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NSC - Q3 2018 Norfolk Southern Corp Earnings Call

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OVERVIEW:

Co. reported 3Q18 net income of $702m and diluted EPS of $2.52.

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PRESENTATION

Operator

Greetings, and welcome to the Norfolk Southern Third Quarter 2018 Earnings Call. (Operator Instructions)

As a reminder, this conference is being recorded. I'd now like to turn the conference over to Clay Moore, Director of Investor Relations. Please go ahead, Clay.

Clay Moore - *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 Third Quarter 2018 Earnings Call. Joining me today are Alan Shaw, Chief Marketing Officer; Mike Wheeler, Chief Operating Officer; and Cindy Earhart, Chief Financial Officer.

Starting with our financial highlights on Slide 4. We delivered another quarter of record financial results. Income from operations was over $1 billion, an increase of 14%. Net income was $702 million, up 39% over the prior year. And earnings per share was $2.52, a 44% increase. The operating ratio of 65.4% is a third quarter record for our company and marks the 11th consecutive quarter of year-over-year operating ratio improvement.

As 2018 draws to a close, we are poised to achieve another year of solid OR improvement and strong bottom line results. Given the progress we've made in the last 3 years and the likelihood we will meet our current financial goals well ahead of schedule, we are moving forward on the next round of initiatives to drive shareholder value. We look forward to briefing you on these new initiatives and the associated financial targets at our upcoming Investor Day on February 11 in Atlanta, Georgia. Please, save the date.

Now, to provide further insight into our third quarter results, Alan will cover trends in revenue, Mike will give you additional color on the state of operations, and Cindy will detail our financial results.

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. Starting on Slide 6. The success of our market approach is clearly demonstrated by sustained growth in revenue, revenue per unit and volume. This quarter marks the 7th consecutive quarter of year-over-year revenue gains, with 7 quarters of strengthening RPU and 8 quarters of volume improvement. For 5 consecutive quarters, we achieved steady year-over-year increases in RPU less fuel, which is hugely important to operating income.

We have succeeded, despite the negative mix impact of continued strong volume growth in intermodal, with balanced and consistent RPU increases in all 3 of our business units. The increasing intermodal RPU coupled with productivity improvements consistently enhances intermodal profitability, auguring well for the future, given that intermodal remains one of the fast-growing segments of the freight market. The strength of our multifaceted plan generated revenue, RPU and volume growth across most markets in our intermodal and merchandise business units. Our balanced focused on margin, price and volume continues to produce revenue growth, benefiting our top line as well as operating income.

Slide 7 highlights the results of our plan that generated 10% revenue growth in the third quarter. This gain was the product of sustained volume improvements, higher pricing and increased fuel surcharge revenue. In merchandise, we achieved record revenue, RPU and RPU excluding fuel on the third quarter. Volume growth was led by gains in ethanol and crude oil. RPU grew year-over-year for the 10th consecutive quarter, highlighting our emphasis on pricing.

For the 4th consecutive quarter, intermodal achieved record revenue with 2 consecutive quarters of 20% year-over-year growth. This increase was generated by records in volume and RPU less fuel. The strong economic environment coupled with a tight truck market continues to drive demand for Norfolk Southern's intermodal franchise, resulting in significant growth.

Pricing gains led to substantial improvement in RPU less fuel and RPU during the quarter. Coal revenue was up 3% in the third quarter, with positive pricing and export volume growth that was partially offset by declines in our utility market. Our strategy delivered strong results in the third quarter with revenue and RPU increases in every business group, underscoring our commitment to competitive pricing as well as our ability to capitalize on market conditions. The continued strength and improvement in our top line metrics illustrates the confidence customers have in our approach.

Moving to Slide 8. Our outlook for the fourth quarter remains positive. We expect revenue and volume to improve with continued strength in consumer demand and the industrial economy, leading to growth in intermodal and manufacturing markets, including automotive and plastics. The favorable differential in oil prices is expected to increase volume in our crude franchise. Coal volumes are projected to be up year-over-year in the fourth quarter, driven by growth in both the utility and export markets. Similar to the third quarter, we anticipate fourth quarter utility volumes to be in the 15 million to 17 million ton range. Export volumes are expected to remain in the 6 million to 8 million ton range.

Pricing to the value of our product remains a key element of our strategy, and we expect that strategy to deliver year-over-year improvement and RPU in the fourth quarter. Our balanced strategy and franchise have positioned us for growth, allowing us to expand with both our existing customers and new customers, maintain a sharp focus on productivity and capacity and deliver results for our customers and shareholders. We are integrated in our customer supply chains and consistently work to understand their markets, partnering for their success and enabling long-term value for NS shareholders. This sustained and balanced approach to both revenue and income growth is delivering results, and we look forward to a strong finish in 2018.

With that, I'll turn it over to Mike for an update on our operations.

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

Thank you, Alan. We are pleased, the velocity of our railroad continues to improve, while handling record volume for a third quarter as well as achieving a record third quarter operating ratio for the company.

