either corporate headquarters in Norfolk, operations headquarters in Atlanta, or choosing to retire or resign.

Moving and relocation costs in 2015 related to this transition are expected to total \$35 million and will begin to be incurred in the second quarter although most of the cost will impact the third quarter when the bulk of the relocations are expected to occur. Efficiencies associated with this consolidation will begin to benefit expenses in the fourth quarter. Next, income taxes totaled \$185 million for an effective tax rate of 37.4% compared with 33.6% in 2014. As you may recall, last year contained a \$20 million or \$0.06 per share tax reduction resulting from a tax law change in Indiana.

Net income and EPS comparisons are illustrated on slide 12. The \$58 million net income decrease is a 16% decline compared to last year, and diluted earnings per share of \$1 was 15% lower than last year. As shown on the final slide, cash from operations covered capital expenditures as well as our higher dividend level of \$181 million.

On our fourth quarter earnings call in January, I mentioned we anticipated returning to a higher level of share repurchases. During the first quarter, we used cash on hand to buy back \$415 million of our shares. We now expect full-year 2015 repurchases to be between \$1.2 billion and \$1.3 billion. And with that, I thank you for your attention, and I'll turn the program back to Wick.



Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

Thanks, Marta. Well, as you've heard, clearly our first-quarter results were not as strong as we and you expected that they would be. In the short term, we face some continuing headwinds in the tough comps from last year. However, we see continuing strength in the overall economy, and as Jim described, we have a lot of opportunities in many of the markets we serve and a great franchise with which to capitalize on these opportunities.

In addition, we are well on the way to restoring our network velocity and efficiency, which will drive further cost out of our operation. And as all of you know, that will also enable us to secure more business at rates that drive positive returns for our shareholders.

As we do that, we also remain committed to returning cash to our shareholders as demonstrated through our strong dividend history as well as through our share repurchase program, whereas Marta just mentioned we're now targeting between \$1.2 billion and \$1.3 billion in share repurchases this year. In sum, we have a proven strategy for success and the right people and resources to successfully execute it. Thanks, and I'll turn it back to the operator for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Bill Greene, Morgan Stanley.

Bill Greene - *Morgan Stanley - Analyst*

Jim, you obviously identified in your slides the challenges ahead from the fuel surcharge mechanism. We asked this last time as well, but since we've gone another quarter and now with the pre-announcement, is there any reason to think you might sort of address that and come back and say maybe we need to adjust that and change that going forward? A number of the freight transports have re-based fuel surcharges given the volatility there, so what are your thoughts on fuel surcharges?

Jim Squires - *Norfolk Southern Corporation - President*

We are working toward shifting more of our revenue to an OHD-based fuel surcharge mechanism over time. And so that's going to take a while. It's contract by contract. Customers have their own preferences. Our overall goal will be to increase rate and grow the revenue, but we recognize that our reliance on WTI in our fuel surcharge program creates volatility in our earnings and that's undesirable. So we will be working overtime to shift to a more OHD-based program.

Bill Greene - *Morgan Stanley - Analyst*

Okay. And then Jim or even Wick, how do you get confident in volume growth being actually a good thing? Obviously last year, we had service challenges and we had unexpected growth, and now we're having sort of a change in the macro outlook that's created some excess resources and yet the service levels aren't back. Can you sort of walk us through your thoughts on does it make sense instead to sort of let's focus on getting the right kind of business on the network to result in a better margin or better outcome and not worry so much about the volume growth instead?

Do you know what I'm getting at? It seems like there needs to be more of a focus almost on shrinking the business. That will improve the service which is even better for pricing.



Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

Bill, I understand your question, and I think it's a very reasonable and interesting one. One of the things that I will say about our volume growth is we don't go out and try to grow volume at rates and margins that don't make sense from the standpoint of shareholder value. We're not -- we're certainly not in the mode of let's just grow volume for volume sake.

In fact, if you look at a lot of our volume growth this quarter, it's been in intermodal where you know we've made a lot of investments, and where we're now seeing, as Jim mentioned, very positive pricing trends. We don't see that as a problem. In fact, we see volume growth at good rates as a strength for us.

We also don't see that volume growth as severely impacting in any meaningful way our service recovery. Our service recovery is based upon getting the right resources in there. We think we've largely done that and we're on the right path back. Last year as you mentioned, we had some volume growth we clearly did not foresee in the second and third quarter and got caught short primarily on the crew side.

The volume growth we're having right now, we see as desirable. We see it as continuing to be a good thing for us. As Jim mentioned, in this quarter in particular, and although we may see it for a little while longer, we saw some mix effects even within our merchandise business that didn't help our overall RPU but even within that, the somewhat lower rated traffic that was growing was still good margin business and business that we want to continue to handle.

Operator

Allison Landry, Credit Suisse.

Ken Ryan - *Credit Suisse - Analyst*

This is Ken on for Allison. Just a quick question on the buyback. As you mentioned, the buyback was pretty big in Q1 and you highlighted a target of \$1.2 billion, \$1.3 billion for the full year. Just curious on how that could possibly trend through the next few quarters and whether there is any limit on how big of a buyback you can do in anyone quarter. Thanks.

Marta Stewart - *Norfolk Southern Corporation - CFO*

The estimate of \$1.2 billion to \$1.3 billion is just a little bit higher than what we were -- what we projected on the January call. We're very comfortable with that level. We did not issue debt last year. We have plenty of debt capacity this year, and we're comfortable with our projections that that's going to be an amount of cash we're going to be able to return to the shareholders.

Ken Ryan - *Credit Suisse - Analyst*

Just as my follow-up, you mentioned that utility coal stockpiles were currently above target. Just curious how far above target you're seeing the stockpiles currently trend at your utilities and how long you would expect it to take to get back to that target level if we assume a normal weather environment.

Jim Squires - *Norfolk Southern Corporation - President*

Based on our estimates, utility stockpiles in the South at the end of March were at around 71.5 days, in the North, 65.3 days. Rough target for southern stockpiles of 70, and for the northern utilities about 50 days. As between the two, the northern utilities are a bit more overstocked. The



stockpile trends will depend heavily on the weather pattern in the summer, and all of our assumptions around utility coal in fact do assume a normal weather pattern in the summer, which would drive our volume assumptions going forward.

Operator

Tom Kim, Goldman Sachs.

