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NSC - Q3 2016 Norfolk Southern Corp Earnings Call

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OVERVIEW:

Co. reported 3Q16 revenue of $2.5b, net income of $460m and diluted EPS of $1.55.

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PRESENTATION

Operator

Greetings, and welcome to Norfolk Southern's third-quarter 2016 earnings call.

(Operator Instructions)

As a reminder, this conference is being recorded. I would now like to turn the conference over to your host, Katie Cook, Director of Investor Relations. Thank you, Ms. Cook. You may 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. The slides of the presenters are available on our website at NorfolkSouthern.com in the investors section, along with our non-GAAP reconciliation. Additionally, transcripts and downloads of today's call will be posted on our website.

During this call, we may make certain forward-looking statements which are subject to a number of risks and uncertainties and may differ materially from our 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.

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

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

Good morning, everyone, and welcome to Norfolk Southern's third-quarter 2016 earnings call. With me today are NS's Chief Marketing Officer, Alan Shaw; our Chief Operating Officer, Mike Wheeler; and our Chief Financial Officer, Marta Stewart.

Our results this quarter, summarized on slide 4, reflect the successful proactive measures and strategies that Norfolk Southern continues to employ as we relentlessly focus on delivering results through efficiencies and asset utilization. We continue our focus on deploying resources to improve service and network performance while streamlining our corporate assets.

Targeted cost initiatives and the disposition of surplus operating property, combined with the lapping of prior-year restructuring costs, drove a 67.5% operating ratio. This marked an improvement of 220 basis points, or 3%, compared to last year, as operating expenses came in 10% lower relative to a 7% decline in revenue.

We extended the high performance levels we have reliably delivered throughout this year into the third quarter, resulting in a record 68.7% operating ratio for the nine-month period. As a result of our efforts, earnings per share for the quarter increased to $1.55, up 4% compared to last year's to $1.49. For the nine-month period, earnings per share increased 8% year over year.

Importantly, we have significantly improved network performance as shown by our composite service metric, which was up 8% for the quarter and 14% for the year. These results, in addition to feedback I am receiving first hand from our customers, confirm what we already know. Our commitment to customer service in tandem with our disciplined cost measures continues to move our Company in the right direction.

With respect to network initiatives, Mike will go over our progress in greater detail, but let me highlight that our team has already exceeded the 2016 rationalization goal of 1,000 miles, and we'll continue to pursue these kinds of opportunities in the future.

Turning to slide 5, as we entered this year, we had committed to lowering our operating ratio below 70% for the year, which I am pleased to say we are well-positioned to achieve, even with economic headwinds. Our cost savings initiatives will generate productivity savings of at least $200 million for the year -- upwards of $250 million in fact -- and we will contain capital spending to $1.9 billion, which is lower than our original $2.1-billion plan, as we continually reassess the optimal deployment of capital in this changing economic environment.

Our employees have consistently demonstrated their commitment to reliably delivering superior results in what has been a dynamic and challenging economic environment. We have worked hard to build a flexible strategy, one that stages us well for top-line growth, coupled with annual productivity savings, which are targeted for over $650 million by 2020. This team's strong start in 2016 reinforces my confidence in our ability to achieve a sub 65% operating ratio by 2020 and deliver substantial shareholder value.

Now, Alan will cover trends in revenue; Mike will provide more detail on how we're managing the operation, including the progress I mentioned on our line rationalization initiatives; and Marta will summarize our financial results. Then we will take your questions. Thank you, and now I will turn the call over to Alan.

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

Thank you Jim, and good morning to our audience. We appreciate your joining us today. Easing economic headwinds contributed to a 3% sequential improvement in revenue as compared to the second quarter of 2016. Our $2.5 billion in third-quarter revenue represented a 7% year-over-year decline, primarily driven by decreases in energy-related markets and the Triple Crown restructure.

The hot summer and sequentially higher natural gas prices softened declines in utility coal, though high stockpile levels continued to dampen the year-over-year comparisons. The Triple Crown restructure enhanced our overall efficiency and profitability while yielding year-over-year volume and revenue declines since the fourth quarter of 2015.

While energy prices improved in the third quarter, they remain below last year's levels and negatively influenced fuel surcharge revenue and several merchandise commodities, including crude oil and natural gas products. Amid the challenging economic conditions, intermodal remains a bright spot with improved service driving growth and domestic business. Despite pricing gains revenue per unit declined 3% due to negative mix associated with increased intermodal freight and decreased coal volume, as well as lower fuel surcharge revenue.

Merchandise revenue and volume, as shown on slide 8, fell 4% in the third quarter. Our chemicals franchise, impacted by continued reductions in crude oil shipments as well as plant closures and consolidations in our industrial intermediates markets, further declined from the second quarter and was a primary driver of the year-over-year merchandise decrease.

Agriculture was impacted by reduced feed, wheat, and corn volume compared to 2015. Automotive shipments were down as a result of a competitive loss, as mentioned on our second-quarter call, and production declines at several NS-served plants. A weak pulp board market, combined with increased truck competition, negatively impacted paper and forest products volume.

These decreases were partially offset by metals and construction volume, which increased year over year and sequentially due to stronger shipments of steel and aggregates. As compared to last year, merchandise RPU increased 1%, reflecting positive pricing gains, partially offset by negative mix associated with increased aggregates and coil steel, as well as reduced industrial intermediates and machinery volume.

Turning to intermodal on slide 9, volume declined 1%, as year-over-year growth in domestic and international volume nearly offset the declines related to the Triple Crown restructure. Excluding Triple Crown, volume was up 6%, while revenue increased 5%. Despite excess truck capacity, our improved service product drove an 8% year-over-year increase in domestic intermodal business. International volume increased 1%, compared to a strong third quarter last year.

Lower volumes of higher-rated Triple Crown freight and lower fuel surcharge revenue negatively impacted RPU, down 7% as compared to last year. Excluding Triple Crown and fuel surcharges, RPU was up 2% in this highly competitive truck price environment, while revenue improved 8%.