Moving to Slide 10. Our reportable injury ratio for the quarter improved year-over-year and sequentially. The safety of our employees and the communities we serve continues to be our top priority and where we focus a lot of attention. Our service levels are improving as evidenced by our service composite, speed and dwell, all improving sequentially.

Additionally, our network velocity as measured at the car level is currently near our highest levels for this year. All 4 measures are currently pacing at or ahead of our third quarter performance.

Turning to Slide 11. In addition to improving service for our customers, we are also driving improvement in our efficiency. A record third quarter train length helped drive an all-time record crew productivity for Norfolk Southern. Specifically, we handled 5% more volume with just a 2% increase in crew starts. We also achieved an all-time quarterly record for fuel efficiency. All of these factors combined to help us achieve a record third quarter operating ratio as well as an all-time record OR for the first 9 months of the year.

Turning to Slide 12. To drive further improvements in the velocity of our operation, we are undertaking the development of a new operating plan. The first step is to streamline the railroad, which will allow us to move assets faster and create capacity for our customers to grow. This process, something we refer to as clean sheeting, starts in the terminals and local serving yards where cars tend to accumulate as they navigate the first or last mile of their trip. The goal is to increase fluidity by reducing car inventories, accomplished in part by increasing service frequency for customers. We also work cooperatively with the customers to create efficiencies in service. We are encouraged by the results we have seen so far as clean sheeting underpins our new operating plan going forward.

As seen on Slide 13, our new operating plan will be built on key principles. As mentioned, it starts with clean sheeting, which will drive car level velocity higher and lower cars online. This will allow us to build more blocks of traffic in the local serving yards that can be picked up by a through train, bypassing the major classification yards. We will also work with our customers and short line partners on additional blocking opportunities. The blocks will be integrated into the system using different train types and drive further velocity improvements and efficiency.

Lastly, we are continuing to evaluate our assessorial program to ensure high asset utilization and capacity for growth. We will provide more details on these operating plans at our upcoming Investor Day in February, including our expectations as to the value we are creating through the new operating plan.

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. As Jim said earlier, we've delivered another quarter of record financial results. Let's take a look at the details starting on Slide 15.

As Alan discussed, we had strong revenue growth of 10%, which when combined with the smaller increase in expenses, resulted in the second consecutive quarter of income from railway operations up over $1 billion, 14% higher than last year. We also achieved a record third quarter operating ratio of 65.4%, improving on last year's results by 110 basis points.

Just as a reminder, 2017 results have been recast to reflect the required reporting reclassification of certain pension and postretirement costs.

Slide 16 illustrates the component changes to operating expenses. In total, operating expenses increased by $152 million or 9%, primarily driven by higher fuel prices and volume-related costs. Fuel rose by $76 million, primarily due to higher prices, which added $65 million. Consumption was up 4% over the prior year relative to the 5% increase in shipments.

Purchased services and rents increased $73 million or 19%. About half of the increase was attributable to higher expenses for purchased services, including volume-related increases, additional transportation and engineering activities as well as higher technology costs.

Higher equipment rents expense reflected slower network velocity, the cost of additional short-term locomotive resources as well as the growth in traffic volume. We expect about half of these additional equipment rent costs to come out in the fourth quarter.

The materials and other category increased $38 million or 23%. Last year's gains on the sale of property were approximately $36 million more than the current year. We have also incurred increases in derailment-related expenses and additional cost associated with the ongoing relocation of our dispatchers to Atlanta.

This year also includes higher locomotive material usage cost due to more locomotives in service. These amounts were partially offset by $20 million of rental income associated with operating property, which you will recall is now included in this expense category.

Finally, compensation and benefits decreased by $46 million or 6%. Incentive compensation was $45 million lower than in the third quarter of 2017, based on the timing of accruals, which were a headwind in the third quarter last year.

Reduced headcount levels saved $10 million over the same quarter last year. Headcount was approximately 320 positions fewer than in the third quarter of 2017 and down about 100 sequentially. Consistent with the first 2 quarters, lower health and welfare rates also resulted in savings of approximately $8 million versus last year. Overtime and recrews added $15 million of cost.

Then moving to Slide 17, you can see a summarized look at our record third quarter results. Income before income taxes increased 14%, and we achieved record third quarter net income of $702 million, up 39% from last year. Diluted earnings per share was also a third quarter record of $2.52, a 44% improvement year-over-year.

Wrapping up our financial overview on Slide 18. Free cash flow for the first 9 months was a record $1.6 billion, and over $2.9 billion has been returned to shareholders via a 19% increase in dividends as well as share repurchases through both the previously announced accelerated share-repurchase program and our ongoing open-market purchase program. Our share-repurchase programs underscore our confidence in the business as we continue to drive growth and create shareholder value.

I'll conclude my remarks by saying the third quarter financial results demonstrate our continued commitment to deliver on our strategic plan objectives and to drive ongoing improvements.