Tom Kim - Goldman Sachs - Analyst

Marta, I wanted to ask about your Roanoke relocation. You talked about the incremental costs you're going to incur this year but I was wondering what are the savings we should anticipate next year? And then more importantly, are there further opportunities to rationalize or consolidate your operations and is there a pipeline that you might sort of allude to? Thank you.

Marta Stewart - Norfolk Southern Corporation - CFO

The Roanoke relocation has, Tom, two components to it. The primary reason why we decided to do that was because we think it will be more effective for our people to be in fewer locations. We think that will help the operations of all of the departments that are involved. That was number one.

As a result of doing that was sort of a catalyst to accelerate some G&A reductions that we had been planning for the next three or four years. That allows us to -- because some people are choosing not to move, that allows us to accelerate those, as I said. We think we'll have about 150 G&A positions between now and the end of the -- between the third quarter and the end of the first quarter of next year that will come out as a result of that.

Tom Kim - Goldman Sachs - Analyst

A question with regard to the coal and particularly the coal exports. What are the levers you can adjust to a potentially longer and deeper down cycle for export coals? To what extent would it make sense to maybe even rationalize terminal interest? And then maybe even with rolling stock, is there something you could do there like are you satisfied with your utilization levels or could you do anything with regard to even that side of the business? Thanks.

Jim Squires - Norfolk Southern Corporation - President

For starters, we can be very nimble with our equipment asset serving our coal business, our export coal business. We can obviously redeploy the locomotives. We can downsize or curtail coal car replacements. We have complete flexibility with regard to the equipment. The infrastructure adjustments would involve adjustments to maintenance levels, particularly in the coal field and in some cases perhaps a longer-term mothballing of the asset but most likely the infrastructure side would involve service reductions until the volumes return.

Operator

Rob Salmon, Deutsche Bank.

Rob Salmon - Deutsche Bank - Analyst

With regard to the merchandise outlook, obviously there are a couple of puts and takes with regard to your growth expectations with weakness on the softening steel production side, as well as growth in several other end markets. When I'm thinking about the crude by rail outlook, it sounds

like you're expecting continued growth. I would imagine we should be seeing that volume growth decelerate and potentially decline in the back half of the year but was hoping for a little bit more color in terms of your expectations regarding that end commodity.

Jim Squires - *Norfolk Southern Corporation - President*

Sure, so we handled around 29,000 crude by rail shipments in the first quarter of 2015. That compares to 22,000 crude by rail shipments in the comparable quarter last year. That's an increase of 34%. Since the first quarter of last year, we have had a handful of new customers come online.

With softening oil prices, we do expect the growth rate for crude by rail to decelerate, but we think we should be able to maintain a rateable 29,000 or 30,000 car loadings per quarter this year. That would imply growth year over year in the second quarter and for the full year, but we would be modestly negative relative to the crude by rail volumes in the third and fourth quarter.

Rob Salmon - *Deutsche Bank - Analyst*

With regard to the train length opportunity on the merchandise network, do you feel like as the service improves that there should be the opportunity to extend out those train lengths in the back half of the year? Or given some of the softening of the growth in crude by rail as well as likely declines in the steel production, will that be an offset in terms of your ability to gain some operating leverage in the merchandise network?

Jim Squires - *Norfolk Southern Corporation - President*

We're always looking for ways to increase our average train length, and in fact we are seeing an increase in our merchandise train length even now. I think we're in the neighborhood of 5,900 feet thereabouts currently, and keeping in mind that around our system, our siding capacity at a minimum is in the 8,000 foot range. A lot of room to grow there and that's something we continue to work on, and that has mostly to do with continuing to adjust our train plan, our operating network plan to be the most efficient.

Operator

Scott Group, Wolfe Research.

Scott Group - *Wolfe Research - Analyst*

Jim, I know you talked about expectations for revenue to remain down the next couple of quarters. I'm wondering if you can share with us a view if you think that the revenue declines moderate in the second and third quarter or do they stay here maybe even get worse, and if you think based on that, should we continue to expect these double-digit type earning declines. And I know you don't typically give that level of color, but obviously a lot of us have struggled modeling the numbers in the first quarter so might be helpful to get your perspective on near-term earnings and revenue.

Jim Squires - *Norfolk Southern Corporation - President*

Let me start by reminding you of the fuel surcharge comparisons in the second and third quarter. In the first quarter of this year, we booked \$163 million in fuel surcharge revenue. That was a \$132 million decline year over year. Last year in the second quarter, we booked \$358 million in fuel surcharge revenue, \$369 million in the third quarter of last year. Assuming stable oil prices for the next couple of quarters, that would imply roughly \$200 million less fuel surcharge revenue per quarter for the second and third quarter.

In the fourth quarter, the comparison gets a little bit easier. Last year, we took in \$308 million in fuel surcharge revenue in the fourth quarter. That right there is a pretty significant revenue headwind for the next couple of quarters. On the other hand, as I said, we expect some of the negative



mix effects we saw in the first quarter to begin to abate. By the third quarter, we, based on our current forecast, would be looking for revenue per shipment excluding FSCs to turn favorable.

Similarly, revenue ex-fuel surcharges in the third quarter would turn favorable, and then by the fourth quarter, we start to see overall growth in the top line. That obviously has a volume component as well and there we're feeling pretty bullish.

Obviously, the declines in coal volume are not helping, but we are feeling as if on the utility side, natural gas substitution has run its course, and we should be able to see a fairly stable utility coal volume run rate for the balance of the year, albeit with the tough comparisons to last year. That's our overall outlook on the revenue and so we have a lot of opportunities to grow revenue, and as I said, the negative mix effects should begin rolling off in the second quarter.

Scott Group - *Wolfe Research - Analyst*

Just other question as we think bigger picture, a lot of the rails have operating ratio targets in that 60%, low 60% range. I'm wondering as you think about the business, Jim, are there -- do you think that there are structural differences for you or Eastern rails in general or is that eventually a place where you think you can get to with the right mix of revenue and cost?

Jim Squires - *Norfolk Southern Corporation - President*

Last year at this time, we were on the verge of producing some of the best quarters that we have produced in this Company's history and the lowest operating ratios as well. That was possible because we were seeing significant growth -- volume growth in our merchandise and intermodal businesses in particular and that was sufficient to more than offset declines in our coal business.

