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NSC - Q2 2014 Norfolk Southern Corp Earnings Conference Call

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OVERVIEW:

Co. reported 2Q14 railway operating revenues of over $3b and net income of $562m or $1.79 per diluted share.

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PRESENTATION

Operator

Greetings, welcome to Norfolk Southern Corporation second-quarter 2014 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 for Norfolk Southern. Thank you Ms. Cook, you may now begin.

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

Thank you, Rob, 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 www.nscorp.com in the investors section. Additionally, transcripts and downloads of today's call will be posted on our website.

Please be advised that any forward-looking statements made during the course of the call represent our best good faith judgment as to what may occur in the future. Statements that are forward-looking can be identified by the use of words such as believe, expect, anticipate and project. Our actual results may differ materially from those projected and will be subject to a number of risks and uncertainties, some of which may be outside of our control. Please refer to our annual and quarterly reports filed with the SEC for discussions 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 investors section.

Now it is my pleasure to introduce Norfolk Southern Chairman and 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 second-quarter 2014 earnings conference call. With me today are several members of our senior team, including our President, Jim Squires; our Chief Marketing Officer, Don Seale; our Chief Operating Officer, Mark Manion; and our Chief Operating -- Chief Financial Officer, Marta Stewart.

I am very pleased to report that Norfolk Southern's second-quarter financial results set all-time records across the board. Earnings for the quarter were $1.79 per share, up 23% compared with the $1.46 we earned in the second quarter of last year. These very strong results reflect a substantial increase in demand coupled with our continuing effective cost control.

Overall, traffic was up 8% reflecting a double-digit rise in intermodal along with increases in both merchandise and coal. These strong volumes resulted in record revenues which topped $3 billion, a $240 million or 9% increase versus last year. Don will fill you in on all the details of these gains in a few minutes.

At the same time, our expenses were up only 3% despite the volume surge and some continuing slowdown in our network velocity. Our resulting 66.5% operating ratio set an all time quarterly record.

To put the volume growth in perspective, our weekly volumes averaged about 153,000 loads in the second quarter of this year, compared with only 141,000 loads on average in last year's second quarter. In fact, we only saw volumes exceed 150,000 loads in two weeks of all of 2013. And in contrast, we have seen only three weeks of less than 150,000 loads since the last week in March of this year.

Now going immediately from the severe winter weather that we experienced to this kind of volume growth has obviously created some challenges for us, but our operating team has clearly risen to the occasion. Our network continues to be fluid and stable although our service metrics are not yet back to last year's levels. Mark will give you the numbers as well as describe our initiatives to improve network velocity.

While the network slowdown and our recovery efforts to give rise to some added cost, our overall expense control was strong. And Marta will go over all of the financials with you in more detail.

To sum it up, it was a great quarter for our Company. And while we don't necessarily see the same kind of volume growth being sustained for the balance of 2014, our results show the strength of our franchise and our potential for ongoing improvement. In recognition of this potential, I'm also very pleased that our Board increased our dividend yesterday by $0.03 per share, or 6%.

And on that note, I'll turn the program over to Don, Mark and Marta and then I'll return with some closing remarks before we take your questions. Don?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Thank you, Wick, and good morning, everyone.

The second quarter of 2014, as Wick stated, was Norfolk Southern's first $3 billion quarterly with revenue growth of $240 million, or 9%, compared to second quarter of last year. Revenue in all three primary business units increased with intermodal up 11% followed by merchandise at 8% and coal up 7%.

With respect to the quarterly revenue variants, our volume increase of almost 145,000 units generated $221 million in additional revenue, while improved pricing and positive fuel surcharge revenue largely offset the negative mix affect of having higher volumes of intermodal traffic.

Turning to the next slide. Despite higher intermodal volumes, our overall revenue per unit increased by 1% in the quarter with steady price increases among most business units. Coal revenue per unit was up 5% due primarily to longer lengths of haul for utility coal, which offset the negative mix affect of lower volumes of export coal.

In our merchandise segment, RPU was up 2% in spite of negative mix affects from higher short-haul movements in the metals and construction and agricultural product segments. Lastly our intermodal sector experienced positive pricing, which was offset by the negative mix effects of increased international volumes, which have lower revenue per unit characteristics compared to domestic shipments.

Now turning to the details of our volume for the quarter. Total shipments increased 8%, due primarily to increases in metals and construction, intermodal, coal, crude oil, natural gas liquids and housing-related commodities. Intermodal volume was up 11% driven by organic growth and new business in international, coupled with continued strength in our domestic market and highway conversion programs.

Our merchandise market also experienced strong growth led by our metals and construction franchise, which was up 13%, followed by chemicals, up 7% and agricultural at 5%. Volume growth of 9,000 units in coal was primarily from increases in the utility sector, which were offset by decreases in our export traffic.

Turning to the next slide, focusing on our individual market segment starting with coal. Coal revenue was up $46 million, or 7%, which was our first quarterly revenue increase in coal since 2011. This gain was led by our southern utility business which grew by 23%, partially offset by a 3% decline in northern utility volume. Utility coal demand has improved as a result of higher natural gas prices and stockpile replenishment coming out of the harsh winter. Eastern utility stock piles remain down by 18% compared to December 2013 levels.

In the export market segment, volumes were down 13% as thermal supply competition remains very strong in Europe. The API 2 index to Western Europe is currently in the $70 range, pushing US thermal coals out of the market.

Export metallurgical coal is also being impacted by weak seaborne pricing and strong Australian competition. In our domestic metallurgical coal market, we saw a 7% decline in volume compared to the second quarter of last year, as the steel market remains over supplied and we experienced the impact of two plant closures in Canada. Finally, industrial coal volumes increase by a strong 24% due primarily to new business gains.

Now let's turn to intermodal. Intermodal revenue in the quarter increased by $62 million, or 11%, to $650 million, which is an all time high record for this high-growth business segments. International shipments grew by 16% due to strong general market expansion, new projects and advanced shipments ahead of the ILWU labor contract negotiations at West Coast ports.

The increase in our domestic volumes continues to be driven by highway conversions across all of our business segments. We are seeing organic growth in our large key accounts, as well as increased use of intermodal by recently acquired premium and truckload customers. Our targeted quarter initiatives, which we've discussed with you in the past, coupled with the associated infrastructure improvements made over the past 10 years, are providing the necessary tools to grow our business efficiently and profitably. And we're continuing to work on increased velocity and performance across this best-in-class intermodal network.

On slide 7 we focus on our merchandise markets, which in the quarter increased by $132 million, or 8%, to $1.7 billion. Metals and construction led this growth with 13% more volume generated by higher volumes of frac sand shipments to the Marcellus and Utica shale regions, growth in imported slabs through our East Coast ports and also increased coil steel due to continued strength in the automotive sector.

The 5% gain we saw in agriculture was driven by year-over-year improvement in shipments of corn due to increased demand in processing primarily for ethanol production. Additionally expanded export activity led to higher volumes of soybeans and wheat.

In our chemical franchise, we continue to see increases in crude by rail, natural gas liquids and other chemical commodities used in the growing automotive and housing markets. Automotive car supply constraints across the North American network moderated automotive volumes in the quarter. But as shown on the chart, our automotive volumes increased by 3% in the quarter despite these challenges.

Lastly, volume within our paper, clay and forest products group was down 1% for the quarter, due primarily to the impact of the recent closure of an international paper mill in Northern Alabama. On a positive note, these declines were largely offset by continued strength in the wood products markets for both lumber and wood chips.

