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NSC - Q2 2019 Norfolk Southern Corp Earnings Call

EVENT DATE/TIME: JULY 24, 2019 / 12:45PM GMT

OVERVIEW:

Co. reported 2Q19 net income of $722m and diluted EPS of $2.70.

CORPORATE PARTICIPANTS

Alan H. Shaw *Norfolk Southern Corporation - Executive VP & CMO*

Cynthia C. Earhart *Norfolk Southern Corporation - Executive VP of Finance & CFO*

James A. Squires *Norfolk Southern Corporation - Chairman, President & CEO*

Michael Joseph Wheeler *Norfolk Southern Corporation - Executive VP & COO*

Peter Sharbel *Norfolk Southern Corporation - Director of IR*

CONFERENCE CALL PARTICIPANTS

Allison M. Landry *Crédit Suisse AG, Research Division - Director*

Amit Singh Mehrotra *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Bascome Majors *Susquehanna Financial Group, LLLP, Research Division - Research Analyst*

Brian Patrick Ossenbeck *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Christian F. Wetherbee *Citigroup Inc, Research Division - VP*

David Scott Vernon *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

Jason H. Seidl *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Jordan Robert Alliger *Goldman Sachs Group Inc., Research Division - Research Analyst*

Justin Trennon Long *Stephens Inc., Research Division - MD*

Scott H. Group *Wolfe Research, LLC - MD & Senior Transportation Analyst*

Thomas Richard Wadewitz *UBS Investment Bank, Research Division - MD and Senior Analyst*

Walter Noel Spracklin *RBC Capital Markets, LLC, Research Division - Analyst*

PRESENTATION

Operator

Greetings, and welcome to the Norfolk Southern Corporation's Second Quarter 2019 Earnings Conference Call.

(Operator Instructions) As a reminder, this conference is being recorded. It's now my pleasure to introduce Pete Sharbel, Director, Investor Relations. Thank you. Mr. Sharbel, you may now begin.

Peter Sharbel - *Norfolk Southern Corporation - Director of IR*

Thank you, Rob, and good morning. Before we begin, please note that during today's call, we may make certain forward-looking statements, which are subject to risks and uncertainties and may differ materially from actual results. 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. The slides of the presenters are available on our website at norfolksouthern.com in the Investors section, along with our non-GAAP reconciliation. Additionally, a transcript and downloads will be posted after the call.

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

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Good morning, everyone, and welcome to Norfolk Southern's Second Quarter 2019 Earnings Call. Joining me today are Alan Shaw, Chief Marketing Officer; Mike Wheeler, Chief Operating Officer; and Cindy Earhart, Chief Financial Officer.

With the results in the second quarter and first half of 2019, we are on track to meet the commitments we made to shareholders in February, namely, an operating ratio this year, at least 100 basis points below 2018 and a 60 OR by 2021.

Our railroad is performing very well. The transition to our new PSR-based operating plan, TOP21, went flawlessly, and we are already seeing the financial benefits with more to come.

TOP21 and Clean Sheeting exposed numerous opportunities for cost savings in the second half of this year and beyond, which we are now aggressively pursuing. These savings, coupled with the modest top line growth we expect in the back half, give us confidence we will achieve our stated goals even amidst economic uncertainty.

Turning to the financial results for the second quarter. Income from operations was $1.1 billion, an increase of 4%. Net income was $722 million, up 2% over the prior year and EPS was $2.70, an 8% increase. The operating ratio improved by 100 basis points versus last year to 63.6%. First half net income and EPS experienced double-digit percentage growth, while we reduced our operating ratio by 210 basis points to 64.8%.

Looking ahead, we expect continued year-over-year improvement in the operating ratio in the second half, leading to an OR for the full year at least 100 basis points lower than 2018.

Before turning it over to Alan, Mike and Cindy, let me say a few more words about TOP21 and our outlook. As you know, the first phase of the new operating plan, which we fully implemented on July 1, focused on our merchandise network. As Mike will highlight, TOP21 reduced plan circuitry for merchandise and auto traffic by 20%, and that's in addition to circuitry reductions accomplished earlier in the year through increased fluidity. 87% of the cars in the merchandise network are now operating with new trip plans. Despite these sweeping changes, crucial network performance metrics, train speeds, terminal dwell and cars online and corresponding customer service metrics have held steady near-record best levels.

As we implemented TOP21, it's also important to highlight that we successfully addressed adverse weather conditions, including floodwater from the Missouri River, which severed our line to Kansas City for more than a month. As I highlighted during our Investor Day, we are transforming our culture to ensure that every employee is focused on achieving our goals and is aligned with how Norfolk Southern will pursue them. Our engineering department is a perfect example of this winning culture. Despite the challenges presented from the flooding conditions I highlighted, they didn't miss a beat. They worked together to execute our plan, quickly restore our track and get us moving again. This is just one example of why this team is the best in the business.

Since launching TOP21, we have seen no adverse effects on network performance or quality of our customer service. The benefits of TOP21 reduced circuitry and improved velocity are already apparent as we can now serve the majority of our customers with more predictable transit times and fewer assets to move their freight. As I noted, we are already seeing a favorable financial impact from TOP21 as well. In conjunction with velocity improvements from Clean Sheeting and pre-implementation work earlier this year, TOP21 has enabled us to reduce employment levels well ahead of plan, which Cindy will discuss later.

We saw this in the second quarter with decreases in headcount-related expense, materials expense and equipment rents. We're confident that as the new plan takes hold in the second half, favorable year-over-year comparisons in TOP21-related expense categories will accelerate, and we've already started work on Phase II of the plan.

Turning to our outlook for the balance of 2019. We expect modest volume and revenue growth. As Alan will explain, the growth is expected to come from select merchant -- merchandise lines of business and from a resumption of intermodal growth, consistent with commentary by our channel partners.

Even as we pursue growth, we are determined to exploit every efficiency we uncover from the new operating plan. As a result of TOP21, we see opportunities for additional cost savings in serving yards, local operations and locomotive maintenance, among other areas.

At Investor Day, I described our belief that to keep up in a rapidly changing world, a company must constantly reexamine its culture. Openness to new people and new ideas is critical. So is having the right leaders in the right jobs doing the right things, committed to shareholder value. That remains our mantra. As new leaders across a broad spectrum of functions dig deep into established ways of doing business.

All of us are working together and seeking ways to improve service for our customers, manage our assets, control our costs, operate safely and develop our people. We continue to transform Norfolk Southern and are excited about the progress we are making.

With that, I'll now turn the call over to Alan.