That's the formula for us going forward. We will begin to see our coal volumes stabilize at some point and we will, we believe, grow our merchandise volumes, our highest incremental margin volumes, and our intermodal volumes with substantial price increases to boot. That is a formula for continued improvement in our financial performance and for materially lower operating ratios in the future.

Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

Let me add to that. I think that sure, inherently, if you -- relative to franchise businesses, the West looks different than the East which looks different than Canada, but we, as Jim mentioned, we came off, we've come off a year we took our operating ratio for the year below 70 for the first time.

We expect to continue to drive operating ratio improvement, and we have a very, very strong franchise, particularly in terms of intermodal and merchandise. I think that the pace of when you get there is obviously always something that the economy will largely determine as well as our own efforts, but we have internal goals for driving operating ratio down and we believe that we'll continue to do that.

Operator

Tom Wadewitz, UBS.

Tom Wadewitz - *UBS - Analyst*

I wanted to ask you a little bit about pricing. You got a lot of moving parts on the revenue side, and you've highlighted the mix headwinds but is there any way to disentangle that and talk about core price and give us a sense of where you're at in first quarter or if you don't want to do that, if you just talk about the progression.

Should we expect ex-mix to see acceleration in your year-over-year price or did you already get the step up from tighter rail capacity in first quarter and it's just negative mix rolling off. How do we think about how much core price you're getting and whether that accelerates if you look into second quarter, third quarter?

Jim Squires - Norfolk Southern Corporation - President

We were successful in meeting our goal of increasing pricing -- core pricing at a rate at or better than real cost inflation measures based on all inclusive less fuel in the first quarter, in most of our businesses. Generally speaking outside coal, we were able to drive pricing higher and I think most encouragingly we saw the largest core price increase across our book of business in our intermodal line.

Tom Wadewitz - UBS - Analyst

Just to refresh, where did -- (multiple speakers)

Jim Squires - Norfolk Southern Corporation - President

Back in the future as well, Tom.

Tom Wadewitz - UBS - Analyst

You referred to AILF. Where did you see AILF in first quarter?

Jim Squires - Norfolk Southern Corporation - President

So reported AILF in the first quarter was 2.8%.

Tom Wadewitz - UBS - Analyst

So it's not -- there's not really a caveat that you're saying across the book you would have done better than that 2.8% if we looked at a core price kind of taking out mix. Is that fair?

Jim Squires - Norfolk Southern Corporation - President

Right, right. With the exception of coal, as I mentioned, virtually across the book. Now there were pockets where it was stronger but on average, we were able to meet the goal of increasing core prices at that rate.

Tom Wadewitz - UBS - Analyst

What about the aspect of accelerating? It seems like you're pretty optimistic about improving the network performance, so you would think that customer service would improve as you look into through second quarter, into second half. I guess the truck market seems likes it loosened a bit. Maybe freight overall isn't as strong, but do you think there is more momentum in pricing that that would accelerate or have you kind of achieved the run rate in first quarter and you stay stable next couple of quarters?

Jim Squires - *Norfolk Southern Corporation - President*

We will stay focused on raising prices at a rate better than -- at are better than rail inflation. That's our long-term goal. The contracts vary quarter by quarter. The pricing opportunity varies by quarter by quarter, but overall we're going to stay very, very focused on that goal and are confident we can achieve it.

Operator

Matt Troy, Nomura Securities.

Matt Troy - *Nomura Securities Intl - Analyst*

I just had a question, maybe a big picture overview of the network. You guys have done a good job of explaining your target of returning the service metrics, be it speed or dwell or your composite service indices back to the peak 2012, 2013 levels by 2Q, and you've also kind of outlined very nicely what you intend to do to get there.

I just wanted to take a step back and maybe understand from an operational perspective if we were to look at a network map, kind of a heat map if you will, what are the key areas that you need to address, the pinch points if you will, because you've given us the pieces to get us there, the targets that'd would like to reach. I just would like a better understanding because we're only 6 to 8 weeks out from kind of the middle of the second quarter or the start of the third quarter when you can hit these goals. What are the focal points that will help you get to these targets? Thanks.

Mark Manion - *Norfolk Southern Corporation - COO*

Our most challenging part of the system last year and into the first quarter was our Chicago line, and really principally between Chicago and the Cleveland area, and a lot has gone on in order to increase our velocity. And I'll say that, that area is running really well now. There's just been a lot of focus on it. In order to do that, there was a -- we really pinpointed the manpower increases which have come along very nicely and I'll just say that we're in pretty darn good shape up in that area from a manpower standpoint now.

Another thing that has been going on for a longer period of time is infrastructure improvement up there. I did mention the fact that we've got a couple of significant infrastructure projects that are now complete that just give us -- it just gives us a bigger pipe to run the traffic through there. Keeping in mind that parts of that area up there will run 100 or more trains a day. Infrastructure improvement, nice increases, the Bellevue project, like I said, is more to come which will be very helpful as well as we go through the summer.

That's the area we put a lot of concentration into, and it's paid off very nicely and of course, a lot of other things going around other parts of the system and other very important parts of the system, but that was a big focus, and it had a -- it's really had a nice ending.

Matt Troy - *Nomura Securities Intl - Analyst*

My follow-up would be on the intermodal piece. The international volume growth of 8% make sense given the potential for some diversions, residually from the West Coast port strike, or work stoppage, but the domestic piece, the volume's up only 3%. I was a little bit lighter than I think we've become accustomed to seeing through given your good traction and progress and highway conversions.

Wondering if you could just update us on the quarter gateway strategy and was that 3% representative more of a GDP level growth what you'd expect this year or were there certain mix factors or contractual factors that said we saw a little bit of a dip in the growth in domestic intermodal for you folks should kind of resume at a multiple of GDP as it has been in the past? Thanks.



Jim Squires - Norfolk Southern Corporation - President

Sure, Matt. Let me take a stab at that. Within the domestic intermodal book, we obviously have several channels. The intermodal company, IMC channel, principally hub and hunt grew at 6%. That's a little closer to our historical growth rate, and that's the sort of growth rate we would expect to see or better out of that channel going forward. Our premium and triple crown books declined somewhat and that's what led to the overall 3% increase in volume in the total domestic book. Going forward, we do think that we can continue to drive the entire domestic intermodal franchise at growth rates more like mid-high-single digits.