Now let's conclude with our outlook for the balance of 2014. We remain optimistic that we will continue to generate growth across most of our business units.

The utility coal shipments are expected to be up throughout the rest of the year as gas prices remain elevated and stock piles are replenished. But overall coal volumes will be tempered by weaker export met and thermal coal market conditions along with lower domestic met coal shipments.

Turning to intermodal, as truck capacity tightens, we anticipate continued volume growth in pricing opportunity in our domestic network. For example, in our rail-owned domestic container segment we successfully increased transcon rates 4% on June 1 and we'll be taking a 3% increase on our local EMP freight effective September 1. These two business segments together represent 17% of our total domestic intermodal book. We also expect continued volume increases in our international intermodal business, but we expect the pace of growth in this sector to moderate somewhat in the second half.

In our merchandise businesses, we expect growth across most market segments. In chemicals, crude by rail continues to be strong. Last year, as you'll recall, we handle approximately 75,000 carloads of crude oil and we expect our full year 2014 volume to be well in excess of 100,000 carloads with substantial opportunity for continued growth in 2015. And natural gas-related commodities such as frac sand and liquid petroleum gases are expected to continue to increase as well.

In metals, US steel production is projected to increase 3% for this year and we continue to see growth across most of these markets. In automotive, our automotive volumes should continue to improve as car supply becomes more fluid and production increases by over 4% this year.

In our agricultural markets, favorable growing conditions for another robust soybean and corn crop should lead to strong year-over-year gains ahead. Lastly, with housing starts expected to grow about 15% this year, we expect continuing volume increases in housing-related commodities such as plastics for carpet, soda ash going into the manufacturing of glass, steel for appliances, synthetic gypsum for wallboard and in asphalt and aggregates for paving.

In summary to wrap it up, we expect continued volume and revenue growth ahead across most of our intermodal and merchandise market segments and in utility coal in the second half. With respect to our yield management plan, as we've shared with you in the past, we remain committed to providing improved service to our customers that supports our ability to price to market at levels that equal or exceed rail inflation and which supports further investments in our network.

Thanks for your attention and I'll now turn the mic over to Mark for his comments on our operations. Mark?

Mark Manion - *Norfolk Southern Corporation - COO*

Okay, thank you, Don.

Well the second-quarter operations were definitely affected by the very positive traffic growth. On the heels of a difficult operating environment in the first quarter, the higher volumes presented a new set of challenges for our operations and slowed our progress in returning the network to targeted service levels and network velocity. However, it did demonstrate that we have a physical capacity in the network for further growth. It also pointed out that, going forward, we need to find ways to respond more quickly to changing market forces, particularly with respect to train and engine employees.

Turning to slide 2 for a review of safety performance, we saw a solid improvement in the second quarter. Reportable personal injuries dropped to 0.88. For the first six months the injury ratio stands at 1.19. Furthermore our serious injury rate has not increased.

We also saw improvement in the rate of train incidents in the second quarter, down to two incidents per million train miles. For the first six months the train incident rates is 2.3 per million train miles. Crossing accident rates were up slightly to 3.8 per million train miles for both the second quarter and the first half of the year.

As illustrated on slide 3, our composite service metric improved modestly from 73.4% in the first quarter to 74.5% in the second quarter, but remains well below the high service levels of 2012 and 2013. For the first six months the service composite was 74%.

Our network has remained very fluid with no significant bottlenecks due to physical constraints. However, service performance and network velocity remained below targeted levels due to a crew base that was planned for lower traffic volumes. Based on recent business growth trends and an updated a business outlook, we've stepped up hiring and training in order to align T&E forces with expected volumes.

Looking at employment for the total Company during the second quarter, we had about 900 fewer employees versus the full year 2013 average. With the additional T&E hiring, we expect that we will ramp back up to the 2013 employment level by the end of 2014.

Train speed shows similar trends and for the very same reasons. In the second quarter, train speed fell to 21.8 miles an hour. For the first six months of 2014, train speed was 22.1 miles per hour.

In addition to the efforts in crew hiring, we also pressed on locomotive availability. Not only did we have all of our surge fleet deployed, but we also stepped up repair activity to increase the total number of available locomotives. As Marta will discuss with you, this resulted in higher cost but it was well worth it to assist in the recovery.

This point is illustrated by our next slide of our dwell times. As you know, terminal dwell is the second major component of network velocity and it improved by 6% from 25 hours in the first quarter to 23.4 hours in the second quarter. Terminal dwell remains above the high performance levels of the last couple of years and will also improve over coming months with improved crew availability.

Moving to the next slide, with a volume increase of 8% in the second quarter, crew starts actually declined by 1%. This margin of difference is in part due to conserving crews through train combinations and train annulments. However, we would still see a very positive margin even with a more robust crew base. Our current crew base is clearly stretched, which is reflected in higher overtime hours and increased recruits, up 20% and 23% respectively for the second quarter, compared to the same period last year.

With the hiring plans I outlined, network velocity will improve over the coming months and we'll see that improvement reflected in further improvement in operating efficiencies, particularly reductions in overtime and re-crews. Higher volumes were largely absorbed with the existing train operation resulting in a 4% improvement in carloads per locomotive. Our fuel utilization was also favorable as gallons per 1000 gross ton miles declined by 4% compared to the same period last year.

Thank you and I'd like to take just a minute to recognize all of our operating department employees. The first and second quarters presented very different but very difficult operating challenges. As always, our people rise to meet every challenge. That's the Norfolk Southern spirit.

And Marta, now I'll turn it over to you.

Marta Stewart - *Norfolk Southern Corporation - CFO*

Thank you, Mark, and good morning, everyone.

Let's take a look at how all of that strong volume translated into second-quarter financial results. As shown on slide 2, and as Wick and Don already mentioned, our operating results were strong. Railway operating revenues of over $3 billion rose $240 million, or 9% versus 2013. While operating expenses increased only $57 million, or 3%. This improved leverage resulted in a best ever quarterly operating ratio of 66.5%.

The next slide shows the major components of the $57 million net increase in railway operating expenses which, as you can see, was largely concentrated in materials and other and in fuel.

Now, let's take a look -- closer look at each of these variances. The materials and other category increased by $35 million, or 16%. About $20 million of this was due to higher casualties and other claims as the prior year had a large favorable personal injury adjustment. In addition, about $10 million of the increase is related to higher material usage, primarily for locomotive repairs.

As Mark discussed, our surge fleet is fully deployed. As you would imagine, those locomotives typically require more maintenance. In addition, we have some spillover of locomotive work related to weather issues from the first quarter. With the anticipated demand that Don described, we plan to continue to use those older locomotives in the second half of the year. Therefore, you can expect a similarly elevated level of material spending.

As displayed on the following slide, the $17 million, or 4% increase in fuel expense, was almost entirely due to higher consumption. Gallons used were up 4% on the 8% increase in traffic volume. Next, depreciation expense rose by $12 million, or 5%, reflective of our larger capital base. As shown on the left hand side of the slide, our fixed assets, before depreciation, are $1.3 billion higher than this time last year.

Slide 7 addresses the $4 million, or 1% rise in purchased services and rents. Most of this increase was due to higher volume related costs, in particular equipment rents, joint facilities and intermodal terminal costs. Somewhat offsetting these volume metric increases were lower professional service fees, as well as lower expenses associated with the shared assets area.

