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NSC - Q3 2014 Norfolk Southern Corp Earnings Call

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OVERVIEW:

Co. reported 3Q14 revenues exceeded $3b, net income of $559m and diluted EPS of $1.79.

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PRESENTATION

Operator

Greetings and welcome to the Norfolk Southern Corporation third-quarter 2014 earnings conference call.

(Operator Instructions)

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

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

Thank you, 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 investor section. Additionally transcripts and downloads of today's call will be posted on our website.

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

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

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

Thank you, Katie, and good morning, everyone. It is my pleasure to welcome you to our third-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 Financial Officer, Marta Stewart.

I am pleased to report that Norfolk Southern achieved another very good quarter, as third-quarter financial results set records across the board. Earnings for the quarter were $1.79 per share, up 17% compared with the $1.53 we earned third quarter last year.

These strong results reflect continued high demand in most of our business groups as overall volumes increased 8%, driven by double-digit increases in merchandise and intermodal, offset by a slight decline in coal. For the second consecutive quarter revenue topped $3 billion, up $199 million or 7% versus last year. And Don will fill you in on the revenue and volume details in a few minutes. Similar to our second-quarter results, our expenses were up only 3% and our resulting 67.0 operating ratios set a third quarter record.

Now while our financial results were very strong, much like in the second quarter the railroads velocity and operating metrics were considerably reduced year-over-year as we continue to be challenged by demand in excess of our forecast for the year. This was particularly significant in terms of our crew base, which was sized for lower volumes.

As all of you know it takes from seven to nine months to hire and qualify new transportation employees, and we are just now starting to see newly qualified conductors marking up in our critical areas. We continue to actively hire and have taken steps to accelerate our training cycle. In addition we temporarily transferred over 100 train and engine service personnel to our busy Dearborn Division from other parts of the network.

We have other special initiatives in place as well to help increase crew availability, and we have a number of important infrastructure projects and new locomotives coming online in the fourth quarter as well. Mark will go over our service metrics and our initiatives for improvement in more detail with you.

While we have demonstrated our ability to successfully manage overall expenses, the network slowdown and recovery efforts have translated to some additional operating costs, and Marta will go over all of them as well as the rest of the financials. In spite of these operating challenges, we are excited about delivering another quarter of record results and we remain optimistic about our prospects going forward.

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

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

Thanks, Wick, and good morning, everyone. As Wick stated we're pleased to report that the third quarter of 2014 was our second consecutive $3 billion quarter, with record revenues in both our merchandise and intermodal sectors, which were partially offset by a weaker coal market.

Revenue growth of $199 million, up 7% versus third quarter of last year, was generated by our merchandise business, which generated $152 million up 10%, followed by intermodal which was up $62 million or 10% over last year. In coal weak global market conditions in the export sector and milder summer weather, which impacted coal demand, resulted in a decline of $15 million or 2% compared to third quarter of last year.

Volume increases in intermodal and merchandise accounted for $219 million of revenue variance in the quarter. Also positive year-over-year fuel surcharge revenue partially offset the negative mix effects associated with higher intermodal volumes and lower coal shipments. Accordingly total RPU was down 1% in the quarter as a result of this negative mix effect between and within our business groups, which I will discuss in more detail as I review each of the major business groups.

Now turning to the components of growth, total volume increased 8% due to 10% gains in merchandise and intermodal shipments which offset a 2% decline in coal. Across our merchandise business very strong performance was led by increased chemicals, automotive, and metals and construction volumes.

In intermodal for the first time shipments exceeded one million units in the quarter, a gain of almost 92,000 units up 10% compared with third quarter 2013, with strength in both domestic and international markets. And in coal volume declined by 2% as export shipments weakened due to continued global oversupply and sluggish demand.

Now moving to our individual market segments starting with coal. Coal revenue was down $15 million or 2% compared to third quarter last year. Coal revenue per unit was flat in the quarter, as declines in higher yielding export traffic offset the positive effects of increased longer haul traffic to our southern utilities.

With respect to utility coal, overall volumes declined by 3% as a result of milder summer temperatures, with July in particular posting the lowest average temperature since 2009. Lower natural gas prices also impacted coal burned during the quarter. This factor, along with a competitive contract loss, resulted in a 14% decline in shipments to our northern utility plants, while volume to southern plants was up 9%.

In the export market third-quarter volumes were down 16%, as excess global supply and lower commodity pricing continued to impact the seaborne coal market, causing declines in both metallurgical and thermal coal volumes at our Lambert's Point terminal.

Within our domestic metallurgical markets volumes were up 8%, led by gains in coke shipments to the steel industry, which more than offset weaker domestic met coal volumes. And finally industrial coal volumes increased by 32% due to new business and organic growth with industrial customers as the economy continues to improve.

Turning to intermodal. Intermodal revenue in the quarter increased by $62 million, or 10%, to $667 million which is a new quarterly record. With respect to revenue per unit, positive pricing activity within the domestic intermodal segment was offset by higher volumes of lower revenue per unit international freight leading to overall flat yield per shipment.

Domestic intermodal volume was up 8% driven by targeted highway conversions across all business segments as well as organic growth with large key accounts across our domestic book of business. On the international side, strong volume growth of 15% was generated through organic growth with our existing shipping partners, new contract business, and from new terminal growth.

Moving to our merchandise markets, these five carload business groups also set a new quarterly record with $1.7 billion in revenue, an increase of $152 million or 10% versus third quarter of 2013. Our merchandise markets also faced negative mix effects as strong volume growth within our metals, construction, and bilevel automotive segments offset gains in higher revenue per unit, agricultural, and chemical commodities. As a result, overall merchandise RPU declined by $7 and was flat for the quarter.

With respect to volumes, growth was led by strong increases in crude by rail and natural gas liquids, which increased our chemicals volume by 17%. Automotive volumes were up 12% versus last year, propelled by significant increases as we took advantage of the auto manufacturer summer shutdown period in July to reduce finished vehicle inventory backlogs that were a result of national rail car supply issues incurred earlier in the year. And growth in frac sand aggregates and steel increased our metals and construction carloads by a strong 12%.

And the excellent 2013 corn crop continued to provide growth opportunities in our agricultural market, helping to generate a volume gain of 6% in the quarter. Finally paper and forest products volumes were flat in the quarter, with double-digit gains in lumber offsetting declines in kaolin clay and waste shipments.

Now I'll conclude with our business outlook. We see continued opportunity ahead to generate solid growth across most of our business units. The exception is coal.

So far this year our utility coal shipments have been higher than expected due to elevated natural gas prices and the need to replenish stockpiles. But the impact of milder weather and lower natural gas prices are now reversing some of that positive trend.

On the plus side we estimate that stockpiles at our utilities remain 19% below December 2013 levels going into the winter heating season. So the wild card is what kind of winter demand lies ahead.

In our met and thermal export markets we continue to see global oversupply and low commodity pricing. And the weaker Australian dollar, which has declined another 6% since September 1, is making Australian coal even more competitive in the global marketplace.

Turning to intermodal, tightening capacity and rising cost in the trucking industry will drive continued volume growth in our domestic markets as we take advantage of opportunities for highway conversion and yield improvement. And we expect continued growth in our international intermodal business through organic growth and new services.

In our merchandise markets we anticipate continued opportunities in crude oil and natural gas related products as well as drilling materials such as frac sand and pipe. We also anticipate higher steel volumes to support the energy and automotive sectors, while housing expansion will help boost volumes in aggregates, lumber, and construction materials.

In the automotive sector volumes are expected to move higher, with increased vehicle production and with new models coming online at several Norfolk Southern served assembly plants. Last, in our agricultural markets expectations for another record corn and soybean harvest in 2014 will lead to domestic growth as well as potential export opportunities in the months ahead.

Now let me summarize. We expect revenue and volume growth in our intermodal and merchandise markets while we continue to face challenging and uncertain conditions in the coal sector. As we move forward we remain keenly focused on improving service to meet the expectations of our customers and to support our ability to price to market at levels that equal or exceed rail inflation.

In turn we will continue to invest in equipment, locomotives, and our network to provide better service today and in the future for our customers. Thanks for your attention, and I'll now turn it over to Mark for our operating report. Mark?