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Thank you, Jim, and good morning, everyone. In the second quarter, we continued to execute our strategic plan of leveraging our improving service product to yield up and drive greater margins. The outcome of these efforts allowed NS to grow revenue and income in a challenging freight environment. We partner with our customers daily on these initiatives through constant communication and collaboration. This has proven an effective approach, clearly demonstrated as we successfully completed the implementation of the TOP21 operating plan on July 1.

Throughout the second quarter, we worked in concert with our customers on the impending improvements through numerous face-to-face meetings. This collaboration, coupled with the flawless execution by our operating team, resulted in a seamless implementation.

As shown on Slide 6, we delivered a second quarter revenue gain of 1%, despite a 4% volume decline. This marks Norfolk Southern's 10th consecutive quarter of revenue growth, building on last year's second revenue -- second quarter revenue increase of 10%. Slower economic growth drove volume declines in intermodal, export coal and steel. Volume decreases were offset by the continued implementation of our strategy to price to the value of our improving service product, generating a 5% increase in revenue per unit.

Merchandise delivered a record for quarterly revenue, with a 2% revenue gain, despite a 3% volume decline. Revenue growth was driven by improved pricing and volume gains in our aggregates and agriculture franchises from increased network velocity.

Midwest flooding adversely impacted merchandise volumes, primarily in our automotive segment. Steel volumes were down 8% due to tariff impacts and lower steel prices. Pipeline activity continues to decrease NGL volumes.

Increased truck capacity, higher inventories and Midwest flooding negatively impacted intermodal revenue, which declined 2% year-over-year. Intermodal volume declined 4% due to reduced domestic volume that was partially offset by 7% growth in our international franchise. Revenue per unit increased 2% year-over-year with solid pricing, reflecting the value of our service product, offset by the negative mix associated with increased international volume. Coal revenue was flat year-over-year as strong pricing was offset by a 6% volume decline, primarily in our export market. The pricing helped increase revenue per unit by 7%. RPU was also enhanced by the positive mix associated with increased volume in our utilities South market.

Production challenges at several mines and low seaborne coal prices resulted in lower export volume against difficult comps. Utility volumes improved year-over-year due to weather delayed tons from the first quarter, service improvements and stockpile replenishment.

Pricing to the value of our service product continues to produce positive results, with RPU growth in all 3 business units and a 5% RPU improvement overall. This gain highlights the successful execution of our plan and contributes to the foundation of our long-term success.

Moving to Slide 7. Consumer confidence remains high, unemployment is near a 50-year low and consumer activity is still strong. The ISM Manufactures Index (sic) [ISM Manufacturing Index[is dropping, although, still in expansion range.

Tariff uncertainty remains a headwind, primarily in the manufacturing sector. Taken together, we remain confident in continued growth in the economy, although, at a lower rate than what we experienced in 2018. Based on this economic backdrop, we expect modest year-over-year improvement in revenue, volume and RPU in the second half of the year, with the bulk of that growth in the fourth quarter.

This growth is a result of our strategy, the success of our TOP21 operating plan and our continued focus on customer alignment. Increased pricing is the largest driver of growth projections, with RPU in the second half expected to increase despite lower diesel rates and difficult comparisons through the second half of last year as well as the impact of lower seaborne pricing in the export market.

I will now highlight some of the primary drivers of our expectations in each of the business units. Within merchandise, we expect oil price differentials will support demand for crude oil shipments to the East Coast. Based on the forecasted 3% increase in U.S. light vehicle production, automotive volume is projected to increase in the second half. Aggregates and sand volumes are anticipated to benefit from improved service levels and a normalized spend throughout the year.

Pipeline activity is expected to continue to negatively impact shipments of natural gas liquids, while steel markets will be disadvantaged by weak demand, tariff impacts and low commodity prices. Our continued focus on pricing to the value of our service product is expected to increase revenue on flat annual volumes.

Intermodal volume is projected to finish 2019 slightly above 2018 levels, as expected growth in the second half will offset first-half declines. We project second half growth in both the international and domestic markets, resulting from sustained year-over-year growth forecast for consumer spending, although domestic growth will be tempered by increased capacity in the truck market.

Our coal markets will likely continue to decline in comparison to 2018. API 2 prices are forecasted to remain at low levels in the second half, while seaborne coking coal prices are projected to decline, impacting both volume and RPU. Utility volumes will be impacted by natural gas prices and weather. In summary, we expect total coal volume to finish below 2018 levels, while RPU is also pressured.

We continue to leverage the value of our service product and secure opportunities that set the stage for long-term success. We remain focused on margin improvement and growth initiatives, supported by a consistent and efficient service product that the market values.

I will now turn it over to Mike for an update on operations.

Michael Joseph Wheeler - *Norfolk Southern Corporation - Executive VP & COO*

Thank you, Alan. Today, I will update you on the state of the railroad and the successful implementation of our TOP21 operating plan. In the second quarter, we continued to drive service improvements for our customers, finalized our new TOP21 operating plan and achieved record operating ratios for a second quarter and the first 6 months of the year. We continue to build on our strong momentum and are confident in our ability to deliver strong value for shareholders and support for our customers.

Moving to Slide 9. Our continued focus on execution of our plan and the principles of precision scheduled railroading is evidenced in our performance metrics. Specifically, our train performance, terminal dwell, shipment consistency and car level velocity for the second quarter were the best on record for any quarter. These achievements are due to the relentless execution by our operations team and laid a firm foundation for our new TOP21 operating plan.

We want to thank our field employees for their unwavering and relentless focus on safety, service and efficiency.

Turning to our service and productivity metrics on Slide 10. These metrics are aligned with our strategic plan, which is built upon providing a service product that will allow our customers to grow with us. As before, the blue bars represent our respective goals for 2019.

Starting with the service delivery index, which is the on-time delivery performance of our scheduled shipments indexed to 2018. This is a customer-facing metric that combines shipment's consistency, which measures trip plan adherence for general merchandise as well as automotive traffic and intermodal availability. I'm pleased to report that we are on track to exceed our goal for 2019 due to our first-half service performance and flawless implementation of the TOP21 plan. As noted on the previous slide, we are delivering a record number of shipments to our customers on time.

We are trending ahead to where we thought we would be with the T&E productivity goal for this year. We anticipate this trend will continue for the rest of the year as we fully implement our TOP21 plan. As mentioned during the last call, our train weight goal is back-end loaded, and we will be monitoring and working on this goal for this year as our new TOP21 operating plan is implemented. We are already seeing improvements in our general merchandise train weights, which are offset by headwinds associated with intermodal and coal volumes.