On slide 10, coal revenue was down 18% for the quarter, with a 15% volume decline as compared to last year. Year-over-year utility volume continue to be negatively impacted by low natural gas prices and above-normal stockpile levels. Warmer summer weather and sequentially higher natural gas prices improved coal dispatch and utility deliveries as the third quarter progressed, generating 18.4 million utility tons, a 28% improvement from the second quarter.

Future utility volumes will be dependent upon weather conditions, natural gas prices, and stockpile levels. Between May and September stockpiles declined by approximately 20 days of burn, though they remained 25 days above targeted levels and are expected to impact utility volumes into next year. Assuming normal weather conditions and natural gas pricing consistent with the current forward curve, we expect to handle between 15 million and 18 million utility tons in the fourth quarter.

While there has been recent strength in spot pricing in the seaborne markets, US export supply has been constrained by the impact of bankruptcies and production rationalizations. Third-quarter thermal exports through Baltimore declined significantly as tonnage shifted to the domestic utility market. For the fourth quarter, we expect to handle 3 million to 4 million export tons, with sequential increases in thermal coal through Baltimore. Coal RPU excluding fuel was down 2% in the third quarter, with positive pricing offset by the mix of reduced export volume.

Turning to our outlook on slide 11, we expect fourth-quarter volumes to be flat or increase modestly year over year due in part to somewhat easier comparisons. In mid November, we will cycle the impact of Triple Crown. The fourth quarter of 2015 also marked the start of the unseasonably warm winter that generated excess coal stockpiles, the effect of global steel oversupply, as well as the beginning of the impact of increased manufacturing and retail inventories. Lastly, we expect a lower year-over-year fuel surcharge revenue decline, with WTI and on-highway diesel prices close to fourth-quarter 2015 levels.

Though some coal stockpile correction occurred in the third quarter, we expect the ongoing inventory overhang to impact fourth-quarter utility coal volumes. Sustained oil prices in a narrow spread between Brent and WTI will continue to limit crude oil rail volume. Though automotive volume for the full year is expected to exceed North American vehicle production growth of 1%, fourth-quarter shipments will decline as compared to last year.

We anticipate year-over-year service-driven growth within intermodal. We will maintain our focus on improved pricing, reflecting the value of our service product. Overall revenue per unit will be impacted by the ongoing mix headwinds associated with increased intermodal and decreased coal freight.

Our long-term view on both market and pricing enables us to navigate the current economic headwinds while positioning us for future growth. Marketing continues to work closely with operations and finance, executing on our financial plan amid dynamic market conditions, controlling what we can control, ensuring that resources are in place to support expected volumes, and allowing us to take advantage of opportunities for long-term growth.

I will now turn it over to Mike to discuss our operational performance.

Mike Wheeler - *Norfolk Southern Corporation - COO*

Thank you, Alan. I am pleased to announce we are continuing to operate at high service levels, while making outstanding progress on our cost-reduction initiatives. As Jim noted, the progress we have made is a testament to our employees and their commitment and focus in executing the key drivers of our strategic plan.

Let me begin with safety on slide 13. While our reportable injury ratio increased in the third quarter as compared to the same period last year, we had an 18% improvement in our serious injury ratio.

Turning to service on slide 14, you see we continued to execute at a very high level as evidenced by our service composite, train speed, and terminal dwell metrics. This is the second quarter in a row with a service composite above 80%. For the third quarter, our service composite and train speed both improved 8%, and dwell improved 3% versus the same period last year.

Overall, our velocity as measured at the car level remains near record levels and continues to aid asset utilization and strong customer service. What is most encouraging is that we have been able to do this while aggressively pursuing cost-reduction initiatives, as evidenced by our 67.5% operating ratio. The improvements in our service metrics demonstrate our continued commitment to driving productivity improvements and increasing customer service.

Now, on slide 15, these cost-cutting initiatives, coupled with our ability to keep the railroad operating at a high level, continued to result in significant productivity savings. The reduction in crew starts for the third quarter significantly outpaced the decline in volume, and we have continued to improve our recrews, overtime, and train length.

Through the third quarter, we have achieved our highest average train length on record. Even with this significant improvement in train length, our velocity has been roughly the same as our record levels of 2012 and 2013. Together, this resulted in improved employee productivity.

Turning to slide 16, in our previous call we said we would give an update on our network rationalization efforts. We have been going at this in a very deliberate way, with three separate strategies tailored to the specific circumstances, with the goal of maintaining or improving service to our customers while reducing our costs and investment needs.

To that end, the most visible way we are changing the network is getting a short-line carrier to operate lower-volume segments. We have completed one large transaction with the West Virginia Secondary, and another transaction is in process. This benefits NS by enabling us to improve capital allocation, continue to serve the customers, and maintain our network reach.

As illustrated on slide 17, we are also concentrating flows on fewer routes. For example, we idled one of our steepest and most difficult-to-operate lines in the coal fields by rerouting coal trains onto our main line which had excess capacity. To retain flexibility, the old route was left in place for now in case there is a business rebound. We have done this at several locations, even outside the coal network, and are continuing to identify opportunities across the system.

Lastly, on slide 18, even if we decide to continue using a route, we have found it is possible to reduce speeds without affecting customer service. These are our secondary main lines. By reducing speeds, we can extend the life of track without affecting safety and delay reinvestment needs. We also realize some modest expense savings as well.

This is a new strategy for NS and reflects a willingness to re-examine our business model in the face of economic realities. Using our full toolkit, we have already exceeded our 1,000 mile goal for 2016, while velocity and service have remained near our historic highs.

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

Marta Stewart - *Norfolk Southern Corporation - CFO*

Thank you, Mike, and good morning, everyone. The third quarter results showed continued strong cost control in the face of modest overall volume decline. Let's take a look at the financial details, starting with operating results on slide 20.