Mark Manion - *Norfolk Southern Corporation - COO*

Thank you, Don. Third-quarter operations were heavily impacted by very positive traffic growth. While we continue to target overall operating efficiency, network velocity and service performance have slipped.

Initiatives to balance and effectively apply resources to those segments of the network that are seeing the most growth are stabilizing the operation. And customers should start to notice improvements in service and service consistency during the fourth quarter. More importantly these efforts will position us for further growth going in to 2015.

On slide 2 our nine-month injury ratio stands at 1.18, down slightly when compared to last year. But we've been seeing improving trends continuing into the third quarter, which had an injury ratio of 1.09. Train incidents for the first nine months are flat compared to the full year in 2013 at 2.4 per million train miles. Crossing accidents increased to 4.0 per million train miles from the first nine months compared to 3.6 for the full year 2013.

As I noted on my opening slide, service levels have been impacted by volume increases and particularly traffic increases across the corridor from Chicago to Philadelphia. Consequently as you see on slide 3 our composite service performance dropped to 68.6% in the third quarter, well below customer expectations and the record service level of 2013.

Moving to slide 4, as you would expect train speed and terminal dwell data show the same trend as the service composite, reflecting slower network velocity. Train speed averaged 20.9 mph in the third quarter and terminal dwell was 24.7 hours. Both were impacted by volume as we've discussed, but there were also a number of track work and PTC projects across parts of the northern region.

These will be completed ahead of seasonal peaks in grain and intermodal. We have and we will continue to take additional steps that will bring measurable improvements to network velocity and service delivery. Some of these initiatives are outlined on slide 5.

Aligning and positioning T&E forces with volume growth is our immediate focus. To address crew availability in the short term we've offered various temporary incentives to our current T&E employees.

114 conductors and engineers agreed to transfer temporarily from various parts of the network to locations on the northern region where volume growth has outpaced crew availability. In addition over 680 employees participated in a vacation buyback program, and we've also offered incentives to T&E employees who were eligible to retire but defer retirement until 2015.

As discussed in my remarks regarding second-quarter operating results, we stepped up hiring and training in order to bring T&E forces in line with expected volumes. Currently we have 1,453 new T&E employees in various stages of the hiring, training, and qualification process.

In the third quarter 206 new conductors were qualified and most of those were placed in the high traffic growth areas along the Chicago to Philadelphia corridor. In the fourth quarter we expect that 596 will be qualified.

At the beginning of this year we had 11,290 T&E employees in active or training status. By the end of this year that number is expected to increase to 12,006 which is a net increase of 716 T&E employees this year.

Several new infrastructure projects in the Chicago area and upper midwest have or shortly will be completed, adding more capacity a more flexibility in our operations in and around the Chicago area. Perhaps the most important of these is the expansion of the terminal in Bellevue, Ohio.

This project, which nearly doubles the capacity of the terminal, will wrap up in December. We will then begin a phased in operating plan with full operations at Bellevue online during the first quarter of 2015.

In addition to more capacity, the Bellevue expansion will give us much more flexibility in routing of trains to and from Chicago and more bypass options during periods of bad weather. Now while Bellevue is the largest infrastructure project, other infrastructure projects are certainly worthy of noting.

The Englewood flyover at Chicago, completed just this month, separates NS operations from Metro trains through Chicago and has significantly improved fluidity of our operation there. The new 51st Street connection near our intermodal facility in Chicago will be completed early next year. When completed the new connection will improve train operations and reduce time and handling for trains moving in and out of that facility.

Our new connection at Goshen, Indiana will also be completed after the first of the year. It provides a direct link from our terminal at Elkhart to the Marion, Ohio branch for more fluid operations and greater flexibility of operations around one of the largest terminals.

And six new receiving tracks at our Conway terminal in Pittsburgh will be in service by the end of the year. This new capacity will improve service in this rapidly growing corridor that includes new crude by rail volume.

Finally in terms of locomotives we'll be taking delivery of 50 new EMDs SD70 AC units beginning this month. In addition we recently reached an agreement to purchase 100 SD90MAC units and started taking delivery of those units in September.

We expect to take delivery of 40 of these units by the end of the year. With these the number of units available for service has reached historic highs in line with historically high volumes. Together with aligning our T&E forces for expected demand, these projects for additional capacity and growth in our locomotive fleet gave us a very strong position moving into the fourth quarter in 2015.

Moving to the next slide, with volume increase of 8% in the third quarter crew starts including re-crews increased by 2%. This margin of difference is due in part to improving operating efficiencies, but also reflects efforts to conserve available crews through train combinations and train annulments.

We would still see very positive margin even with a more robust crew base. Our current crew base continues to be stretched, which is reflected in higher overtime hours up 32% for the third quarter compared with the same period last year.

With hiring and other steps I have outlined, network velocity is expected to improve as we move into the fourth quarter and we expect to see that reflected in further improvements in operating efficiencies, particularly reductions in overtime. That trend should continue into 2015 when we expect that our crew base will be fully aligned with expected volumes.

A 1% improvement in carloads per locomotive reflects our ability to absorb higher volume with existing train operation. And fuel utilization was also favorable as gallons per 1,000 gross ton miles declined by 4% compared to the same period last year.

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

Marta Stewart - *Norfolk Southern Corporation - CFO*

All right. Thank you, Mark, and good morning, everyone. Let's get started with a summary of our operating results on slide 2.

Revenues exceeded $3 billion, up $199 million or 7%, driven as Don mentioned by double-digit volume gains in intermodal and merchandise. Operating expenses increased only $50 million, or 3%, resulting in a third-quarter record operating ratio of 67.

Slide 3 shows the major components of the $50 million net increase in railway operating expenses, which you'll note were almost entirely concentrated in the materials and other category. Now let's take a closer look at each expense category beginning with materials and other on slide 4.

This line item increased by $45 million, or 23%. As in the second quarter, the largest reason was significantly higher usage of locomotive materials, which was up almost $20 million.

As Mark discussed, we have all our surge fleet locomotives deployed as total units in service are near historical highs. Also contributing to the rise in this category were higher casualty claims accruals and higher loss and damage costs.

The relative increase in claims accruals was the result of favorable adjustments last year. The increase lading damage costs were due to two derailments during this quarter which damaged finished vehicles and totaled $10 million. For the fourth quarter we continue to expect a high rate of locomotive material usage and we also face an unfavorable comparison in casualty claims accruals relative to last year.

Turning to slide 5, purchased services and rents were up $9 million or 2% largely due to higher volume related activities particularly in the areas of intermodal ops, equipment rents, and joint facilities. Next depreciation expense for the quarter rose by $6 million, or 3%, reflective of our larger capital base. We expect a similar increase in the fourth quarter.

As shown on slide 7, fuel expense decreased by a net of $3 million or 1%. The 2014 third-quarter average diesel fuel price of $2.96 per gallon was the first sub $3 quarterly average in more than three years. This lower price accounted for a $21 million reduction while higher consumption increased fuel expense by $16 million. As Mark noted this is only a 4% consumption increase on an 8% rise in traffic.

Slide 8 details the $7 million, or 1%, decline in compensation and benefit costs. As discussed in prior quarters, continued favorability in post retirement medical and pension accruals coupled with slightly lower health and welfare costs resulted in a $44 million reduction in expense.

Partly offsetting this decline were increased pay rates of $16 million, higher incentive compensation of $12 million, and $10 million more in overtime. With the exception of incentive comp, we expect these variances to continue at similar levels in the fourth quarter.

Turning to our nonoperating items, other income net was up $2 million on higher property sales, and interest expense on debt was up $7 million related to last year's debt issuance.

Slide 10 depicts our income tax accruals and the effective rates. Total taxes were $333 million, up $67 million largely due to higher pretax earnings. The effective tax rate was 37.3% compared to 35.6% last year which have the benefits from a state tax decrease and tax credit.

Slide 11 displays our net income and EPS comparisons, which were both third-quarter records. Net income of $559 million was up $77 million, or 16%, and diluted earnings per share was $1.79, up $0.26 or 17%.