Operator

Chris Wetherbee, Citigroup. Mr. Wetherbee, your line is open for questions.

John Barnes, RBC.

John Barnes - RBC Capital Markets - Analyst

First, on the operating ratio improvement, not asking for a specific target but whatever we model for OR improvement, you've kind of given -- you've got the service related costs, you've got the savings from Roanoke, you've got some things like that. Can you just talk about the magnitude of each of those and kind of from most important to least important, what's going to drive the improvement going forward?

Marta Stewart - Norfolk Southern Corporation - CFO

The main thing that will drive improvement will be getting the network back to the velocity that Mark mentioned. The train speeds, the terminal dwell improvements that he mentioned he thinks will happen the second half of the year. That is the main thing that will help us with expenses. I would like to point out if you're looking at the OR that going forward as Jim mentioned, the fuel surcharge component of it is going to be quite a drag. It's on our operating margins the rest of the year.

John Barnes - RBC Capital Markets - Analyst

From network velocity, what's the next couple of catalysts there?

Marta Stewart - Norfolk Southern Corporation - CFO

After network velocity?

John Barnes - RBC Capital Markets - Analyst

Yes.

Marta Stewart - Norfolk Southern Corporation - CFO

It's just the general productivity work, and again, that network velocity we think will begin to -- will happen towards the end of the second quarter so we expect that improvement to happen in the second half of the year.



Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

If you look at our track record for the 2012, 2013 period, and we discussed this a lot, when you ramp the network up, you start to take not only do you take the costs out that Marta has been discussing, but it then sets the stage for even further projects to continue to drive costs down, particularly as volume grows.

And it's that combination of an ever higher network velocity, Mark mentioned Bellevue and we've talked to you about the savings that are coming online as we turn Bellevue, but it's that combination of having a stable high velocity network which then sets the stage for continuing projects to drive velocity along with the leverage, as Jim mentioned, the volume growth that really drive the economics of Norfolk Southern and for that matter, any railroad.

John Barnes - *RBC Capital Markets - Analyst*

The follow-up is, Jim you talked about stability on the coal franchise. Can you talk about how you weigh getting to a more stable but lower level of coal, both on the domestic and the export side, and when you start to make maybe some of those service adjustments and begin to take assets out, begin to downsize or rationalize the size of your coal support network, when do you begin to do that?

What do you have to see from a stability standpoint to really start to hammer the cost on the coal side if stable is going to be what we get going forward?

Jim Squires - *Norfolk Southern Corporation - President*

Let me start with the utility side of the franchise and give you some of our assumptions for the balance of the year, and I'll be referring to utility tonnage here. We did 20.1 million tons of utility coal in the first quarter, and our current forecast has that level of utility volume holding basically steady for the remainder of the year. As I mentioned, we do believe that gas substitution, with net gas in the current price range, has run its course.

There is very little tonnage left to come out due to mats, and of course the implications of carbon regulation down the road are somewhat unknown at this point. But in terms of mats, we'll maybe see 500,000 fewer tons this year. At that level of volume, that's albeit significantly depressed from last year and even more so from years past, we probably do not have an opportunity and would not want to take out significant infrastructure.

On the other hand, we can and already have downsized our equipment investments in our coal business. At this level of volume, we can make do with our current coal car fleet for some time that have been relieved of the significant capital investment in coal cars. That pertains really more to the export side of the business so let me touch on that as well.

We handled 5.3 million tons of export coal in the first quarter. That's down significantly from last year first quarter which was our peak quarter for export coal. For the remainder of the year, we are calling for 4.5 million to 5 million tons of export. We feel pretty confident on the thermal side of that.

If there is a downside, potential it would be more on the met side. Our central ag producers are very challenged right now. But again, at kind of a \$20 million annual run rate -- 20 million ton annual run rate for export coal, we probably would not want to significantly downsize our infrastructure although we do have the opportunity to reduce spending on equipment and the people side of it is something we can modulate as well.

Operator

Chris Wetherbee, Citigroup.

Prashant Rao - Citigroup - Analyst

This is Prashant in for Chris. I apologize earlier. We were having a little headset issue here. I realize we're running a little bit late in the call, so I'll keep it brief. We're curious to know about the growth potential for the core business, taking apart, leaving aside fuel surcharge and coal, if you get a coal normalization, do you think we could see the core grow in double digits?

And in 2015, are really coal and services that's the biggest factors preventing that? Is there any way to isolate either? Is that the right way to sort of think about that? Thanks.

Jim Squires - Norfolk Southern Corporation - President

If by core business you mean our merchandise business, our industrial business products, is yes, we do see growth potential there in 2015 and beyond, definitely. There are always puts and takes. We have some challenges in our metals and construction franchise right now due to very low steel prices and reduced demand for pipe, in particular.

The Wall Street Journal quoted \$444 per ton as the going price for hot-rolled coil this morning. That's down from \$474 at the end of March, so steel prices are very depressed and our capacity utilization is tracking below 70%. We have some challenges on that side of our met-con franchise. On the other hand, still within met-con, aggregates were up significantly, construction car loadings were up, cement traffic was up, all driven by housing and road construction.

There are definite bright spots on the energy side of the core franchise as well. We see continued opportunity. Over in chemicals, we were able to grow NGLs, and crude by rail we've already discussed, our plastic businesses were up. Those were all indications of a pretty healthy industrial economy and should be the drivers of significant growth in our industrial products franchise going forward.

Our ag volumes were up in the first quarter as well, and we see continued promise there for the balance of the year as well. Overall, we feel really good about our industrial products franchise, albeit there are always a few soft spots. And intermodal continues to grow, and on top of the volume growth this year, we expect to see significant price increases. I mentioned that our core prices were up in our intermodal business more than in any other business segment in the first quarter, and that's very, very encouraging.

Prashant Rao - Citigroup - Analyst

Just as a quick follow up, on the comp and employee issue, it looks like on a per average employee basis, the year-over-year change is just under about 2%, which thinking about that and going forward through the year on a year-over-year basis how to think about that line item, are there offsets to the headwinds and what are some of the initiatives that you guys see on the table maybe in terms of combating some of the headwinds you pointed out in the slides?