Locomotive productivity continues to be another strong metric for NS, and we are tracking to meet or exceed our goal for this year. Locomotive as well as T&E productivity are being negatively impacted by the decline in gross ton miles. But we are actively adjusting resources to ensure we remain on track to meet our goals. Our team is flexible, dynamic and will adjust to ensure we hit our targets as business levels change. And the cars online is trending very positively, thanks to our fast and consistent service product. It should also be noted that this number includes cars and storage of approximately 15,000, up 5,000 from the prior quarter. This is the capacity dividend we have referred to previously, which we created in-part by the timely adjustment of our equipment distribution to match market conditions.

I would also like to update you on the progress of our new TOP21 operating plan on Slide 11. As you may recall from our Investor Day, our new operating plan has 4 major objectives: operate as one network, a balanced train plan between terminals, serve our customers frequently and reduce dependence on major terminals.

This iteration of TOP21 primarily focused on our general merchandise, bulk and automotive business.

As Jim noted, we are already working on the next iteration of our operating plan, while we continue to harvest the opportunities from the newly implemented operating plan. We implemented some of our operating plan changes throughout the second quarter. These targeted implementations were concentrated primarily around the edges of our network. The successful implementation of the full plan on July 1, which involved over 180 iterations before implementation, was a partnership between network planning and optimization, who modeled the plan, marketing, who is involved in both developing and communicating the plan and transportation who executed the plan.

As promised, we have been and will continue to work closely with our customers to collaborate on the new operating plan. Prior to TOP21 implementation, we held 19 joint customer employee town halls across the network and met one-on-one with all large customers. This provided our customers the opportunity to better understand TOP21 and the benefits of the plan.

Turning to Slide 12. I would like to give you a comparison of the final TOP21 plan that was implemented on July 1 versus the baseline plan. A key pillar of the new operating plan is expanding the use of distributed power for our merchandise and automotive trains. TOP21 will also drive at least a 20% reduction in circuitous miles by utilizing capacity at regional yards, focusing less on creating density at hump yards. There will also be a 15% reduction in train miles for manifest, automotive and locals, as well as at least a 10% reduction in train starts.

This was a significant undertaking with just under 90% of merchandise and automotive traffic receiving a new trip plan. This will result in a more efficient network with fewer trains, as shown on the graph on the right.

We are confident that execution of our new operating plan will drive further improvement in the near and long term.

I will now turn it over to Cindy, who will cover the financials.

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Thank you, Mike, and good morning. I'll begin with our operating results on Slide 14. Income from railway operations was $1.1 billion, a 4% improvement over the prior year and a second quarter record. Driven by 1% increase in revenues and a 1% decrease in operating expense. Our operating ratio was 63.6%, also a second quarter record, and a 100 basis point improvement on last year's results.

We continue to make significant progress on the financial goals of our strategic plan, and expect that our full year operating ratio will improve at least 100 basis points over the prior year.

Slide 15 illustrates the changes to operating expenses. In total, operating expenses were $12 million lower than last year's expenses. As we recognize the benefits associated with our improved network velocity ahead of the full TOP21 implementation in early July.

I'm looking at each of the income statement line items, lower fuel price during the quarter drove the decline in fuel expense. Purchase services and rents were down due to a decline in equipment rents, a function of improved network fluidity and lower volumes. These decreases were partially offset by planned increases in technology spending.

Materials and Other were slightly higher than prior year. Our operational initiatives drove a reduction in the number of locomotives in service and freight cars online, resulting in $10 million of savings associated with materials. These expense reductions were offset by higher claim costs of $12 million, driven by increased environmental and loss in damage expenses.

While compensation and benefits expense was up slightly, we continued to see a decline in headcount. Average headcount for the second quarter was down over 1,200 sequentially compared to the first quarter. The operational improvements from Clean Sheeting and running a consistent plan every day have resulted in the pull forward of benefits from reduced headcount. We expect headcount for the remainder of the year will continue to decline as we reduce resources as a result of our TOP21 implementation.

During the second quarter, we had savings of $24 million due to lower employment levels, overtimes and recrew. In addition, we also had lower incentive compensation. However, these savings were offset largely due to the absence of last year's employment tax refund as well as higher wage rates. You will recall that second quarter 2018 benefited from a $31 million refund from employment taxes on stock-based compensation. Finally, depreciation was up, reflecting our increased capital base.

Let's move to our summarized financial results on Slide 16. During second quarter, we recognized a $28 million impairment loss related to certain natural resource assets that we seek to monetize.

We continue to execute on our strategic initiatives and that includes evaluating all noncore assets to ensure we are driving the greatest return for investors. This loss, included in other income, was offset in part by gains from nonoperating property sales and higher investment returns on our corporate-owned life insurance. Interest expense on debt was up $22 million due to higher overall debt balance compared to June of last year.

Wrapping up our bottom line results. Net income was $722 million, up 2% and diluted earnings per share was $2.70 an 8% improvement. Both of these measures are second quarter records.

Slide 17 depicts our cash flow for the first half of the year. Cash from operations totaled almost $2 billion, generating nearly $1 billion in free cash flow.

We are committed to returning capital to shareholders, as evidenced by the $1.5 billion of capital returned in the form of dividends and share repurchases, a 36% increase over last year.

We are executing on our strategic plan and are confident we'll continue to produce improved financial performance that drives shareholder value. Thanks for your attention. I'll turn the call back to Jim.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Thank you, Cindy. As the first half of the year demonstrates, we are laser-focused on executing today while planning for tomorrow. And as we have done before, we won't rest when we reach our goals. Each and every member of the NS team is working in unison to achieve our efficiency and growth objectives. Thank you for your attention, and we'll now open the line for Q&A. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from the line of Allison Landry with Crédit Suisse.

Allison M. Landry - *Crédit Suisse AG, Research Division - Director*

Just given the current week's volume backdrop and the negative freight indicators and economic indicators, do you have less confidence in the long-term revenue CAGR targets that you set out at the Analyst Day? And maybe if you could also speak to whether you've seen any change in the pricing environment sequentially?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Allison, let me begin by saying that we are focused on the things that we can control and those things are delivery of revenue growth. Alan described our modest growth objective in the second half through pricing to the value of our service and volume growth in select merchandise verticals, which I'll turn it over to him in a minute to describe further.

At the same time, we are very focused on the productivity and efficiency opportunities that we have uncovered through Clean Sheeting and through TOP21 implementation. So we're focused on the things that we can control and we are very confident that we will hit our goals this year, at least 100 basis points improvement in the operating ratio over last year and 60 by 2021. Now Alan, why don't you dig into the outlook a little bit further.