Wrapping up our financial overview on slide 12, cash from operations for the first nine months totaled $2.3 billion, covering capital spending and producing nearly $1 billion in free cash flow. We distributed $511 million in dividends and $166 million in share repurchases. Thank you and I'll now turn the program back to Wick.

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

Thank you, Marta. Well as you've heard it was another very good quarter for Norfolk Southern. However as good as these results are, it's clear that could have been even better if we had been able to achieve the network velocities in line with our performance for the prior two years.

And not only did these operating issues have an impact on our financial performance, more importantly they kept us from delivering transportation services to our customers at the level that they had come to expect from our Company. For that reason we are very focused on getting back to the service metrics that we posted in the prior two years as quickly as we can and then improving further from there.

Mark outlined some of the steps that we are taking and while it will take a little time to reach our 2012, 2013 velocities, we're very confident that we are on the right path and that the infrastructure and resources that we are adding will set the stage for us to grow volumes and provide even better service in the future.

We have a great team at Norfolk Southern and I have every confidence in our ability to continue to provide outstanding service to our customers and outstanding results for our shareholders. Thanks for your attention and I'll turn it back to the operator for your questions.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Our first question comes from the line of Bill Greene with Morgan Stanley.

Bill Greene - *Morgan Stanley - Analyst*

Yes, Hi there, good morning. Wick or Mark I wanted to talk a little bit further on the service issues.

Is it just as simple as adding locomotives and employees? Is it really a resource constraint? I'm sure you're aware of the other argument that M&A is a solution there. So can you sort of talk about what levers you can pull on, how you see this?

Mark Manion - *Norfolk Southern Corporation - COO*

I'm sure Wick will talk about the M&A side of it. In priority order for us it's a crew issue.

The reality is you need a sufficient number of crews in order to handle your volume. And our volume just outpaced the crews. So as I've said we're ramping those up, and we start to turn those crews on, Bill, in a bigger way in November and December and that will be very helpful.

But we are already seeing improvement from those temporary folks that I spoke of that went to our northern region. Now in addition to crews -- and as far as locomotives go the reality is we've got enough locomotives right now. But when you get into a lower velocity situation that eats up your locomotives, so you get to the point where you can't hardly have enough.

So it will be helpful to have these additional locomotives coming on and they already are coming on. So that will be good.

Now another important factor here is these infrastructure projects. As business is ramped these projects -- and I won't go through them again, I mentioned them, they will be -- no one project by itself fixes it, but you combine those projects, particularly with our Bellevue infrastructure project, that just plain gives you more capacity.

And that's the sort of thing that from a standpoint of being sustainable and allowing for more growth going forward, that's what those infrastructure projects get you. So we're really looking forward to that.

And then the last thing I would mention is that we've been doing a lot to find some routes around Chicago. And one for example is we've got a line that's immediately south of Chicago. We refer to it as our Streator line.

And we're taking a hard look at -- well we're actually starting to use that in a greater way for more interchange of traffic, but we're even looking at increasing our infrastructure on that route in the short term. So those are the kind of things that bulk you up to be able to handle more traffic and operate more effectively than we currently are.

Wick?

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

Well, I will say, too, that the problems that we're experiencing are not unique to Norfolk Southern. There are a lot of issues across the industry which are well documented and everyone is talking frankly about them.

That does have some impact on us. Certainly the Chicago Gateway has been congested and erratic over the past number of months, but all the carriers are trying to address that and I think that collectively we are all taking the right steps to address that.

The simple fact about Chicago is that there is an enormous amount of rail infrastructure from both the east and the west that just points that way. That's where a lot of railroad capacity meets.

And we're always going to do a lot of business through Chicago. And there are lots of different opinions about it, but we are looking bilaterally, as Mark mentioned, with other carriers in terms of thinking about alternative locations when that's possible, but it's not always possible for a number of reasons.

And the other thing I will say is that we have seen very positive impact over the past two years in Chicago from CREATE. It has opened up a lot of real congestion points for us, former congestion points. And not just CREATE but projects like the Englewood flyover, which effectively gave us 6 to 8 hours more access to our main line every day, are really important.

Every franchise is different, Bill, as you know. But when we look at the issues that we're facing, have been facing, and we do the analysis, and we've done a lot of analysis, it comes right back to what Mark was saying.

Bill Greene - *Morgan Stanley - Analyst*

Let me ask one follow-up to this, and if I missed this in your prepared remarks I apologize. But have you quantified what the service challenges have cost this year? Or maybe even include weather, just so we have a sense for look, there is this much embedded in the cost structure this year that if it goes according to plan won't be there next year?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Well in the third quarter -- it is difficult Bill, this is Marta, it is difficult, Bill, to kind of tease it apart from the volumetric increase. But generally speaking rough numbers you can assume that most of the increase in overtime, which this quarter was $10 million and last quarter was a similar amount, most of the increase in overtime is related to that.

And I'd say the other biggest item would be the increased locomotive materials because Mark's folks have had to fix the heavy bad order locomotives. And so I would estimate for this quarter you take all the overtime of $10 million, somewhere between one-half to three-quarters of the $20 million increase in locomotive materials and that would be about the impact the service had on our expenses.

Bill Greene - *Morgan Stanley - Analyst*

Okay. Fair enough. Thank you for the time.

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

Thanks, Bill.

Operator

Our next question comes from the line of Allison Landry with Credit Suisse.

Allison Landry - *Credit Suisse - Analyst*

Good morning. Thanks for taking my question.

So in spite of the service issues in the third quarter you were able to post pretty strong incremental margins. But looking at -- and granted it's only three weeks, but if we look at the recent volume data it suggests that there's been a pretty material slowdown in growth. Is this a direct result of not having enough crews? And obviously the outlook for coal isn't positive. But do you expect a return to growth in automotive and Ag once you get some of these qualified employees in the network?

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

Good morning, Allison, this is Don.

We're not seeing a slowdown in our business. What we are seeing is the lapping of very strong comps in the fourth quarter from last year. As you'll recall our merchandise volumes in 2013 in the fourth quarter were up 8% and our intermodal volumes were up 6%. So we are beginning to face tougher comps year-over-year.

The second thing I would add there too is that we are seeing a deceleration in coal volume on the export side, and we're seeing weaker utility volumes as I pointed out due to natural gas prices dropping in milder weather. We also saw our intermodal business peak fairly early toward the end of September.

And that is predominately on the international side with consumer goods coming in for the holiday season. So I wouldn't read too much into the over, year-over-year volumes other than the comp and the fact that coal is decelerating somewhat and that we probably have seen our fall peak, even though it was a small fall peak in intermodal.

Allison Landry - *Credit Suisse - Analyst*

Okay. And as a follow-up question on the post retirement pension expense for this year, could you parse out the difference between the two? And I know that you made some changes to the post retirement plan, so how do we think about what will persist in terms of a tailwind for next year and what are your initial expectations for pension expense in 2015?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Okay, well I'll take that in two pieces. First of all with respect to this quarter in the post retirement and pension, the bulk of that is post retirement, $31 million and the pension was $8 million. Both of those were decreases compared to last year.

And we've had similar amounts each quarter this year relative to the prior year. Going forward into next year, of course that's going to be dependent -- we'll be able to give you more visibility into that in January. That's going to be dependent on the interest rate as of the end of the year and where our pension assets stand.

Thinking about it if we had to look at it as those items right now, we would probably have about even 2015 expenses in those areas compared to 2014. So, in other words we're not going to have the big leg down that we had in 2014, but we think we're going to stay about even.

Allison Landry - *Credit Suisse - Analyst*

Okay and is that basically because the changes that you made in the retiree medical plan could potentially offset any increase in pension expense?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Well the change that we made is going forward, so with regard to post retirement medical the change that we made is a go-forward change. So that would impact 2014 and 2015 the same way. That's why that's the same. And then the pension on its own, the asset plan, the assets have done very well and unless interest rates change marketably between now the end of the year, that should stay flat to same.

Allison Landry - *Credit Suisse - Analyst*

Okay. Thank you so much for the clarification.

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

Thank you.

Operator

Our next question is from the line of Jason Seidl of Cowen & Company.

