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NSC - Q2 2015 Norfolk Southern Corp Earnings Call

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OVERVIEW:

Co. reported 2Q15 net income of $433m and diluted EPS of $1.41.

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PRESENTATION

Operator

Greetings. Welcome to the Norfolk Southern Corporation second-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 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 NorfolkSouthern.com in the Investors 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 Investors section.

Now it is my pleasure to introduce Norfork Southern's CEO and President, Jim Squires.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Thank you, Katie. Good morning and welcome to Norfolk Southern's second-quarter 2015 earnings conference call. With me today are our Chief Marketing Officer, Alan Shaw; our Chief Operating Officer, Mark Manion; and our Chief Financial Officer, Marta Stewart.

Now let's go straight to the financial results. Our reported second-quarter earnings were $1.41 per share, 21% lower than last year's record results. The decrease was largely due to lower coal volumes and lower fuel surcharge revenues.

These are challenging conditions, but there is some good news, as our business mix undergoes a significant change. Our intermodal volumes topped last year's second-quarter record levels, and our merchandise items were up for the quarter as well despite pressure in the steel market.

Moreover, revenue per unit excluding fuel surcharges was positive for merchandise as well as for intermodal, which was even more positive than the first quarter. Alan will provide more detail on our revenue for the second quarter and outlook for the remainder of 2015.

I'm proud to report that our service improved significantly during the second quarter. Our composite service metric, an internal measure we used to assess network performance, is approaching 80%. And this quarter we will continue progress toward the higher service levels achieved in 2012 and 2013.

We remain firmly committed to continued service improvement; and Mark will share the latest on our service and operations outlook. Marta will wrap up the presentations with a full review of our financial results.

Before getting into the specifics, let me emphasize that we are confident in our long-term strategy and our prospects for growth and strong financials. We have a solid franchise and the right team in place to execute our strategy to be a top performer in the industry.

On that note I will turn the program over to Alan, Mark, and Marta and will return with some closing comments before taking your questions. Alan?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Thank you, Jim, and good morning to everyone. I'll begin by providing context to our long-term focus from a sales and marketing perspective, and then I'll review our second-quarter performance and our outlook for the balance of the year and beyond.

With our diverse portfolio, we are well positioned to capitalize on the broad structural changes in the US economy. Our extensive intermodal network and strategic corridor investments have enhanced our position in truck competitive markets, where demographics and regulatory action will constrain truck capacity, highway congestion will increase, and the economics will continue the momentum of highway conversions to rail.

Within the energy arena, we benefit from the movement of crude oil to the East Coast refinery complex as well as increased natural gas drilling within the Marcellus-Utica region, driving inputs of sand and pipe and outputs of natural gas liquids. While reduced commodity prices have tempered 2015 growth, this will continue as a significant market for us.

Similarly, our coal franchise, which has been impacted by lower market prices this year, will remain an important part of our business.

In manufacturing, the United States has substantially improved its cost competitiveness in terms of wages, productivity, and energy costs. While foreign-exchange is impacting some production, the overall picture for US manufacturing is still one of expansion, and NS is well positioned to benefit, as our service region covers 65% of the manufacturing in the United States.

In housing, recent data is supportive of the view that home sales and new home construction will be growth areas, with expectations for housing starts to be up more than 10% this year and continued growth projected for 2016 and beyond. Our team will focus -- excuse me; our team will pursue strategic and innovative solutions in partnership with our customers, allowing NS to capitalize on these market opportunities and generate revenue growth.

Improved service will provide increased capacity on our network and enhance the value of our product, aiding our efforts to convert additional highway freight to rail and achieve market-based pricing gains that we expect to exceed the cost of rail inflation. Additionally, we will endeavor to reduce volatility from fuel surcharge structures.

As previously discussed, we have near-term headwinds (technical difficulty) notably from declining coal and fuel surcharge revenues. However, we will lap these comps which, coupled with the strength in the markets just referenced, affords us great opportunity for future growth.

Now let's turn to our second-quarter performance. Marta will provide complete quarterly financial results later on the call, but I would like to discuss operating revenue, as you can see on slide 3.

Overall you will note the negative impact of the declining fuel and coal revenue. However, the positive aspect is that volume and revenue per unit excluding fuel increased for both merchandise and intermodal.

On slide 4 you will note that, facing very strong comparisons with second-quarter 2014, overall volume declined 2%, with growth in intermodal and merchandise driven by increased consumer spending, energy outputs, stronger housing starts, and automotive production. These gains were more than offset by a 21% decline in coal.

As expected, coal faced a particularly tough comparison against prior-year volume, which I will talk about more on the next slide. Coal revenue declined 33% to $453 million for the quarter, with revenue per unit down 14%. Low natural gas prices depressed eastern coal burn by 15% in the first two months of the second quarter, which reduced utility coal volume by 23%. A strong dollar and global oversupply led to a 38% decline in export coal volumes.

As shown on slide 6, coal market conditions will continue to challenge our coal volumes for the remainder of 2015. Natural gas price projections below $3 per million BTU have impacted and coal burn, and current stockpile levels will present headwinds for utility deliveries. We continue with our guidance of a run rate of roughly 20 million tons per quarter.

Export coals are challenged due to foreign exchange rates and global oversupply, and we believe our run rate will fall to an estimated 3 million tons per quarter.

Moving to our intermodal markets, pricing gains continued to create improvement in revenue per unit excluding fuel. (technical difficulty) were effectively flat against last year's strong comps due to West Coast port issues impacting transcontinental freight, coupled with temporary headwinds associated with rail service performance and increased truck capacity.

Our international units grew 8% in the quarter, benefiting from West Coast port issues as some vessel traffic shifted to the East Coast, a conversion we expect to continue. While current truck capacity and lower fuel prices have limited near-term growth in the market, contract rates in the truck market continue to climb. This environment, particularly as our service product continues to improve, bodes well for intermodal pricing moving forward.

Moving on to merchandise on slide 8, volume grew 1% in the second quarter. Excluding fuel, revenue per unit also increased as solid pricing partially offset the negative effect of fuel surcharges.

Metals and construction volume was down 6% for the quarter driven by global oversupply in the steel market and the impact of low natural gas prices on drilling inputs. Aggregates were up due to construction growth in the southeast.

Our agriculture volume decreased 1% primarily due to reduced volumes of fertilizers and wheat, while ethanol volumes grew from greater gasoline consumption. A 13% gain in chemicals volume was due to crude by rail as well as year-over-year growth of natural gas liquids from Marcellus-Utica shale plays.

Automotive volume was up 2% with stronger vehicle production. Finally, paper and forest products volume was up 2%, resulting from a rise in consumer spending and the housing recovery.

Let me close today with an overview of our expectations. In the near term, foreign exchange rates and low commodity prices will negatively impact coal, crude oil, and steel volumes. Combined with the overhang of fuel surcharges and despite an expected continued improvement in core pricing, we expect third- and fourth-quarter revenues will trail last year.

Even with these shorter-term challenges, our diverse franchise presents rich opportunities for volume and revenue growth in key markets through the balance of 2015 and beyond. We expect growth within our intermodal markets, and our international volumes will benefit from organic growth at East Coast ports. Longer term, truck capacity constraints coupled with increasing demand and economics, will drive highway conversions.