Wick Moorman - Norfolk Southern Corporation - Chairman & CEO

If you look at our comp right now, obviously, and we've discussed this before, we have the labor agreements which cover about 85% of our workforce. We had the effective -- effectively an early pay increase as a result of the last round of negotiations that kicked in in January rather than July 1, as Marta has discussed.

As we look at overall headcounts, we are clearly focused right now on getting the right number of people in our train and engine service workforce to handle the traffic without delay. I will say that as these numbers, and Mark showed you the conductors and engineers we expect to bring on in the next couple of months, most of them are included in the headcount today because they are trainees at the end of the first quarter. As they come on, they come off training status in which they are effectively paid a salary and start to be paid on a trip rate so that will then be proportional to our operations.



Then on the non-agreement side and particularly the G&A side, as Marta mentioned, we're always looking at ways to do everything we need to do with a lower headcount and the Roanoke closure will help precipitate some of that. We will continue to look at that and try and drive those costs down wherever we can.

Jim Squires - *Norfolk Southern Corporation - President*

Let me just add a footnote to the Roanoke office closure question. Having spent a lot of time with our marketing team in the last couple of months, I am really, really excited about having all of our sales and marketing team under one roof here in Norfolk.

That is going to allow us to produce a much more focused and consistent approach to growing our top line, and we'll have an opportunity to move people around between jobs that they might not have been able to move around between in the past. And there will be similar synergies from a workforce standpoint across all of the functions that are currently in Roanoke today, our IT and accounting departments for example.

Marta Stewart - *Norfolk Southern Corporation - CFO*

On the operations side, what I would add is, we can exactly write [no B] increases that Mark described we have. What we're projecting for the remainder of the year is another 500 increase. Most of that will occur by the end of the third quarter, and that is almost exclusively in the operating area. So by end of the year, we think we'll be up a thou.

Operator

Brian Ossenbeck, JPMorgan.

Brian Ossenbeck - *JPMorgan - Analyst*

Two quick ones. Jim, you mentioned a lot of the headwinds of the strong dollar on some of the disruptive imports that we're seeing in the steel, but you also mentioned you expect ethanol and soybeans to be up. So maybe if you could just summarize why you think those are moving and if overall you think that the strong dollar is a positive factor or a negative, excluding coal for the rest in the business, if the strong dollar is a positive or a negative.

Jim Squires - *Norfolk Southern Corporation - President*

Most of our business is US domestic economy focused so there are certainly pockets of resistance in the revenue based on the stronger dollar. We highlighted a few of them, the most prominent of which would be export coal and pockets elsewhere as well. I don't see an overall dampening effect on the total revenue necessarily outside export coal from the much stronger dollar. In certain pockets of our business, it'll be an additional challenge but we have enough drivers of revenue growth within the US domestic economy to push the top line higher based on our portfolio even with the strong dollar.

Brian Ossenbeck - *JPMorgan - Analyst*

One follow up on the export coal side. You mentioned you're pretty confident in the thermal side, and how that looks for the rest of the year, but I know the mix has bounced around a little bit. Can you just give us a refresher on what the mix was in the first quarter and perhaps what you expect for the rest of the year? Thanks.



Jim Squires - *Norfolk Southern Corporation - President*

In the first quarter of this year, 64% of the export tons we handled was metallurgical and 36% was thermal. That compares to last year's 69% met, 31% thermal. We had a relatively high proportion of thermal coal in the first quarter of this year. We think that will revert in the balance of the year to more of the 75/25 type of split. Going back, we were almost all metallurgical coal but the last couple of years, 70%, 80% met and the rest thermal has been the common split. We think we'll get back to something like that split.

I will say, though, that the demand feels firmer on the thermal side of the franchise right now and northern end producers were able to jump on some opportunities there in the first quarter, and that's why we saw the thermal part spike somewhat relative to the metallurgical coal moving predominantly over Lamberts Point. And by the way as you probably know, most of the metallurgical coal we handle moves over Lamberts Point and most of the thermal coal moves over Baltimore.

If there's a potential downside in our assumptions, roughly 4.5 billion to 5 billion tons per quarter for export coal, it would be on the metallurgical coal which in our case is coming out of central app. Because of all of the factors we mentioned, the very strong dollar, the global oversupply of coal, Queensland at 1.09 and spot coal is moving four places below that because of the low, very low bulk dry shipping rates. It's just an extremely difficult environment for central app producers in particular right now.

Operator

Justin Long, Stephens.

Justin Long - *Stephens Inc. - Analyst*

I wanted to ask a question about PTC. As you have continued to roll out this technology, how much of a disruption is it causing to the network? Is this a contributor to congestion in the rail network today or would you say it is not a significant needle mover when you think about fluidity?

Mark Manion - *Norfolk Southern Corporation - COO*

It's something we're paying a whole lot of attention to, and it has everything to do with how well we plan it. Those PTC cut overs take place on a regular basis each month, and the good thing is, is that our signaling communication group are doing a very good job of reducing the amount of disruption that takes place with each of the events. And case in point, when we started this out, and we've been doing it for a while now, but when we started these out, the outages were in the neighborhood of 12 hours, and of course, we'd do a lot of scheduling and planning around that to really minimize the disruption but as we've gone along here, outages have gone to eight hours and now in more cases down to six hours.

And we've got some things going on where we think we can reduce them even below six, some of them down to as little as four hours, so a lot of planning and schedule workarounds so the disruption factor will be minimized going forward but still something we do a lot of planning around.

Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

I'll add one thing to that which we -- I think it's very good question, and we have not talked about that in any detail nor have the other railroads, but I will say that we got a lot of the really problematic areas on the railroad in terms of traffic disruption done last year. We still have some more to go and my analogy for it last year is it was -- we were almost -- it was almost like we were constantly running a low-grade fever.

We had a lot of work to do out there and a lot of significant disruption that, as Mark said, we planned around it. We did everything we could but nonetheless, it was disruptive and it's something that we, as Mark has described, we continue to work on and in fact it's a real point of focus for us right now as we look at restoring our network velocity.



Justin Long - *Stephens Inc. - Analyst*

I'll just sneak one more in on intermodal. I was curious, are you getting a lot of pushback from your customers and your IMCs on the intermodal price increases you're going on with today? And also as of today, how much of your book of business in intermodal has been repriced at higher levels, call it that mid-single-digit range over the past year?