Jason Seidl - *Cowen Securities LLC - Analyst*

Good morning. Staying on the service a little bit, with all these new locomotives coming on should we start seeing that locomotive increase expense for materials start abating in 4Q? Should I be a little bit lower than it was in 3Q?

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

Jason I wouldn't want to predict that it's going to come down much in the fourth quarter because they really -- we start to see most of this power in the November/December timeframe. But certainly as we bring these new locomotives in and as velocity improves, as Mark says we're going to have the ability then to take, hopefully, a good number of these older, higher maintenance, less efficient locomotives out and put them back into our surge fleet, and also put them back into the queue where we've got a lot of them for our rebuild program.

Marta Stewart - *Norfolk Southern Corporation - CFO*

And right now Mark's folks are estimating. They're going to do whatever it takes to fix these locomotives. But as you know the locomotive material was up $10 million in the second quarter, $20 million in the third quarter, and they think they'll be somewhere between those two for the fourth quarter.

Jason Seidl - *Cowen Securities LLC - Analyst*

Okay. Thank you. And as it pertains towards all the merger talk we have and also all the talk about Chicago, Wick I think you mentioned that there's only so much you can do with the rails working together. But what can the railroads do short of a merger to sort of help improve some of the service levels through either joint projects or joint ventures?

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

Well I think everyone is doing a lot of work on that, Jason, along the lines of what we're doing. We work together in Chicago to try and manage the flows through there. We do that collectively, as you know.

Every railroad that I'm aware of is looking at additional infrastructure, if it's required on their routes coming into Chicago. Certainly that's true in the West, as you know.

And I think that as we do that, as we make sure that we're resourced properly, that we're going to be able to handle business and handle more business through Chicago successfully in the future. I think, this is my opinion, I think what we have seen this year is something of an anomaly in that we had, as you know, and extraordinarily tough winter. And then we had a really very unusual kind of volume growth through a single gateway driven by the energy business.

At some point that returns to more normal growth levels and we can manage through that. So I'm optimistic that as the CREATE projects continue to come online and as we all work together, that Chicago will always be a very, very busy place to operate. It will occasionally be a tough place to operate, but collectively we can make Chicago work in the current industry configuration.

Jason Seidl - *Cowen Securities LLC - Analyst*

Thanks for the commentary, Wick, and thanks for the time.

Operator

Our next question comes from the line of Tom Wadewitz at UBS.

Tom Wadewitz - *UBS - Analyst*

Yes, good morning. Wick, I guess I apologize for asking about this again, I don't know if you love talking about it, but just to be completely clear on this, and you've probably said this in various ways, do you think that it would be -- are you essentially, do you have a position on rail combinations in terms of you think it's a bad idea and you think regulators wouldn't approve it?

Or are you open to the idea and you think there are pluses and minuses? What's your clear position on the idea of rail combinations? I know obviously you've talked around it a bit today.

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

Tom, this is something that I have said in a lot of forums and I'll go ahead and say it briefly. And I'll preface it by saying that different people in the industry have different opinions about this.

I will go ahead and say I have a very high regard and respect for the head of the CP, but this is just a place where I have a different opinion. I think that a major railroad merger is not a good idea. It is highly problematic for three reasons.

The first is that our history is that putting these big companies together is very difficult and at least historically has led to significant service problems for some period of time. The second reason is that while historically a lot of mergers were justified because of significant synergies, if you put two big carriers together there aren't that many overlapping routes, there aren't that many redundant facilities.

You can save some money, yes, but it's not necessarily order of magnitude that it used to be. And then third and most important I think it would go into the face of a regulatory environment which is not receptive in any way to major combinations.

And there are the new rules out there that it has to be pro competitive. That is not defined, and it could be defined in ways that are very onerous and in which you could give up all of the potential benefits and more in a transaction.

So I just think they don't make sense at this time. And as I say reasonable people can differ on that, but that's certainly my opinion.

Tom Wadewitz - *UBS - Analyst*

Okay that's very helpful, I appreciate you giving a very clear response to that. That's very helpful.

I've got a question for Don. The yields in third quarter were weaker than we would have expected. I know you gave us a lot of detail on why mix is a headwind in various respects.

What is your visibility to pricing and to yields as we go into 2015? Discussions with customers, contracts you've already signed for 2015? Can you give us some flavor and a sense of how much confidence you might have in stronger pricing and stronger yields when you look to 2015?

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

Good morning, Tom.

As you well know the capacity factor in transportation in North America has tightened significantly. As we've said many times in the past we price to the marketplace and we see increasing opportunities for price improvement ahead. We have about 15%, right at 15% of our remaining pricing to do on the book for 2014. And we have about 50%, right at 50% of our book of business to be repriced in 2015. And we will be taking that tighter transportation capacity into our strategy and you will see that in the results of our price activity.

So we price to the market. The market is tight for capacity. That enables us to have a more optimistic outlook on pricing ahead.

Tom Wadewitz - *UBS - Analyst*

Should we expect that yield is going to -- excuse me, mix is going to continue to be a headwind in 2015? Or some of the mix pressures you saw in third quarter maybe they ease up a bit so the pricing flows through a bit more to the revenue per unit?

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

Tom, we have so many moving parts with respect to the different business segments. I even mentioned this morning that in our automotive sector, which was very strong in the third quarter, up 12%, we had a much higher percentage growth in bi-level traffic which is the cars -- the railcars that transport SUVs and pickup trucks.

The load factor is not as high for SUVs and pickup trucks on a rail car versus passenger cars. And there is a differential of about 15% in the revenue per unit, revenue per car for those bi-levels versus tri-levels. That's just an example of how the mix continues to play out.

In coal when our export market is down that's our highest revenue per unit business. And when our northern utility business goes up, for example, that's lower. So I don't know what all the combinations are going to be in 2015. We will just have to see how it works out. But we will continue to see negative mix, if nothing else, as we grow intermodal at a much faster pace and coal continues to either be flat or modestly down, which is the ultimate mix effect.

Tom Wadewitz - *UBS - Analyst*

Right, okay. Thank you for the time. Appreciate it.

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

Thanks, Tom.

Operator

Our next question is from the line of Chris Wetherbee Citigroup

Chris Wetherbee - *Citigroup - Analyst*

Good morning. Wanted to talk a little bit about the service metrics and a little bit more about the timing of potential improvements, and maybe understanding a little bit better the sequential deterioration at least in the velocity metrics and the terminal dwell that we see publicly.

It seems like we're sort of ending the third quarter, beginning the fourth quarter at a low water mark. Just want to get a rough sense if you think, Mark,from your perspective that this is sort of November/December as you get those new crews on board, you start to be able to turn the metrics a little bit more constructively. And during the quarter if there was something specifically other than just the confluence of volumes that was causing that sequential deterioration?

Mark Manion - *Norfolk Southern Corporation - COO*

I think we've seen the trough on this, and in fact the public metrics do lag a little bit, and we are seeing improvement that's going on more recently. And something that we track is specifically where our velocity is in various parts of our system.

And the reality is our eastern region, our western region, that is two-thirds of our system has been operating rather well from a velocity standpoint. And the problems have been pretty localized to that east/west gateway between Chicago and Jersey or really Philly.

So we see much better fluidity in that area at this point. Still very heavy; we've still got all the business up there because as far as the volumes go that area has continued to have a lot of traffic. I think we see that sustained.

But we will see improvement as we go forward in the quarter and I think we said that last quarter, that we'll start to see our improvements in the fourth quarter. But as we said before the people, the resources really come on more in the November/December timeframe. But we're already seeing that tick up.

Chris Wetherbee - *Citigroup - Analyst*

Okay. That's helpful, thank you. And then switching gears, Don if I could ask a little about the coal side, I just want to understand the yield dynamic as we think about fourth quarter and going forward.

Obviously you have had some mix issues and export declining a little bit. You had a pop in the second quarter which, I think was driven by some of the longer haul utility moves.

But as you think out to the fourth quarter with where the seaborne market is and where the utility demand is coming from, is this roughly the right way to be thinking about yield, what we saw in the third quarter? Just want to get a rough sense on the mix potential in the shorter term if I could.

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

I think what we saw in the third quarter will be what we are seeing in the fourth quarter predominately. Sequentially coming from the second to third quarter you'll recall that we had a $43 million increase in coal overall which was driven predominantly by a 23% increase into our Southeastern utilities.