The energy markets, we anticipate more corn and ethanol shipments due to rising levels of gasoline consumption as well as project-related growth. And our natural gas liquids market will see continued strength from fractionators in the Marcellus-Utica region.

With North American light vehicle production projected to be up 3% year-over-year, we expect continued growth in automotive volumes. Lumber, plastics, basic chemicals, aggregates, and consumer goods will all benefit from increased housing starts and construction activity.

As we cycle the near-term challenges from declining coal and fuel surcharge revenues, we are well positioned for and excited about our prospects moving forward. Thank you for your attention, and I will now turn the presentation over to Mark for an update on operations.

Mark Manion - *Norfolk Southern Corporation - EVP, COO*

Thank you, Alan, and good morning, everyone. I'd like to update you this morning on the state of our railroad, which has shown nice improvement; but first I'll update you on safety.

We continue to strengthen our safety process through the engagement of our people and the ownership they take for safety. The safety of our employees, our customers' freight, and the communities we serve have been and will continue to be at the core of everything we do.

Our reportable injury ratio for the second quarter was 0.96 and stands at 1.04 for the first half of the year. This is down compared to the first half of last year, which was 1.23. As you see, our train accident rate is up slightly year-over-year, while our crossing accident rate was down slightly.

Now let's take a look at our service. We told you on the last call that we'd turn the corner with our service and we expected the service composite performance to be near 80% by the end of the quarter. For the month of June we operated in the [mid-70%s] and actually achieved a composite performance of 79% on June 30 (company corrected after the call).

Looking at the graph on the right, you can see the improved performance from first quarter to second quarter, and again from second quarter to third quarter. Clearly we're trending in the right direction, and our customer service is reflecting that. Nevertheless, we're not satisfied with where we are, and our team is working hard to further increase our composite performance and reach a higher velocity.

Train speed and terminal dwell are improving as well. Our speed of 22.5 miles an hour for the week ending July 10 was our highest speed in over a year. Our weekly dwell numbers have been below 25 hours for seven consecutive weeks, which has not happened since July 2014.

Our resources have come online as expected, and we are consequently seeing our metrics improve in a predictable pattern. As the momentum continues through the second half of the year, our focus will be on further improving our service levels and maintaining the right resource balance.

Turning to the next slide with regard to crews, we've come a long way to ramping up areas where we were short. On the slide you can see a net increase in conductors in the first and second quarters, where we were replenishing locations where we were shorthanded.

We are continuing to fill in shortage areas in the third quarter, but new hiring is tapering back to a normalized level. Hiring going forward will be in line with attrition.

On the locomotive side, we've almost completed the receipt of the SD90MACs. In addition, improvement in system velocity has been another driver in our higher locomotive availability. This is allowing us to store some of our locomotives, which will lead to a surge fleet and better reliability for the locomotives left operating.

In closing, we're very encouraged that our resources are coming in balance with our business volume, and our operating metrics are trending favorably. We're tightening our belt as we move through the second half. Increased velocity will help us make more efficient use of manpower as well as locomotives and our car fleet.

We look forward to continued improvement in our customer service through the rest of the year. Thank you, and now I'll turn it over to you, Marta.

Marta Stewart - *Norfolk Southern Corporation - EVP Finance, CFO*

Thank you, Mark, and good morning. Let's take a look at our second-quarter financials.

Slide 2 presents our operating results, where we faced strong headwinds compared with the record-setting second quarter of 2014. As Alan discuss, the effects of sustained lower fuel surcharges and continuing challenges in the coal markets drove operating revenues down $329 million or 11%. Nearly three-quarters of the revenue decline was due to lower fuel revenue, which totaled $119 million for the second quarter and, based on current oil price forecasts, is expected to be a similar amount for both the third and the fourth quarters.

Operating expenses declined by $124 million, which only partially offset the lower revenues, resulting in a 20% reduction in income from railway operations and a 70% operating ratio.

The next slide shows the major components of the $124 million or 6% net decrease in expenses. Total operating costs benefited from lower fuel prices and favorability in materials and other category. Now let's take a look at each of these variances.

As shown on slide 4, fuel expense decreased by $153 million or 38%. A lower average price accounted for most of the decline. Reduced consumption added another $5 million of favorability as gallons used were down 1.5% on the 2% decline in overall volumes.

Materials and other costs, shown on the next slide, decreased by $13 million or 5%. Lower environmental expenses and favorable personal injury experience totaled $20 million for the quarter.

Additionally, material usage, primarily for locomotives, declined by $7 million. Partially offsetting these decreases were increased travel and relocation expense.

Going forward, we expect continued favorability related to locomotive materials in the third quarter. However, it will be fully offset by the impact of the costs associated with the closure of the Roanoke, Virginia, offices. We incurred approximately $5 million in the second quarter related to Roanoke relocation, and we expect to incur an additional $30 million over the remainder of the year, with the majority of these costs affecting the third quarter.

Moving on to purchased services and rent expense, our costs increased by $24 million or 6%. Higher volume-related and service recovery costs, primarily associated with intermodal operations, equipment rent, and joint facilities, combined to account for $20 million of the increase, of which we estimate about $5 million was related to the service recovery effort. Expenses associated with software costs were also higher in the quarter.

Slide 7 details the $9 million or 1% increase in compensation costs. Although a relatively small net variance, it was comprised of a number of significant items, as listed on the slide.

The first two -- increased pay rates and higher payroll taxes -- were, as we previously discussed, front-end loaded this year. The pay rate increase totaled $27 million, but will begin to moderate in the second half of the year to around $17 million per quarter. The payroll tax increase was $13 million and should moderate to about $8 million per quarter.

The next two items were largely service recovery related. An increased number of trainees accounted for $10 million of additional wages. As Mark mentioned we have turned the corner on our hiring efforts, and trainee expenses should begin to decrease in the second half of the year.

Additionally, we incurred $6 million in higher labor hours as crew starts were up, notwithstanding the drop in volume. Partially offsetting these costs were lower incentive and stock-based accruals, down $47 million and driven by the decline in financial results.

Next is depreciation expense, which increased by $9 million or 4%, reflective of our larger capital base. With regard to capital spending for the remainder of the year and given the lower than expected volumes, we have trimmed back our 2015 capital budget by $130 million or about 5%. Two-thirds of the reductions are related to work on our line of road, and one-third is related to equipment.

Slide 9 presents our income tax for the quarter, which had an effective rate of 38.1% compared to 37.4% in 2014. The slight increase in the effective rate is principally related to lower returns on corporate-owned life insurance. Assuming normalized returns on these assets in the second half of the year, we expect the full-year rate to be about 37.5%.

Slide 10 shows our bottom-line results, with net income of $433 million, down 23% compared with 2014, and diluted earnings per share of $1.41, down 21% versus last year.

Wrapping up our financial overview on slide 11, cash from operations for the first six months was $1.5 billion, covering capital spending and producing $587 million in free cash flow. With respect to stockholder returns, we repurchased $765 million of our shares year-to-date and paid $360 million in dividends.