While revenues were down 7% on 4% lower volume, operating expenses declined by 10%. The 67.5% operating ratio for the quarter was a 3% improvement over last year's third quarter, and the operating ratio of 68.7% for the first nine months was an all-time record.

Slide 21 shows the expense reductions by income statement line item. Every category of cost was lower in 2015, a result of targeted expense reduction initiatives and the lower volume. Additionally, the comparison was affected by last year's restructuring costs, particularly in depreciation.

Now, let's take a closer look at the components. Slide 22 highlights the major drivers of the variance in compensation and benefits. While the overall net change was relatively small at $11 million, it contained some offsetting items.

First, with regard to employee counts and employee hours, the efficiency improvements in the first half of the year continued as overall headcount was down over 2,400 employees versus last year and was down slightly sequentially. This reduced headcount, along with lower overtime and fewer recrews, resulted in $47 million of year-over-year savings, and the associated payroll taxes were favorable by $5 million. We also had $9 million in lower pension expense. These items helped offset increases in incentive compensation of $39 million, wage inflation of $14 million, and health and welfare rate increases of $12 million.

For the remainder of the year, we expect headcount to remain relatively flat sequentially. With regard to incentive comp, wage rates, and health and welfare costs, we expect to have similar year-over-year increases in the fourth quarter as we had in the third quarter.

Slide 23 depicts purchased services and rents which was down $65 million, or 14%, year over year. The largest reduction was attributable to $37 million in decreased Triple Crown costs. Recall that the curtailment of Triple Crown operations was effective on November 15 of last year, so our fourth-quarter variance for this item will be about half this amount.

Also contributing to the reduction of this line item was $7 million of lower equipment rents. This was due primarily to the improved velocity Mike described, and we expect this benefit to continue into the fourth quarter.

Next is fuel expense as shown on slide 24. The $40-million, or 18%, decline in fuel cost for the quarter was largely a result of lower oil prices, which decreased the price per gallon by 12%. We also had lower consumption due to the lower traffic volume.

Slide 25 details our materials and other category, which decreased $54 million, or 22%, year over year. This improvement reflects $28 million of gains on the sale of two operating properties.

Next, reductions in material cost totaling $15 million were primarily from locomotives and freight car materials. And the last variance on this slide is principally due to moving costs associated with last year's Roanoke office closure.

Turning to nonoperating items on slide 26, this, too, was affected by the prior-year comparison, as we had a large gain on the sale of a nonoperating property in the third quarter of 2015. Somewhat offsetting this decrease were higher returns from corporate-owned life insurance.

Moving on to income taxes on slide 27, the effective rate for the third quarter was 34.8%, versus 37.6%. The lower effective rate was related to the increased life insurance returns as well as to the effects of stock-based compensation and several other smaller items. For the full year, we now expect to have an effective income tax rate of roughly 36%. Summarizing our third-quarter earnings on slide 28, net income was $460 million, up 2% versus 2015, and diluted earnings per share were $1.55, 4% higher than last year.

Wrapping up with year-to date-cash flows on slide 29, cash from operations was $2.3 billion, and free cash flow was a little over $1 billion. With respect to capital return to shareholders, we have paid $523 million in dividends and repurchased 603 million of our shares. We remain on track for full-year capital spending of $1.9 billion and a share repurchases of $800 million.

Thank you for your attention, and I will turn the program back to Jim.

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

Thank you, Marta. Let me close by saying that the focus, agility, and determination of our team are readily apparent in our performance this year. As we move forward, we are well-positioned for growth opportunities longer term and confident in our ability to drive shareholder value.

With that, we will now open the line for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Jason Seidl with Cowen.

Jason Seidl - *Cowen and Company - Analyst*

Thank you, and good morning, everyone.

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

Good morning, Jason.

Jason Seidl - *Cowen and Company - Analyst*

I wanted to start off with your RPU, and you mentioned in the coal business, RPU, I think, was negatively impacted a little bit by a mix shift away from some of the export, but I think in your commentary, you also said that sequentially, as we look to 4Q, that we should start seeing a pickup on some of the thermal exports. Should I assume that's going to positively impact your RPU reported when we see the fourth-quarter numbers, all things being equal?

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

No, Jason. The thermal coal typically goes go through Baltimore, which is a lower length of haul for us, and so I want to make it clear that while we will enjoy the increase in the coal through Baltimore and that growth, that will be a drag on RPU within coal.

Jason Seidl - *Cowen and Company - Analyst*

That's good clarification. Also, you guys noted you are ahead of schedule here in your, let's call it, network rationalization. I know you have that pending stuff down in Delaware that you're doing. In terms of how it flows through the income statement, I'm assuming there's very little, but it's probably more on the CapEx side. Is that the right way of looking at the thousand miles that you've done already? And is there potential that you exceed that -- I think the original mark was 1,600 miles, ultimately, that you looked at?

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

Mike, why don't you take that question?

Mike Wheeler - *Norfolk Southern Corporation - COO*

Sure. Jason, you are exactly right. There is a modest expense savings, but the main driver is it allows us to reallocate capital. And going forward, we plan to meet our goal for 2020, and we are going to keep looking for opportunities, and if there's more, we will take them.

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

Jason, the short-line strategy is about putting the right player on the field for the business, too, and serving the customer. That's really what it's all about. There are some benefits financially as well, but this is really a strategy to provide the best service provider we can for the customer.

Jason Seidl - *Cowen and Company - Analyst*

And in terms of that ultimate number of 1,600 miles, is that something that you are likely to exceed now, or is it just that's what you identified and that's it?

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

Yes, just a technical correction, it's actually 1,500 miles is the goal. But, yes, we are on track. We're making great progress, and we think there's definitely more to come.

Jason Seidl - *Cowen and Company - Analyst*

Okay. Thank you guys for the time.

Operator

Scott Group with Wolfe Research.

Scott Group - *Wolfe Research - Analyst*

Hey, thanks, good morning, guys.

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

Good morning, Scott.