Slide 8 details the $11 million or 2% decrease in compensation and benefit costs. As we previously discussed, the first quarter amendment to our retiree medical plan, along with strong equity returns in 2013 and a lower discount rate, resulted in a decline of about $40 million in post retirement medical and pension accruals.

In addition, health and welfare benefit costs were slightly lower for the quarter. Partly offsetting these declines were higher incentive compensation, increased pay rates and increased overtime. The higher incentive comp was due to bonus accruals related to the strong operating results as well as to higher stock-based compensation.

Overtime increased by $9 million and was mostly incurred in two areas of our workforce, employees who operate our trains and employees who repair equipment, principally locomotive. We expect a somewhat elevated level of overtime for the remainder of the year. As Mark described, we have already hired and will be continuing to hire train and engine employees. So the overtime in that area should gradually moderate as the employees become qualified.

Slide 9 depicts our second-quarter income from operations. With revenues up 9% and expenses up just 3%, the operating margin expanded by 22% and exceeded $1 billion for the first time in the Company's history.

Turning to our nonoperating items, both categories were $11 million unfavorable for the quarter. Other income net declined by 38% due primarily to reduced coal royalties associated with lower coal production. And interest expense on debt was up 9% due to last year's debt issuance.

Slide 11 shows our bottom line results with record quarterly net income of $562 million, up 21% compared with 2013 and diluted earnings per share of $1.79 up 23% versus last year.

Wrapping up our financial overview on slide 12, cash from operations for the first six months was $1.4 billion covering capital spending and producing $628 million in free cash flow. Although capital spending year to date is somewhat behind last year's pace, we still continue to project full year CapEx of $2.2 billion. Within this total amount, we have reallocated resources to acquire some used locomotives and to enhance capacity.

With respect to stockholder returns, we repurchased $100 million of our shares and paid $335 million in dividends. These dividends reflect the $0.54 per share amount paid in the first and second quarters. As a Wick mentioned, our Board yesterday raised the dividend rate to $0.57 per share, a 6% increase which will begin with our September dividend payments.

Thank you and I'll now turn the program back to Wick.

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

Thanks very much, Marta.

Well as you've heard, we are obviously very pleased with our second-quarter results. Clearly there is still work to be done in terms of improving our network velocity and service levels, and we have a solid plan in place along with a great operating team to do just that. But even with that slower velocity, I am very proud of the way that our team kept our cost in check, even in the face of a volume surge, the magnitude of which, quite frankly, none of us saw coming.

Looking ahead, as you heard from Don, while we still have some questions around coal and particularly export coal, we continue to see strong fundamentals in most of our businesses. Looking even more broadly, we believe that the US economy will continue to recover at a reasonable although not robust level for the balance of this year and next, which should also help us to continue our upward momentum.

There are some question marks on the regulatory front, most immediately concerning the transportation of crude oil. But I remain convinced that the US rail system can transport crude oil safely and that the regulators understand and believe that as well, and that they will not issue rules which will seriously diminish our ability to do so.

I'll close by repeating again, our core strategy at Norfolk Southern, which is to focus on delivering superior transportation service to our customers in the most efficient and effective way possible at prices which reflect the value of that service in the marketplace, and, thereby, deliver superior returns to our shareholders. We have the franchise and the team to execute this strategy and our second-quarter results offer proof that we're on the right track.

Thanks and I'll turn it over to the Operator for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Allison Landry, Credit Suisse.

Allison Landry - *Credit Suisse - Analyst*

Wick, I wanted to follow up on the last comment that you made with respect to crude by rail regulation. We've recently been hearing some chatter actually that the DOT and PHMSA might put out potentially even as soon as today or tomorrow, rules not only concerning the tank cars but also the speed limits. And some of the numbers that we've heard are a limit of 25 miles per hour. I know that the industry has talked about 40 being the lowest that you could do, but let's just say that the scenario is 25, what happens and how would the industry respond? Would you stop moving crude altogether or substantially decrease what you're moving?

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

Allison, it's a good question and we obviously do expect to see very shortly the regulators put out a notice of a proposed rule. There's a lot of speculation about what might be in that proposal, but there will then be the opportunity for all of us to discuss it before they come up with a final regulation.

And obviously speeds in the range that you mentioned, 25 or 30 miles an hour, would be extraordinarily disruptive to our rail network not only to trying to ship crude in which the exposure quite frankly would go up significantly because it would take a lot more trains and cars to move the same amount of oil, but it would be incredibly detrimental to the service and all of the rest of our business including Amtrak and including our auto business, our intermodal business, you name it. And the resulting capacity loss I think is something that the rail network quite frankly could not manage.

So we have done a lot of modeling, we have had a lot of discussion with the regulators and I believe that we'll be able to make our case that a minimum speed in the 40 to 45 mile an hour range is not only safe, which it is, but also is the range in which it will not be extraordinarily disruptive to the North American rail network.

Allison Landry - *Credit Suisse - Analyst*

Okay, so potentially we could see the proposed rule come out with something more onerous than you guys would like, but there is an opportunity to go back and revisit that?

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

They're clearly in the process. It will be a proposal and there will be, as I said, a comment period and a period for the rail industry to present evidence. And we will have compelling evidence that any significant speed restriction would be in fact disruptive to the point of almost shutting down the North American rail network.

Allison Landry - *Credit Suisse - Analyst*

Okay, that's great color. And a follow-up question turning to coal, is it safe to say the rate concessions on the export side are largely behind us or should we expect further rate cuts just as prices continue to be weak globally? And at what point does it become uneconomical to continue making these downward adjustments and maybe instead you start reallocating some resources elsewhere since you're seeing growth across the business?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Good morning, Allison, this is Don. We believe as long as metallurgical coal prices in the world market remain in the [120] level and they've been stable at the [120] level now for a couple of quarters, our export pricing is at the bottom and it's going to remain flat in the third quarter based on that. I will tell you thermal API 2 pricing in Western Europe has deteriorated further. We do not plan to try to follow that coal or incent that coal with transportation pricing because frankly, the delta is too wide for us to make much of a difference in that market.

Allison Landry - *Credit Suisse - Analyst*

Okay, great. Thank you so much for the time.

Operator

Thomas Kim, Goldman Sachs.

Thomas Kim - *Goldman Sachs - Analyst*

Can you elaborate on what your core pricing (inaudible) was in the second quarter?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

We don't comment on what our core pricing results were. I will tell you that we're pleased to advise that it was in excess of our rail inflation rate. And as we pointed out in the revenue per unit review in my remarks, we were pleased to see the results in our coal business was revenue per unit being up 5%, our merchandise business up 2% and our intermodal business even with last year even though our international business volume was up 16%, double the domestic rate of growth. And as you know, our domestic intermodal as a -- about a third higher revenue per unit than our international business based on international containers moving. So we were very pleased with our pricing results in the quarter.

Thomas Kim - *Goldman Sachs - Analyst*

Okay, that's great. Thank you. And then to what extent could you comment a little bit more about the coal pricing, the domestic coal, domestic utility coal versus the export side? Would you be able to elaborate in terms of the trends we've seen in the second quarter in particular for the export coal?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Our trend in export coal in the second quarter was essentially flat with the first quarter. As I mentioned in the previous question, we don't see that moving now we're pretty much at the bottom of the market and we don't have plans for any appreciable movement downward in our export market rates at this point.