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

Jim Squires - *Norfolk Southern Corporation - President, CEO*

As you've heard this morning, we expect continued pressure in the short term, particularly in the third quarter and to some extent in the fourth, from lower coal volumes and lower fuel surcharge revenues. On the positive side we expect service will continue to improve, and better service will help us grow.

As we pursue growth in a changing mix environment, we're working to improve our train performance by further enhancing and innovating our supply chain integration with customers and employees and by leveraging technology. And we're committed to coordinating service capacity and capital investment along with pricing and volume growth to maximize returns for our shareholders.

In addition, we will continue to capitalize on market opportunities that enhance our network capacity and efficiency, as with our pending acquisition of rail lines from the Delaware & Hudson Railway Company. As we do so, we are committed to reinvesting in our franchise and returning cash to our shareholders.

In sum, we have strong prospects for future growth. Intermodal and merchandise growth, increased consumer spending, rebounding housing markets, and improved manufacturing activity all support an optimistic longer-term outlook.

While we do face challenges in the short term in 2015, we have a strong legacy of success and we are confident we're taking the right steps to continue creating value for our customers, the communities we serve, our employees, and of course our shareholders.

Thank you for your attention. I'll turn it back to the moderator so we can take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Allison Landry, Credit Suisse.

Allison Landry - *Credit Suisse - Analyst*

Good morning. In terms of the service performance, when do you expect to have the network back in balance? And could you quantify for us the impact of the inefficiencies in the second quarter?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Good morning; it's Jim. Let me take a first stab at that.

We've made significant improvements in service in the second quarter. Velocity and terminal dwell are both trending favorably, and we're making a lot of headway on our internal composite service metric as well.

So we continue to expect that trend to continue in the second half as well, in the third and through the fourth quarter. And that will continue to be our goal, to push service ever higher. Mark, would you like to comment next?

Mark Manion - *Norfolk Southern Corporation - EVP, COO*

Only to say we've made a lot of progress. I mean, if you think about it, what we've accomplished so far, we're about 90% of the way toward what has been our historical high in the past, and we have every intention of getting all the way there.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Marta, why don't you comment on the resource implications in the second half?

Marta Stewart - *Norfolk Southern Corporation - EVP Finance, CFO*

Yes. We had estimated that our service-related costs in the second quarter would be $25 million, and it turns out that that estimate was pretty much dead on. We estimate that most of that is in compensation and benefits: $15 million of the $25 million is there.

I talked about the two major things in that $15 million, and that is the higher than usual level of trainees, which we expect some of that to continue into the third quarter, and the other one is additional labor hours. The remaining $10 million of service recovery costs are scattered in various categories, in about $3 million to $4 million increments.

We have a little bit more fuel than we would have had otherwise. Our equipment rents were impacted by about $3 million due to the velocity, and then purchased services and truck costs. So those are all the components of the $25 million.

Going forward, Allison, we think that we will just have about $5 million of that hanging over into the third quarter. And that is primarily, as Mark described, as we work our trainees into our regular qualified fleet; we still have a slightly elevated level of trainees.

Allison Landry - *Credit Suisse - Analyst*

Okay, great. Thank you. And just my follow-up question: what was the split between export met and thermal coal during the second quarter? And do you have any sense of what you're thinking for this in the second half?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Hey, Allison; this is Alan. The split was about three-quarters met and one-quarter steam thermal coal. Going forward, we've got it down to about 3 million tons per quarter, and it's going to be a function of foreign exchange rates and the two indices that we watch closely, which are the Queensland coking coal for met, and then the API 2 for thermal.

Allison Landry - *Credit Suisse - Analyst*

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

Operator

Bill Greene, Morgan Stanley.

Alex Vecchio - *Morgan Stanley - Analyst*

Good morning. It's Alex Vecchio in for Bill. So you mentioned that you expect the domestic utility coal to run about 20 million per quarter and you lowered the export coal run rate to about 3. You also talked a little bit about some other commodities.

But when we take it all together can you give us a sense of what's embedded in your expectations for total volumes on a year-over-year basis in the back half of 2015? Do you think 4Q volumes might be positive on an easier comp, or should we be expecting volume declines to persist for the balance of the year?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

We see some fundamental growth in many of our markets which we expect to continue into the second half of the year. The overhang we're going to see is the fuel surcharge revenue that Marta referenced, which is going to mask the core pricing gains and the volume growth that we're seeing in other markets.

Alex Vecchio - *Morgan Stanley - Analyst*

Okay. Do you have a sense for like how the total carloads might track, though, in the back half?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

We expect that it will be up over last year.

Alex Vecchio - *Morgan Stanley - Analyst*

Okay; that's helpful. Then just specifically on the lowered expectations, for 4Q revenues to be actually down year-over-year instead of I think slightly up was your prior expectation, is that entirely attributable to either the export coal and fuel surcharge? Or are there other areas that contributed to that slightly lower outlook on the fourth quarter?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Good question. The other primary driver of that would be reduced crude oil volumes. You can see that very easily as you take a look at Brent and the WTI pricing.

Alex Vecchio - *Morgan Stanley - Analyst*

Okay, great. Thanks very much for the time.

Operator

Scott Group, Wolfe Research.

Scott Group - *Wolfe Research - Analyst*

Hey, thanks; morning. So, Marta, you guys have been giving a little bit more transparency, which has been helpful. Wondering if you have a comfort telling us that second quarter is the bottom for earnings and we should see sequential earnings improvement from second quarter to third quarter. Or if maybe from a margin standpoint we see less of a margin headwind from -- in third-quarter than we did in second quarter, if you feel comfortable there.

And then maybe specifically on the $47 million of lower incentive and stock-based comp, if you have any rough guidance on that for the third and fourth quarter.

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Marta Stewart - *Norfolk Southern Corporation - EVP Finance, CFO*

Okay, well, let me start with the second question first. The stock-based comp did have a very large decrease in the second quarter of this year, and that's primarily because of the comp with the second quarter of last year.

As you know, that was an all-time high quarter for us, and so the accruals that quarter were very high; therefore the relative comparison. Going forward into the third and fourth quarters, we think we still will have favorable comparisons in that line item, but they won't be to the degree they were in the second quarter.

And then moving on to the rest of the year overall, I think it's really driven by the things Alan discussed with coal and crude. But we expect that some of the comps will get a little bit easier otherwise; and so we do expect somewhat of an improvement going into the back half.

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes. Volume comps will improve as we get deeper into the second half of the year.

Scott Group - *Wolfe Research - Analyst*

Okay, that's helpful. Then maybe one last one for Jim or Alan, just big picture as I think back the past five years or so. You guys have seen some of the better volume growth in the industry, but yield growth has lagged the other rails. Do you see that changing or the focus changing, where you start to get more pricing and maybe sacrifice a little bit of volume going forward?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Scott, it's Jim. I think you put your finger on the issue in the second quarter in particular and for the balance of the year, albeit the next couple of quarters ought to be less worse. So, yes, we certainly are going to lean into revenue per unit growth.

The encouraging thing about even the second quarter was, outside of goal, growth in revenue ex- fuel surcharge impacts, and we would expect that to continue for the balance of the year. So we're seeing that positive trend in overall mix, and we're going to continue to push on that along with core pricing.