Scott Group - *Wolfe Research - Analyst*

Alan, wanted to just follow-up on the coal price -- the coal RPU first. Are you seeing any of the pickup in met export yet? And just given that the much higher the benchmark, how quickly can you start raising your met rates, and do you plan to do so?

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

Scott, I will address the first question. Initially, we're going to see a slight uptick potentially in export met in the quarter. Most, if not all, of our uptick is going to be on the thermal side.

As I noted in the comments, it's somewhat restricted by production, and the producers need to have some comfort level that the prices that are out there now are sustainable. I don't think anybody believes they are going to stay at $200 per metric ton, but if they can get some visibility that the prices are going to be at a level where they can bring back production, that will encourage more business -- more production and more business on us. We have taken a look at some of our export pricing in the fourth quarter, and we anticipate doing that again in the first quarter dependent upon market conditions.

Scott Group - *Wolfe Research - Analyst*

So given that a little bit more shorter length of haul export that's lower RPU, a little bit more met, and then sounds like higher met pricing in aggregate, would you think that coal RPU was flat, up, down sequentially?

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

I think in the fourth quarter, the shift of more lower length of haul thermal coal through Baltimore will offset pricing increases that we have.

Scott Group - *Wolfe Research - Analyst*

Okay. Got it. And then Marta, just one for you on the operating issue. I think at some point earlier this year, you talked about hoping for a sub-70 OR each of the second through fourth quarters. Is that still the way to think about the fourth quarter?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Yes, we are still expecting sub-70 OR in each of those quarters.

Scott Group - *Wolfe Research - Analyst*

Okay. Thank you.

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

Scott, I would like to clarify a point. As I was talking about the offsets, I was speaking sequentially, not year over year.

Scott Group - *Wolfe Research - Analyst*

Got it. Okay. Thank you.

Operator

Allison Landry, Credit Suisse.

Danny Schuster - *Credit Suisse - Analyst*

Hi. Good morning. This is Danny Schuster on for Allison. Thank you for taking my question. I just wanted to ask how your same store core pricing looks sequentially versus last quarter and how we should think about that over the next quarter or two here?

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

Sure. Alan?

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

Danny, we are continuing to get traction in our pricing, and we are negotiating pricing in excess of inflation. As we've noted before, we are facing some limitations in the upside due to loose capacity in the trucking market.

Danny Schuster - *Credit Suisse - Analyst*

Okay, great. Thank you. And just wanted to follow up on some of your commentary on slowing speeds on secondary mainlines. How much longer do you think you can extend the life of the track, and how much of a dent can that make in your overall maintenance infrastructure spending on an annual basis looking forward?

Mike Wheeler - *Norfolk Southern Corporation - COO*

Well, it really doesn't extend the life of the track. We're going to have that track because it's part of our network reach always, and we will have it maintained at the right level for the lower speeds. But it does allow reduced maintenance levels over time.

Danny Schuster - *Credit Suisse - Analyst*

Great. Thank you.

Operator

Chris Wetherbee, Citigroup.

Chris Wetherbee - *Citigroup - Analyst*

Thanks. Good morning.

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

Good morning, Chris.

Chris Wetherbee - *Citigroup - Analyst*

I wanted to ask about the progress on the productivity side. So $250 million I think is the target now. Just wanted to be a rough sense of maybe how we think we are progressing towards that $250 million. And maybe some initial thoughts on 2017, whether you should see this a linear progression towards the $650 million or so over time, or just how we think about the progress there.

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

Let me address first the $250 million that we are currently targeting for the full year. We increased our outlook there from $200 million last quarter. Reason being, we found that even with the sequential uptick in volumes in the third quarter, we were able to hold the line on resources and did not incur additional overtime. In fact year-over-year overtime was, again, down considerably.

Similarly, employee headcount declined modestly sequentially. We had been forecasting flat. So that's the source of some of the additional productivity pickup in 2016. Marta, why don't you address 2017? We will come back to you with a more robust outlook on productivity and across the board in January when we report our fourth-quarter earnings.

Marta Stewart - *Norfolk Southern Corporation - CFO*

Mike and his folks are working now on our specific productivity initiatives for 2017, and as Jim mentioned, we'll be able to give you more details on our January call. We do expect to keep pushing on that, and they worked very hard this year, especially in light of the overall decline in volumes in the year, to accelerate as much of the productivity improvements as they did into 2016.

Chris Wetherbee - *Citigroup - Analyst*

Okay. That's helpful. That's great color. And then as a follow up, just thinking about some of the network initiatives that you guys are undertaking and maybe some of the outsourcing to short lines or sales there, in terms of operating property gains on sales, should that be something that will be part of the calculus as we move forward?

Is that something that might be recurring, or is it more a little bit more one time, you see it as a little bit lumpier here and there in various quarters? Just want to get a sense of maybe how to think about that bigger picture as you go through your process.

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

Sure. Those gains on sales do tend to be lumpy. And so there's a certain level of gains that we have experienced over the course of the year, but quarter to quarter, it can vary quite a bit. We don't see the opportunity to recognize gains there from sale or disposition of operating property so much as a result of the line rationalization program rather an initiative to just identify and dispose of surplus operating property. That's what we booked in the third quarter.

Chris Wetherbee - *Citigroup - Analyst*

Okay, so not necessarily core to the bigger picture productivity targets that you have?

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

Right. Right.

Chris Wetherbee - *Citigroup - Analyst*

Thanks for the time. Appreciate it.

Operator

Tom Wadewitz, UBS.

Tom Wadewitz - *UBS - Analyst*

Good morning. I wanted to ask you -- you've commented a little bit about pricing, but wanted to see if you could give perspective -- I think one of the other railroads talked about, obviously, UNP talked about some market challenges they said in the coal and international intermodal markets. It was a little unclear whether that was increasing rail competition or whether that was structural pressures from customers.

Are you seeing anything in those two markets where you'd say the utilities are pushing us harder and we can't really resist, or change in container shipping line, the consolidation, Hanjin bankruptcy, that's having an outsized impact on your pricing?