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Sure. Allison, we remain fully committed and confident in the execution of our strategy. As you know, it's a balanced strategy and it's delivering service growth and productivity. We've got the most powerful intermodal franchise in the East, which is married to the consumption part of the U.S. economy. And the economy continues to move in the direction of the consumer. And the consumer-related economic indicators are still relatively strong. We've got a diverse merchandise franchise, which offers many opportunities for growth. In the second half of this -- the year, we're looking for growth in automotive, consistent with projections for improved U.S. light vehicle production. We're looking for growth in the crude oil markets. We're looking for growth in sand and aggregates as well due to improved service and more normalized shipping patterns. Our read of the tape is that this is going to offset some headwinds that we're seeing in other markets, such as NGLs and the steel market. In our intermodal franchise, outlook is very consistent with what we're hearing from our channel partners.

With respect to pricing, we continue to see strength in pricing. This past quarter was the second best quarter and year-over-year improvement in pricing in the last 7 years, and we've had 7 consecutive quarters of sequential year-over-year gains in pricing in our merchandise franchise. So we've got a rapidly improving service product. We're building credibility with our customers, and we're pricing to the value of that product.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

So Allison, to sum up, we are determined to realize revenue growth opportunities wherever we can, in the second half and for the duration of the plan. I'd like to turn it over to Mike, if I may, just to talk a little bit more about the productivity and efficiency opportunities, which we are also aggressively pursuing right now.

Michael Joseph Wheeler - *Norfolk Southern Corporation - Executive VP & COO*

Yes, sure. So the first thing we're doing is working on harvesting the opportunities out of the new operating plan as the new operating plan was put in place. It's uncovered even more opportunities for us to become efficient and take costs out and that includes an additional tranche of DP trains that will help us as well. The other thing we're looking at is making sure we're really synced up well with the local operating plan with the implementation of the new train plan and that will also give us opportunity to create some efficiencies while still ensuring that we give a good service product to the customers.

The other thing we continue to look at is the locomotive fleet. We see some opportunities there in the locomotive fleet as well as how we maintain the locomotive fleet, what are the opportunities going forward there. And then last but not least, we are already starting to model the new -- the next phase of the operating plan, which encompasses all our traffic on the network, which we'll plan on rolling out early next year. So a lot going on to continue to work on productivity and efficiency.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

So to sum it all up, ours is a balanced plan that positions us for enhanced shareholder value in any environment.

Allison M. Landry - *Crédit Suisse AG, Research Division - Director*

That's all really helpful and definitely encouraging to hear the pricing comments. If I could just ask one more question on the comp and benefits per employee. Cindy, it was really helpful when you outlined some of the year-over-year factors there, but in terms of, sort of, thinking about this on a dollar basis or per employee basis, is this kind of the right range to model this going forward?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Well, Allison, yes. Thanks for the question. As you noted, we had really good head start on reducing our headcount. Year-over-year, we're down about 1,500, and as I said, sequentially, about 1,200. When you look at the reductions that we've made so far in that 1,200, 1,500, about half of the ones we've made were conductor trainees. So obviously, they're at a much lower pay rate than, you say, our average employee. So you'll -- you're seeing a little bit of that impact. In other words, the takeout is not quite as high as you would normally think for an average employee. But going forward, we are going to continue to work on headcount. You saw what Mike presented in terms of TOP21. The number of train start reductions that we're looking at. So we're going to continue to push to reduce headcount, not only in T&E but in all areas of the company we're looking for additional productivity.

Operator

The next question comes from the line of Jordan Alliger with Goldman Sachs.

Jordan Robert Alliger - *Goldman Sachs Group Inc., Research Division - Research Analyst*

So the service metrics, many of them are looking good, like dwell and velocity, pointing in the right direction, which suggests that PSR is kicking in. I'm just sort of wondering, I know you sort of reaffirmed the 100 basis points improvement, but how do you think about how that starts to really dig in and move that operating ratio lower as we move through the second half of the year and into 2020 and beyond, from a timing standpoint I guess more than anything?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Yes. Thank you, Jordan. The service metrics and the network velocity metrics are trending very favorably. And that's something we're extremely proud of, as, I guess, is obvious. Having just cut over to an operating -- a new operating plan with far-reaching effects on our traffic. So we've seen that in all of the metrics that you mentioned and in the metrics that Mike went through as well. That service platform and the service delivery index goal we've set for ourselves, which we're trending well toward are the basis of everything we're trying to do, in terms of the revenue and on the expense and productivity side as well. So yes, we do expect to see, we already are seeing significant opportunities for savings as a result of TOP21 implementation and the Clean Sheeting that preceded it.

Jordan Robert Alliger - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Great. So I mean -- yes, I mean, basically I'm just trying to get a sense that obviously you're in literally early days in terms of flipping the switch July 1, but presumably, as the metrics improve, operating ratio improves, I mean, it's -- that's how it translates from here, whether it'd be headcount, or the rents, et cetera.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Yes. Of course. And -- so we are still expecting to produce an operating ratio at least 100 basis points better than last year for the full year 2019. And are confident we're going to get there.

Now remember, we did have a significant property sale in the fourth quarter of last year and that resulted in gain, and we're comparing to that fully loaded 2018 result.

Jordan Robert Alliger - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Just one more quick question. The Phase II, I assume, of TOP21 will include the intermodal network sometime early next year. While you're doing that network change, will you -- do you expect to continue to be able to push for volumes on the intermodal network as you're undergoing that portion of TOP21?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

We do, we do. Intermodal has been our volume growth engine and it has been a significant contributor, a growing contributor to revenue and bottom line as well. So yes, we continue to expect to grow in that network even as we begin considering how and how much of it to fold in to the TOP21 operating plan.

Operator

Our next question is from the line of Brian Ossenbeck with JPMorgan.

Brian Patrick Ossenbeck - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

I just wanted to ask Mike, when you look at the operating metrics, fuel efficiency got a little bit worse, when you look at GTMs for this quarter. Was that something that you expected coming out of the cutover from the operating plan? Or is that something else that was going on from a mix perspective? If you look at the other results of some of the Class I of this quarter, they started to see some pretty good increases in efficiency. So it's not one of the metrics you talked about too much in the past. I just wanted to get your thoughts on how that trends through the back half and into next year.

Michael Joseph Wheeler - *Norfolk Southern Corporation - Executive VP & COO*

Yes. The fuel efficiency was really not impacted by the TOP21 plan. It was really driven by the drop off in the gross ton-miles. So we've got a lot of initiatives to help drive that. And the coal volumes down hurt that a little bit too. But yes, we're keeping an eye on that. Lot of initiatives to work on that as well and that's in our plan.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

So Brian, we recognize that we have some ground to make up when it comes to fuel efficiency. Running bigger, heavier trains as a result of TOP21 implementation very late in the second quarter or early in the third quarter should help with our overall fuel efficiency. And in addition, as Mike mentioned, we have numerous initiatives in the management area that we believe will result in an improvement in fuel efficiency going forward.

