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MANAGEMENT DISCUSSION SECTION

Operator: Greetings and welcome to the Norfolk Southern Corporation third quarter 2021 earnings call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce Meghan Achimasi, Senior Director of Investor Relations. Thank you. Ms. Achimasi, please go ahead.

Meghan Achimasi

Senior Director-Investor Relations, Norfolk Southern Corp.

Thank you and good morning, everyone.

Please note that during today's call, we will 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.

Our presentation slides are available at nscorp.com in the Investors section along with our reconciliation of non-GAAP measures used today to the comparable GAAP measures. Along those lines, recall that in the third quarter of 2020, we recorded an impairment charge of $99 million related to an equity method investment, so we will speak to the quarterly results excluding that charge. A full transcript and download will be posted after the call.

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

James A. Squires

Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

Good morning, everyone, and welcome to Norfolk Southern's third quarter 2021 earnings call. Joining me today are: Cindy Sanborn, Chief Operating Officer; Alan Shaw, Chief Marketing Officer; and Mark George, Chief Financial Officer.

Our third quarter results reflect a strong performance from the team, as we delivered third quarter records for operating ratio, net income, income from railway operations, and earnings per share. While volume held steady with last year, revenue grew an impressive 14%, and our 60.2% operating ratio reflects a 230 point improvement on a year-over-year adjusted basis, our second-best OR performance ever, outpaced only by last quarter's 58.3% mark.

In the midst of significant supply chain disruptions and labor shortages across the country, we're delivering upon our commitments. And we could not have achieved those milestones without the tireless work of our employees, who day in and day out keep our customers' goods moving safely and efficiently. To our employees, thank you for your efforts to keep our economy moving.

Now, let's turn to Cindy to go through our operations. Cindy?

Cynthia M. Sanborn
Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.

Thanks, Jim, and good morning.

In the quarter, we continued to successfully drive productivity improvements throughout the network. We worked to be as efficient as possible as we adjusted to accommodate demand shifts in many of our markets. This quarter shows continued progress as we attack our cost structure while positioning ourselves for further improvement in both cost and service levels.

The quarterly operating metrics on slide 6 clearly show that once again we generated positive operating leverage on flat unit volumes and GTMs that were up 5%.

While we are proactively hiring train crews, efficiency in all areas of our operations, including engineering, mechanical, and communications and signals, enabled us to run the network with 7% fewer people in the quarter compared to a year ago. Because assets drive activity, reducing the number of active locomotives was an important lever in managing the size of the workforce.

Both train weight and train length continued to improve, driven by a focus on improving the productivity in our bulk network. Coal, grain, and other single commodity unit trains offer real opportunity for gains through collaborating with our customers on operating trains with more cars per set and by doubling up existing trains over portions of their route. I expect we will show continued progress in the fourth quarter as we see the fruits of our efforts. While strong coal traffic helped drive train weight more than length, train length continued to improve and set another quarterly record.

After seven consecutive quarters of fuel efficiency improvements, we saw a modest deterioration this quarter despite the increase in train size, as our horsepower leverage was challenged at times due to volatile traffic flows and we had modestly fewer of the very heavy, highly fuel-efficient trains. I am pushing the team to respond more quickly in the face of change, and we are committed to closing the gap with our peers over time and are redoubling our efforts in this critical area.

As you can see on slide 7, train speed and terminal dwell were generally flat versus second quarter and do not reflect performance at desired levels. While there were some effects from Hurricane Ida, those impacts were localized, and I'm extremely proud of how the team, especially engineering and our signal forces, helped us return our routes in Louisiana to operation and reopen the New Orleans gateway very quickly.

As I mentioned last quarter, we are experiencing hiring and retention conditions that are increasingly challenging, especially in some of our more critical locations, and it is having an impact on our network. Despite hiring all year long, attrition has been accelerating in each of the last two quarters in several of those critical areas. In many of these locations, we've been able to absorb the impact by executing upon productivity initiatives, and this will be very much a part of the equation going forward as we grow capacity, which I'll talk about more in a moment.

Some of the things we are doing to create relief, we've more than tripled our conductor trainee ranks since the first quarter so that we can effectively backfill in critical areas. We've implemented tools such as perfect attendance bonuses, referral bonuses, and signing incentives to improve the stickiness of our current and future workforce. And we continue to leverage the valuable go teams to quickly respond to business opportunities where needed.