Thank you for your attention, and I'll turn the call back to Jim.

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

Thank you, Cindy. Guided by the strategic plan we announced in late 2015, thanks to the hard work of our management team and employees, we have consistently achieved the results we promised shareholders.

This year, we are on track for another year of OR improvement and strong bottom line growth, and we are confident we will make further progress next year and beyond. In the last few months, we have begun overhauling our railroad from top to bottom, leaving no stone unturned in the quest for efficiency, growth and shareholder value. As we revamp how we operate, we will listen to our customers and find new ways of meeting their needs. We will use our knowledge of our company to innovate from within. We will bring in outsiders, where they have experience or skills we lag. We will collaborate with our supply chain partners and others to learn their best practices, and yes, as you just heard from Mike, we will implement PSR principles, where they lead to a better result for customers and shareholders. All of the above, we are open to all good ideas that will advance customer service and shareholder value regardless of the source.

In summary, we are excited about the momentum we have today and intend to deliver on our promises in the future as we have in the past. We look forward to announcing new financial targets at our Investor Day in February and to showing you the path we will take to get there.

Thank you for your attention. We'll now open the line for Q&A. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is coming from Allison Landry with Crédit Suisse.

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

Certainly, great to hear about implementing precision railroading. Jim, just on one of your last comments, you mentioned that you guys are trying to implement it as long as it improves customer service and enhances shareholder value. So is there anything that, maybe, you see in PSR that may not fulfill those 2 initiatives?

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

Well, Allison, as I said, ours will be an all-of-the-above approach to improving customer service and productivity. We will implement PSR principles where they can allow us to better serve our customers and shareholders along with ideas we get from our customers, our supply chain partners, from those both inside and outside the company today. We will endeavor to implement a new operating plan while minimizing service disruption, and we're not going to sit our growth while we do so. This remains an environment very conducive to growth, and we're determined to capitalize on it.

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

Okay. So just, I guess, thinking about that, does that tell us that maybe you're not fully embracing it? Like we've seen it at CSX? And perhaps maybe you're taking a similar approach as Union Pacific, is that a fair way to think about it?

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

We're looking at everything out there, including elements of PSR that are complementary to our strategy. So it's too soon to go into the specifics of our new plan. We will give you those specifics in February along with the new financial goals, but suffice it to say, our goal is to produce a railroad that provides a more consistent service product at a lower cost.

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

Okay, great. And then if I could just get in my follow-up question. Could you help us to frame or quantify how much the network inefficiencies cost you in the quarter? I know that there were some elevated equipment costs and some derailment costs and of course, the network velocity and whatnot. Maybe if you could help us to understand what the impact of that was in the quarter?

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

Sure. Well, we did have some lingering service-related costs as we indicated we would last quarter. Cindy can give you some more specifics on the individual line items, but despite the additional expenses, we were able to produce another quarter of year-over-year operating ratio improvement and significant incremental margin from the growth. Cindy?

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

Sure. Allison, you're right. We did continue to have some network velocity costs. We have not quantified those really since the first quarter. We do continue to see them come down somewhat. You did see some elevated equipment rent. As I pointed out in my comments, we expect about half of the increase of what you saw in equipment rents to come out in the fourth quarter. And we expect velocity cost to continue to come down as the service improves.

Operator

Next question comes from Jason Seidl with Cowen and Company.

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

I want to switch it up and talk a little bit about intermodal here for a minute. Obviously, you've been growing in that area, and that's partly your growth plan going forward. We're still in a fairly tight truck market right now, but as you guys know that changes over time. Can you talk about the plan, and how much it's predicated on trucking capacity being tight out east, and what Norfolk can do to grow that even in, let's say, a flat truck market as opposed to a tight truck market?

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

Alan, I'll let you take that one. Let me say though that intermodal has been a consistent grower for us through tight and less tight truck markets. Alan?

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

It -- Jason, we've grown our revenue in intermodal year-over-year for 8 consecutive quarters. As Jim notes, that includes a very loose truck market at the end of 2016 and early 2017, and then, what we're experiencing right now. We're very encouraged by what we're hearing from our channel partners with respect to the outlook for next year. We still expect truck rates to go up. We still expect intermodal loadings to go up next year, and there is a gap there between intermodal pricing and truck market pricing that we're going to lean into and be able to price into.

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

And I'll link this to your new operating plan. And I understand the details will be given at the Investor Day. But how crucial is the new operating plan to continuing to grow intermodal, and even more importantly, continuing to realize the price resources?

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

Alan?

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

Jason, we've got -- we have a great intermodal franchise. And we run a lot of point-to-point trains in that franchise. And we're working very closely with our customers and within the operations division, are improving the productivity. And you're seeing that reflected in bottom line results. And we're going to continue to focus on price. We've talked earlier about the cadence of pricing opportunities within intermodal would last well into 2019. We still expect that to occur, and we're going to continue to focus on productivity. Thank you very much.