Brian Patrick Ossenbeck - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

And there would conversion of the locomotive fleet, do you see would that be a step change in that function as well?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

That will help.

Michael Joseph Wheeler - *Norfolk Southern Corporation - Executive VP & COO*

Yes. And I don't know necessary it's a step-change because this is something that we're going to do over the next several years. But it does help because you're able to handle more tonnage with fewer locomotives.

Brian Patrick Ossenbeck - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Okay. And then just a quick follow-up for Cindy. Can you give us an update on headcount guidance for the year, I think last time we heard it was down at least 500 for the year? It seems like it's moving along pretty well, but the mix may be a little bit different with the trainees coming out first and then considering we're looking at a fully loaded comp with land sale gains -- I think you had a loss this quarter. What's the outlook for land sales kind of all in when you look at the back half of the year?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Well, in terms of headcount, you're exactly right. I mean we guided to at least 500 down by the end of the year compared to the end of the year in 2018. And as I said, we're already down 1,200 sequentially from the first quarter. We aren't guiding to a specific headcount number, but as I mentioned previously, we do expect that headcount is going to continue to come down as we've reduced work associated with TOP21. We're going to be looking at all areas of the company, including mechanical, G&A, all those areas. We continue to push on the productivity.

In terms of land sales. In operating property, I think we had guided to between $80 million and $100 million worth of gains for a year. And I think that's still a -- I'm sorry, $30 million to $40 million -- hold on one second, $50 million for the year. I'm sorry. And that's still a good guidance for the year.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Now Brian, the item you mentioned was in Other income, it was actually a nonoperating item. And there, we did incur a loss as a result of marking down certain assets. Cindy, why don't you explain what was going on with that?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Yes. We did call out the $28 million loss that was related to some of our natural resource assets. That really relates to one of our wholly-owned subsidiaries, Pocahontas Land Corporation, which has been part of our company for -- since the early 1900s. As part of just continuing to look at our assets, we determined that, that's really not a core asset to our business. And as we've looked at land and other assets that we've had over the years, we just felt like this was an asset that we didn't need to continue to have. It wasn't strategic. So we decided that we would hold that subsidiary for sale, and we wrote it down to fair market value. So that's what the $28 million is.

Operator

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

Scott H. Group - *Wolfe Research, LLC - MD & Senior Transportation Analyst*

So when I look at the -- I'm going to stick on labor. So when headcount down 5% sequentially, labor cost only down 2% sequentially. And I get the issue of those trainees. I'm wondering if there's any severance as well in the quarter, if you could say. Now going forward, should we think about the headcount and the labor cost moving more in line with each other? Are the additional headcount reductions more on trainees or more regular employees? And then Cindy, I know you're not giving a specific guidance on headcount, but now that were through sort of TOP21 and that volumes are weak, do you think we could see a similar reduction in headcount in the second half as what we saw in the first half sequentially? There's a bunch there...

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Cindy?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Yes. Scott, in terms of -- the first question was in terms of severance and there really hasn't been any severance related to the reductions of that headcount. Going forward, in terms of the mix of employees that will be coming out, yes, it's more of the -- of what you could consider sort of average compensation that you've seen. We've got the conductor trainees we got out early. So you'll see more of a normalized comp coming out associated with that -- with the headcounts that comes out going forward.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

And a little bit of that other came out near the end of the quarter too.

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Yes, exactly. I said about half of it was really related to trainees. Your last question, Scott, was?

Scott H. Group - *Wolfe Research, LLC - MD & Senior Transportation Analyst*

Just given now that we're through TOP21 and given the sort of the weak volume trends, can we see similar sequential reductions in headcount in the second half to what we saw in the first half, similar?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

I would say that we -- as I said before, we're going to continue to bring the headcount down in the T&E side around the work that's gone away, reducing the train starts. I mean there will be headcount associated with that as well as in other areas. But I'm not giving specific guidance on headcount numbers. And we're going to push as hard as we can on that.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Scott, whether it's additional headcount reductions, whether it's the other things that I mentioned in my opening statement, cost savings and serving yards, local operations, locomotive maintenance. We will push as hard as we possibly can on the efficiency and productivity in the second half. And we have lots of opportunities that we're working on, as Mike went through earlier as well.

Scott H. Group - *Wolfe Research, LLC - MD & Senior Transportation Analyst*

Okay. Jim, last quarter, you said, let's get through TOP21 and then we could talk about yard rationalizations. Can you give us an update on what you're planning to do there? And then just as I think about the model, like, sometimes third quarter margin's better than second, sometimes not. Do you think we can get sequential margin improvement in 3Q versus 2Q?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Let's start with the yard network. We've already converted 2 hump yards to flat switch operations coming out of TOP21. And we'll continue to look things over. It really depends on the level of volume under the new plan that's moving through a given yard. Once that volume drops below a certain level, it makes sense to convert to a flat switch operation as long as you're going to keep it open. We'll continue to work on that. There may be opportunity -- other opportunities around the network. In addition, we're looking over our entire portfolio of local serving yards to see what fits well with TOP21 and what doesn't. In terms of the trend in the operating ratio, again, at least 100 basis points improvement for the full year versus 2018, fully loaded. That's our goal. And we're confident we can meet it.

Scott H. Group - *Wolfe Research, LLC - MD & Senior Transportation Analyst*

Okay. Alan, can I just ask you one last one real quick? You talked about coal RPU being pressured. Was that a comment that you think full year RPU is lower? Was that second half lower year-over-year? Or is that just sequential? I want to put some context around what you said.

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Yes, Scott. Look at second half of the year. Last year, as commodity prices ran up, we were able to increase our pricing on our metallurgical export market. Now commodity prices are declining. I think the latest I saw was about $178 a metric ton, where we're over $200 this time last year. And that's going to put pressure on the pricing in the metallurgical export market. And then overall, Scott, as you know, the API 2 remains really weak. It is difficult for U.S. suppliers to participate in that market unless they're hedged. And so I think that's going to have a negative impact on thermal volumes in the second half of the year.