Jim Squires - *Norfolk Southern Corporation - President*

We are not getting a lot of pushback on price increases. We are aligned with our intermodal partners in the view of the marketplace and desire to take prices higher at this point. If you look at our equipment by line of business as an indicator of where we have the opportunity to lean into price most, E&P is about 17% of the total book by volume, and that's the rail owned fleet, rail equipment owned fleet, is that's where we have the most ability to take prices up on a spot basis. And also on the triple crown side of things, at 10% of our total book by volume, we can lean into rate there as well.

Operator

Brandon Oglenski, Barclays.

Brandon Oglenski - *Barclays Capital - Analyst*

Jim, welcome to the hot seat. As you guys know, we've been supportive of the stock here so I'm going to try to be constructive with these questions, but I do think it's worth it for your shareholders to ask some of the difficult questions here though, too. Granted, I've never run a train. We just live in Excel models so please tell us where we're wrong. This quarter, volume was up 2%. You had 3% growth in merchandise.

Intermodal was up 5%, and yet earnings are down 15% on what was a pretty easy comp from last year given all the weather disruptions. That's a lot of the frustration I think with your shareholders, and if I listen to the strategy to drive improvement going forward, it's getting price above inflation which we got this quarter, it's getting growth in those intermodal and merchandise segments and it's the stability in the coal book.

But I guess my concern here is, where is the profitability outside of coal? I think you've even said it and Wick said it in the past, coal is a very profitable segment for you, but where are the margins and returns on intermodal and merchandise?

And is that going to be enough to drive future earnings growth for this Company or do we have all of these continual cost pressures and fuel surcharge headwinds where we're just not going to be able to see a lot of earnings expansion even with those pretty robust growth rates outside of coal.

Jim Squires - *Norfolk Southern Corporation - President*

Let me just say, we appreciate the candor and by all means, ask the tough questions. We demonstrated last year that we can drop the operating ratio significantly based on solid general merchandise volume growth and intermodal volume growth even with coal headwinds. When you're talking about coal volumes down 7% overall in a quarter, that's a pretty strong headwind and that is more difficult and we lost ground this quarter, no doubt about it. But that will stabilize.

We will see a bottom on coal volumes, and as we've discussed on this call, we think we may be there already. And then we have the opportunity to see continued growth in many areas of our merchandise franchise and in our intermodal franchise. Put on top of that significant price increases and you do have a recipe for growing earnings. It's essential that we get the network back up to speed. We have a plan to do that. We have the resources coming online.

There will be some cost headwinds to get from here to there in the short term, but once the network is back up to 2012, 2013 service levels, we will see significant cost dropouts as well. It's the combination of that basic efficiency and the cost reduction that comes from running a faster network, bottoming out of coal volumes, and the combination of volume growth and price in our general merchandise and intermodal businesses.

Brandon Oglenski - *Barclays Capital - Analyst*

You're not the only railroad to see some pretty challenging coal numbers, and I do agree with Wick's assessment that there's differences between the East, the West in Canada but there are some similarities between the West and Canada at least in terms of achieving mid to low 60s OR for a lot of these carriers with public targets to get there.

If I'm hearing you correctly, Jim, it sounds like we need to have stability in coal before we can get any real traction on the operating ratio, but I think there'd be a lot of skeptics on the buy side or at least your investor base where if we look at natural gas being sub-\$5 in the future, there's still some incremental gas capacity in the East and on top of it, the export market doesn't look all that solid as you've confirmed on this call. Can Norfolk get traction on margins even if coal continues to be maybe a modest headwind heading forward?

Jim Squires - *Norfolk Southern Corporation - President*

I think we can, I really do. This is going to be a tough year. We will start to see the top line grow again in the fourth quarter we think based on our current forecast. Until we get the top line moving, it will be difficult for us to make a lot of improvement. That's coming. That's coming.

These mix effects that you saw in the first quarter are somewhat transitory. Coal volumes will bottom out. We cannot say with total assurance that we have hit bottom in terms of coal volume today, but we've studied our utility franchise pretty carefully and we do believe gas substitution becomes more difficult at this point with gas plants running full out.

On the export side of things, there are headwinds there, but there are opportunities as well, particularly on the thermal side of that franchise. We think we can do it. We've got a couple of tough quarters ahead of us with the fuel surcharge headwind, with some additional costs out there to get service back up, but once we're there on the service, once we see coal volumes stabilize and we get past this fuel surcharge headwind, we're in great shape to improve our financial performance.

Operator

Ken Hoexter, Bank of America.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

I'm going to take a little bit different tack on some of the same questions there, but it looks like service starting to show some improvement, still the mid 70s operating ratio for the quarter. Why such a contrast, maybe if I could address this to Mark, between your need to add the 650 employees between the conductors and engineers, the 200 some odd locomotives?

And when you look at Canadian Pacific's plan to cut resources which creates a lot of capacity. Maybe Mark, can you just describe maybe a little bit of the differences in the operations or how you're running it so we can understand why we can see such a great contrast between one creating capacity and the ability to move more versus what -- how you're structuring the operations?

Mark Manion - *Norfolk Southern Corporation - COO*

Well, as far as the resources that we're adding, we know that when we're in the process of ramping up, it's almost like you can't have enough locomotives. You need a certain number of locomotives just to spin yourself up and that's what we're in the process of doing and in fact, I've got



my sights set on storing locomotives before long. In fact, we'll probably get into that by May and give ourselves a surge fleet of -- we'll see how far we go, 100 to 200 locomotives.

Same thing on the people side. You need a certain number of people to man your trains, and it is activity based. We pay them when they work. We need to take on more people.

We will stabilize on the people side by the end of the second quarter, and from there on we are essentially outside of business growth opportunities as we get into the second half. We're going to be leveled off on people and we'll be hiring for attrition. We don't see ourselves doing anything particularly differently than what the other railroads do as far as that goes.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

And so I guess maybe just to keep digging into that to take it a step further, is it the network resets you've done a few times over the long weekends or is it changing the operating plan which creates that extra capacity?

Mark Manion - *Norfolk Southern Corporation - COO*

No, it's the -- we said last year that depending on the severity of the winter that we would do as we typically do, as we come out of these winter events. These are big network systems and they ramp up on a gradual basis; that is what has been happening ever since March. We're seeing some nice ramp up now, and I'm sure you look at our numbers as well. You see our cars online going down. You see our bad older ratio going down.