In the utility market, I will tell you that most of our gain in RPU, revenue per unit, was attributed to longer hauls, coal that's originating in the Illinois Basin and the Northern Appalachia Pittsburgh [8 seam] moving to our southern utilities. That business was up 23% in the quarter and our business in the north was down 3%. So we had a very favorable extended haul result that drove RPU and coal.

Thomas Kim - *Goldman Sachs - Analyst*

That's great, thank you very much.

Operator

Scott Group, Wolfe Research.

Scott Group - *Wolfe Research - Analyst*

Don, just to follow up on that last point about the coal yields, do you expect that mix up much better growth to southern utilities relative to northern, you think that mix continues, is that a long-term trend or is this something that's choppy and maybe not so sustainable?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Good morning, Scott, it's a good question and we're seeing a continued conversion of utility coal from Central Appalachia with higher cost of production to the Illinois Basin and to Northern Appalachia. And I will share with you in the second quarter our origination percentages. We were 34% central app, 31% northern app, where within 3 percentage points of Northern App now equally Central App which has been our traditional source of thermal coal.

But the notable change was that the Illinois Basin in the second quarter was now 19% of our thermal originations which is 3 percentage points higher than the PRB originations come into our network now at 16%. So we're seeing Illinois Basin growth take place and we're certainly seeing Northern Appalachia growth take place both into the southeast, we expect that trend to continue.

Scott Group - *Wolfe Research - Analyst*

And is there something about why it's more going to the southeast than the northeast and that should continue?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Well the southeastern stock piles are at a level that they're being replenished coming off of winter. We expect that replenishment to continue in the second half of 2014 and also higher natural gas prices have created a situation where thermal coal is dispatching at a higher rate in the south than it did this time last year.

Scott Group - *Wolfe Research - Analyst*

Okay, great. And then second question, when we -- we're hearing about adding more people but hopefully overtime and things like that and come down and service gets better, net, net should that mix change should that be good for operating margins and incremental margins in the back half of the year? You typically see earnings improve in the back half and just want to understand, should that continue this year?

Marta Stewart - *Norfolk Southern Corporation - CFO*

This is Marta, Scott. The overtime was about half and half occurred in the T&E and the non T&E area. So the effect of the hirings that Mark described will reduce and moderate as the year goes on as these folks get qualified. We'll reduce the T&E overtime. We expect the non T&E overtime to continue right about this level through the end of the year.

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

Yes, Scott this is Wick, I would say too that overall we know and we've done a lot of analysis that tells us that as network velocity improves, our costs come out. And our expectation is that over some period of time through the second half and into next year, as that network velocity increases, even with the additional employees in T&E, our overall cost structure should benefit from it.

Scott Group - *Wolfe Research - Analyst*

Okay, so ultimately a good thing. Okay. All right, thanks a lot for the time, guys.

Operator

Bill Greene, Morgan Stanley.

Bill Greene - *Morgan Stanley - Analyst*

Don, can I ask you to comment a little bit on some of the things you said in your prepared remarks, capacity we know is getting tighter, you mentioned that it's getting tighter in the truck market we've seen that very clearly in a lot of the data points. How soon is it before we have to start to see some higher pricing for the rails simply to handle this demand, to try to create, if you will, some elasticity of which I know there's very little? And along those lines, how much is service a limiter on what you can do on price?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Good morning, Bill, let me take -- I'll take the first part first, the first part of the question first. We are seeing truckload capacity tighten. We've seen that trend take place now over the past 15 to 18 months and it certainly is continuing to open up opportunities for us to improve our pricing for intermodal where you know we still have a differential of 12% to 15% generally between intermodal prices and truckload prices.

That's -- a good example of that is what I mentioned in my remarks looking ahead of us taking a 4% increase on our originated business going west on transcontinental and a 3% increase effective September 1 on our local EMP business as well. And that's 17% of our domestic book of intermodal, which I think is indicative, it illustrates the movement that's beginning to take place on pricing and intermodal.

We don't see any change or reversal in truckload capacity as long as the economic trends continue to move upward and so we expect a more favorable pricing environment ahead. And you will see us take more selective increases ahead with that.

Now with respect to the second part on service, as Wick mentioned and as Mark mentioned, none of us are satisfied with our service levels at this point. We're working very closely with all of our customers to work through any concerns and issues until we can get our service back to where we expect it and where our customers expect it. But I will tell you that with double-digit growth in most of our corridors, including Crescent Corridor and Heartland, in the quarter service has not been an impediment to us handling our international business or continuing to have a successful track record of converting highway freight to rail.

Bill Greene - *Morgan Stanley - Analyst*

Okay, very good. Wick can I ask you one other question and that is, you probably saw the BN agreement with SMART on possibly moving to one-man crews if ratified on areas where they have PTC in place. Do you think that this is a possible game changer for the industry? I know PTC is far from operable, but as we get there is this something we need to keep in the back of our minds?

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

We certainly have seen that agreement. We're trying right now internally to work through all of the economics of that agreement to see what kind of impact something like that would have at Norfolk Southern. It's clearly a [see] change agreement but I think it's -- we're a long way from understanding how the economics play out. And as you say, it's PTC contingent and our best guess right now on when PTC is actually operational across the entire North America rail network is approaching 2020.

So is it interesting? Yes. Could it be significant? Yes. Does it have any immediate impact? I don't see that.

Bill Greene - *Morgan Stanley - Analyst*

Okay, that's great. Thank you for the time.

Operator

Chris Wetherbee, Citigroup.

Chris Wetherbee - *Citigroup - Analyst*

Question for you Mark on the velocity side, looking as you move through the second quarter and clearly there was volume growth I should say coming out of the winter, but as you saw the quarter progress it seemed like some of those metrics might be deteriorate a little bit towards the end of the quarter. We've seen the recent bounce back here, but want to get a rough sense of when we think we can start to see some more material improvement there and should we be focused on that? Is that something we need to be considering as we look for those metrics to improve and ultimately continue to drive what were very, very strong incremental margins in the quarter?

Mark Manion - *Norfolk Southern Corporation - COO*

Yes, Chris, realistically as we go through the third quarter, there's going to continue to be a lot of pressure on the operation. We see a lot of volume, third quarter is always a robust quarter anyway and it looks like this one certainly is going to be. So we are going to stay up against it and we're not going to have -- we're not going to see additional crews that are coming into the operation in the third quarter. We will start to see some -- we will put some additional locomotive power against it as we go into the third quarter.

We are continuing as we have been, we continue to march forward with improvements from additional infrastructure projects and they are very helpful. They make -- they have made a world of difference and we're certainly seeing that play out now. So we're going to hold our own but we're not going to see a tremendous amount of improvement during the course of the third quarter.

Chris Wetherbee - *Citigroup - Analyst*

Okay, that's helpful. I appreciate the color. And then Don a follow up on the question before as you talked about the changing mix in southern utilities taking coal from different originations and ultimately having it playing out to through the business. Can you give us an update on where southern and northern utility stock piles rest relative to historical or multi year averages? Want to get a rough sense of have we played this catch up or how much is left to go into the second half of the year?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Chris you may recall that back in the first quarter after we came to the so-called polar vortex winter, we at the end of our first quarter, we shared a number that the stock piles in our network had come down by about one third. We estimate now that we've worked off a portion of that reduction but they are still down about 18% compared to December when we went into the weather. And gas prices are still trending in an area of -- they're about [380], [390], Illinois Basin coal, PRB coal and Northern App coal will dispatch at those prices. So stock piles have not been replenished, there's still some work to be done. And as long as gas prices are in the range that they're at today or higher, we'll see utility coal demand in the south and hopefully in the north pick up as well.