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

Let me comment on the question more broadly, and then I will turn it over to Alan for specifics. Alan mentioned loose truck capacity. Competition is alive and well, and we are facing intense modal competition.

Nevertheless, with our service levels where they are with the service product that we are offering, we feel confident that we will be paid for the value of our service rendered. Let me let Alan address the specific markets that you referenced.

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

Sure. Our price plan is consistent across all markets. And within coal, we've talked about taking a look at the export pricing ex fuel surcharge. Even though we had a pretty negative mix within coal, our coal RPU was only down 2% in the third quarter.

Within international and intermodal, we are continuing to align ourselves with folks who are adding capacity to the East Coast, and while Hanjin did create a slight impact to us we're taking a long-term focus on our pricing because we have a better service product and we know service is key and core to our focus on pricing.

Tom Wadewitz - *UBS - Analyst*

Okay. Great. Thank you. For the second question, I just wondered if you could give a comment an incremental margin perspective in 2017. If we go back to -- it's tough to know what volumes are, but if they're up a couple percent, it seems like you would be positioned to put up very strong incremental margins, maybe better than the normal 50% we think of, just given the cost take-out, given capacity in the system. Is that a reasonable conclusion, that if you get a couple points of volume, you might do a lot better than the typical 50% incremental next year?

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

Tom, I think we will defer answering that question to January when we'll come back to you with a more comprehensive outlook, including our expectation with regard to productivity, operating leverage, inflation, and so forth. One thing I think worth flagging, though, is some rather extraordinary inflation factors next year, in particular, health and welfare benefit costs. Marta?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Yes, we do expect that next year, as Jim said, we'll give you a total amount for the compensation and benefits. It's expected inflation in January, but we do already know that we are going to have higher inflation in the union medical plan.

With regard to incremental margin question, it really does depend on -- if we have growth, and as Mike and Jim have both said, the service is positioning us to get that growth. If we have growth, we will have incremental margin improvement in all of the categories. But recall that we have the incremental margin hierarchy, which dependent on where the volumes come, the order in the most incrementally margin positive is merchandise, then coal, then intermodal.

Tom Wadewitz - *UBS - Analyst*

Okay great. Thank you for the detail. Appreciate it.

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

You're welcome.

Operator

Brandon Oglenski, Barclays.

Brandon Oglenski - *Barclays Capital - Analyst*

Yes, good morning, everyone. Jim, can you talk to the commentary around flowing network speeds. I understand that on your secondary lines, you could get some more capital out of it, especially if your volumes are down. But I think generally, when we've looked at significant OR improvement for other rails, it's been driven primarily by getting velocity up in the network. Is that the real long-term strategic vision, that in aggregate, we want to have speeds lower or higher?

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

Well, definitely higher, and I think Mike emphasized that. The great thing about what we're doing is that we are able to slow down our trains in some parts of the network without slowing network velocity overall. So it's a very targeted initiative. It does result in cost savings primarily from longer maintenance cycles on those branch lines, but overall, network speeds are up, and that's where we want them to stay.

Mike Wheeler - *Norfolk Southern Corporation - COO*

Just remember, these secondary mainlines do have lower speeds originally before we reduced the speeds, so it's not like our main lines that have the high speeds. So reduction in speed wasn't that significant, but it is in the capital reallocation. So that's why -- because of that, we've still been able to keep our network velocity high, like I said, at the carload level at our record levels.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay, and Jim, sorry I'm really stuffed up here. But can you talk a little bit about terminal rationalization because I do think that might be where some difference is between getting velocity higher versus what the East Coast railroads have been able to do in the past. I know -- excuse me -- when you launched your new plan, you had called out terminal rationalization as a piece of that opportunity.

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

Sure. Absolutely. And that's something that we are going to continue to look at, and there may be opportunities there. On the other hand, we want to maintain a certain level of customer service. We've underscored the importance of that several times, and having a robust classification yard network is one component of providing good service in our merchandise franchise.

Mike Wheeler - *Norfolk Southern Corporation - COO*

Yes, I will just remind you that we did reduce one of the hump terminals out of our network this year, earlier this year, and then also one of our other hump terminals, we've reduced the throughput, and therefore, the cost about half. So we continue to look at that, but all in light of making sure we keep the service product at the high levels.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay, thank you.

Operator

Ravi Shanker, Morgan Stanley.

Ravi Shanker - *Morgan Stanley - Analyst*

Thanks. Good morning, everyone. Jim, I think you mentioned that you are going to need to price above inflation. You have any thoughts on what inflation is looking like for next year?

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

Again, we will defer an answer to that until January and give you our outlook there. It's obviously an important piece of the puzzle. But we did want to flag one inflation item in particular. Health and welfare benefits cost increase should be substantial next year, so that's a bit of a headwind. And there are some other things that are in play as well on the inflation front, but let us defer a complete answer until January.

Marta Stewart - *Norfolk Southern Corporation - CFO*

And generally speaking, like we did this year, this year we gave for 2016 an overall comp and benefits inflationary increase of 3.5%, and the other expense categories are generally in line with inflation that you see in the rest of the economy.

Ravi Shanker - *Morgan Stanley - Analyst*

Great. Understood. And just a followup, given some of the changes you are making for the network both with the rerouting as well as the short-line outsourcing, are you fundamentally rethinking some of your end markets and where your growth comes from over time, and maybe, like some of the rails, deemphasizing core a little bit and focusing more on intermodal?

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

No, I think we are continuing to focus on opportunities for growth wherever we can find them. We are intent on growing this Company in the years to come and want to have a solid platform for doing that across our different lines of business.

Naturally, the line rationalization opportunity is greater in some parts of the network than it is it others, particularly in the coalfield, and we've been through in past quarters what we have done specifically by way of line rationalization there. But the end markets are what they've been, and the growth opportunities are what they have been as well. Alan, do you want to add a little color to that?