Operator

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

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

So I was wondering if you could talk about the timing and scale of implementing this new operating plan. Just wanted to get a better understanding of how we should think about the rollout? And as you go through this process, would you be open to the idea of bringing someone in with PSR experience, in some of these operating principles? Or do you feel confident with the team you currently have in place?

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

Justin, let me take the second part of that question, and then I'll let Mike talk about the sequence of events. Obviously, we're going to give you more detail on the new operating plan in February. We have brought in those with PSR experience, and we will continue to do so. Recognizing that we don't have a monopoly on good ideas and that we can benefit from the perspective of those outside the company who have implemented PSR principles and other best practices. Mike?

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

Yes. So talking about our plan, we are currently doing the clean sheeting now. We're currently out across the railroad, looking at our local serving yards and terminals and working with customers and how we get that done. And we will be doing that for several months now. And in February, at the Investor Day, then we'll start telling you about what we're going to do with the operating plan that's been developed from the clean sheeting that we've done across the railroad. But there'll be different cadences to this. We're going to do certain changes to the operating plan, get that in place, get the benefits of that across the supply chain, and then we'll take another step forward, harvest some more benefits. So it's going to be -- it's going to have cadence to where we do some, do some more, and that continue to get the benefits.

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

Okay. And secondly, it seems like one of the areas of focus in the new strategic plan will be reducing equipment on the network. You mentioned cars online. Do you have any initial thoughts on how your locomotive and rail car needs could change over the next couple of years? Just curious what you see as the targeted size of your equipment fleet relative to where it is today?

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

We'll give you more information on those kinds of targets in February. Obviously, better locomotives and freight car productivity will be key elements of the plan. As Mike went through, one of the big goals is to drive down cars online and increase overall network velocity. That implies significant productivity in both locomotive and freight car categories.

Operator

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

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

I fully appreciate, I guess, the time it takes to form and communicate a new operating plan. So we can certainly wait until February for that and I look forward to that. But a plan, I think, is probably devised with some specific targets in mind or some philosophical view about what the returns in the business should be either on an absolute basis, but probably more appropriately relative to what the benchmarks are achieving in the space. So I know I asked this exact same question last quarter. So forgive me, but Jim, as you think about what the company is managing to now actively, are there any structural reasons for the profitability in Norfolk Southern to be any different than CSX in kind of over a mid-to long-term time frame?

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

Our financial objectives in the next long-range plan will be the same sorts of objectives that we have driven toward in the current long-range plan, i.e., both top line growth and of course, earnings growth through a combination of revenue and margin improvement, the latter being critical to financial success in our industry. We certainly recognize that and we'll be pushing hard for significantly lower operating ratios in the next plan. We will also be focused on return on capital. That too is a critical metric in our industry. The railroads being a capital-intensive business, we focus heavily on return on capital. So you will see new objectives in each of those categories in February, and I can assure you they will be aggressive goals. We're working hard on them and putting in place the specific initiatives that will allow us to drive shareholder value.

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

Okay. And then just 1 follow-up for me. Last quarter you and Cindy talked about the balance sheet being evaluated to have an optimal capital structure. I fully understand the operating plan takes maybe a long time to formulate, but the balance sheet actions should be, I think, relatively straightforward, given your communications with the credit-rating agencies. You did raise some debt. You did an accelerated share repurchase relatively recently. Is that all we should expect on that front? Or should we expect some communication, or can you update us now on where you think the optimal leverage for the company is?

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

I'll turn it over to Cindy for her thoughts on financial strategy, but let me say again what we have achieved thus far. In 2018 alone, for the year-to-date, $2.9 billion in capital returned to shareholders via a 19% increase in dividends and the ASR and normal course share buybacks. Cindy?

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

We will continue to evaluate the balance sheet. But I will say that such as we said in the last quarter that we feel pretty comfortable with the credit bands that we're in and kind of sitting in the middle of that middle range. We will continue to look at it, and we'll continue to talk about that, and we'll update you, again, in February. But for now I think we're comfortable in that range.

Operator

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

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

First one to start on the pricing side. Get it's -- Alan, you kind of mentioned a little bit of what's going on in the intermodal side. I think you also mentioned some improvements on the coal side too. But as you think -- start to think about 2019 presumably, there is sort of a bigger percentage of your contracts that may come up in the earlier part of 2019. Just want to get a sense of maybe how we should be thinking about the momentum? Is there an opportunity to get better price in 2019? Or some the factors that you're kind of seeing now potentially with volume, the decelerating, at least, growth decelerating a bit, will that have an impact? Just want to get a sense of maybe how you're thinking about the setup in the context of the sort of new operating plans you're doing? Would pricing be a tailwind, a greater tailwind in '19?

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

Chris, great question. Pricing is going to be a key component of our plan moving forward as that is now. Our -- the price that we secured in the third quarter was the highest level that it's been in 6 years, and we set a quarterly record for price within our intermodal franchise. Now as I've noted, we see a lot of strength and support for pricing moving well into 2019, particularly in truck-competitive markets. Coal pricing is going to be dictated by seaborne coking coal prices which right now remain elevated and natural gas prices which right now are fairly strong. There's a lot of strength in our truck-competitive markets. And so we continue to see opportunity and momentum within pricing for intermodal and our merchandise franchise.