We're satisfied with the level of core price increases that we have experienced so far this year. And we're going to continue to push that, based on market conditions, at a rate better than rail cost inflation.

Scott Group - *Wolfe Research - Analyst*

Okay. Thank you, guys.

Operator

John Barnes, RBC Capital Markets.

John Barnes - *RBC Capital Markets - Analyst*

Hey, good morning. Thank you for taking my question. A couple of things on the service side, going back there for just a second. You talked about crew starts still being up in the quarter, despite carloads being down on a year-over-year basis.

Are you getting towards a better ratio of crew starts to carloads? And is that where you start to see that improvement from, say, that $25 million drag to the $5 million drag on the efficiency cost?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Mark, why don't you take that one?

Mark Manion - *Norfolk Southern Corporation - EVP, COO*

Okay; I'd be glad to. We are seeing improvement, particularly as we got into the latter part of May and June. And we think that we'll continue to see improvement as the velocity of the railroad picks up; it obviously helps the crew starts.

We've really been a big way reduced our re-crews these last couple of months. So we feel that trend will continue.

John Barnes - *RBC Capital Markets - Analyst*

All right, very well. Then lastly, as my follow-up, the other rails have all as part of their earnings announcements, have been pretty vocal about furloughs and locomotives in storage. You didn't provide really near the degree of color around that.

Is it that you haven't really started the furlough plan yet? Is it that you're still winding through in dealing with the service, so you haven't yet started that?

Or -- and the same thing on locos. It sounds like you put some in storage, but can you give us a feel for maybe the numbers in storage and where you stand on just resources in the pipeline?

Mark Manion - *Norfolk Southern Corporation - EVP, COO*

Yes, sure. Be glad to. First of all, on the locomotive side, we have begun storing; we're at about 50 locomotives in storage right now. And we're going to be able to continue storing.

I would like to see us get up into the 200 range. Not sure just how quickly we can do that, but that's the plan and, again, as the velocity improves it will help us do that.

On the crew side, we haven't furloughed because we haven't had the need to furlough. We're trying to be really measured and balanced as far as the hiring goes.

We're getting, as I indicated remarks -- we are reaching that point where we are about at a balance and we are tapering off on the hiring now. But we will probably see -- we're beginning to see indications in just a very few select spots where there would be a possibility of furlough going forward. But I don't think it's going to be a big number.

If you look back through history our number on the furlough side just hasn't been quite as high as what some of the other railroads experience. So we'll see how it goes, but I don't think we're going to have a big furlough number. We're trying to hire the right number of people.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

I would characterize our resource plan in the second half as one of stabilization. You heard Mark say earlier that we're trending towards attrition-based hiring in the second half.

Similarly, we're starting to put locomotives up. We had a few more units coming online, but very few.

So -- and we can pivot on resources if we have to. If we see the trend in carloadings moving against us, then we can obviously pivot quickly in resources, and we demonstrated that in the second quarter by reducing our capital spending for the year, as Marta mentioned now.

And we're doing so without hurting the long-term prospects of the enterprise or really disrupting our reinvestment plan. But we certainly can modulate resources, and we will if necessary.

Operator

Chris Wetherbee, Citigroup.

Chris Wetherbee - *Citigroup - Analyst*

Hey, thanks. Good morning, guys. Can you maybe comment a little bit more about pricing? You highlighted that sequentially; I think we saw a bit of a step up in the pricing dynamic.

I just wanted to get a rough sense of maybe how big -- what the magnitude of that was and maybe how you think about the opportunity. How much more do we have as we go through this year? Does it still feel like the underlying businesses where you are getting growth are still relatively ripe for that?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Thanks, Chris; we'll let Alan address that.

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Certainly. Chris, we are seeing market-based pricing that is generally above rail inflation. And the good point for us is that we're seeing it in our growth markets: we're seeing it in intermodal where our RPU was up, ex-fuel was up 3% in the second quarter and we expect that kind of growth to continue.

There is a latent demand for rail capacity out there. And the prices that we're putting out into the market are holding, and we expect that to continue.

Chris Wetherbee - *Citigroup - Analyst*

Okay; that's helpful. Then when you think about the buyback in the second half of the year, you've stepped forward I think of the first half so far and bought back a decent amount of shares. I guess when you think about the second-half outlook, should we expect more of the same? Just want to get a rough sense, at these levels, how you see that opportunity playing out.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Marta, why don't you take that one?

Marta Stewart - *Norfolk Southern Corporation - EVP Finance, CFO*

We had previously guided to a full-year share buyback of 1.2 billion, and we're still on track for that.

Chris Wetherbee - *Citigroup - Analyst*

Okay. So that's the way we should think about the back half?

Marta Stewart - *Norfolk Southern Corporation - EVP Finance, CFO*

That's correct.

Chris Wetherbee - *Citigroup - Analyst*

Okay. Thanks for the time; I appreciate it.

Operator

Jason Seidl, Cowen and Company.

Jason Seidl - *Cowen and Company - Analyst*

Thank you very much and good morning, everyone. I wanted to touch on intermodal a little bit. You referred to it obviously as one of your growth markets; and obviously it's done well over the last couple years.

Wanted to ask: have you guys lost a little share back to the trucking market? We've seen some of the major truckload carriers add a little capacity out here, and the East is a little bit more competitive.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

We'll let Alan address the specifics of the volume trend in the second quarter, but let me just say intermodal will continue to be one of our growth opportunities -- truckload diversions in general, both intermodally and our merchandise sectors as well. The really encouraging thing about the intermodal revenue trend now is the increasing revenue per unit, as Alan mentioned earlier. Alan?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes, number one, we're facing pretty difficult comps. Our intermodal franchise grew 11% in the second quarter of last year, so we posted growth on top of that.

Truck capacity, as you noted, has improved; but it still trails demand, and you can see that empirically in the fact that truckload pricing continues to move up. Which gives us not only a good outlook for what our volumes are going to look like long term but also what our pricing is going to look like.

We are seeing really strong growth in our international segment where our customers are shifting more volume to our East Coast port partners. So that's a bonus for us, and long-term we feel really good about our intermodal market with respect to growth opportunities in both volume and in pricing.

Jason Seidl - *Cowen and Company - Analyst*

And that stuff that shifted to the East Coast, how sticky do you think that business is going to be for Norfolk?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Some of it is. Certainly, there will be some that moves back to the West Coast, which is only natural. But the percentage of volume movement to the East Coast ports, while it was a very low 30%s will probably move up to 33%, 34%. So there is growth opportunity for our East Coast ports.

Jason Seidl - *Cowen and Company - Analyst*

Perfect. A little follow-up here for Marta. Marta, I think you alluded to the fact that your relocation cost for Roanoke was $5 million in the quarter; and I think you said you expect $30 million for the remainder of the year, most in 3Q.

If you exclude those relocation costs in 3Q, how should we look at your margins on a sequential basis for the railroad?

Marta Stewart - *Norfolk Southern Corporation - EVP Finance, CFO*

I think the -- and Mark can speak more to, has spoken more to how the system, we expect the fluidity to improve. So I think the main thing that you will see is that those service recovery costs that we quantified at $25 million in the second quarter, we only expect $5 million of those as we work through our higher levels of trainees to remain in the third quarter.