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

I would suggest that markets are dynamic, and so are we. So we are going to manage to the changing markets that we see. We are going to put a good service product out there that our customers value in an attempt to pull more business off the highway. And that can be in an intermodal container. It can be in a gon. It can be in a boxcar. It can be in a hopper.

Ravi Shanker - *Morgan Stanley - Analyst*

Very good. Thank you.

Operator

Justin Long, Stephens.

Justin Long - *Stephens Inc. - Analyst*

Thanks, and good morning. You talked about productivity of $250 million this year, but could you comment on how much of that amount is coming from restructuring Triple Crown and restructuring the coal network, or does that productivity number exclude those items?

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

It excludes those items, so we don't count as productivity the lapping of the restructuring costs for Triple Crown for example.

Marta Stewart - *Norfolk Southern Corporation - CFO*

If you look at the change from having had the restructuring charge last year to this year, we don't have that difference in the productivity improvement. We have the benefit of running a more profitable, more focused Triple Crown network and a more focused coal network. So the benefits after the changes are in productivity, but the variance due to the restructuring charge is not in that number.

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

With regard to the line rationalization initiatives, the productivity benefit there comes from reduced labor costs, from materials, maintenance expenditures, et cetera. So the line rationalization initiatives are not in and of themselves a productivity producer, but they spin off lots of productivity benefits in the forms I just mentioned and otherwise.

Justin Long - *Stephens Inc. - Analyst*

Okay, great. That's helpful to clarify. And secondly, I know you aren't giving too many specifics on next year, but I was wondering if you would be willing to share any initial thoughts on how you believe volumes could trend in 2017? And maybe just directionally, it might be helpful if you could walk through some of the commodity groups where we could see meaningful moves either up or down.

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

Okay. We can do that, bearing in mind we'll present that in the context of an overall outlook in January. But Alan, talk about what we're seeing right now in terms of volume ups and downs next year.

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

Certainly. I'll provide a broad overview, and then we'll be back with you on our January call. Intermodal, we continue to see growth in that franchise once you strip out the year-over-year impact of Triple Crown. That will become readily evident. Ex Triple Crown and fuel surcharge in the third quarter,(corrected by company after the call) our intermodal revenue was up 8%.

Coal was another one -- and I want to make it perfectly clear, we had some very strong sequential improvements in coal in the third quarter, and coal in the fourth quarter is doing fine for us. Coal dispatch in the East right now is a load follower, and so it will be heavily dependent upon the weather. If we have a warm winter like we had last year, we are going to be in the same position in January as we were in January of this year. So that's why I think it's prudent for us to speak in more detail with you on our January call about volumes.

Justin Long - *Stephens Inc. - Analyst*

Okay. Great. And any thoughts on general merchandise as well?

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

Merchandise is going to have some puts and takes in it. Energy continues to be pressured, so we will probably have some negative comps within our crude oil franchise. We are continuing to monitor steel capacity plant utilization and steel pricing. That could potentially have an impact. We will provide more color on the January call.

Justin Long - *Stephens Inc. - Analyst*

Okay. Great. I will leave it at that. Thanks for the time.

Operator

Ken Hoexter, Merrill Lynch.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Great, good morning. Just a clarification real quick. Marta, you had mentioned some asset sales had declined below the line, but then above the line in operating income and other, you had an increase of $29 million this quarter. Just can you detail when and where you would put that above the line?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Yes, so as you know, Ken, and I think you and several others of your colleagues had mentioned this over the years, there's historically been diversity in the industry of where land sales are. Over time, the industry has moved to where almost everyone has the operating land sales in operating expenses and then the non-operating ones down in other income. So that's what we're doing here, too. The reason why I called that out this quarter was because it was so large.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Okay, great. I just wanted to clarify that. Thank you. I know you're not giving too much detail on 2017 yet, but maybe just in general terms, Jim, can you talk about your thoughts on cash, and more specifically, CapEx, given the reduced line maintenance and PTC rolling over. Do you look at CapEx dropping down to, I don't know, 15%, 16% of revenues, or do you have some general thoughts on where you think CapEx goes?

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

Sure. We would expect to peg CapEx at 19% of revenue next year and for 2018 as well. That's our current thinking on the level of CapEx, reflecting the continuing spend on positive train control through 2018. After that, our plan is to reduce CapEx to 17% of revenue.

That's obviously something that we are going to continue to monitor, and we want to make sure that those investments are generating appropriate returns as we go through the plan period. But right now, that will be our plan, 19% for the next couple of years and then 17% thereafter.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

So no real roll off given any of the cost savings or line rationalizations in your view for the next year or two?

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

We're going to stick to the 19% of revenue for the next two years. We will generate some savings from the line rationalization program, but we would expect to deploy that capital elsewhere.

Ken Hoexter - *BofA Merrill Lynch - Analyst*

Okay. Thanks for the time.

Operator

Walter Spracklin, RBC Capital Markets.

Walter Spracklin - *RBC Capital Markets - Analyst*

I want to come back to the land sales on the operating results, Marta. I know when you had given us some guidance around materials and other last quarter and your operating ratio, you were giving us $10 million reduction in materials and an OR that would actually be up slightly in the third quarter. With your land sale, you're actually down $54 million, and your OR was better, so it seems like it was really driven by the land sale.

So my question is, you've pointed us to sub-70 for fourth quarter. Is that contingent -- or what level of land sales would you expect to go into that number? And so should we still be looking at a $10 million reduction in the fourth quarter materials? Is your -- and I think, Jim, you mentioned your longer-term targets are not including land sales, but I'm just curious whether you be giving us guidance on what the operating land sales will be in 2017?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Let me take that in two pieces. First of all the materials guidance was for a decline of $15 million in the third and fourth quarter, and so materials did come down $15 million. You are correct that the land sales is something that is variable, and so we didn't forecast that. The other biggest increase in that line was the land sale gains. Even without any land sale gains, the timing of those are variable, so there may or may not be some in the fourth quarter. But even without the land sale gains, we think we'll be below 70 OR in the fourth quarter.