That tended to weaken as the summer wore on and we saw milder weather, lower gas prices. Our Northern utility business was down, but Southern utility was only up about 9% in the third quarter. That did impact RPU.

As far as export goes we pretty much see the same type of market condition. Don't see a lot of significant change. It's weak on thermal and met coal and we don't expect that to improve in the fourth quarter, nor do we see any driver for improvement in the first quarter for that.

Chris Wetherbee - *Citigroup - Analyst*

Okay. So this is sort of the run rate the next couple quarters, at least on the export market in your view?

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

We hope so.

Chris Wetherbee - *Citigroup - Analyst*

Okay. Thanks very much for the time, I appreciate it.

Operator

Our next question comes from the line of Scott Group with Wolfe Research

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Scott Group - *Wolfe Research - Analyst*

Hey. Thanks. Good morning.

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

Good morning.

Scott Group - *Wolfe Research - Analyst*

Don that was helpful in terms of the coal mix and how you think about that going forward. I want to ask about intermodal mix, with the peak you're saying happened already, international growth going to slow. Does intermodal mix become more a positive as domestic starts to grow faster?

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

We expect that mix to moderate, that mix differential between domestic and international. International has been very strong this year because of the West Coast ILWU negotiations that shifted business to East Coast ports.

We've also had some organic growth with our international partners and some new businesses through new terminals and new contract arrangements. We will start to lap those events as we get into 2015 and we will see domestic growth outpace international growth in my opinion going forward. So we will see that mix effect start to moderate.

Scott Group - *Wolfe Research - Analyst*

It should probably reverse and turn positive, is that fair?

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

It will start to turn positive, correct.

Scott Group - *Wolfe Research - Analyst*

Okay. And then one for Mark. You gave a lot of numbers around what you are planning with headcount.

I'm not sure what it means for net overall headcount the way we see it. What kind of headcount growth do you think we should be modeling in fourth quarter and 2015? And given the catch-up in the headcount, do you think we'll have headcount up more or less than volume growth in 2015?

Marta Stewart - *Norfolk Southern Corporation - CFO*

I'll take the 2014 question and let Mark address the 2015 question. For 2014 we continue to think that we're going to end the year about even to where we were last year.

So that would be -- last quarter we talked about being 900 up from the second quarter. As Mark said we're up about 400 this quarter. So it's going to be up another 500 in the fourth quarter.

Mark Manion - *Norfolk Southern Corporation - COO*

And going into next year partly in terms of continuing to build our crew base to keep up with today's business levels, and then partly for more business opportunities that are coming up in 2015, we'll add another net 500 to 600 people to what we have at the end of the year.

Scott Group - *Wolfe Research - Analyst*

Okay. So we should probably think about volume growth still outpacing headcount by a good amount next year?

Mark Manion - *Norfolk Southern Corporation - COO*

Oh yes. For the first -- it's going to take us, well really we'll be working on it through the first half. But keeping in mind that once we end the year and turn the corner into 2015, the additional people we have are going to be very helpful in terms of improving our service product. So we won't be completely done until we get into the latter part of the second quarter.

Scott Group - *Wolfe Research - Analyst*

Mark, can I just ask what's the difference in the 1,900 people you talked about that you are training versus that 500 number? Is that just attrition? Is that the difference?

Mark Manion - *Norfolk Southern Corporation - COO*

I want to make sure I understand the question. I'm not sure about the 1,900.

Scott Group - *Wolfe Research - Analyst*

I thought in your prepared comments, maybe it's not 1,900, but you gave a large number of people currently being trained, and now you're talking about adding another 500 people from here. So is the difference just attrition?

Mark Manion - *Norfolk Southern Corporation - COO*

I spoke of since the beginning of the year we have started in training or have produced a total of 1,700-plus people. And then I further defined how that looks in the third quarter and what our net will be by the end of the year.

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

Scott, I think there are three things that go on there. One is some of this -- we continue to have attrition in the T&E workforce. That's a number we have to take into account.

We have some very modest attrition even in the training program. Not much, but there is some there. And then the other thing is at any given time you're trying to take a snapshot of qualified employees and trainees.

So, when Mark talks about the total number of people in the pipeline, there are 500 people who come out, finish their training in the fourth quarter plus or minus, and then there are additional people in that bigger number you mentioned who are finishing their training later in the first quarter of next year. So it's always hard to pin down at any given moment what's going on.

But I think the net -- the important message here is that we have a lot of people in the pipeline. We are starting to see significant increases. But going back to your original question, our T&E staffing, once we get it to the point where we need for it to be, we'll still be growing at a rate that's less than our volume growth. We still expect continued efficiencies in terms of train length and train operations in the same way that you've seen us produce them over the past couple of years.

Scott Group - *Wolfe Research - Analyst*

That's helpful, Wick. Thank you.

Operator

Next question comes from the line of Brandon Oglenski with Barclays.

Brandon Oglenski - *Barclays Capital - Analyst*

Good morning everyone. I know it's been a long call, but Wick I want to follow up on that commentary there because it sounds like there's a lot of puts and takes as we look at 2015.

But if you are adding all these assets and people you should get better productivity, as you just mentioned. Does that suggest that the sustainability and incremental margins like we've seen this year should extend into 2015?

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

I'll let Marta comment on that too. I do think that as we increase -- there's no question as we increase network velocity even as we add these resources that it's a more efficient railroad. It's a more productive railroad.

And in addition it augments our opportunities for volume growth because of the service component. So there's a lot of goodness there.

In terms of incremental margins, Marta I think our expectation is they'll remain very strong. Whether they'll continue quite at the pace that we've seen them this year we're not sure, but we expect to continue to produce strong incremental margins in the business.

Marta Stewart - *Norfolk Southern Corporation - CFO*

I agree with you, Wick. The only thing I would add to that is just a reminder and you probably already have this, Brandon, but just a reminder that this year's incremental margin is affected by that post retirement medical and pension, which Allison asked about. So if you back that out we get more closer to a run rate incremental margin.

Brandon Oglenski - *Barclays Capital - Analyst*

Completely understood. And I think that shines a light on a pretty bright outlook here for the Company. If I could just ask one follow-up here. You have well over $1 billion in cash right now, and I know you have some debt maturities, but it seems like your share repurchase program has really slowed down. You have a big authorization out there. With that outlook and arguably one of the cheapest valuations within your sector right now in the marketplace, why not be more aggressive on the share repurchase?

Marta Stewart - *Norfolk Southern Corporation - CFO*

As you know, Brandon, we believe in share repurchases. We've been a long time buyer of our shares. Other than the recessionary year of 2009 we've bought a significant number of shares since 2006.

Over that time period and continuing into now we moderate those share repurchases just based on overall market volatility. And so all I can say is that we remain share repurchase, we expect to continue to remain that and we were just going to modulate it based on market conditions.

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

Brandon let me add to that. As we always discuss, our first priority is capital expenditures to grow the Company. We're in the middle of that process right now. Our second is dividends.

We have a very strong dividend track record and we will continue to have a strong dividend policy. And then share repurchases as Marta said, we stay in the market. But I will also say it's something that we constantly reevaluate.

And we'll continue to reevaluate it and certainly the factors that you mentioned are very legitimate factors. So going forward we'll continue to look at that. And if we see a certain point where we think we need to become more aggressive or change our policy we're certainly willing to do that and will.

Brandon Oglenski - *Barclays Capital - Analyst*

Thank you.

Operator

Our next question comes from the line of Bascome Majors with Susquehanna International.

Bascome Majors - *Susquehanna Financial Group - Analyst*

Yes, thanks for the time. So the fuel surcharge program you introduced in 2008, believe it kicks in at $90 WTI, and oil has trended below that for most of this month, which would imply that at least fuel prices could fall further while at least some your surcharge revenues are staying flat. And I know that's not your only program and some are based at lower levels, but can you give us an update on the fuel surcharge mix and how it trends among your business groups, and how you expect lower fuel prices to impact your revenues on that front going forward if energy prices where to trend around where they are today?