So you should expect the others to fall off: the extra overtime, the extra re-crews that he spoke about, that sort of thing. Those we do not expect to continue in the second half.

Jason Seidl - *Cowen and Company - Analyst*

Okay. So sequentially, if we exclude the Roanoke costs, it should look okay compared to 2Q then?

Marta Stewart - *Norfolk Southern Corporation - EVP Finance, CFO*

Yes.

Jason Seidl - *Cowen and Company - Analyst*

Fantastic. Thank you for your time as always.

Operator

Bascome Majors, Susquehanna.

Bascome Majors - *Susquehanna Financial Group - Analyst*

Yes, good morning. I wanted to focus a little more on seasonality, now that you've reported a full quarter with the fuel surcharge headwind presumably as steep as it can get, with the WTI-based programs, with the $64 trigger now at zero. The volume trend on a year-over-year basis seems to be stabilizing. The service levels are improving, as you talked about earlier.

So looking forward, the second half is consistently seasonally stronger than the first half for you guys. But the Street consensus is modeling a second-half versus first-half earnings increase at a pretty steep level; it looks like the steepest since 2009.

So just from a high level, do you think -- are you looking for an above-seasonal outcome in the second half here?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Well, Bascome, as we said earlier we do expect second-half results to be less worse than we experienced in the first half. However, we still do face some significant headwinds, particularly in the third quarter.

Fuel surcharge revenue in the third quarter of last year was still running strong, just below second-quarter fuel surcharge levels in 2014 -- pardon me, just above. So actually it's a little bit tougher headwind in the third quarter.

In addition, we do have the extra Roanoke-related expenses we've flagged. In other areas of expenses we would expect a more favorable trend. Alan, would you like to comment?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes, I think that we are going to see -- we'll have better comps in the fourth quarter with respect to volume than we will in the third quarter. We're still right now exposed to foreign exchange risk and the prices -- many of the commodities that we handle, and we see that with coal, crude, oil, and steel right now.

Bascome Majors - *Susquehanna Financial Group - Analyst*

All right. Thanks for the color, guys.

Operator

Rob Salmon, Deutsche Bank.

Rob Salmon - *Deutsche Bank - Analyst*

Hey, thanks. If I could turn the discussion a little bit back to the intermodal side of the business, particularly the domestic side, how much do you think that, in terms of the volume growth deceleration, was a result of some of the pricing initiatives; service not being quite where you guys wanted, although it's continuing to get better; as well as just some softer broad-based demand that we saw last quarter?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Alan, why don't you comment on that?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes, as we take a look at our second-quarter domestic intermodal business, I think the headwinds and the factors that limited our growth are temporary. Number one is the West Coast port issue. As you were probably aware, much of or a high percentage of the volume that comes in the West Coast in 40-foot containers gets re-stuffed into 53-foot boxes and moves transcon, anywhere between 25% and 40%.

That would show up normally in our domestic volumes, but did not this quarter. So that was a limiting factor, particularly early in the quarter.

And then while we didn't lose business to truck due to service, it limited our ability to grow. And we're working hard, we're improving our service, and we think that will be behind us.

Rob Salmon - *Deutsche Bank - Analyst*

Do you think that some of the pricing initiatives that you guys undertook, did that have an impact one way or the other in terms of the domestic volumes?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

No. We see that truckload pricing is actually up this year. Our customers are increasing their pricing. So this is an overall healthy environment for pricing in the truck market right now. It's just not growing as much as it did this time last year.

Rob Salmon - *Deutsche Bank - Analyst*

Would you expect pricing as we look out to next year to be in line with what you're experiencing this year? Or do you expect that to potentially improve, given the better service proposition? Or are you a little bit cautious about some of the more balanced supply/demand in the truckload marketplace?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes, I'll address that long-term. We feel that the fundamentals are there long-term for increased demand for highway to rail conversions. We are taking a long-term view of this, as are our customers when we sit down and we figure out our relationship going forward and the need to assure rail capacity and pricing.

Rob Salmon - *Deutsche Bank - Analyst*

Thanks so much for the time.

Operator

Matt Troy, Nomura Securities.

Matt Troy - *Nomura Securities - Analyst*

Thanks. Good morning, everyone. Just wanted to ask a question about intermodal and specifically the peak season. We've heard mixed messages across the freight ecosystem about an inventory build in retail. We've certainly heard that from retail as substantially impacting volumes in June. Some folks expressing optimism, if you will, about a peak season perhaps being a little bit later; but it's just that, optimism.

I was just wondering, based on the hard and real conversations you're having with your customers, what's your sense for the traditional peak? I know it's flattened in the last several years.

But is it something that we should expect to see emerge in third quarter? Is the initial read that it will be somewhat disappointing? I just wanted to get a sense of what your planning was given the resources on the network and your conversations with customers.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Thanks and good morning, Matt. Alan, what's your sense of peak?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Well, as Matt had noted, it's relatively flattened out and it's spread over the entire year over the last couple years. Generally peak for us has been associated with international volumes. It largely shows up in August and September.

And as we've noted, our international volumes are really healthy right now. We've got a good franchise. Customers are shifting more international volume to the East Coast ports, so there's opportunity for growth for us in August and September in our international franchise.

Matt Troy - *Nomura Securities - Analyst*

Okay. That international share gain, obviously contributing to that, I'm wondering if you could help us from a mix perspective. Is that comparable in terms of length of haul versus when you were getting handoff traffic from the West Coast carriers? Is it mix negative in that it might be a little bit shorter? Or is it moving further inland and actually into West Coast markets?

Just wondering about that share gain and just what it meant from a mix implication on that new port volume that had been diverted.

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes, I wouldn't say it's negative. It does allow us to generate more revenue density on a train. And to the extent that we can provide more efficient service associated with that, then it certainly makes it more truck competitive.

Matt Troy - *Nomura Securities - Analyst*

Okay, got it. Thank you, everybody.

Operator

Ken Hoexter, Bank of America.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Great. Good morning. Alan, just a little bit on coal again. Just you've seen accelerating downtick on your volumes overall -- the total volumes almost 4% quarter to date.

Is there anything dragging coal down further, given you're down about 20% quarter to date? I get the 3 million ton outlook on international and that accelerates to a down, I don't know, 40%, 45% year on year.

But are we seeing something on the domestic side? Maybe you could address on the utility side a little bit.

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Ken, I think we're still going to hold firm with our projection of 20 million tons for domestic. That will be -- and that's over the next 18 to 24 months. It's going to be subject to weather conditions and just general demand. But no, we really haven't seen anything right now in the domestic that is any more alarming than what we've already guided to.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

But you are seeing an accelerating down, right? We are seeing an acceleration on the downside?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

For the first couple weeks of this quarter our domestic volumes are down versus last year. But we still feel good about 20 million tons for the quarter.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Okay. Then on the domestic side, I just want to revisit the individual lanes. Can you talk about growth on the Crescent versus the Heartland and where you are seeing that? Are you seeing growth differentials between the different lanes?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

We are seeing -- our primary growth drivers right now are on Crescent and on Heartland.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Can you provide us the updates like you used to on percentages, or do you no longer provide that level of detail?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

We've seen Crescent and Heartland Corridor volumes along with other targeted corridor volumes rise in line with the trends that we have seen the last couple of quarters, if I recall. So for example, Crescent was up 6% in the quarter, better than the overall domestic intermodal trend. Heartland was up 2%.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Okay. Just if can follow up on the first one, Alan, just to let it go at this, but if we are at 20 million tons on domestic, I just want to understand: is that utility and steel and industrial? Or are you talking 20 million utility alone?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Ken, That would be 20 million utility alone.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Okay. Then just if you get the 3 million tons and 20 million utility -- okay. Just there's quite a large differential between where you are trending now. So you're looking for a pretty big snap up in the last two months of the quarter, I guess, then.