Operator

Our next question is from the line of Tom Wadewitz with UBS.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

Wanted to -- maybe a quick follow on, on the questions on export coal and I'll -- a bit on TOP21. I apologize if I mix -- missed this, there were some overlapping calls, but what do you think on full year tons for export coal? Did you give a comment on where you expect that to be?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

No, Tom. I did not give guidance on that. Calling for export coal volumes to decline year-over-year in the second half of the year, pressured in the thermal markets. And then you heard -- you just heard the commentary on pricing as well.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

Sure. What was the full year mix of thermal and met in your export in 2018? And what did that look like in second quarter?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Generally, it runs about 55% to 65% is met, and we were in that ballpark in the second quarter. Similar to where we were last year. Was -- the met steam mix was pretty consistent. We had a little bit more mix towards Baltimore in the second quarter of this year.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

I mean given -- yes, given the comment though, it seems like there you would expect more pressure on thermal export than on met export. Is that the right way to think about it and does that show up in worse kind of -- or maybe a different mix in sequential decline in second half. Or how do you -- I guess I'm trying to resolve the comment on weakness in thermal, but the mix not changing.

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Overall, I think you're right in terms of pressure on thermal volumes and then pressure on metallurgical pricing. And the mix is going to shift in that band that I just gave you.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

Right. Okay. And then a question on TOP21. The framework that you've talked about, I think, Jim, has been along the lines of we want to execute on the plan, make sure it works before we take resources out. And I just wanted to get your sense of is that still the right way to think about it, that you've got some amount of resource in the system that you'll give a bit more time before you take it out or you've seen enough that you -- it's running well and you can pretty quickly start taking out the resource whether that's headcount, more locomotives, whatever it would be?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Well, let me start by saying, we made great progress on resources in the second quarter, even before we flipped the switch on TOP21. So we got a running start on this. But to answer your question, yes, absolutely. We see further opportunities to reduce resources in all of the ways in which we've already discussed this morning. And now that TOP21 has been implemented and the network is running well in its aftermath, we're going to go after the resources.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

Okay. So you don't need further time to assess success. You say, okay, it's working and we can go after it right now?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

That's correct.

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Once the work is gone we take the resources out.

Thomas Richard Wadewitz - *UBS Investment Bank, Research Division - MD and Senior Analyst*

Right. Okay. Good. Well, congratulations on the launch on TOP21.

Operator

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

Justin Trennon Long - *Stephens Inc., Research Division - MD*

So I wanted to start with TOP21 and wanted to get some help understanding the different iterations of the plan. So Phase 1 is under way. It sounds like Phase 2 starts at the beginning of next year. But when will the implementation process be complete across the entire network? And in terms of how this plan impacts the OR, should we be expecting more of an OR benefit in the early stages of TOP21 or the later stages of TOP21?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Justin, as we laid out at Investor Day, we will follow the initial implementation of TOP21 with further refinements. Now the first target of opportunity will be additional benefits, operational benefits, within the remaining merchandise bulk commodities that can be further consolidated into the TOP21, version 1, operating plan. So Mike, why don't you elaborate on that?

Michael Joseph Wheeler - *Norfolk Southern Corporation - Executive VP & COO*

Yes. So you almost want to call it 2.0 of what we implemented. It's going -- gone very well so we're taking a look at what are the next opportunities. We talked about how we made a big effort to add more distributed powertrains. We did that. But we also knew there was more opportunity behind that, and that's what we're looking at now. So there'll be some minor iterations of this current plan that will -- we will model and put in place. Add more distributed power, that'll give us more benefits as well. So we're kind of taking the opportunity to harvest everything we can find as we get better and better with this plan and concurrently start working on the next plan.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

And in terms of the pace of OR improvement, as we have said, in 2019, at least 100 basis points over 2018 and 60 by 2021.

Justin Trennon Long - *Stephens Inc., Research Division - MD*

Okay. And secondly, maybe this is one for Mike. I heard you give some numbers on the number of railcars that have been put into storage, but any update in terms of where we are in rationalizing the size of the locomotive fleet? I know you'll always make adjustments based on demand, but based on the current freight market and volume environment that we're seeing, can you talk about where your active locomotive fleet is today versus what you would consider to be an optimal level?

Michael Joseph Wheeler - *Norfolk Southern Corporation - Executive VP & COO*

Yes. Okay. So we've got about 550 locomotives that we have stored that are available as needed. And I'll remind you that we also sold about 150 units that we've pulled out over the last year as well. So that's where we're at. So it's pretty big reduction from the fleet. And as part of what we've talked about, taking a look at how the TOP21 plan is working as well as looking at our yard and the local network, there's more to come and we're working on that right now.

Operator

Our next question is from the line of Amit Mehrotra with Deutsche Bank.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

I just wanted to come back to the yield-up discussion, if I could. Jim, when you and the management team unveiled it back in February, you and the other executives called it an aggressive but achievable plan, and that was when mid-single digit volume declines were not really kind of in the -- on the horizon, so to speak. So I just wondered, if you could talk about how that's impacting, if at all, the pace and magnitude of the yield-up strategy. I guess over the last few months we've also had a little bit more STB rumblings with respect to some of the ancillary revenue changes that are trying -- aimed to change behavior with respect to PSR.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

I'll let Alan weigh in here. But let me say that the price increases we have taken and expect to take in the future are based on the value of the service we are providing our customers. Service with which they in turn can create value in their businesses. So that's the basis of the price increases. And the service is at a very high level and that has enabled us to take the pricing up. Alan, your thoughts?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

It's foundational to what we're doing. Our approach is a balanced strategy of converting a great service product into both revenue growth and productivity, and you're seeing that in our results. And as I noted, we had -- just had our second best quarter of year-over-year pricing increases in the last 7 years. And within our merchandise network, we've had 7 consecutive quarters of improving year-over-year pricing increases. Customers see the improvement in our service product. They know that we're collaborating with them on our changes to our operating plan, they're part of the discussion and they're part of the process. They also know that we're providing them with a platform for growth. And so they want a sustainable supply chain partner that's going to give them the opportunity to grow in the future. That's what we're delivering.

Amit Singh Mehrotra - *Deutsche Bank AG, Research Division - Director and Senior Research Analyst*

Right. Yes. No, that makes total sense. And if I could just follow up on that precise point. There's -- from the pricing perspective, there's only one rail that we can actually truly kind of calculate what's being realized solely on price or core price. One of the proxy metrics we use, at least, and this could be wrong or not, is revenue per revenue ton-mile, which I think we look at as a proxy for price. So if I look at it on that metric, the growth in revenue per revenue ton-mile for the company was up about 5% in the second quarter. It actually decelerated from 6% in the first quarter. So first, is that the right way we should be measuring your progress with respect to the yield-up plan. And then if so, can we expect maybe greater gains in that metric as you guys get further along the process?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

I mean that's a proxy for it. It also -- as you know, the denominator is influenced by circuitry and -- with the TOP21 21 plan. We're going to benefit from that.

Operator

The next question is from the line of Chris Wetherbee with Citigroup.