Our train performance is improving. Our connection performance improves. The number of locomotives available improves. All of that drives overall network velocity but it happens in a gradual way.

We'll see that -- we will continue day in and day out to see that gradual improvement take place, through May, through June, and I think by the end of June, we'll see some pretty darn good numbers.

Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

Just in the overall theme, let me say one more thing about that. And it goes back to this idea, every franchise is different. Every railroad is different. The Eastern carriers obviously are, as all of you know, shorter haul complex networks, and that's fine. For one thing, we live where all the people, and that we think that has a lot of positives in terms of growing but the overall belief that I think everyone in the railroad industry shares is that velocity creates capacity, and that's where we're going.

The first thing you do is get your velocity where you want it to be, where we've had ours in the past. As you see velocity go up, as Mark mentioned, cars online go down. Our terminals get more and more fluid, and that's what then drives further operating and cost improvements. That's the path we are on.

If you look at some of the things we've done in the past here, we've done a lot of work on our terminals in terms of we closed two significant yards, we've expanded one to make up for that and to make up for changes in our traffic base. The patterns may look somewhat different based on the franchise, but the theme is always the same in terms of constantly improving the velocity of your railroad no matter whose railroad it is in order to create cost efficiencies and create further capacity.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

If I could get the follow-up, I guess Jim, as you prepare to take over in two months or so, what are your thoughts on M&A? Obviously, we've heard Wick's kind of thesis in the past. I'm just wondering how you view the world and obviously given the discussions that we've heard from some of

the Canadians, and maybe your peer on the east in the past, just want to get your insight and whether you think it's possible, and if not, why not. And then if not now, does that mean something could happen in the future, maybe just some thoughts on that.

Jim Squires - *Norfolk Southern Corporation - President*

Sure, well I'll share a few thoughts and then I'll invite Wick to chime in as well.

Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

we'll see how well I've trained him.

Jim Squires - *Norfolk Southern Corporation - President*

Let me start by saying that we are a public company. We're obviously here to serve our shareholders, so there are no categorical answers in that regard. On the other hand, we do see significant challenges associated with further consolidation. The regulatory review process for consolidations in this industry is very, very time-consuming, onerous, and risky. And I say that as one who practically lived at the Surface Transportation Board for a year and half or so as we were going through Conrail.

It is a very unpredictable process, and it is a very costly and risky process as well. There are relatively few synergies to be achieved in exchange for those risks as well. The remaining combinations in this industry are end to end and by definition have fewer synergies available. We don't think it's a good idea and we think we have a great business plan to run this Company on a standalone basis, and what we can do with this Company is better than anything that could be achieved through combinations.

Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

Jim and I agree completely about this, but I think Jim's first caveat obviously is important. We are a publicly traded company. We are interested in long-term welfare and benefit to our shareholders. That is our job, and we understand that very clearly. But I think that what is sometimes really underestimated by those who don't live or immerse themselves in the regulatory environment in the way that we do is just how hard it would be, A, to have any kind of transaction approved, particularly under the new merger rules where by definition, it has to be procompetitive, whatever that means, and no one has defined that.

Second, the enormous risks that the conditions imposed if you were even able to get a merger approved by the STP would negate any and all benefits and beyond of the transaction itself, and there would be an enormous amount of resistance on the certain parts of our customer base. We just think that you never say never and the time may well come, but right now is not a time where trying to do a transaction of any size makes any sense.

Operator

Jeff Kauffman, Buckingham Research.

Jeff Kauffman - *Buckingham Research Group - Analyst*

I want to ask a question on a different aspect of the coal franchise. Given that most US-based coals are well out of the money globally and given that the utility inventories remain quite high, I think up till now, everybody's focused mainly on the volume aspect of the coal franchise but I guess the question becomes at what point do either the coal producers or utility customers say, if we want to keep the coal moving, we need a pound of flesh, and let's revisit the pricing so that we can keep coal competitive and keep coal moving.



When we look at your contracts both for export and domestic, can you give us an idea of when they get repriced, come up for renewal, and how much confidence do you have in this kind of environment that we won't have this new leg down this fall when these contracts or next year go to reprice?

Jim Squires - *Norfolk Southern Corporation - President*

We believe we continue to have a compelling value proposition in our ability to deliver coal from various basins in various ways to our utility and export customers, and we're going to price that on a value basis. On the export side, there just isn't that much we could do, unfortunately.

Our major customers are finding it very difficult to place coals into the global market, particularly on the metallurgical side. Our goal as is the case across our franchise is to obtain the maximum value for the dollar for the value that we provide our customers, and we'll continue to do that in the coal business and elsewhere throughout our franchise.

Jeff Kauffman - *Buckingham Research Group - Analyst*

And domestic?

Jim Squires - *Norfolk Southern Corporation - President*

Same story. As I said, we think natural gas substitution, which has been the driving factor in the declining utility volumes, has largely run its course, and we are in position to continue to deliver coals to our utility customers. Normal summer weather is critical to our assumptions in that regard, though. Another very cool summer and we could see further declines but provided we have a normal summer, we think we're in good shape to manage a pretty consistent run rate on utility coal this year.

Operator

Jason Seidl, Cowen and Company.

Jason Seidl - *Cowen and Company - Analyst*

Two quick ones. One, can you talk a little bit about your ability to price as your service level start coming up because clearly you're getting price now and service is well, let's call it less than optimal. Is there any relation between rail service and pricing or should we not look at it that way?

Jim Squires - *Norfolk Southern Corporation - President*

Clearly, there is and our pricing potential will only improve with better service levels. In the long run, you have to give the customer something more in order to obtain price increases, and that's one of the big reasons we are spending now to get service back up so that we will be able to grow volumes but also so that in the long run we'll be able to take prices up for a better and better product delivered to the customer.

Jason Seidl - *Cowen and Company - Analyst*

My follow-up and I apologize if you guys already covered this because there's some overlapping calls this morning. We haven't seen any announcements out there in terms of getting Don's position filled. I was wondering where you guys are at there and are you reviewing outside candidates as well as inside?



Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

We are reviewing both internal and outside candidates. We have been running a process. We expect to complete that process and make an announcement within a matter of a few weeks.