Chris Wetherbee - *Citigroup - Analyst*

Okay and those stock piles are relatively balanced between northern and southern utilities?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

We see a little more opportunity right now in the south than we do the north, but I will tell you that it's not much difference. And as you know, our utility volume is about 50/50 split between the north and the south.

Chris Wetherbee - *Citigroup - Analyst*

Okay, that's helpful. Thanks for the time, I appreciate it.

Operator

Jason Seidl, Cowen and Company.

Jason Seidl - *Cowen and Company - Analyst*

The first question is going to focus on the intermodal side of things. Obviously we've seen you take some of the prices up on some of your book of business but I think you mentioned it was 17% of your domestic book. Can you talk to us about what percentages more of your domestic that you might be taking up in the near future? Can you just do an across the board tariff increase on some other segments of your business, are there any other larger contracts that are rolling over this year?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

No, we have contracts in place with intermodal and we cannot do an across the board increase. What we will have to do is time those increases when the contracts make available the opportunity to do that. Quite a bit of our business is priced year to year. So as we get through this calendar year that will open up additional opportunities for our partners in the intermodal market to take a pricing as well.

So this is a good start with our rail control containers, our EMP containers taking the 4% westbound on transcon to 3% coming September 1 within local. You will see us take more but it will be incrementally as contracts open up and give us the opportunity to do that.

Jason Seidl - *Cowen and Company - Analyst*

So this seems like more of a 2015 event then?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Yes, in those contracts I would point out that we do have escalators that apply in until we get to the point where we can take a market-based increase.

Jason Seidl - *Cowen and Company - Analyst*

Okay. and a follow up is related to crude by rail. When you're looking at the safety statistics, and I know that part of the focus on this release is going to be on the train speeds, but of the actions that we've seen across the rail networks that have been highly publicized, how many were actually due to excessive train speeds?

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

None to my knowledge.

Jason Seidl - *Cowen and Company - Analyst*

Okay, that's what I thought. Okay, guys, those are my two. I appreciate the time as always.

Operator

Ken Hoexter, Merrill Lynch.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Congrats on pretty solid results and record operating ratio, great to see that it continues. On the -- a thought, Mark, on the capacity here. You're almost running at 2006 peak levels on a carload business, you mentioned how much you're up, or Wick did year over year, so you mentioned your thoughts on your ability to recover velocity with employees and adding the crews on, what about CapEx? Do you need to increase that, is this a physical capacity that you're starting to pump up against, or can you talk about what your thoughts are? And maybe Don, your thoughts on throwing in there on the Crescent and Heartland if you're starting to see the ramp up on the capacity there as well?

Mark Manion - *Norfolk Southern Corporation - COO*

It has been very interesting to see how well we have digested the freight from the additional freight volume from an infrastructure standpoint. And we just have not had bottleneck situations, and like I commented some in the past on these calls, is the more than 10 years worth now of continual infrastructure improvement that it takes place on an ongoing basis and there are a variety of projects that are loaded up in the pipeline and they keep coming out. We've got more that will be completed and more that will be started this half. So we're trying to stay ahead of it and so far we are staying ahead of it.

We've got our modeling and our capability to, based on traffic forecast, to see where the next tight spots will be and that's when we put the infrastructure projects up against them. And that process has been working well. And so we're going to keep doing what we're doing. And we got a major project, I think you're aware of, coming out later this year. It'll be in the fourth quarter when we have our Bellevue expansion that opens up that is going to be very helpful to -- as far as lightening any capacity constraints up in our northern area. So that's the way we're looking at it.

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Ken, I would add, this is Don, I would add too that when you look at the composition of our growth in the quarter for example, out of our 145,000 loads, 95,000 units were intermodal. And we've done a lot of work to densify our double stack operations, get the right box on the right car and that helps us manage capacity much more effectively. We're not adding trains and intermodal to handle the 95,000 additional units that we handled in the quarter. So that de facto is additional capacity.

And with respect to the corridors, the Crescent Corridor I mentioned double-digit growth earlier. Crescent was up 11% in the quarter, Heartland was up 10%, Meridian was up 15. And because of what I just mentioned, we are not running into capacity issues at all in those corridors. As I also mentioned in my remarks, we've made the investments over a multi year period in those corridors with speed enhancements and terminal operations, new terminals. And frankly we're positioned for growth and we're planning for growth.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Great, appreciate the insight. And then secondly on your strong free cash flow, guess two parts to that. One, we saw the dividend increase, why not more engaging on the share buyback given your large authorization? And maybe Marty, your thoughts on that. And then also I think Marta you mentioned you're buying used to locomotives, are there any available out there given everybody's using surge capacity and does that mean maintenance could go up even higher I guess given these are the bottom of the barrel ones that are left in the market if they're not already being on the network?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Well with respect to the locomotive, yes, we -- what I mentioned was is that we'd reallocated within the capital budget some of the funds towards used locomotives this year. And our mechanical folks have inspected those and luckily we have the Juniata shops and they can refresh those. And so we feel that we're in a very good position to be able to acquire those and those are small pockets of locomotives here and there that are purchasing folks can find and our mechanical folks inspect and know that we can repair adequately at Juniata.

We already had, before this reallocation, we already had 75 new locomotives that we're buying this year, 25 have come in and 50 will come in the back half of the year and that's why our -- one of the reasons why our capital spending is backend loaded this year because those 50 will be coming in in the last six months.

So with respect to your free cash flow question, you are correct, we're having very strong free cash flow. We had talked about the increased dividend. We have the strong capital spending this year. We have been forecasting for the next two or three years we're going to have heavy capital spending as we have some freight car purchases that are going to be timed in the next couple of years.

And so we feel that the share repurchase level that we have is appropriate given the free cash flow, given the capital that we feel is needed to reinvest in the system and which has good returns. And really overlaying it all too is that the entire stock market is high and so we have in the past moderated our share repurchases when the stock market is high.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Thanks for the insight, appreciate the time.

Operator

Brandon Oglenski, Barclays.

Brandon Oglenski - *Barclays Capital - Analyst*

Good morning, everyone, and congrats on well -- congrats as well. Wick, can I ask you, we've seen several quarters now of pretty robust margin expansion I think driven by some pretty good cost outcomes. You're getting the growth outside of coal and I realize we still have some questions going forward in your coal markets. But I think the big issue for investors in your stock is, can this Company sustainably grow earnings even with the segment like coal down let's say in 2015 if that were the case. Do you feel like you have the confidence now that you are at a point where it doesn't necessarily matter what one commodity [segment] is doing on your network, you have a robust enough franchise now that you can maintain earnings -momentum and margin expansion as long as the macro economy is cooperating?

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

I think the overall answer to that is certainly yes. We have some work to do as we discussed extensively in terms of continuing to improve productivity and efficiency from the levels we're currently at. We're going to do that. I think that that's going to give us the ability to continue to drive more volume through the network in a very cost-effective manner and give us strong operating margins, operating leverage on that growth.

I think the only caveat, and you mentioned it as well, is that we're going to have growth. We see strength in a lot of our businesses as we've all discussed, and as Don has really worked through the details with you. I think the only question mark about cool is it's still a significant amount of our business and I know Brandon you're aware and everyone on the phone is of how much coal revenue we have lost over the past two to three years. I guess in excess or at least close to $1 billion over a two-year period.