THOMSON REUTERS

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Okay, all right. Thanks for the time.

Operator

Justin Long, Stephens.

Brian Colley - *Stephens Inc. - Analyst*

Morning. This is actually Brian Colley on the call for Justin. So just wanted to talk about the negative mix impact we're seeing from coal, particularly with intermodal being the largest driver to carload increases for the rails. If this trend doesn't really have an end in sight, are there structural changes or pricing efforts where we could see you get more aggressive in order to mitigate this negative mix impact?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

We certainly did see an effect from mix at a high level in the second quarter. And with coal being down as much as it was, that creates a challenge for us in terms of improving margin and growing the bottom line.

With that said, our longer-term outlook is for coal volumes to stabilize. Now we've guided down on the export side of the business for the foreseeable future; now that's been a historically very volatile part of the business, but the good news is we think that we have seen and are at the bottom in terms of utility coals.

Now the volume may vary from quarter to quarter depending on weather in particular. But we think 20 million is a reasonable run rate at least for the next 12 to 18 months or so.

So that would imply stabilization. We'll wait and see. Eventually we will see supply come out of the global market, and we should see a boost to export coal volume as well, and that will help with the mix.

In the meantime we're going to grow intermodal and we will grow merchandise volumes. It's one of three parts to our overall strategy: grow the top line through pricing based on market conditions at a rate better than rail inflation; grow volume, particularly intermodal and merchandise volume, profitably.

And secondly, we're going to work on return on capital by prioritizing capital spending in favor of revenue growth opportunities and profit margin. And third, service: continuing to improve service is really the key to both top-line growth and better returns on capital as well.

Brian Colley - *Stephens Inc. - Analyst*

Thanks. If I could just follow up real quick on that, some of the rails have talked about this incremental margin framework of around 50% longer term. Is that the right way to think about your business once we start to see volumes increase on a year-over-year basis?

And if so, is that incremental margin framework only achievable in a coal environment that's at least flat or stabilized?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

We do believe 50% incremental margin is a reasonable goal going forward. Now that certainly (technical difficulty) if coal volumes do in fact stabilize.

Brian Colley - *Stephens Inc. - Analyst*

Great. Thanks for the time.

Operator

Cherilyn Radbourne, TD Securities.

Cherilyn Radbourne - *TD Securities - Analyst*

Thanks very much and good morning. Was just wondering if you could offer some thoughts on where you think headcount will end the year versus last year.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Marta?

Marta Stewart - *Norfolk Southern Corporation - EVP Finance, CFO*

Okay. Previously in our January and our April calls, we guided to the fact that we thought we would increase 1,000 in total from the fourth quarter of last year average, and we still think we're on that run rate. So if you look at the fourth quarter of last year to the first quarter of this year we were up 500. Then sequentially the first quarter to the second quarter, another 100.

So net we're up 600 through June 30. So we expect that in the third and fourth quarters we'll be up an additional 400.

Cherilyn Radbourne - *TD Securities - Analyst*

Okay, that's helpful. Then I think you have indicated that it's your intention over time to convert to on-highway diesel-based fuel surcharge programs. Just wondering if you can provide any update on your progress year-to-date on that.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

I'll let Alan address that; that is a goal. We recognize that there's been a bit of a mismatch in having our revenue fuel surcharges based on WTI with expense obviously based on diesel prices. Alan, why don't you talk about our plan for reducing some of that volatility?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

One way to reduce the volatility would be to shift the benchmark from WTI-based to an on-highway diesel. We're going to approach that with our customers as individual contracts expire.

The average duration of our contract is a little bit over three years, so it is going to take some time to make a meaningful shift in that. We are also committed during that time period not to sacrifice market-based pricing for a premature shift in the fuel surcharge program.

Cherilyn Radbourne - *TD Securities - Analyst*

Okay. Thank you; that's all for me.

Operator

Ben Hartford, Robert W. Baird.

Ben Hartford - *Robert W. Baird & Company - Analyst*

Thanks. Marta, real quick, could I get your perspective on the dividend? I noticed on Friday the announced dividend for 3Q was flat relative to 2Q. It looked like that was the first time that has been the case sequentially, Q2 to 3Q, since 2009.

Can you talk about some of the components that drove the decision not to raise the dividend sequentially? Maybe just provide perspective on what you expect the dividend policy to be going forward.

Marta Stewart - *Norfolk Southern Corporation - EVP Finance, CFO*

Well, our dividend policy just overall -- stepping back, our dividend policy long-term is a one-third payout ratio. In the past we have sometimes raised the dividend in July and sometimes not, so that's not really a departure from what we've done over the years.

You're correct that the last couple of years we have raised in January and July.

So we feel comfortable with the $0.59. We feel comfortable where we are with our payout ratio. And then the future, of course, will be guided by our future profitability.

Ben Hartford - *Robert W. Baird & Company - Analyst*

Okay. That's helpful. Thank you.

Operator

David Vernon, Bernstein Investment Research.

David Vernon - *Bernstein - Analyst*

Great. Thanks for taking the question. Hey, Alan, maybe just to -- could you talk a little bit about the core pricing trends in the fuel business, sort of ex-fuel? That number was down a lot, a little bit more than it has been in the past. I'm just wondering if that was all fuel decline, if you are also seeing some negative mix or some possible price declines in there.

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Hey, could you repeat that?

David Vernon - *Bernstein - Analyst*

As you think about the coal pricing, ex-fuel?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Coal?

David Vernon - *Bernstein - Analyst*

Yes.

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Okay. Yes, there were -- we did see a decline in our pricing with respect to coal. A lot of that has to do with mix changes. As you know export tends to be a longer-haul move for us than utility. So a 38% decline in export coal volumes in the quarter is going to have a disproportionate impact on our overall RPU ex-fuel.

David Vernon - *Bernstein - Analyst*

So it was predominantly mix? There wasn't another step down in export rates or any pricing action on the utility coal business in the quarter?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

I would say it is predominantly mix. We're looking at each of our individual moves individually with our customers, and applying market intel and analytics to figure out what drives the best results for our shareholders.

David Vernon - *Bernstein - Analyst*

Okay. Then I guess as you think about the volume guidance for the back half of the year, I think you said you're expecting overall volume to be up year-over-year. In light of the accelerating coal headwind and crude maybe moderating, are you expecting a pickup in economic activity?

Or is there something specific that you can point to that would give you confidence on the volume growth? Or is it just a case of the comps moderating?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes -- and let me be clear, that's more towards the fourth quarter of the year than the third quarter. We've got some heavy comps also in the third quarter.