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

Okay, okay, that's helpful. And then just maybe a detailed question here. When you're thinking about headcount, I guess maybe putting the new operating plan aside for the time being, if you're thinking about the next quarter or 2, maybe this is a question for Cindy, how should we be thinking about sort of the cadence of headcount growth or contraction? You've had a nice deceleration here. Volume growth continues to be pretty decent. Just want to get a sense of where you are getting to the point where you feel like you might have to start adding resources either sequentially or year-over-year?

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

Cindy?

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

Sure, Chris. So if you looked at headcount, we said, we were down about 300 year-over-year and down about 100 sequentially. We were hiring T&E in the third quarter, and we had actually increases in our T&E headcount, but we were able to reduce other -- the areas other than T&E to kind of keep that number down or relatively flat. Going into the fourth quarter, we expect to continue to be hiring some T&E, particularly in our main corridors, but we will also continue to try to manage the non-T&E headcount. So you can expect to see it flat, maybe up slightly into the fourth quarter. And then into '19, we'll talk a little bit more about that as our plans come together.

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

Flat to up sequentially in 4Q? Just want to make sure, I am clear on that.

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

Yes.

Operator

Our next question is from Walter Spracklin with RBC Capital Markets.

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

So with regards to the new plan, have you started it now, or is it something that you formulated and you plan on implementing and telling us about in February? Just trying to understand whether the results are something we can see on a continuous basis, or is it something that kind of starts in a certain period in the future -- certain time in the future?

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

We have begun implementing the clean sheeting part of the new operating plan. So yes, that has been underway for some time now. We've been going across the railroad from location to location, clean sheeting, as Mike has described. And we'll continue to push hard on that until we have laid the foundation through the clean sheeting process for a new operating plan for the network.

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

And part of prior plans at other railroads entailed a fairly significant headcount reduction and quite a change in the infrastructure within each of the organizations, and we've heard -- you would have seen very significant reductions in number of hump yards and so on. Your approach in the past has been a little bit more balanced, I think, you've termed it, Jim. Will this plan be more aggressive on headcount reduction and infrastructure changes or continue to be more on the balanced side?

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

Labor productivity being a key component of overall productivity and necessary -- a necessary component of further progress on the operating ratio, we will be focusing on that element of the plan, certainly. As we roll out the new operating plan, we would expect to achieve a greater labor productivity as well as asset productivity through fewer locomotives and freight cars out on the network.

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

But is that incremental? Or -- in the prior plans, we've seen 30% reductions in labor force. We've seen 75% reductions in number of hump yards. Improvement could be a little bit or a lot, I'm trying to get a sense of are we -- incremental improvement or is it along the lines of these other very significant changes in infrastructure and labor force?

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

We'll give you more details in February. But as I have said, we do expect to put some aggressive, ambitious goals out there for the operating ratio and for further overall financial improvement. Labor productivity and asset productivity, network productivity will be absolutely part of that and will be necessary to achieve those goals.

Operator

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

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

Can you give us any sort of hurricane impact in the quarter and any sort of guidance on incentive comp year-over-year for the fourth quarter?

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

Okay, Mike, why don't you take the hurricane question and then Cindy talk a little bit more about incentive compensation.

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

Yes, we weathered the hurricanes really well. Hurricane Florence came on land, and we were able to restore our main lines pretty quickly within 24 hours. We did have some water impact around New Bern and we had some of our bridges underwater, but we were able to use short lines to re-route that traffic to some of our major customers. So Hurricane Florence was really the short-term impact, as we got the railroad up very quickly. And same thing with Hurricane Michael, it moved across our network pretty quick. We were responding right behind it as it came in, pretty much removing trees and putting generators out at signals and grade crossings, and again got the railroad up very quickly. So both storms moved right through our network, we were able to recover quickly. And really that's a testament to the -- to our engineering folks who staged a lot of equipment, assets, generators out in the right locations so that we could recover quickly and we did. So we had very minimal impact and were able to get the railroad up very quickly.

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

Cindy?

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

Yes, in terms of the cost of the hurricane, I mean, I think all of our preparation work really paid off. And the cost were really not significant at all in terms of the hurricanes. On your second question around incentive comp. You'll recall and I said in my comments that third quarter of 2017, we had a large incentive comp adjustment. We did an adjustment in 2018 in the second quarter. Going into the fourth quarter, will really depend on the company performance as to whether there's any sort of adjustment to incentive comps. So we'll just have to wait and see how we do as the fourth quarter continues.

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

But nothing obvious on the year-over-year comp, good or bad for 4Q, Cindy?

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

No, nothing.