If we see stability in that market, and there's certainly lots of signs particularly in the utility world that we are seeing stability now, I think we're poised to do very well. If something unforeseen comes along in the coal world or in the overall macro economy, then clearly we'll have challenges too. But given the conditions that we're seeing today, we continue to see, have a very positive outlook for our Company in the next -- certainly in the second half and I think in 2015 as well.

Brandon Oglenski - *Barclays Capital - Analyst*

Well I appreciate that, Wick, And Don, as a follow up, beyond intermodal because I know you talked about rate increases this summer, but are we -- because of the constraints that we're seeing across the system, not just at Norfolk, but it seems like some other carriers are at capacity as well on the rails side, are we moving into a higher rate of price inflation for this industry?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Brandon, we always price, try to price to market and we think the truckload market will continue to tighten and that will support pricing with anything that's related to truckload activity. The rest of the business we'll just have to stay tuned and see how the market moves. We're going to stay close to that market and we will price to that and ensure that our yields meet our target of equaling or exceeding rail inflation going forward.

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

Brandon, let me, and to everyone, let me say one other thing. I think that we talk about capacity in the transportation marketplace, but Don, always points out that there's truckload capacity and that's one marketplace. But we have a very different set of dynamics in utility coal where the competition is not with the highway, it's more and more with the gas and different coal sourcing. You look at the energy markets, the competition there has a very different set of factors which aren't necessarily all driven just by what we see in the transportation marketplace. So every marketplace that we're in is different, has different dynamics, and as Don always said, we take that into account and try to price effectively in that particular market place.

Brandon Oglenski - *Barclays Capital - Analyst*

Thank you.

Operator

Walter Spracklin, RBC.

Walter Spracklin - *RBC Capital Markets - Analyst*

Following up on that last question, we've heard some of your competitors up north talking about more about yield management programs and in fact coming up with tight capacity in the rail system, or in fact looking at pruning some of the lower return customers. Is that something that you foresee that perhaps without really rate increases per se but rather reallocating capacity to higher returning customers, is that something that is new to your organization, is it an opportunity that is emerging for Norfolk Southern, is it something that you see playing out in the next year or two?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Good morning, Walter, this is Don. We plan to continue to improve our service product to serve all of our customers. We do not have plans to segment business that would deviate from that overall objective. So I would say that our commitment to our customers is very strong and that's to provide a good reliable service at a fair price.

Walter Spracklin - *RBC Capital Markets - Analyst*

Okay and second question here, Wick you mentioned in your opening remarks that the first or the second quarter saw some volume that perhaps unsustainable for the rest of the year and I think a lot of the questions today were zeroing in on the fact that you typically do better in the third quarter than you do in the second, you had a very good quarter the second quarter. So I guess what I'm trying to understand is, is there -- was there any carryover volume from first quarter to second quarter that really helped you drive some good operating productivity that probably won't carry into third as Mark had indicated with some of the higher account, employee count? Or is there -- is the incremental margin here that you're getting on this volume steady through third quarter mean that the seasonal pattern of you doing better in the third quarter than the second quarter can hold again here again this year?

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

Well first of all in terms of first quarter carryover, we've looked really hard at that question and quite frankly we -- as the second quarter went on, we became more and more convinced that there was very little of that. There is some -- has been some pent-up demand in the automotive network with vehicles stored at assembly plants because of the slowdown of the North American rail network and the car supply problems for the automotive industry. We've had a big push on in the past three or four weeks and Mark and his team have done a great job on our network of bringing those numbers down significantly.

I think the tenure of my remarks begin with is that we certainly didn't forecast an 8% percent year-over-year volume growth. And we saw a lot of strength across a lot of the businesses. We continue to see that strength, I was trying to temper my own enthusiasm and say I'm not sure we're going to see the third quarter up 8% year over year or the fourth quarter. We had a good second half last year, but we do expect to see continuing strength in these businesses.

Walter Spracklin - *RBC Capital Markets - Analyst*

Okay, well it was very much a good quarter, congratulations. Thank you.

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

Thank you so much.

Operator

Justin Long, Stephens.

Justin Long - *Stephens Inc. - Analyst*

Thanks and congrats on the quarter. I wanted to first follow up on an earlier question in intermodal. So intermodal growth has really started to accelerate. I was wondering if you could talk a little bit more about how much runway you still have to add to train links? How long can the high single digit or low double-digit intermodal volume growth continue without adding additional train starts?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Mark you want to -- ?

Mark Manion - *Norfolk Southern Corporation - COO*

Yes, I'll -- let me lead off with a comment about that Don. Our intermodal train length is in the neighborhood of 6,000 feet. And so when we look at the -- when we look at our high density corridors as far as where we handle intermodal, we can handle significantly more than 6,000 feet, 8,000 at a minimum and in a lot of cases we run over 10,000 feet. So there's still a lot of room to grow in that area.

Justin Long - *Stephens Inc. - Analyst*

Okay, great, that's helpful. And as a follow up, I was wondering in coal do you have any major contracts in that business that are coming up for renewal over the next couple of quarters or so?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Justin, I will tell you that we have some opportunities that will be coming over the next three to -- three quarters and we're optimistic that those opportunities will bear fruit, but we're not there yet.

Justin Long - *Stephens Inc. - Analyst*

Okay, great. I'll leave it at that, thanks for the time.

Operator

John Larkin, Stifel.

John Larkin - *Stifel Nicolaus - Analyst*

Mark, I think you mentioned that you were planning on adding roughly 900 new folks throughout the remainder of 2014 to bring the manpower level up to roughly where it was in 2013. Are all those people coming off furlough, do they need complete training, partial training, how long does it take to bring them up to speed and how expensive is that process?

Mark Manion - *Norfolk Southern Corporation - COO*

We have earlier this year, we began bring people out of furlough, we were pretty successful in getting more people than usual to actually make some transfers from location they were furloughed to other locations where they were needed. That process is complete. And going forward, the additional people we bring on are new hires that go through our training program and we will see -- we'll essentially see the first of those people coming out qualified in the fourth quarter.

John Larkin - *Stifel Nicolaus - Analyst*

Okay, thank you. Perhaps another question on the reallocation that occurred in the capital budget maybe from Marta. It sounded as if some money was reallocated towards the purchase of used locomotives that could be remanufactured at Juniata and there were some bottleneck elimination projects perhaps in there as well. What projects did you draw that capital from and what was the thought process behind perhaps paring back the spending in that area?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Well some of those areas were naturally delayed frankly because of the weather in the first quarter. Our engineering forces were busy with the weather and so there was a little bit of when you schedule out their work for the rest of the year a little bit of over -- flopped over into 2015. So some of it occurred naturally, both in engineering and some of it also in the mechanical area. There was some car work that is going to flop over into 2015.

So the total amount that we reallocated was about $40 million. About two-thirds of it to used locomotives and about a third of it to very targeted, very specific locations that came out of that model Mark described about very small pinch points. And so the remainder that is spread throughout the system in different places with sightings and that sort of thing.

John Larkin - *Stifel Nicolaus - Analyst*

Very good. Thank you again.

Operator

(Operator Instructions)

Rob Salmon, Deutsche Bank.