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

Good morning, this is Don. As you indicated we have many different fuel surcharge formulas that have been negotiated with numerous customers in contracts and other instruments. So we do not have one fuel surcharge program.

Our carload business generally is based off of West Texas Intermediate Crude Oil while our intermodal business is based on highway diesel fuel. So we don't even have the same standards for all of the business because there are different characteristics of the business itself. We have a 60-day lag generally on our carload business, a weekly lag on our intermodal business. That will continue to move up and down.

With crude oil prices, diesel prices, crack spreads, all of the things that impact fuel over time. So I can't give you a specific outlook for that because, frankly, I can't tell you where the forward curve will wind up for West Texas Intermediate Crude or on highway diesel for next year.

Bascome Majors - *Susquehanna Financial Group - Analyst*

Well if oil were to stay in the low $80 range is there a significant portion of your business where surcharges would be locked in or not fall further?

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

I just can't give you color on that because we have so many different formulas that have been negotiated with customers.

Bascome Majors - *Susquehanna Financial Group - Analyst*

All right. Well thank you for the time.

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

You're welcome.

Operator

Our next question is from the line of John Larkin with Stifel.

John Larkin - *Stifel Nicolaus - Analyst*

Thanks, gentlemen, for taking my questions.

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

Thank you, John.

John Larkin - *Stifel Nicolaus - Analyst*

Just wanted to talk a little bit more about the application of incremental crews and incremental locomotives to solve the service issues that you have been grappling with here the last couple of quarters. Seems to me that as things play out here into 2015 that you're going to have enough resources to bring your velocity up, your terminal dwell down, which effectively will create more capacity.

Now you said earlier that the new locomotives will be here and that will give you the opportunity to push the more costly less efficient older units into the reserve fleet. How do you handle the crew situation at that point, if, in fact, you do rebound to previous velocity in terminal dwell numbers?

Mark Manion - *Norfolk Southern Corporation - COO*

Well that would be a good thing. As far as the crew base goes we're planning, like I said, on that 500 or 600 net add people next year. But as velocity goes up it lessens the need for crews. So we can always throttle that back some if we need to.

John Larkin - *Stifel Nicolaus - Analyst*

Okay. And then Marta, you answered a question earlier regarding the cost of the congestion. And I was just wondering if there is a revenue component to that also? If in fact service had gotten to the point in some parts of the network where customers have gone a different direction with their transportation needs until you can get this service back up to where you know it needs to be?

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

This is Don.

On the top line side of our business car utilization and available capacity to move more volume is probably the larger concern with respect to current velocity. Obviously, we're having some pressure points with certain customers. We're working through those. But my larger concern is utilization of equipment and capacity of the fleets in general.

John Larkin - *Stifel Nicolaus - Analyst*

Is it reasonable to assume that revenue growth might have been a point or two higher if you had not had those equipment availability problems?

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

We would have had some higher revenue in the automotive sector, some areas like that, but I'd like to maybe showcase that question and just point out that sequentially from the second quarter to the third quarter, the second quarter was our all-time high top line revenue. We only missed that by $19 million in the third quarter with coal being the swing of $58 million between the second quarter and the third quarter.

We were up $43 million in coal in the second quarter, we were down $15 million in the third quarter. So sequentially we came close to meeting an all-time record with coal swings of $58 million quarter to quarter.

John Larkin - *Stifel Nicolaus - Analyst*

Got it. Thanks for the color.

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

Thanks, John.

Operator

Our next question is from the line of Justin Long with Stephens.

Justin Long - *Stephens Inc. - Analyst*

Thanks. And I wanted to ask my first question on pricing.

As you've implemented some of the rate increases in intermodal that you talked about last quarter, have shippers been pretty receptive given the tightness in capacity? Or are you getting any pushback on pricing up in this type of service environment?

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

We are always sensitive to the timing of pricing, but capacity and tight capacity are the two things that are driving price improvement in today's marketplace. So the price increases that we took in our domestic rail control containers in June and September have stuck and we continue to assess that market going forward for additional price opportunity.

Justin Long - *Stephens Inc. - Analyst*

Okay, great. And as a follow-up on coal, I wanted to ask about domestic coal into 2015. And I know it's tough but let's just assume normal weather patterns. And based on the stockpile levels that you referenced in recent conversations with customers, do you think domestic coal is flat or down again in 2015? Or is there a chance you could see some improvement?

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

Let's segment the market with respect to export with the Australian currency differential expanding and the benchmark met coal price of $119 a ton, and a thermal index to Europe at about $72 a ton. If those two indices continue to be that low, US producers will be very pressured to have any growth in export in 2015.

The wild card, as I mentioned on our utility coal, will be what kind of weather we have during the winter. We are 19% below stockpiles as of December 2013 right now, and if we get anything like last year's winter we will see some increase in demand for utility coal during the winter and coming out of the winter because I suspect natural gas prices will rise as they did last year and electricity demand will increase.

So those are export. We don't see any significant driver in the near term. Utility would be the upcoming winter and what kind of weather we get.

Justin Long - *Stephens Inc. - Analyst*

Okay, fair enough. I'll leave it at that. Thanks for the time.

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

You're welcome.

Operator

Our next question comes from the line of Walter Spracklin with RBC.

Walter Spracklin - *RBC Capital Markets - Analyst*

Thanks very much. Most of my questions have been answered. I'm just going to call it and follow up on one and that is on your buyback.

I know Wick you were saying about reevaluating constantly that buyback and certainly it's trended well below what we thought you would do when you announced your last program. So I see $1.5 billion in cash on the balance sheet but also about $550 million of debt repaid.

In that reevaluation aspect what has caused you a little bit of concern about buying back your shares at these levels? And if you do reevaluate, do we go to -- what is the flex up that we could see? Is it incremental or could you see a significant increase in your buyback next year?

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

Well I don't know that I'd comment on what we would see in terms of any magnitude of a change. I'd certainly think though that as we went into the year we were looking at all of the factors around share price.

And as they have moved -- and as factors have changed, valuations have changed, we'll take a look and see if our program needs to be evaluated again, as I mentioned. I think the important message is that this is something obviously that we actively discuss and that we look at where markets are. And we'll come to an opinion on what we need to do go forward in 2015.

Walter Spracklin - *RBC Capital Markets - Analyst*

Okay. Just to slip in another one, on the crude by rail we've heard the other companies talk about the factors and spreads and drivers in their specific origination markets that might -- that the current volatility and the energy prices would cause.

Don, what are you hearing from your customers in terms of their propensity to relax some of their shipments on crude that you either originate or carry by interchange? What are your thoughts going forward on that market?

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

We're not receiving any input from our customers that the short-term rent crude spreads that have become very close, they're within $3 a barrel right now, are impacting their plans to continue to take Bakken and Western Canadian crude. We're being told that most of them have arrangements that go beyond short-term fluctuations in the market, and their expectations are that the Brent and WTI spread will increase over the next several months.

Walter Spracklin - *RBC Capital Markets - Analyst*

And barring that increase we might see some action?

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

We're not getting that indication at this point. Our crude oil, for example in the third quarter was up over 12,000 cars over the third quarter of 2013.

We're now handling 30,000 cars a quarter, which is what the third quarter represented. So we're seeing our crude oil business both from Western Canada and from the Bakken, the Williston Basin, continue to show some robust dynamics.

Walter Spracklin - *RBC Capital Markets - Analyst*

Okay. That's all my questions. Thank you very much.

Operator

Our next question is from the line of Rob Salmon of Deutsche Bank.

Rob Salmon - *Deutsche Bank - Analyst*

Good morning. You know Mark, you did a really good job in terms of laying out the expectations with regard to overall locomotives and crew that are coming on and how that should play out with regard to service performance. If I could barrel in a little bit more in terms of your intermodal service performance.

It looks likes that's taken a little bit of a harsher leg down at the start of the fourth quarter relative to where we had been in the third. Could you talk a little bit about the dynamics and how you see that side of the segment improving throughout the fourth quarter? I realize a lot of this traffic is coming on that Chicago and to kind of the New England area, which is more heavily congested right now.

Mark Manion - *Norfolk Southern Corporation - COO*

Yes, I'd be glad to. And that fits right up with the comment I made about the fluidity on that east/west corridor opening up so nicely here more recently.