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

Okay. Okay. And then Jim, you mentioned that you brought -- you've brought in some precision railroading people. Can you maybe add a little bit more color there? Is it senior people? Is it people in the yards? Just how many people? Just maybe a little bit more there would be helpful.

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

Well, we have people on the ground with PSR experience, assisting us as we move through clean sheeting. We also have people who are advising us on the new plan as we put it together, the new operating plan, the new strategic plan with that kind of a background. So we've -- we feel we've covered the bases, and as I said before, we know we don't have a monopoly on good ideas. We are open to all best practices including but not limited to PSR.

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

But are you sort of open to adding to the C-Suite or executive sort of levels, if appropriate?

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

I have total confidence in my team. And I believe that we have what we need in that team to deliver the results that we will lay out for you in February, just as we have delivered the results for you up to this point for the last 3 years.

Operator

The next question comes from the line of Brandon Oglenski with Barclays.

Brandon Robert Oglenski - *Barclays Bank PLC, Research Division - VP & Senior Equity Analyst*

Alan, I want to come at your revenue outlook. Because it looks like you have pretty bullish comments across your 3 segments here, merchandising, intermodal and coal. I was wondering if you can balance that in the context of the looming tariffs and a lot of Chinese goods that can be implemented in January. Have you have heard any concerns from your customer base around what's upcoming in 2019?

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

Brandon, what we're seeing is a little bit of inventory stockpile or an inventory pull ahead. However, if you take a look at the macro data, the inventory sales ratio remains flat and at a pretty low level, which in any case the demand for product is pretty strong. You take a look at manufacturing in September was up 5.1% year-over-year, the strongest gain in almost 8 years. Retail sales in the third quarter were up 5.9%. So the economy remains very strong. The tariffs add some uncertainty to what our customers are thinking, however, the underlying economy as represented in the macro numbers is very strong, which gives us a lot of confidence in our volumes and our revenue in the fourth quarter and well into 2019.

Brandon Robert Oglenski - *Barclays Bank PLC, Research Division - VP & Senior Equity Analyst*

Okay, I appreciate that, Alan. And then, Jim, maybe a little bit more strategic one. And I don't want to focus necessarily on your competitor. But if CSX were to run at a significantly lower operating ratio, and we've seen them improve system velocity, and I know it's not defined the same anymore. But is that a concern for you if you can't get your cost base down equal to your competitor? Is there a lot of traffic that potentially could be at risk as you look out over the next couple of years?

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

Well, let me state what I think is the obvious. We are focused on enhancing value at Norfolk Southern, leveraging our franchise, and we have for the last 3 years fulfilled our commitments to shareholders. Now think about it, think back. Over 500 basis points improvement in the operating ratio in 3 years, double-digit EPS growth, ahead of schedule on both of those metrics which we laid out 3 years ago, substantial shareholder value delivered. So we will continue to push for the best possible result at Norfolk Southern. We are very confident in our prospects, and we'll give you the details on the new plan in February.

Operator

The next question is from the line of Turan Quettawala with Scotiabank.

Turan Quettawala - *Scotiabank Global Banking and Markets, Research Division - Director, Transportation and Aerospace, Equity Research*

I guess just talking a little bit about PSR here. One of the other things that does happen is -- and quite a bit of an improvement in CapEx, and you have talked about obviously reducing cars online and so on and so forth. Should we assume just sort of directionally that CapEx should be going down here going forward? Or do you think it sort of stays align a little bit?

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

We believe that 16% to 18% of revenue is an appropriate range for capital spending. We believe that's necessary in order to sustain our franchise and to invest for growth. In addition, we have significant expenditures now and on the horizon for locomotives. We're in the middle of a substantial locomotive conversion program, and we intend to continue layering in new locomotive acquisitions as well.

Turan Quettawala - *Scotiabank Global Banking and Markets, Research Division - Director, Transportation and Aerospace, Equity Research*

Okay. And I guess just one more. I don't know if it's possible to get some early indications on coal here for next year, just on the export side? Obviously, this year has been pretty strong on export coal. Just wondering, do you think that there's a potential for growth, further growth in the coal franchise on the export side next year?

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

Certainly, the seaborne prices have increased as the year has progressed. And if that holds into next year and coal production comes online, then yes, we could see growth in our export coal franchise next year.

Operator

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

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

We've seen some pretty credible press reports about you relocating your headquarters from Norfolk to Atlanta. And this morning, you just announced a February Investor Day to be held at Atlanta. I know this isn't a done deal, but can you talk high level, is this a synergy play, just to get management closer to the operating team, a local talent pool play or really just more about cost reduction? And you -- maybe just a little bit about the real estate situation that's creating this opportunity and whether or not you'd expect that to be net cash positive to your investors?

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

We are considering headquarters relocation to Atlanta as has been reported in the press. It is not a done deal. A number of aspects of the relocation still have to come together for it to become a reality for us. The impetus for headquarters relocation is alignment and teamwork. It's our belief that we will function more effectively as a team. We will be more aligned if we are in 1 place. We do own property in Atlanta, which we have been seeking to sell for some time now. And that would be one aspect of headquarters relocation that would need to be resolved before we do it. And we will certainly report to you, as we report our results, any real estate gains that might accompany that transaction.