Christian F. Wetherbee - *Citigroup Inc, Research Division - VP*

Wanted to kind of come back to some of the commentary around second quarter operating performance relative to maybe what we can expect post the TOP21 roll out and maybe as we move forward through the PSR plan towards the 2021 targets. Conceptually, as you think about the second half of the year, should we assume that there's maybe incremental operating leverage that you can capture relative to the first half of the year, as you've made the big strides on the headcount reductions, but your outlook for sort of volume maybe is a little bit better in the third quarter and fourth quarter, and clearly, yield side still remains reasonably strong. Just wanted to get a rough sense on that. I know that 100 basis points is the target for this year, but when you think about sort of first half versus second half, it seems fair to assume that you might be able to pick up a little bit operating leverage in the back half.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

We did see significant operating leverage in the first half, and we expect that trend to continue with our emphasis on pricing to the value of our service with targeted growth opportunities, modest growth opportunities, but some tailwind there as well. So you roll it all up for the full year and we believe that we can achieve that at least 100 basis points improvement on the operating ratio versus last year.

Christian F. Wetherbee - *Citigroup Inc, Research Division - VP*

Okay. Maybe, Alan, a question on the intermodal side. Just wanted to get a sense, I mean you made some positive commentary around intermodal and obviously, some of that's probably coming from the channel partners. When you think about your book of business, stuff you need to cull off the network, maybe some lane selection that you need to do. How far along are you on that process? Do you see more -- incrementally more or less as you move into the back half of the year? I guess kind of thinking about that in the context of maybe somewhat better intermodal outlook for the back half of the year or at least maybe consistently strong for the back half of the year.

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Well, Chris, lane rationalization for Norfolk Southern is an ongoing process. We have done it every year since 2013. And last year, we were able to deliver 18% revenue growth with lane rationalization on top of 11% revenue growth in 2017. We are committed to doing this in collaboration with our channel partners and providing them with sufficient notice so that they can plan accordingly with their customers.

Christian F. Wetherbee - *Citigroup Inc, Research Division - VP*

Okay. So -- but incrementally, first half, this is just an ongoing process, we shouldn't be thinking about it as sort of more or less relative to what we've seen so far in 2019?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Typically, we operate with these or we execute these changes in advance of bid season at the beginning of the year. Again -- once again, Chris, it's to make sure that we're collaborating with our customers.

Operator

Our next question is from the line of David Vernon with AllianceBernstein.

David Scott Vernon - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

Alan, I just wanted to follow up on the confidence around the volume growth coming back in intermodal in the back half of the year. Is that based on, so your expectation that the truck market starts to firm up? Or is there some visibility you have in terms of share shifts within the smaller domestic market that's going to get you back to growth?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

It's based on the overall macro environment. We're not -- it is based on conversations with channel partners. You're starting to see some improvement in spot rates, maybe we're at an inflection point. So that's our read. And once again, it's modest. And however, recognize that our international volumes continue to grow. So when we improve our domestic volumes, then it could easily turn into growth within the overall intermodal franchise. And once again, we've got the best intermodal franchise in the East. And so we're going to be at the forefront of that growth.

David Scott Vernon - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

And I guess as you think about -- within the environment right now, being a little bit softer on the truck rate side, I think some of the intermodal providers we're talking about, how there are lanes where truck is actually priced under door-to-door intermodal. Is there anything you guys need to do on the pricing side to get that growth back? Or do you feel like you can kind of yield up into this softer truck market and still get volume growth?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

Yes. We're very pleased with the outcome of bid season, in terms of the rate increases we were able to achieve. Once again, it reflects the value of our product and it reflects the strength of our intermodal franchise. We got a great franchise, it's a point-to-point franchise, which frankly means we don't have to make a lot of adjustments to it. There is some cyclicality in the truck market, and you can find some lanes out there where the spot rate is under intermodal. However, we're not going to chase that. We're going to continue to price long term to the value of our product, and we've got long-term relationships with our channel partners. They understand that.

Operator

The next question comes from the line of Jason Seidl with Cowen and Company.

Jason H. Seidl - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

I'll stick with intermodal here as well. Can you talk a little bit about the upcoming peak season? Do you expect sort of a normalized peak? And then on the international side, obviously a lot of growth coming there. How much of that growth do you think is just sort of East Coast share wins versus the West Coast or maybe that you just won some business versus your competitor in the East?

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

I think we're looking for a normalized peak. Our channel partners are anticipating volumes will start to pick up in August. On the international side, we've got great alignment with the steamship lines that are adding capacity to the East Coast, and that's driving a lot of our growth.

Jason H. Seidl - *Cowen and Company, LLC, Research Division - MD & Senior Research Analyst*

Okay. Makes sense. And I have a quick question. You mentioned flooding in Casey. I think you said -- guys said, your line was out for more than a month. I don't seem to recall you mentioning any costs associated with that line being out. I was wondering if you can give us a little more meat on the bone there?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

The impact on expenses was immaterial. We did have some additional capital costs associated with the flooding. Cindy, order of magnitude?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Yes. I would just repeat that, I mean obviously there were comps associated with it, but it was primarily capital, and on the expense side it was nonmaterial expenses.

Operator

The next question comes from the line of Walter Spracklin with RBC Capital Markets.

Walter Noel Spracklin - *RBC Capital Markets, LLC, Research Division - Analyst*

So I wanted to come back to the overall volume inflection, positive growth in each of the metrics on the top line you were mentioning. I'm seeing minus 4 -- obviously, minus 4% volume down the second quarter. Your carload data to date is, I know early in the quarter, but minus 7%. I just got to go back perhaps, Alan, to the question about what are you hearing? And it seems to be across the board in each of the -- each of your segments that are trending down here so far in the third quarter that -- what are you hearing from your customers that suggest that not only is minus 7% going to stop dropping, but you're going to see in fact enough growth to swing you back into the positive territory for the rest of the year. Is it any one commodity? Is it a big share win that you've gotten. You've secured and you can see in the back half? Just a little bit of color on that would be great.

Alan H. Shaw - *Norfolk Southern Corporation - Executive VP & CMO*

So Walter, we are targeting growth in the second half of the year. The majority of that growth will occur in the fourth quarter, as I noted in my prepared remarks. In our conversations with our customers, I just talked with Jason about what we're hearing from our channel partners within intermodal. And then in the merchandise network, we see the crude price differentials, creating the opportunity for growth in the second half of the year because of our flawless implementation of TOP21 we've got the capacity dividend to apply to that.

We see improved service, which will allow continued growth in aggregates. We're looking for more normalized shipping patterns within our frac sand markets and U.S. vehicle production is -- light vehicle production, pardon me, is projected to increase by 3% in the second half of the year. And we serve more U.S. automobile production than any other railroad in North America.