And along with that while our intermodal terminals still have a lot of business, they're heavy, they are in a very, what I'll call a very orderly fashion. So they are able to process well in the intermodal terminals and our main lines, which as I've said before is our heaviest capacity mainlines we've got on the system, they are open for business. So I see that moving in a positive direction for our intermodal business as we go into the rest of the fourth quarter.

Rob Salmon - *Deutsche Bank - Analyst*

Okay that's helpful. And I guess given the lower overall fuel prices, obviously that does cage a little bit of the value proposition for the intermodal side of the business. Don, if the intermodal velocity improvements are constrained, would that cage at all your optimism for the growth outlook for intermodal as we look out into 2015 and kind of current WTI levels? Or are the trucking capacity constraints such that you think you'll be able to materially outgrow GDP, even if the velocity is constrained near term?

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

The latter is the case. Trucking and motor carrier capacity will be tight in 2015.

We don't foresee fuel prices at current levels changing that dynamic or changing the economic model. So we expect our domestic intermodal business to continue to show significant growth.

Rob Salmon - *Deutsche Bank - Analyst*

Perfect. Thanks so much for the time.

Operator

Our next question is from the line of Thomas Kim of Goldman Sachs.

Thomas Kim - *Goldman Sachs - Analyst*

Good morning. I just had a couple questions on the coal side. In prior calls we talked about export coal freight rates effectively bottoming out, and I was wondering, Don, if maybe you could just give a little bit of color around the third quarter export coal freight rates versus the second, the prior quarter and maybe year on year?

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

No change second to third quarter, and we anticipate no change third to fourth quarter. And for that matter, based on what we're seeing, first quarter, as well.

Thomas Kim - *Goldman Sachs - Analyst*

Okay, thanks. And then just with regard to the utility coal mix, can you talk a little bit more about how the sourcing has shifted maybe Q on Q? Could you give us a breakdown of how much coal is coming from the App versus the Illinois Basin and so on?

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

We're still about 34% of our originated coal coming out of central App, 28% coming out of northern App, 19% from the Illinois Basin, and 16% from the PRB. The largest change, as you know year-over-year that we described in the second quarter, is the Illinois Basin now exceeding the originations that we handle from PRB.

Thomas Kim - *Goldman Sachs - Analyst*

Thank you.

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

You're welcome.

Operator

Our next question is from the line of Ken Hoexter with Merrill Lynch.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Great. Good afternoon, I guess, by now. Just wanted to follow-up on the efficiencies, and I guess this might sound odd just given your operating ratio being at the 67%, but looking at -- you talked about having more locomotives on the fleet now. If we go back a decade you still haven't hit peak volumes.

So surprising you've got more locomotives. I just want to understand over the past years have we lost some of those efficiency gains?

Does it take a whole new operating plan or anything that has to shift in order to get the velocity and everything back up? Or is this just little bit by little bit, just looking at what some of the other carriers we've seen making major changes to improve performance?

I just want to understand how we've gotten to this point of decreasing efficiency yet having more on the network. Should we take some of that off in terms of the locomotives and crew and get that efficiency back up?

Mark Manion - *Norfolk Southern Corporation - COO*

Well, you know obviously, a big add on these locomotives these days is working our way out of a difficult situation with the velocity issue. So we should see that improve as we go into next year like we've already talked about.

But in addition to that we've got to keep in mind that there has been a significant mix change over time and with our intermodal business growing the way it has, that adds locomotives to the fleet. And you know just looking at productivity in a little broader way, also keep in mind that we are three years in a real concerted way working on various things from a productivity standpoint that has had the effect of lowering our overall cost structure. And that's why we see a more modest expense increase with all these other things going on.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

But just understand that wouldn't they be more -- unit trains if you're running more intermodal and especially given the Crescent and Heartland Corridor build-outs. So you've got more point to point.

I guess I'm just trying to understand have you put too on to create too much congestion and that's causing that velocity, given the volumes. I'm just trying to understand versus 10 years ago where you had more volumes and now you've got more locomotives and more infrastructure on the network today.

I'm just trying to understand is there something that needs to be overhauled in the operating plan? Or is it just continuing to add more assets?

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

Well I think -- let me add to what Mark said. If you go back 10 years the railroad and the operations looked very different than they do today in terms of our mix of business.

And we have added substantially more intermodal business. It's a much bigger part of our franchise, and intermodal trains are dispatched with higher horsepower per trailing ton and that's had a significant impact on our locomotive requirements.

The second thing that has happened to us is that our unit trains have grown significantly, and particularly with the crude oil, but even before that, with real emphasis on unit trains in Ag, automotive, and grain. And all of that traffic is great traffic and it's very profitable and we want it and that's the way the customers want to ship it, but it has in some ways also impacted our requirements for locomotives. Unit train movements in and of themselves require more locomotives for volume growth than just putting volume on the existing merchandise network.

So listen, we tune our operating plan every year. We have a significant number, as Mark mentioned, of operating efficiencies and plans for even more. And we'll continue to achieve even more, but as I think I said earlier, Ken, every railroad franchise is different. And we do a lot of analysis on our franchise to ensure that we don't have too many locomotives, but that we don't have too few.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Great. And Wick, if I could just revisit your answer to Tom's question on the M&A side, you talked about history of putting them together was difficult and the mergers didn't justify, or might not have as many synergy opportunities and then the regulatory environment.

What was your reaction though when you heard this news that you said no way right away? Did you think we've got to sit down with the board and sit and look at opportunities because if CSX is taken off the board do we need to think about how we line up?

Because yesterday, obviously, on Hunter's call you went over why the regulatory issue might not be as big, but it's finding a partner and gaining efficiency. So just trying to understand what was your and perhaps the board's view in terms of if it does move forward how do you think the industry changes? Or does it not and that's just a one-off?

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

Well I think, without going into specifics, listen we're always thinking and always have about the industry structure and ways that it might change. And we review that with the board every year.

As we go forward if there are changes in the structure, and as I said earlier people have different views of what the potential is, what the likelihood of a transaction being approved is, we'll evaluate it with our board and see if there are actions that we need to take. And that's what we've always done, that's what we'll always do.

But I'll say something Jim Squires reminded me of, and that is that we may not agree -- I may not agree with Hunter on everything, but there is something that Hunter and I agree on wholeheartedly, as does everyone else in this business, is that we don't really have to have mergers to have a very bright future here at Norfolk Southern and as an industry.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Wonderful. I appreciate the time and insight. Thanks, Wick.

Operator

Our next question comes from the line of David Vernon of Bernstein Investments.

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

Hey, good morning and thanks for taking the question. Don, could you comment a little bit about how historically you've seen tighter truck capacity or looser truck capacity actually impact rates in the merchandise segment?

Obviously excluding the coal and the intermodal business? Just trying to think what percentage move in truck rates has turned into what type of base pricing in your experience?

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

Well certainly as the trucking market tightens it has a positive halo effect on intermodal pricing opportunity, as well as the carload pricing opportunity. In our merchandise business anything that moves in a boxcar from paper products to consumer products to manufactured components, a lot of that business is directly competitive or driven by trucking capacity and that gives us an opportunity.

So, and other components like automotive parts and vehicles, steel traffic, so there's a range of commodities that tighter truckload capacity. And when I say truckload capacity I'm talking about everything from dry van to flat beds to covered bulk trucking that gives us an opportunity.

And I would add not just trucking; when we look at the barge industry right now it is essentially sold out. And agricultural commodities and with the crop being as large as it is, we expect barge to continue to face that type of capacity constraints. All of those are pointing to a market that's more favorable for improving yields in our book of business.

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

But I guess as you think about how to dimension that and how you've seen it play out in the past, is there anything you can share as far as orders of magnitude in terms of how impactful the changes in the trucking market are?

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

I can't really put a number behind it or a past trend. I'll just say that we see it as a positive opportunity in the marketplace.

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

Okay. And then just as a quick follow-up, you mentioned that the export rates had held in flat sort of sequentially, but it does look like the rate per ton is still down a little bit sequentially. Is that just then mix in the underlying domestic?