Operator

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

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

So I wanted to ask you about the, kind of, I guess the broader review on the approach on PSR and so forth and the financial targets. As you -- in February, as you think about that backdrop, how much does a review of profitability of the segments play in? I think a component we've tended to see with PSR at railroads as you look through the book and say, okay, maybe this is a piece of business we're not making a lot of money on. We can see some of that go away, or we pretty significantly change the service that we offer. So I'm just wondering is that part of what you're doing here in the PSR or the other strategic -- or do you think the volume you have is a good volume and you don't need to see some of it move away?

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

What you have described, Tom, certainly is a part of the strategic review that we have underway. Now that's something that we do all the time. We are always looking at our book of business and seeking to optimize its profitability by one means or another. So that's ongoing. That is not necessarily new, but yes, at a high-level, we are doing that as part of the new long-range plan. Alan?

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

Tom, you see us continue to take a look at our intermodal franchise. And we have announced some lane closures over the last year, 1.5 year, and yet still have shown 8 straight quarters of volume improvement. Those actions in the productivity improvements that they generate as well as the pricing opportunity has really helped us improve the profitability of our intermodal franchise and allowed us to reinvest in it. As Jim noted, this is -- that's an ongoing effort across all of our business units, so it's nothing new. It's part of good housekeeping that we do every day.

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

Okay, good. That's helpful. And then, maybe just 1 on the current dynamic in the truck market. How that affects you? I think it's hard to tell, it seems like broader freight backdrop is pretty strong. That said, you see evidence of softening in the truckload spot market, maybe not so much on the contracts side. Have you seen some kind of wrinkles of weakness coming in? And how do you think about the kind of how tight things are? And the kind of outlook for pricing going forward?

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

Tom, our channel partners have indicated to us that they're expecting a very strong fourth quarter. And with consumer confidence being at an 18-year high, we expect that to continue well into 2019. Our contract structure will allow us to continue the momentum with pricing. So we're very confident about volume opportunities and pricing opportunities in the truck-competitive environment for the remainder of this year and in next year.

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

Right. Okay. So you really haven't seen signs of weakness?

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

No.

Operator

The next question is coming from the line of Kenneth Hoexter with Merrill Lynch.

Kenneth Scott Hoexter - *BofA Merrill Lynch, Research Division - MD and Co-Head of the Industrials*

Jim or Mike, I guess, I just wanted to understand what changed through your process and maybe mindset here at -- as you, kind of, just step over to this clean sheeting PSR process? You've always talked about this is the right plan for you in terms of focusing on top line growth. And I guess maybe just to understand, is this kind of an evolution of that same plan or a complete overhaul and looking at your peers saying, we need to kind of shake that up? And I guess within that, Mike, I don't know if you want to maybe walk through the process of clean sheeting in terms of what you've been doing so far?

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

Well, Ken, let me respond first, and then I'll turn it over to Mike. Certainly, we are looking to change the way we operate. That's necessary. The network has evolved over the years. It's time for a major network overhaul, an operating plan overhaul anyway. So that's something that we are focused on as a natural development in the life of the network, if you will. It's time for that kind of a bottom-up review of how we operate. So certainly, the underpinnings of it are organic in that sense, driven by our customer base, our mode of operations up to this point and the need to continue to push productivity and efficiency, while preserving the capacity for growth.

Mike, a little bit more about clean sheeting?

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

Yes, this is evolutionary. As Jim noted, we've optimized our networks in the past and now, we're going to take the next step and kind of optimize them together. But clean sheeting is really a deep dive at our local serving yards and kind of the nodes to that area. And we bring our service design folks in, we bring our customer service folks and, we bring the marketing folks in, we look at all the local service schedules, and we make sure they are synced up as good as they can with the main train network. We talk to customers about how we get traffic in and out of their facilities quicker, get them through our yards quicker. So it's a deep dive at all of these nodes across our network, which are the local -- local serving yards. And it's a pretty intense work that we do. We do it over several weeks and then we come out of there with a better, more-efficient operating plan, and you saw some of the results we showed you.

Kenneth Scott Hoexter - *BofA Merrill Lynch, Research Division - MD and Co-Head of the Industrials*

So does it go so far as to just looking at improving the performance at those yards? Or does it step back in terms of the clean sheeting in terms of your network structure, right? So when you look at a peer now that's, I guess, ripping up the entire hub-and-spoke concept of intermodal. I know, Alan, you mentioned, closing some lanes, but does it, kind of, structurally change how you think about even the yards themselves?

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

So what happens is after the clean sheeting is done, then you are able to put the train plan network in a more optimal fashion where you get the benefits of what you've done with clean sheeting. That answer your question?

Kenneth Scott Hoexter - *BofA Merrill Lynch, Research Division - MD and Co-Head of the Industrials*

Yes.