Last year we handled over 24 million tons in the third quarter of the year into our utility market which may -- going back to Ken's question previously -- may be one of the reasons he's looking at some pretty hefty negative comps in our coal market. So comps will improve for us. We still see strength in many of the markets that we talked about with respect to intermodal, housing, energy-related, the NGLs out of the Marcellus and Utica, and automotive.

David Vernon - *Bernstein - Analyst*

Okay, so the -- but from an economic perspective, your still expecting slow, steady growth. You're not expecting -- you're not hearing anything that would tell you that there's like a reacceleration or anything in the back half?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

No, we're not. The overhang of the oil and gas industry is weighing on manufacturing, but consumer spending is up. But nothing extraordinary.

David Vernon - *Bernstein - Analyst*

All right, thank you.

Operator

Tom Wadewitz, UBS.

Tom Wadewitz - *UBS - Analyst*

Yes, good morning. Jim, I wanted to ask you a question. It's I guess notable you did lower the CapEx number this year, and I know that sometimes that's tricky to do when you're in the midst of a year and you have to plan these things ahead of time. So that's notable.

Do you think your approach in terms of managing the Company is going to be a little more aggressive in terms of paring back on CapEx versus maybe what we've seen over the last eight years or so, 10 years? Is that a fair way to look at it?

And if so, how would you think about 2016, 2017 CapEx? Could those fall a bit from where we're at this year?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Morning, Tom. Let me comment first on the [2015] midyear reduction. We did make the decision to reduce capital somewhat this year (company corrected after call).

I wouldn't make too much of it. It was a rather modest 5% reduction. But we saw an opportunity and we jumped on it. We're trying to be disciplined with our capital spending and, as I said, target revenue growth with our CapEx and profit margin.

Going forward, we will try to manage capital spending ex-PTC down to about 15% to 17% of sales. Now that may take a while. That's a big change from the level of capital spending where we've been; but we recognize the need to be judicious with capital reinvestments.

We're committed to the business. We're absolutely going to reinvest in core assets on a steady-state basis. But we will also be mindful of the need to drive returns through better capital turnover as well, and that means prioritizing capital toward revenue growth.

Tom Wadewitz - *UBS - Analyst*

Right. So that doesn't sound like a big change, but maybe somewhat of a tweak in terms of the way you look at CapEx.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Right, exactly.

Tom Wadewitz - *UBS - Analyst*

Okay. Then as a follow-up -- and I think, Jim, this is probably for you and for Alan -- what about on pricing? Is there also room for not a major change but a little bit of a tweak, where you say we're going to be a little bit more focused on price versus volume? Whereas in the past we've been looking at both price and volume, but maybe a little bit more focused on volume?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Well, I wouldn't say we've held back in terms of our pricing emphasis in the past, so no real change there either. But we are determined to raise prices in line with market opportunities and market conditions at a rate better than rail inflation.

That is our goal. We recognize that that's a vital part of growing our top line. Alan, you want to comment on that?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes, I would say that looking forward particularly in our growth markets, price and volume are not mutually exclusive. We're investing long-term. Our customers see the same issues in the trucking industry that we do, and they are looking for long-term partnerships.

Tom Wadewitz - *UBS - Analyst*

Okay. So no real change in price versus volume for you guys versus the prior team. Obviously you're part of the prior team, but I'm just saying given your -- you could tweak things on the margin given your new positions.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Listen, we want both. We want both pricing and volume growth, and we think we can get both.

We're going to lean into pricing. We recognize that that's a critical part of growing the top line.

But we see lots of volume growth opportunities out there as well. Truck conversions will continue to be central to our volume growth strategy, and that means intermodal but also carload. So yes, pricing; yes, volume growth.

Tom Wadewitz - *UBS - Analyst*

Right, okay. Thank you. Appreciate it.

Operator

Brandon Oglenski, Barclays.

Brandon Oglenski - *Barclays Capital - Analyst*

Good morning. Thanks for taking my question here. Alan, I hate to keep harping on this; but it does look like in the last five weeks or so -- and this is really near-term by the way -- but your volume run rate has definitely stepped below 150,000 units per week. So from our perspective it looks like things are sequentially deteriorating.

I know you're calling for sequential improvement. So is there something about the last six or two months that we shouldn't be concerned with, that will come back in your network as we go through the fourth quarter this year?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

No, I would say we are keeping a very watchful eye on it, and a lot of the decline that we've seen over the last four to six weeks, as you noted, has been associated with our export coal franchise, which we previously discussed.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay; appreciate that. And, Jim, I guess following up on that line of questions there, Norfolk has seen pretty good volume growth the last five years under Wick, and obviously the OR was flat. I know you had a lot of coal headwinds through that period.

You did say that you think coal markets are at a bottom. But I feel like we've had that conversation on this call for three or four years now, where we think things have bottomed, but then natural gas prices go lower or another external shock happens with coal, and we're again facing that same headwind.

I'm sure it's not lost on you that you're OR is now probably the highest amongst the major railroad tier that are publicly traded. So what can investors expect from you as CEO? Are we going to aggressively attack the OR with cost reductions even if coal doesn't stabilize from here?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

You bet. We absolutely are determined to lower our operating ratio and think we have the ability to do so. Let me just reiterate our strategy here: it's a three-part strategy.

The first thing we're going to do is grow the top line. Now that will obviously be easier if coal volumes stabilize; but we're determined to grow volume and pricing.

And secondly, we are going to push on return on capital by prioritizing capital spending around revenue growth, recognizing that it is in capital turnover where we have lagged in the past few years.

And third, service is the key to all of this. And I'm really pleased to report that we saw service and network improvements in the second quarter. We expect those to continue in the second half.

So the way we look at it, there's been progress evident on all fronts in terms of the top-line growth, with the exception of coal, which faces clear near-term headwinds. We did see growth in merchandise and intermodal revenue ex-fuel surcharges; so that's very positive.

Secondly, in terms of return on capital, it's a longer-term story but we demonstrated our willingness to take a look at our capital spending plan in the second quarter, and we will continue to do so in line with our previous comments.

And third, service is the key to it all, and we saw service improvements in the second quarter which we expect to persist in the second half.

Brandon Oglenski - *Barclays Capital - Analyst*

Thank you.

Operator

Brian Ossenbeck, JPMorgan.

Brian Ossenbeck - *JMPorgan - Analyst*

Thank you and good morning; thanks for taking my call. On the strength of the merchandise, I just wanted to ask for a bit of characterization of the NGL market opportunity out of the Marcellus and Utica. It looks like chemicals was clearly a good area for carload growth this quarter.

How early do you think you are in pursuing that opportunity? Are there other fractionators, other facilities coming online?

And maybe from a mix perspective if you could characterize the length of haul relative to the overall portfolio.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Alan, why don't you tackle that one?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Sure. There is additional capacity coming online in the fractionator area also with current fractionators expanding. So we continue to see growth in that.

The length of haul is really no different from what else we're handling. I will tell you in the chemical arena the other headwind we are facing, though, is crude oil; and that's been another decline for us in the last couple weeks.

So back to the earlier question of what's changed in the last four to six weeks, it's effectively export coal and crude oil.