Because the overall length of haul doesn't look like it's changing all that much. So I'm just wondering is there any pressure on you to start thinking about pricing in that domestic market given the challenges in competition with lower-priced gas?

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

No. There are no pressure points that change from the second quarter to the third quarter. It's all relative to mix.

We saw our Southern utilities long-haul traffic start to moderate in terms of its year-over-year increase because of milder summer weather and lower natural gas prices. And also within the export market we saw a relative larger decline in tonnage over our Lamberts Point pier versus our Baltimore tonnage, which is shorter haul.

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

All right. Thanks for the time.

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

You're welcome.

Operator

Our next question is from the line of Jeff Kauffman with Buckingham Research.

Jeff Kauffman - *Buckingham Research Group - Analyst*

Thank you very much and good evening everyone. Thank you for taking my question.

First of all congratulations in a challenging quarter. I'd like to ask about two items which I think are more temporary in terms of laying on earnings.

Marta, you hit the first regarding the cost of congestion. You talked about the $10 million in overtime, you talked about the effect of locomotive maintenance.

What you didn't discuss is maybe what the effect of this congestion and slower train speed might be having on insurance and claims. I know you did note the $15 million increase in personal injury reserve.

What do you believe, Wick or Don, the impact of this congestion is having on your claims expense? And do you believe this is more of a transitory thing and when fluidity gets better we hopefully see that begin to come down? And how would you ballpark the impact of that financially?

Marta Stewart - *Norfolk Southern Corporation - CFO*

We don't believe that the service is having any impact on our claims expense. What I was talking about there was the year-over-year last year in the third and fourth quarters we have favorable claims experience. And so the comp this year -- so we have a comparative increase, but the costs themselves have not increased because of the service.

Jeff Kauffman - *Buckingham Research Group - Analyst*

But your personal injury rate is up above the last couple year's level and it's up above the nine-month level. What would you attribute that to?

Marta Stewart - *Norfolk Southern Corporation - CFO*

That isn't in the serious injuries area that would be impacting expenses in any significant way, but I'll have Mark elaborate.

Mark Manion - *Norfolk Southern Corporation - COO*

As far as the injury rates this year we had some higher injuries actually January, February, second quarter was improved, and now third quarter is improved as well. And we've got a strong start on fourth quarter. So that's actually going in the right direction.

Jeff Kauffman - *Buckingham Research Group - Analyst*

All right. And then let me switch to Don. Don, it seems like a lot of shorter-term items are depressing the yield. I know you mentioned coal may stick around for a while, but others are more mix related.

But your revenue per car was up almost 1% last quarter, it's down almost 1% this quarter. What do you think the underlying rate of core price increases are relative to what the reported rev per car we're seeing is? And when do you think we start to see a number that's a little closer to what your core pricing is actually doing?

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

We see our core pricing continuing to exceed rail inflation right now. We think it will continue to get better.

The all-inclusive less fuel index, which is in a lot of our contracts in the third quarter, only generated about 8/10% in terms of year-over-year increase. That is slated to increase in the fourth quarter up to about 1.8% and for 2015 it's projected to be running about 2.5%, 2.6%.

So we'll see the escalators in our base contracts and our repricing activity, which I've discussed relative to a much tighter transportation capacity market. Those two in combination you will continue to see improvement in our overall revenue per unit and also our core price.

Jeff Kauffman - *Buckingham Research Group - Analyst*

Okay, thanks a lot. I know it's been a long call.

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

Thanks.

Operator

Our next question is from the line of Keith Schoonmaker of Morningstar.

Keith Schoonmaker - *Morningstar - Analyst*

Yes thanks. You can't knock the operating ratio, but long run are there strategic paths that would enable handling demand surges while maintaining high service?

Or is this just the inevitable nature of dealing with high demand? For example changes to work rules or single man crews that might enable handling a little more adeptly?

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

You know, I think that's a great question. One of the things that we certainly are doing right now is going back and looking through a lot of our processes and a lot of our practices to take the lessons learned.

And clearly one thing that we're being very thoughtful about is adding some more what I would describe as resiliency to our network. And that can come in the way, shape of a slightly different, not radically different way in terms of how we think about our crew base, particularly in critical areas.

It can come in the form of making -- of having a somewhat bigger surge fleet of locomotives. And it certainly comes in the form of doing something which as many of you know we've systematically done, which is think about continuing to look at pinch points on the network.

So I think that we'll take these learnings and we'll make some changes that will give us that additional resiliency. Certainly work rules are something we're always focused on.

There's another round of labor negotiations that kicks off here soon, and we'll see if there are things that can be done there, as well. But I think that we can do a lot in the shorter term to give ourselves the ability to handle situations a little better.

But I'll go back to what I said. I think we had a somewhat extraordinary set of circumstances this year, with the very unusual weather followed immediately by significant surge in traffic beyond what we expected. But we'll learn from that.

Keith Schoonmaker - *Morningstar - Analyst*

Great, thanks. Just as a quick follow-up on service issues, do you believe that highway conversions was constrained or slowed due to service issues? Or does trucking capacity offset most of these decisions?

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

I think the overall intermodal network we saw growth that we would have seen. I think equipment availability would have been a little higher in the third quarter, which could've generated on the margin higher volumes and higher revenue in intermodal and automotive. I will add automotive to that.

I don't think it was material. Going forward we don't see in the fourth quarter and on into 2015, we do not see a lot of excess trucking capacity that can take any diverted traffic from rail, not that we expect that. So as our service continues to improve, that really shouldn't be a major concern going forward.

Keith Schoonmaker - *Morningstar - Analyst*

Good. Thank you. High-quality problem to have.

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

Yes, thanks.

Operator

Our next question is from the line of Cleo Zagrean with Macquarie.

Cleo Zagrean - *Macquarie Research Equities - Analyst*

Good morning and thank you. Could you please comment a little more on same-store pricing trends in the quarter? Perhaps with some detail into repricing for new business and how you see the balance of price and volume begin to shape for 2015? Thank you.

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

As we've indicated we are seeing our core pricing coming in in excess of rail inflation. We expect that to pick up as we continue to reprice into 2015. As I mentioned we still have about 15% of our 2014 book to reprice and about 50% of our business next year in 2015 to reprice. And our prices will reflect the tighter capacity in the transportation market as we complete that.

Cleo Zagrean - *Macquarie Research Equities - Analyst*

Thank you. And as my follow-up we heard yesterday on the Canadian Pacific merger conference call their view that the national network is about to hit some limits for capacity and efficiency absent mergers, which they see as the main solution. Would you agree that absent mergers the national network is coming up to some significant challenges? And maybe as part of your response if you could help us with some quantification of impact of your infrastructure projects into next year as a result and into the longer-term as much as you would like to comment? Thank you.

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

I'm not really of the opinion that we are in any eminent danger of hitting significant capacity problems across the industry that will impact our ability to grow for the longer term. I think if you just look at Norfolk Southern and the things that we're doing in terms of everything that Mark mentioned, the Bellevue expansion, a lot of work in our Chicago/Philadelphia corridor, and a lot of work in other places to streamline the network, to add capacity in critical areas, I think that we have a very solid program as we have had for years and will continue to have to strategically augment our capacity as we see volume growth.

When we get into a period, as I have said several times, of unusual volume growth that was difficult for us to predict, we may get a little bit behind the curve as we have. But we're responding to that. We have a lot of work underway and once that work is in place we expect our velocities to go right back up, as we've said. So I think every rail carrier looks at it that way. I think we have the ability to continue to invest, continue to add infrastructure, and continue to grow the business without the need for a merger.

Cleo Zagrean - *Macquarie Research Equities - Analyst*

Thank you. So to clarify you do not see any structural thresholds or limits to growth for the industry given the current makeup of the players?

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

No, I don't. I think that we can all respond as individual carriers and working together to handle what we think, as I've said before, a very bright future in terms of increased volume on the railroads.

Cleo Zagrean - *Macquarie Research Equities - Analyst*

Thank you very much.

Operator

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

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

Well thank you very much, everyone, for your patience and for the very good questions. We appreciate them and we look forward to talking to you again at the end of next quarter.

Operator

Thank you. This concludes today's teleconference.

You may disconnect your lines at this time. Thank you for your participation.