Our read of the tape is that, that's going to offset some declines. We fully expect to see declines in NGLs. We expect to see pressure within our export coal market, as I noted earlier. And the metals market has been weakened by low-commodity prices, although we're starting to see price increases for hot-rolled coil steel take effect and stick.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

So for all the reasons Alan has mentioned, Walter, we do expect growth, volume and revenue growth. Modest volume and revenue growth in the second half. We're all about pursuing the efficiencies that we have uncovered as a result of Clean Sheeting and TOP21 as well. And we'll continue to push on all of those opportunities hard in the second quarter (sic) [second half], even as we go after the growth that we can find.

Walter Noel Spracklin - *RBC Capital Markets, LLC, Research Division - Analyst*

And that's great color. I appreciate that Alan and Jim. And that leads me to my second question. When I look at your TOP21 and kind of compare it to past iterations of PSR, when I look at the 100 basis points that you're guiding to for this year, 60 for 2021. It's a little different from PSR, right? I mean PSR is front-end weighted, big reductions in OR. And then those OR reductions taper off as we get through the plan. What your suggest is that you're looking for 100 basis points this year, but then accelerating to, you know what, 220 per year in the next couple of years, and that's where I'm struggling a little bit.

If you can tie TOP21 in to show why operating ratio was in fact going to double in its pace of improvement in 2020 and 2021 to get to that 6% target, certainly be helpful.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

There is more to come. And as we laid out at Investor Day, this will be an iterative network planning process and there will be additional phases of operating plan change and optimization coming. Those will be the basis for further operating ratio improvements as well as the growth that we can manage for the duration of the plan period into 2021.

Walter Noel Spracklin - *RBC Capital Markets, LLC, Research Division - Analyst*

Will you be providing guidance again, like you did this year for 2020 operating ratio as you get into the 2020 period?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

We'll see. I would certainly expect us to update you on the productivity and SDI, service delivery index, goals that we laid out for you. We'll give you new goals, which are, in turn, linked to the operational and financial improvements we expect to drive.

Operator

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

Bascome Majors - *Susquehanna Financial Group, LLLP, Research Division - Research Analyst*

Yes. Volume was down year-over-year in the quarter, but revenue was still up slightly and margins expanded about a point to drive the income up 4% -- excuse me, operating income. But if you look beyond the financials, the operating metrics were up a lot more, velocity up 20%, dwell down close to 40%. Why aren't we seeing more cost fall out of the system from this more fluid network? I mean is this temporal challenges like the stock comp benefit you had last year that hurt the year-over-year comparison in labor? Or is it just a situation that investor expectations around how quickly we're going to see stair step margin improvement in NS. Are those just too high early on here?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

We did see TOP21 driven expense improvements in second quarter, as Cindy went through in labor, in materials, in equipment rents. And we would expect those savings to continue and to accelerate in the balance of the year. Now in the second quarter, those favorable expense trends were offset in certain cases by the comparison to last year. For example, the employment tax refund we booked in the second quarter of last year. And there were some other things as well. For example, in materials and other, that masked the improvements in materials expense. Going forward, we do expect to see additional TOP21 driven savings in all of those categories.

Bascome Majors - *Susquehanna Financial Group, LLLP, Research Division - Research Analyst*

Last one. The -- I believe it was Slide 10, where you lay out your KPIs. What's the reiteration of what you talked about at the Investor Day with 2019 goals and 2021 goals? You gave some directional commentary about where you're tracking mid-2019, but you don't have hard metrics on the slide. Can you give a little more color about the degree of progress we've made towards the bridge from '18 to '19 goals here? What looks like a layup and what's a bit more stretch from where we sit today?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Thank you. Mike, why don't you go through your commentary again on each of those goals?

Michael Joseph Wheeler - *Norfolk Southern Corporation - Executive VP & COO*

Yes. So the service delivery index were -- as we noted, were trending ahead of that. And we're on track to exceed the goal. Same thing with T&E and productivity. We're trending ahead of that as well. And so we feel comfortable about that. Train weight, we talked about it being back-end loaded. And as we implement the new TOP21 plan, we ought to see some improvements there. We're already seeing some in general merchandise. Locomotive productivity, we are on track to meet or exceed, and the cars online, we are exceeding and we'll be exceeding for the year.

Operator

The next question is from the line of Harry (inaudible) with Bank of America Merrill Lynch.

Unidentified Analyst

So just quickly on some housekeeping items. So the tax rate came in a little lower than what we had been looking for this quarter. Maybe you could talk about, if there was something unique about this quarter and what the expectation might be for the second half. And then also if you could give the number on real estate gains for the quarter?

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Cindy?

Cynthia C. Earhart - *Norfolk Southern Corporation - Executive VP of Finance & CFO*

Yes. Effective tax rate was 22.7%, which had some benefits in it, 2 pieces, really. One being the benefits of stock-based compensations that hit the quarter. And then secondly, the returns on corporate and life insurance. For the full year, we're expecting that the effective tax rate will be between 23% and 24%. And in terms of real estate sales, on operating property, they were not significant. And we already -- we called out, there was nonoperating property sales of -- I guess it was around $10 million.

Unidentified Analyst

Got it. Okay, that's helpful. And then just -- I wanted to return to this OR question and I feel like maybe we've beat it to death a little bit, but you guys had set out efficiency targets obviously at the analyst day. And it feels like volumes have come in a little bit weaker than what most people would have expected. Maybe if you could just talk about the extent to which you see your cost structures as moving in tandem with what volumes are because it feels like certainly on OR and also on headcount, you're trending well ahead of your full year target, at least through the first half.

Should we expect some moderation in the pace of those gains? Because it feels like it would be the opposite given kind of the implementation of TOP21 now just starting up in July. Maybe you could talk about the extent to which you see that cost structure is variable with volumes.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

We created ratio-based KPIs, that Mike has been through, in order to keep us focused on productivity relative to GTMs on the network. That was the basic rationale for setting forth our KPIs in that way. And that's what we remain focused on, and we're making progress. We're winning there, because as Mike went through, we have generated or are close to generating the types of results that will at least meet or exceed the target ratios for 2019. So we are adjusting the resources in light of the volume trend, thus the intense focus on productivity and efficiency in all of the different areas we've been through.

Operator

This concludes the question-and-answer session. I will now turn the call back over to Mr. Jim Squires for closing comments.

James A. Squires - *Norfolk Southern Corporation - Chairman, President & CEO*

Thank you very much, everyone, for your time and attention this morning. We appreciate your questions, and we look forward to talking with you next quarter. Thank you.

Operator

Ladies and gentlemen, thank you for your participation. This concludes today's teleconference. You may now disconnect your lines at this time, and have a wonderful day.