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

So looking into 2017 and beyond, we will update you on any and all land sales of which we are aware at the time, but granted, it's difficult to forecast the timing of closing in many cases, as with nonoperating property. You pretty much have to close before you book the gain, and timing of closing can be uncertain. When it happens, we will make sure we let you know, and if possible, in advance.

Marta Stewart - *Norfolk Southern Corporation - CFO*

I will say that historically, these haven't been very significant. In the last couple of years, they've ranged between $10 million and $20 million for the whole year, so $28 million in one quarter is large, which is why we called it out. But certainly, Mike and his folks and Alan in his folks in the real estate side are looking to monetize any surplus assets after they've analyzed it to make sure that it doesn't have other opportunities for us now or perhaps in the future.

Walter Spracklin - *RBC Capital Markets - Analyst*

Okay. And did I hear, you it's below 70 excluding any land sales for fourth quarter for OR? Is that right?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Correct.

Walter Spracklin - *RBC Capital Markets - Analyst*

You mentioned some of the rerouting operations. What point do you decide -- you mentioned you are keeping them open for now contingent on whether volume will come back. At what point do you decide this is a structural or a permanent business level on those lines and decide to, in fact, close down those operations? How much OR improvement in synergy or efficiency can we get if you start closing down some of these reroutings that you've done to date?

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

That's a judgment call. And we do abandon lines from time to time on a fairly small scale. Every year we have line abandonments that we undertake. The additional savings would be rather modest from going from mothballing to outright abandonment because for all intents and purposes, we're not spending any money on a line that has been mothballed as we went through earlier.

Walter Spracklin - *RBC Capital Markets - Analyst*

Okay. Thank you very much for the color.

Operator

Brian Konigsberg, Vertical Research.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Yes, hi. Good morning.

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

Good morning.

Brian Konigsberg - *Vertical Research Partners - Analyst*

I just wanted to ask about fuel surcharges and within the contracts to the extent you made progress during the quarter transitioning from WTI to on-highway. Maybe just add on to that, to the extent that we do see rising fuel prices, how much incremental fuel cost might you have to absorb before you start to see those surcharges start kicking in?

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

Alan, why don't you take the question about the trend in the fuel surcharge mechanisms, and then Marta, maybe you can comment on the leverage aspect.

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

First and foremost, our focus is on price when we renegotiate contracts, so we are not going to give up on price the change of fuel surcharge program. We have reduced our revenue that is tied to a WTI-based fuel surcharge from about 53% to slightly below 40% at this point.

Marta Stewart - *Norfolk Southern Corporation - CFO*

With regard to the effect on the income statement, our fuel surcharges in the third quarter were down $46 million year over year, and our fuel expense line was down $40 million. You can see that was a $6 million compression in our operating income.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Got it. Just as fuel may start to rise, how high would that need to go? How much additional expense might you absorb before seeing a meaningful contribution from fuel surcharge?

Marta Stewart - *Norfolk Southern Corporation - CFO*

As we've discussed in the past, our primary trigger in the merchandise area, which is largely where that 40% Alan mentioned is still on WTI. The primary trigger point is 64, so as prices rise from where we are now, the closer they get to 64, each of those, we will have that compression similar to what I described there. One way to look at it is to examine the change in WTI in OHD that we had third quarter 2015 to third quarter 2016, and then see what that did to our fuel surcharges, and then you can extrapolate from there, depending on how you're forecasting oil prices to go up in the future.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Got it. Of I could just sneak one quick one in. Just on pension, if you snap the line today, can you give us a look at what 2017 looks like from a headwind or tailwind perspective?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Well its possible, if you snap the line today with interest rates where they are, we would have some increase in pension expense, but as you probably know, the interest rates for making those calculations are determined as of the end of the year. So once we see what interest rates are at December 31, we will get an estimate for our pension expense for next year, and we will provide that information to you on the January call.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Thank you.

Marta Stewart - *Norfolk Southern Corporation - CFO*

You're welcome.

Operator

Scott Schneeberger, Oppenheimer.

Scott Schneeberger - *Oppenheimer & Co. - Analyst*

Thanks. Good morning. Just curious, any thoughts or considerations with regard to weather, third quarter, fourth quarter impacts? Thanks.

Mike Wheeler - *Norfolk Southern Corporation - COO*

As you know, we had hurricane Matthew strike our southeast area on October 6, and fortunately, we were able to get our network back up very quickly and provide service back to our customers. Really pleased about that, shows the resiliency of our network, and really shows the planning and coordination that we put into place in advance. From a cost standpoint the impact is really immaterial, very minor.

Scott Schneeberger - *Oppenheimer & Co. - Analyst*

Great. Thanks. And just curious about the automotive segment, as we look into 2017. I realize you're not providing any material guidance, but just thoughts and considerations as we move into next year in that segment?

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

What are you seeing there, Alan?

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

We are closely aligned with North American vehicle production, and so as that goes into 2017, is how our automotive volume goes. We are going to be closely monitoring the energy markets. We are going to closely monitor steel markets and retail inventory levels throughout the holiday season as we look into our volumes for 2017.

Operator

Thank you. Brian Ossenbeck, JPMorgan.

Brian Ossenbeck - *JPMorgan - Analyst*

Hey, good morning. Thanks for getting me on the call here. Just to go back to the network initiatives, I know you said your velocity and service has been maintained, and that's important to the network overall, but from an actual headcount perspective, Mike, you mentioned a few actions that were taken, but can you give us an actual impact on headcount that these network initiatives on the rationalization of 1,000 miles and what 1,500 would do? Can you give us an impact on headcount because if we look at the five-year plan, you're looking at 65% of the savings coming from comp and benefits?

Mike Wheeler - *Norfolk Southern Corporation - COO*

Well just remember, these are our secondary mainlines so we don't have as many folks maintaining those as our core mainlines, so that's why I talked about modest expense savings. As we continue to rationalize, we will have some headcount reduction, but it will not be at large significant levels. I will just say that we are on track for the headcount reductions we've got in our 2020 plan.