Operator

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

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

It'd be great to get a sense for one of the tenets to your plan here is that you're going to be integrating some of the other segments into merchandise, what I am assuming you're talking about intermodal and merchandise, exactly how separate have those networks been running to date? And when do you -- and can you give us some sense of how much of the networks are actually going to be integrated?

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

Yes, so our multilevel and intermodal networks have pretty much been integrated for several years, and Alan noted the productivity we've got out of those. So those have kind of been integrated. Merchandise has been optimized and developed on its own and then the bulk networks kind of been its -- mainly its own separate networks. So those are the three separate networks. We have done some integrating of different parts of that but not at a level that we're looking at for the next operating plan.

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

And I guess as you start to kind of think about putting that premium traffic in with some other cargo traffic, is that going to have an impact, do you think, on the services that you are actually able to offer to the marketplace as opposed to having 1-, 2-, 3-day-a-week service? Are you going to be able to offer a broader set of service as well kind of going down -- as we move through the next couple of years?

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

Oh, yes, absolutely. I mean, this is intended to make sure we actually provide more service to the customer. So yes, that's what we expect.

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

The frequency of service certainly can increase under this new operating plan, we believe. Our goal, as I said earlier, is to achieve this with a minimum of network disruption. That doesn't mean service won't change to some customers, however. It will, it will. There will be different service parameters in some cases. Our goal is to provide a more consistent lower cost service product.

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

I guess just within your markets, Jim, right obviously, in the Eastern part of United States, I would imagine that getting to a more frequencies on a day-of-week basis would give you a significant advantage relative to truck. Is that right? Or am I thinking about that wrong?

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

Yes, that is true, and that also can result in cost reduction because of the increased velocity of the network.

Operator

Next question is from the line of Brian Ossenbeck with JP Morgan.

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

Maybe just go to Alan on domestic coal. And you mentioned in the slides, in prepared remarks, there's some increasing demand on utility coal. Could you give us a sense of where the stockpiles are? What the winter setup looks like from a network and equipment perspective? And then just any sort of outlook with natural gas here, cracking above $3 for the first time in a long time?

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

Brian, stockpiles are largely -- have largely declined over the last year. In the north, they are at about 50 days. They've declined about 30 days in the last 12 months. And in the south, they're about 65, 66 days, and they've -- we estimate they've declined about 22 days within the last year. And so you see that setup for increasing demand for our services in the fourth quarter and in the first quarter of next year, obviously, with natural gas prices closer to $3.25 or $3.20, that helps too. Because as you noted, that's up about $0.22 per million BTUs where it was this time last year.

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

Okay, got it. And then on the export side. I know you gave some color on that already. But was there any impact from the hurricanes as they came through the network? I know you don't really have any storage capacity at Lamberts Point, but is there any sort of catch-up that you would expect to hit the fourth quarter?

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

We had a force majeure within our coalfields for about 3 days earlier this month as a result of the hurricanes. And so you'll see a little bit of catch-up associated with that. We also did some maintenance at our Lamberts Point facility as well. So we fully expect that assuming good production that export volumes will ramp up sequentially week-over-week, as the quarter progresses.

Operator

Our final question is from the line of Matt Reustle with Goldman Sachs.

Matthew Edward Reustle - *Goldman Sachs Group Inc., Research Division - Senior Equity Analyst*

Just first on the PSR initiatives. Can you differentiate how much of this is an opportunity for you to just improve your own results, how well you run your business versus how much of this is something that you need to do to bring down the cost structure to fend off competition as the trucking market eventually does recover and as your peer in the east has brought down its own cost structure?

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

We believe that by implementing best practices developed from within, developed with our customers in a consultative process, developed with our supply chain partners and including PSR practices can lead to both a better and more consistent service product and a lower cost structure.

Matthew Edward Reustle - *Goldman Sachs Group Inc., Research Division - Senior Equity Analyst*

Got it, okay. And then just quickly on crude, seeing a nice pick up there. Are most of those barrels coming from Canada? Or are you are seeing any split between the Canadian mix versus the Bakken mix? And if you have contracts, are you -- part of the contracts tied to those barrels?

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

Yes, Matt, most of our increase in crude oil volume is the Western Canadian-select which is -- I'm sure you're aware, is very much in the money. There is a great arbitrage opportunity on the East Coast for that. So that's where we're seeing the volume growth. We expect it to continue in the fourth quarter and continue well into 2019. So we're optimistic about our volume outlook for the remainder of this year whether it's in coal or intermodal or merchandise, and we expect that to continue in 2019 both for demand for our product and our ability to price.

Operator

At this time, I will turn the floor back to Jim Squires for his closing remarks.

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

Thank you, everyone, for your questions today. We are excited about the momentum we have. We intend to deliver on our promises in the future as we have in the past. We look forward to announcing new financial targets at our Investor Day in February and to showing you the path we will take to get there. Thank you very much.

Operator

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