Rob Salmon - *Deutsche Bank - Analyst*

Don, when I'm thinking about the intermodal pricing opportunity you had highlighted the 17%. If I'm thinking about that remaining 83%, I know you said basically over full year the majority of that comes up whether it's a rebid or it's just an escalator embedded in the contract. Can you give us a sense what percentage is going to be repricing in the back half of this year with the new contract as opposed to a escalator?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Rob, I will tell you that the EMP fleet, the rail owned or rail control containers that I referenced with respect to the increases we're taking locally and west bound, that will be most of the increases we're taking in intermodal for the second half. Unless we're taking an increase in an existing contract with an escalator that triggers quarterly or triggers annually within the second quarter.

Rob Salmon - *Deutsche Bank - Analyst*

Okay, all right, that's helpful. And then with regard to the ag outlook, I think your words were either strong or robust in terms of the back half of the year. How should we be thinking about that in terms of the third quarter/fourth quarter because I realize there are puts and takes with your network?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Yes with respect to the third quarter, we'll see the new crop start to come in late August, early September. So it will be into that timeframe before you see it. We still see a lot of volume activity associated with the 2013 crop which were strong as well. So we see opportunities ahead in corn and soybeans predominately with this new crop. There's over 90 million acres of corn planted and over 80 million acres of soybeans planted, and growing conditions are very good because they're getting the proper rainfall. So we expect export activity to be there and some other domestic opportunities as well.

Rob Salmon - *Deutsche Bank - Analyst*

All right and we should think about that rippling through your ethanol franchise as well I would imagine.

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Well the ethanol production, ethanol prices and ethanol demand continues to trend upwards. So we see opportunity ahead for greater activity in ethanol and inbound corn for processing to make the ethanol.

Rob Salmon - *Deutsche Bank - Analyst*

Thanks so much for the time.

Operator

Keith Schoonmaker, Morningstar.

Keith Schoonmaker - *Morningstar - Analyst*

If I'm reading the data correctly it appears you improved RTM per fuel gallon pretty nicely over the prior-year period, almost 5%. As we think about the sustainability of the quarter's low operating ratio and the importance of fuel in the cost structure, maybe you could comment, is this an idiosyncratic period as far as fuel economy or is this just another data point on the overall improvement trend line?

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

I think the way we would look at it and the way we do look at it is that it is just a data point on a trend line, but it's trend line that we expect to continue to get better overtime. We have a lot of technology out there that we're employing to reduce fuel usage. That's ramping up nicely, we still have a ways to go with that, the LEADER technology. But it's employed across more and more of the railroad. And our goal is to drive on an average the fuel usage per ton mile down.

We're always going to see seasonal variations, we certainly saw that in the first quarter particularly with the very cold weather, you have to leave diesel locomotives idling, you run shorter trains and you do a lot of things. But we think it's -- obviously this quarter is a good productivity improvement and we expect overall to see our fuel usage go down in the future as our technology gets better and better.

Keith Schoonmaker - *Morningstar - Analyst*

Thanks, And for second question I'd like to ask a little bit about the intermodal volume increase. I know it's a phenomenon that probably occurred later in the quarter, but could you comment on what portion of the volume increase you believe resulted from customers concern West Coast disruption risk? And related to that, does the summer's intermodal volume trend give any insight into your expectations concerning volume that may result from the completion of the Panama Canal project? Thanks.

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

We have difficulty identifying the portion of the 16% increase in international that was directly attributable to the ILWU contract negotiation. We know it was present, we've been told by customers that they were making some secondary arrangements or contingency plans. So part of our increase of that 16% we know came from that.

But frankly we've also been seeing an ongoing trend of conversion of international shipments in our network from the West Coast ports to East Coast ports of entry with all water services. So we know that's a part of it. Plus, I have to remind you too that the inland port that we opened in partnership with the Port of Charleston had a very good quarter, that's in that higher number. Plus we had a couple of new accounts in that quarter as well. So it's a combination of all of those things.

Keith Schoonmaker - *Morningstar - Analyst*

Okay, any insight in Panama yet or too early?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

The Panama Canal, our view and of course our view is going to be basically predicated by what our customers decide to do, and our customers are the steamship lines and the beneficial cargo owners that are working with the steamship lines. But they're telling us that they don't see at this point in time a pronounced impact when the canal opens most likely now in 2016 because of so much activity that's already beginning to take place through the Suez Canal with larger vessels coming to these coast ports and as the freight originations in Asia continue to shift away from China and go southward toward Malaysia and Vietnam et cetera. So we're being told at this point not to expect a significant shift in the business when the canal opens. We just have to wait and see and of course we're staying close to our customers who will make the ultimate decision of how they want to move their cargos.

Keith Schoonmaker - *Morningstar - Analyst*

Great, thank you for the comments.

Operator

Jeff Kauffman, Buckingham Research.

Jeff Kauffman - *Buckingham Research Group - Analyst*

Congratulations, the quarter looked fantastic. Marta, I want to come back to the question Ken Hoexter asked on cash flow. I heard what you said, you have the debt coming up in September, I think it's about $430 million give or take. I guess the question I have is your cash balances are up almost $1 billion from where they were a year ago, working capital, the whole increase has been cash. Even with the higher level of cap spend in some of the projects coming on and the debt payout you still look to be cash flow neutral. I hear you that the stocks up a lot with the market but is there a better use ultimately or reason to have $1.5 billion, $1.6 billion cash sitting on the books?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Well we don't believe -- we do have that now, you are correct, we don't believe we're going to end the year at that. As you had pointed out, we have that $430 million debt maturity in September and we now currently plan to pay that off. So that's going to be a use of the cash. And also as I explained earlier, we have higher CapEx in the second half of the year, so we do not expect to end the year at this high of a cash level.

Jeff Kauffman - *Buckingham Research Group - Analyst*

Okay, but even with all of that, it still looks like you're going to finish close to $1 billion, $2 billion, $3 billion that is above the normal amount of cash you hold. Is there a 2015 project that you're thinking about?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Well you are correct that that's above what our historical norm where we run cash. 2015 will have the heavy CapEx, we also hope that it's going to have the very strong free cash flow which will support that. And so I think what we're trying to do is just maintain our discipline, keep an eye on the market and be ready to take advantage of any volatility that arises.

Jeff Kauffman - *Buckingham Research Group - Analyst*

Okay, enough said. Thank you very much.

Operator

Don Broughton, Avondale Partners.

Don Broughton - *Avondale Partners - Analyst*

I want to strategically get your outlook on this both you and CSX have certainly seen strong demand at least in your system in the short term you've proven to be much more resilient than they have after reporting a multi-quarter performance of high volumes, lower headcount. I'm hearing a prediction of higher overtime in the second half, but you also had a strong safety performance. So when you're looking at this, do you look as this an opportunity to leverage -- further leverage your assets in infrastructure with existing headcount or just slightly higher? Or do you think there's a greater opportunity in materially growing headcount and using the service disparity to gain real volume, real market share?

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

Well I -- Don, that's an excellent question. The one correction or clarification I'd make is what I think we expect in terms of overtime is just to see overtime rates year over year certainly in the third quarter dollars continue to be higher. But that will I will also point out is in the contrast to in 2012 and 2013 we drove overtime way down compared to prior years. So we think we have the capability and we'll do that again.