Brian Ossenbeck - *JPMorgan - Analyst*

Okay. Then Alan, a quick one for you on intermodal. You talked about that intermodal competition from truck and taking share off the highway. Of course, it's very loose market right now, so how are you balancing that business and trying to get volume while maintaining price for the longer term as you mentioned? And what's your expectation for the truck market and when it gets tighter and what really drives that? Is it the ELD, or is it something else?

Alan Shaw - *Norfolk Southern Corporation - Chief Marketing Officer*

The key determinant for us on our growth has been an improved service product within the intermodal franchise, so that's how we're balancing this. We and our customers are taking a long-term view of our capacity and the benefit of our service product, which is how we are focusing on price.

With respect to the trucking market, we do anticipate that tightens next year, potentially towards the latter half of the year with the implementation of ELDs and a normalization of inventory levels. That's one of the reasons I referenced that earlier. It will probably be at a higher -- the new norm is probably higher than it has been in the past, but we still think that a reduction in the inventory sales level is warranted and would ultimately benefit volumes for us.

Brian Ossenbeck - *JPMorgan - Analyst*

Okay. Thanks for your time.

Operator

David Vernon, Bernstein Research.

David Vernon - *Sanford C. Bernstein & Co. - Analyst*

Hey, good morning, and thanks for taking the question. Just wanted to follow up, and wonder if you could us some color on the short-lining approach you guys are taking. Are you guys actually selling assets at this point, or just hiring a short-line operator to do some of the feeder moves, if you will? And is there any union implications that we should be worried about as far as your expansion into that program going forward?

Mike Wheeler - *Norfolk Southern Corporation - COO*

So these are all leases that we've done. We've been doing leases for many years now. That's how we do the short-line program. And no, we work very well with our organizations on these leases and don't expect any impact there.

David Vernon - *Sanford C. Bernstein & Co. - Analyst*

The unions are okay with shifting the work over to the lower-cost operators?

Mike Wheeler - *Norfolk Southern Corporation - COO*

I didn't say that. I don't think that they are okay with it, but they understand where we're going. They understand that it's not a big part of our network. It's very small. And typically, we give them the opportunity to either go with the short line or come work with us because they are great assets that we would like to have, but it's their choice. That's how we work through that.

David Vernon - *Sanford C. Bernstein & Co. - Analyst*

Okay. And then Marta, maybe just as a quick followup, I think you talked about a sub-70 OR in 4Q. That would imply a little bit of an acceleration on the rate of improvement on the margin line. Is there anything specific that you would point out to as driving that, or is that just a function of the moderation in volume against what you guys have already executed on the productivity side?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Well, it includes a continuation of the efficiencies that Mike and his team have been able to get out. And one thing I will make sure everybody remembers is that the fourth quarter of last year had restructuring costs, and so that was one thing that elevated the operating ratio in the fourth quarter of last year.

David Vernon - *Sanford C. Bernstein & Co. - Analyst*

Okay. Thanks.

Operator

Cherilyn Radbourne, TD Securities.

Cherilyn Radbourne - *TD Securities - Analyst*

Thanks very much, and good morning. I wonder if you could talk a little bit about how you balance service versus cost efficiency. That concept has come up a number of times. I noticed that the service composite has improved meaningfully on a year-over-year basis, but it's been pretty stable at 80% on a year-to-date basis. So just curious if that's a service level that you're consciously managing to, or is there room for that to continue to go higher even if you achieve productivity gains?

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

We think we are at a pretty steady state in terms of the composite metric right now, which, by the way, we would characterize as a network performance metric. We are also measuring and managing to customer service metrics directly in each of our different lines of business. The two go hand-in-hand. We watch network performance metrics, and in the field we manage to them, but at an enterprise level, we are also obviously very focused on customer service metrics, direct measures of customer service as the customers see them.

But our strategy overall is to reduce any and all spending. Wherever we see an opportunity to reduce spending we will. However, we are going to seek to maintain a consistent level of customer service. That's the smart thing to do from a cost-saving standpoint, and it also is our platform for growth in the future.

Cherilyn Radbourne - *TD Securities - Analyst*

Thank you. That's all for me.

Operator

Don Broughton, Avondale Partners.

Don Broughton - *Avondale Partners - Analyst*

Good morning, everyone. Most of the good questions have been taken, so I'll ask one of the housekeeping questions. Perhaps I missed it in your opening comments, Marta, but can you give us a little bit more insight on the tax rate? How sustainable is that because that was certainly a good -- almost 300 basis points less than I was looking for?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Yes, we did have under 35% tax rate in the quarter, which was lower than what we had been guiding to, and that was primarily due to corporate owned life insurance, which when those returns come in, they are not taxable, and so that affects the effective tax rate in the quarter that those returns are booked. And then the other main reason was stock compensation.

I mentioned those two in my prepared remarks, and there were a couple of other items that were smaller. One of them is tax credits. If you recall last year, Congress passed the extension of the tax credits in the fourth quarter of last year, so those were all booked in the fourth quarter. Since they extended them into 2016 when they did that, then we have been able to do those in each of the quarters, so it gives us a lower effective rate throughout the year rather than it getting booked all at once.

Don Broughton - *Avondale Partners - Analyst*

Good to know. So we should expect an oscillation back towards a more normalized tax rate in fourth and ongoing quarters then?

Marta Stewart - *Norfolk Southern Corporation - CFO*

Next year, a more normalized rate, but in the fourth quarter, we expect to stay at 36%, and then for the full year, as I mentioned, for the full year, we think we will be around 36%.

Don Broughton - *Avondale Partners - Analyst*

Thank you so much.

Operator

I would like to turn the call back to Mr. Jim Squires for closing comments.

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

Thank you for your time, everyone, this morning. This concludes our third-quarter conference call.

Operator

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