Operator

David Vernon, Bernstein.

David Vernon - *Bernstein - Analyst*

Marta, first question for you. How much additional borrowing capacity do you have and have you gotten more comfortable raising the borrowing and leverage profile of the business going forward?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Yes, we have quite a bit of additional borrowing capacity. As I mentioned earlier, and as I'm sure you know, we didn't issue any debt last year so we are planning to issue debt this year and we're comfortable bringing up our leverage levels but staying within our current credit ratings band, BBB+, BAA1.

David Vernon - *Bernstein - Analyst*

Is there a target level of coverage that you're shooting for?

Marta Stewart - *Norfolk Southern Corporation - CFO*

The target is to stay within the credit ratings band because last year we didn't issue, we floated down a little bit within the band. We're still within the band but floated down a bit so we're comfortable ramping up towards the upper end of the band but staying within it.

David Vernon - *Bernstein - Analyst*

Maybe just as a quick follow-up, Jim or Mark. Have you guys given a thought into how much of the service related costs you guys are pouring into the network right now actually do come down?

I get the velocity driven improvement allow you to pull some costs down, but I would also think that the change in freight flows across your network are requiring a different level of resourcing that you've had in the past. Is it a change in like the haul of longer haul, intermodal, less short haul coal, that kind of stuff? How much of the extra investment you're putting in should we expect to actually come out?

Marta Stewart - *Norfolk Southern Corporation - CFO*

We're expecting the \$42 million that we highlighted in the first quarter, we think is going to moderate to \$25 million in roughly the same categories that I outlined, a little bit less percentage-wise in compensation because the compensation part in the first quarter had a transportation part and a maintenance of way part related to the weather.

Percentage-wise, the comp part will come down a little bit and the total will be \$25 million, and then we believe we get up to the train speed levels that Mark described in the second half. We think we will not have service so that \$25 million, in other words, would go away in the third and fourth quarters.



David Vernon - *Bernstein - Analyst*

But do you get the \$42 million or the \$25 million back next year or do you think there's just going to be some of that cost is just going to be in the network.

Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

No, I think those costs are the cost that we view as their purely transitory in nature. The answer to your other question is that yes, as we see business mix change, we can see some shifting in resource requirements, particularly in terms of maybe where we need train crews but net-net, I don't think that those changes are material in terms of overall crew requirements or train operating cost.

David Vernon - *Bernstein - Analyst*

Even with the difference in length, the haul on coal, you'd think that would just take more labor hours.

Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

You're looking at length of haul on coal changing as basins change, as Illinois basin coal comes on, we hauled the coal longer, farther as the mix changes within coal. In intermodal, we've done a pretty good job and expect to continue to. We're really not necessarily running a lot more trains but just getting more and more containers on each one of the trains through stacking in additional train length. As I say, Mark, I don't think net-net, that amounts to a whole lot. Do you?

Mark Manion - *Norfolk Southern Corporation - COO*

No, I don't.

Operator

Cleo Zagrean, Macquarie.

Cleo Zagrean - *Macquarie Research Equities - Analyst*

My first question relates to coal so I appreciate that we may be looking at a stabilization in quarterly run rates on the domestic and maybe the export front, as well. But still this year we're looking to it sounds like 10% decline in the domestic volume and maybe mid-teens in export. What does coal alone do to your operating margin, also your operating ratio this year in terms of a headwind?

Jim Squires - *Norfolk Southern Corporation - President*

It unquestionably is a headwind. When we see the kind of year-over-year declines that we experienced in the first quarter of 2015 and projecting for the balance of the year. Yes, we think a steady -- a steadier run rate for both utility and export coal tonnage but the comparisons are difficult.

Second quarter of 2014 was our peak quarter for utility coal volume, and so we are comping that, that very difficult comparison. Similarly in the third quarter, we -- as utilities rebuild stockpiles into the third quarter, we are facing some difficult comps. By the time we get to fourth quarter, it's get a little bit easier, and we would expect to see lesser year-over-year volume declines.



On the export side of the franchise as we have discussed, the comparisons really get easier in the second half, beginning in the second half, and again, particularly the fourth quarter. Fourth-quarter 2014 total export tonnage was 4.8 million so dropped below 5 million by the fourth quarter of last year. Tough middle part of the year, tough couple of quarters coming, by the fourth quarter we start to see growth resume.

Cleo Zagrean - *Macquarie Research Equities - Analyst*

Can you say maybe if you face specific challenges in your franchise compared to your recent peers and how we can think about the operating ratio impact?

Jim Squires - *Norfolk Southern Corporation - President*

No, we don't think we face peculiar or particular challenges relative to our Eastern competitor in this regard.

Cleo Zagrean - *Macquarie Research Equities - Analyst*

On the operating ratio, if you'd like to quantify or maybe just say that you're not prepared to maybe assess the impact of coal, that's fine. But on the ex-coal and ex the fuel surcharge hit this year, would you comment as to whether you see mix, you know, just below the top line being the tailwind or a headwind on the operating income level? We're focusing so much on the top line but surely there must be benefit in growing intermodal and merchandise, right? If you can help frame that for us, that would be very helpful.

Jim Squires - *Norfolk Southern Corporation - President*

Absolutely. We've said in the past and it's still true today that our general merchandise businesses, particularly volume moving in our scheduled network, are our highest incremental margin businesses. You layer it on top of the natural spontaneous favorable economics of volume growth in this business significant core price increases and that's really a key driver of improvement for us.

Much of this unfortunately will be masked in the middle part of the year by the fuel surcharge headwind, which will be significant and with the kinds of deltas to last year, we're talking about in the top line from fuel surcharge alone, we will probably see margin pressure in the second and third quarter unlike in the first quarter where the decline in fuel expense actually exceeded the decline in fuel charge revenue. That will flip most likely given the magnitude of the fuel surcharge revenue headwind in the second and third quarter.

Operator

At this time, I will turn the floor back to Wick Moorman for closing comments.

Wick Moorman - *Norfolk Southern Corporation - Chairman & CEO*

Thanks, everyone, for bearing with us on what has been a somewhat of a long call but hopefully we have given you a lot of data and a lot of color on what we're doing. We appreciate your time and we look forward to talking to you next quarter.

Operator

This concludes today's teleconference. You may disconnect your lines at this time. And we thank you for your participation.



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