I think it goes back to what Don has talked about is that we have done a lot of analysis across our railroad which has really proved to us that maintaining a high network velocity, albeit it may take more resources in some way, it's certainly going to require some more crews as Mark pointed out, ultimately gives us a lower cost structure, total cost structure and a more efficient operation. And in addition it gives customers the service that we want to give them. So when we see our network running at the levels that it is today, we know it's still efficient and you've seen the numbers. And we think that we need to still bring on the resources, drive the velocity up, give the customers that service that's going to give Don and his folks more ability to go out and get more business. It's going to go out -- allow them to go out and charge fair prices in the marketplace for that and it's going to give us a better cost structure.

And Mark reminds me that we said at the beginning of the year that we had a number of productivity improvements underway and that we estimated at the time that, that would take about $100 million out of our cost structure, and we still think we're going to achieve that number this year. So we think we've got a good strategy but it's a service and velocity-based strategy and it's paid off for us in the past and it'll continue to pay off for us.

Jeff Kauffman - *Buckingham Research Group - Analyst*

So your comments about overtime are really more of a reflex back towards what's more normal after making the significant productivity in velocity gains you've posted recently, is what you're trying to say, if I hear you right?

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

Yes, go ahead, Marta.

Marta Stewart - *Norfolk Southern Corporation - CFO*

Well we were -- the overtime that we think we're going to have for the rest of the year is very targeted where we think it's going to occur. So let's split into the two pieces.

On the T&E side, which is about half of it, we think because of the need to train these people as one of the other people asked about those are not going to be qualified until the fourth quarter, many of those new people. And so we don't expect the T&E overtime to decline until the fourth quarter but we do expect it to decline.

On the other side is our shop employee generally speaking and most of that has been incurred on the taking care of the older and now the used locomotives. So on that side, we do -- we are not projecting to significantly ramp up the number of employees because that is more of a shorter term in nature.

Jeff Kauffman - *Buckingham Research Group - Analyst*

That makes much more sense. Thank you.

Marta Stewart - *Norfolk Southern Corporation - CFO*

So that portion of the workforce will be -- will stay most on overtime but the T&E will work itself back to straight time as the people get qualified.

Jeff Kauffman - *Buckingham Research Group - Analyst*

Thank you and I look forward to seeing you next week.

Operator

David Vernon, Bernstein Investment Research.

David Vernon - *Sanford C. Bernstein & Company, Inc. - Analyst*

Marta, to step back from the short term use of cash and think more about the longer term, you mentioned a step up in equipment power replacement. Is that something that you think could push the capital spending above that 18% to 19% of sales that we've seeing the last couple of years?

Marta Stewart - *Norfolk Southern Corporation - CFO*

For that, that 18% in 19% of revenue is an elevated level for us. I think we signaled in the last -- within the last year that we think we're going to stay at that elevated level for at least two more years largely because of the car replacement needs. And longer term -- and of course PTC is in that too -- is elevating that too. So right now, trailing 12 months we're at -- our [2.2] is at 19%. 2% of that is PTC. So when you back that out and get to 17% and when you get past the next two years, we are targeting after that to get back more in the historical range of 16%, 17% of revenue.

David Vernon - *Sanford C. Bernstein & Company, Inc. - Analyst*

And given Wick's comments around PTC maybe extending into 2020, would that 2% continue to linger or this going to be more front end loaded?

Marta Stewart - *Norfolk Southern Corporation - CFO*

That we'll have to see how that plays out.

David Vernon - *Sanford C. Bernstein & Company, Inc. - Analyst*

All right, thanks. And maybe a quick follow up on intermodal Don, you mentioned the escalators than are in the contract, so would you have expected them to maybe deliver it a little bit more on the wholesale contracts from a pricing perspective giving the spike in truck rates? Or could you talk a little bit about how that lag or mechanism should work so that we can try to gauge the opportunity going forward?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

The escalators in our intermodal contracts would be more correlated to the rail cost adjustment factors all inclusive, less fuel which is an independent factor from motor carrier cost. So those escalators are not tied to truckload pricing in general.

David Vernon - *Sanford C. Bernstein & Company, Inc. - Analyst*

So you haven't tied the intermodal pricing to your wholesale or to your retailers to the truck rate?

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

No, we do not in general.

David Vernon - *Sanford C. Bernstein & Company, Inc. - Analyst*

All right. Thanks, that's my follow up, appreciate the time.

Operator

Cleo Zagrean, Macquarie.

Cleo Zagrean - *Macquarie Research Equities - Analyst*

In the opening remarks you mentioned that you're looking to price equal or above rail inflation, can you help us understand how you think about pricing a portfolio, how a managed portfolio on pricing versus margins? Are these areas where you're only able to price in line with inflation benefiting from a more (inaudible) such that margins and returns across the portfolio are even? I would appreciate any insight into that.

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

Cleo, good morning. With respect to our pricing philosophy, again we look at the market segments and we try to maintain a direct correlation with our yield management plan and the various market segments that we're participating in. And that runs the range of additions from truckload capacity to barge capacity, conditions and barges, the availability of barges to a lesser degree than a truckload. And then rail to rail competition.

And then of course we always have an ongoing change in the mix of our business. So when you're looking at revenue per unit of our book, it will be an ongoing change in that book based on things like the longer haul of coal that's taking place today in utility coal. The fact that for example in this quarter we had no liquidated damages on coal so the revenue of coal has no LDs in that. So does that get at the essence of your question?

Cleo Zagrean - *Macquarie Research Equities - Analyst*

Yes, I was trying to make sure that we keep our eyes on the right metric in terms of the bottom line and to not get overly concerned if some mixed issues at the top line could point to a deterioration. Is there any reason of concern for you that in some markets you're only pricing in line with inflation versus staying maybe [other roads] are trying to price consistently above.

Don Seale - *Norfolk Southern Corporation - Chief Marketing Officer*

You're making a very good point and we look at the overall margin and incremental margin of the business, the book, taking into account the price and mix. And we are not -- we don't become concerned with mix changes. They are what they are and we manage through that and that doesn't impact or alter the yield management or pricing plan.

Cleo Zagrean - *Macquarie Research Equities - Analyst*

Thank you. And my follow up is also in regard to a comment you made in the opening remarks that from the experience so far this year, you have learned about new ways to adjust your resources to respond to changes in demand. Can you help us understand whether some of the changes that you are making should help with the long-term progression in margins once we're out of this congestion? Any benefit, sustainable benefit from the changes in the network and investments that you are making spread by this experience that maybe would lift your long-term efficiency goals or bring them sooner? Thank you.

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

We -- obviously anytime we not only experience a high volume growth quarter like this one but certainly the quarter like the first quarter with the network disruptions across the North America rail network that we've seen, we try to go back and see what learnings we can take from them. I think to Mark's point about we have to think again about our train and engine service resources and how we are able to respond to unanticipated growth. We're going to go back and I think learned some lessons from that.

And I think what you will see as a result is that over some period of time we will become more efficient because when we see something like the situation we've had in the second quarter we'll be able to react more effectively to it and hopefully not lose network velocity or see increased over time because we'll have responded with the resources in a more flexible way. But there's a lot of learning to be had out of all of these experiences and we're always looking at what has happened and trying to improve ourselves as a result.

Cleo Zagrean - *Macquarie Research Equities - Analyst*

Thank you very much.

Operator

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

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

Well thank you, everyone, for your patience and your questions. And we look forward to talking to you all again at the end of the third quarter.

Operator

Thank you. This concludes today's teleconference, you may disconnect your lines at this time. We thank you for your participation.