Brian Ossenbeck - *JMPorgan - Analyst*

Okay, thanks. Then just one quick follow-up on coal, and maybe this will answer some of the questions about the possibility for it to improve in the third quarter and beyond. Where are the inventory levels at the utilities?

I think in the past quarter is was around 70 days for the South, which was right around target, but North was a little bit above where average was. If you could just update us with those numbers.

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes. On average, the utility stockpiles are about 20 days above target: about 25 days up in the North and 15 days in the South.

Brian Ossenbeck - *JMPorgan - Analyst*

Okay, and South target is 70 or so and the north is 50, roughly?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Right.

Brian Ossenbeck - *JMPorgan - Analyst*

Okay. All right. Thanks a lot for the color.

Operator

Jeff Kauffman, Buckingham Research.

Jeff Kauffman - *Buckingham Research Group - Analyst*

Thank you very much; hey, guys. Quick question, I want to go back to the question you had on length of haul and mix in the coal franchise. I understand the export tends to be longer-haul coal and that would be a mix impact. But when I'm running the algebra it looks like your length of haul was down almost 7%, 8% on the coal franchise. I'm just doing basic math, dividing revenue ton miles by tons.

Can you talk about some of the other mix elements going on? Because I thought the story was we're sourcing more out of Illinois, a little less out of Central App. In theory, that should have been additive to length of haul. So could you just discuss a little bit more what's going on with mix in the coal area?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes, we did have some spot moves in the second quarter of last year that were longer length of haul. And our utility South network tends to be a little bit longer length of haul than our utility North.

Jeff Kauffman - *Buckingham Research Group - Analyst*

Okay, so that was the primary driver of the mix differential. Does that continue into 3Q or was that more of a second-quarter effect?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Well, it depends upon -- are you comparing it sequentially or are you comparing it year-over-year?

Jeff Kauffman - *Buckingham Research Group - Analyst*

Let's go year-over-year.

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Then I would say that that does continue into the third quarter.

Jeff Kauffman - *Buckingham Research Group - Analyst*

Okay. Then Ken Hoexter's question, similarly, you identified the 20 million as just being domestic utility, the 3 million being export. So really no change in your fuel in terms of coke, iron ore, or domestic industrial?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Correct; which also, to your point, tends to be a shorter length of haul.

Jeff Kauffman - *Buckingham Research Group - Analyst*

Right, and fewer tons per car. Guys, thanks.

Operator

Cleo Zagrean, Macquarie.

Cleo Zagrean - *Macquarie Capital Securities - Analyst*

Good morning. My first question relates to merchandise yields. With [sinits] down 10% year-over-year and a continuation of the first quarter, perhaps down low single digits ex-fuel, can you help us understand any change in trend there in terms of mix and same-store sales into the second half and maybe next year? Thank you.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Cleo, actually RPU, excluding fuel surcharge in the merchandise segment was favorable in the second quarter.

Cleo Zagrean - *Macquarie Capital Securities - Analyst*

I was referring to revenue per ton mile, what people may also call yield.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

Revenue per ton mile? Well, let me just say that our expectation is that we will see a continuation of core pricing, same-store sales pricing, at a rate in line with market conditions and better than rail inflation. So that's a trend that you saw when looking at it at the level of RPU ex-fuel surcharges in the second quarter.

And as we said we expect that to persist especially in merchandise but also intermodal in the second half. Alan, did you want to add anything to that?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes, I would say there were some mix impacts. We've seen declines in steel, which we've commented on, and frac sand, which tend to have a higher RPU for us. So there's a negative mix impacted there.

Cleo Zagrean - *Macquarie Capital Securities - Analyst*

Okay, and those maybe should stabilize into year-end? Should we enter some kind of normalized comp next year?

Jim Squires - *Norfolk Southern Corporation - President, CEO*

These mix impacts come and go. There is no longer-term negative mix trend underway that we can see.

There was certainly some mix noise in the first quarter, a little bit in the second quarter as well. But overall we saw progress where it counts, and that's in revenue per unit growth, excluding the effects of fuel surcharges outside of coal.

Cleo Zagrean - *Macquarie Capital Securities - Analyst*

I appreciate it. Then my follow-up relates to the coal outlook longer term. You said you saw some stabilization 12 to 18 months out. But as you look to gas capacity additions coming on in 2017 and 2018, do you see a need to potentially adjust your network ahead of that? Or you do not see those representing a big threat to coal volume domestically? Thank you.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

The outlook gets cloudier the further we go out. And looking beyond 12 to 18 months, we certainly do see the potential for further incursion of gas on our network due to new gas-fired generation.

And yes, we will and we are currently looking at our coal-related assets. Those would fall into a couple of buckets.

Our coal car fleet, we had several years ago plans to replace coal cars pretty aggressively. We've basically been able to eliminate that from our capital budget, given the trend in coal volumes.

Our coal track network is certainly under review as well. And we have other coal facilities that we're taking a look at, looking out even beyond the 12 to 18 months.

Cleo Zagrean - *Macquarie Capital Securities - Analyst*

I greatly appreciate it. Thank you.

Operator

Tom Kim, Goldman Sachs.

Tom Kim - *Goldman Sachs - Analyst*

Good morning; thanks. I had a couple questions on intermodal. I guess first off on the international side, we obviously have seen that the big benefit with the West Coast port disruptions effectively being resolved, and I guess as we look forward to the second half of the year, what do you think a reasonable growth rate for international intermodal should be? Would it be safe to assume something close to GDP is reasonable?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Typically we've said that international will grow at 1 to 1.5 times GDP. To the extent that there is a greater shift towards East Coast ports certainly at least in the near term, we have the opportunity for growth that's above that.

Tom Kim - *Goldman Sachs - Analyst*

Okay; that's really helpful. I guess as we look a little bit further forward, and supposedly the Panama Canal expansion should be completed first half next year, I would think that this should drive more business to the Gulf and to the East Coast. But I'm wondering what's your perspective around the puts and takes around the intermodal side of the business? Thanks.

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Did you say Gulf and the East Coast?

Tom Kim - *Goldman Sachs - Analyst*

Yes, the US Gulf and the East Coast.

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes, we've already seen a shift as many of these vessels are using the Suez Canal to hit the East Coast. And the West Coast labor disruptions shifted even more so.

The Panama Canal could certainly help. We don't think that it's going to be a threat to our international franchise.

Tom Kim - *Goldman Sachs - Analyst*

Okay. That makes sense. Just to clarify then, so you're basically assuming that the share shift has effectively been done given that some of the big line [historically] moving capacity through the Suez?

Alan Shaw - *Norfolk Southern Corporation - EVP, CMO*

Yes, I would say much of it has been done. There is still some that's being implemented right now, which is why we're seeing pretty strong growth in our international franchise.

Tom Kim - *Goldman Sachs - Analyst*

All right. That's very helpful. Thank you.

Operator

Thank you. At this time I will turn the floor back to Mr. Jim Squires for closing remarks.

Jim Squires - *Norfolk Southern Corporation - President, CEO*

All right. Well, thank you, everyone. We appreciate your participation in today's call and we look forward to speaking with you next quarter.

Operator

Thank you. This concludes today's teleconference. Thank you for your participation and you may now disconnect your lines at this time.