People are the backbone of the railroad, and we need to make progress on these initiatives to better manage the effects of a tight labor market. We are committed to having the right amount of resources in the right place at the right time, which will drive both cost control and service quality.

As our business mix continues to evolve, creating capacity across our market segments has become an even more significant area of focus, as highlighted on slide 8. Some shippers are looking to take advantage of unexpected market opportunities by shipping extra volume. Others are looking for us to help them adjust to volatility coming from other parts of their supply chains. And of course, all place a high value on service predictability.

We're adjusting our network and operations to generate the various types of capacity that customers are looking for. For example, increases in bulk train sizes give shippers extra lift without further demands on our crew base. Train size increases often require connecting railroads, customers, and Norfolk Southern to change processes, and we have found those process changes are worth the effort because they improve asset turns and capacity. We also continue to focus on terminal efficiency, whether helping to drive dwell at our biggest hump yard, Elkhart, to very low levels or tactically redirecting trains to intermodal terminals that have the capacity to unload quickly.

Moving to slide 9, I want to show how we can use these capacity efforts to drive productivity. We've had great success over the past two years driving train size, and in doing so have addressed a handful of infrastructure bottlenecks. We're fast-tracking a set of siding improvements, the first of which went into service at the end of the third quarter so we can keep making progress.

Bigger trains unlocked by siding extensions help drive locomotive utilization because it allows us to fully match train size to available pulling power. And because locomotives are at their most efficient when pulling hard, this is a key lever to our fuel efficiency improvement.

While I've used locomotives and fuel as my primary example, capacity additions have a similar effect on our crew productivity, more cars per crew, asset turns, keeping trains moving with greater train capacity, and it also helps our customers with improved train and car performance.

On slide 10, we are complementing our investment in physical capacity with a comprehensive technology strategy that makes our crews more efficient and our assets more productive. Virtually all of our routine signal and track maintenance is now scheduled via the mobile track authority app. A process that used to be measured in minutes can now be accomplished in seconds. It is inherently more efficient than the radio process of the past and, most importantly, safer because it reduces transcription errors. In the words of our chief engineer, the app has been a game-changer for the productivity of his forces.

We're doing the same with our mobile train reporting app, which enables our train crews to quickly report completed work and to receive updated customer work requests while en route. This takes a lot of hands out of the process, including significant retyping and delay and enables our crews to be more productive. We're still early in the deployment of this application, with rollout to the local trains that do the preponderance of pickups and setoffs just beginning. The use cases for this technology in the field are numerous, and driving adoption and innovation around this platform is a focal point that will allow us to capture additional benefit.

The common use thread in these apps is that better information allows people to plan. Our track supervisors can better plan their schedule knowing the availability of track time, and our customers can better plan their plant operations and product pipeline with up-to-date shipment information.

Now I will turn it over to Alan.

Alan H. Shaw

Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

Thank you, Cindy, and good morning, everyone.

In the third quarter, we continued to execute on our growth plan, yielding double-digit revenue gains in each of our three markets, further demonstrating our ability to deliver value for our customers and shareholders.

Beginning on slide 12, I will highlight our results for the third quarter. We achieved total revenue of $2.9 billion, representing a 14% increase from the same period last year despite flat volumes. Our revenue performance this quarter was driven by significant gains in revenue per unit and revenue per unit less fuel, both reaching record levels with double-digit year-over-year growth. This reflects the success of our ongoing efforts to yield up and improve revenue quality, a strategy that enhances our long-term potential for revenue and margin growth as conditions improve.

Revenue in our merchandise segment improved 10% year over year, while volume increased 5%. Growth was led by our chemicals franchise that benefited from recovering energy demand that drove higher shipments of crude oil and natural gas liquids. Also contributing to merchandise growth was sustained strength in steel markets due to record high commodity prices and growth in manufacturing activity. Steel shipments were up an impressive 34% from the same period a year ago.

Partially offsetting these gains were declines in shipments of finished vehicles and vehicle parts due to the ongoing semiconductor shortage. This limited automotive production activity and further depleted finished vehicle inventories to new lows. Both revenue per unit and revenue per unit less fuel improved year over year due to price increases.

Our intermodal franchise experienced several headwinds related to supply chain disruptions that negatively impacted volume in our domestic and international business lines. In both segments, unprecedented demand from inventory restocking and consumer spending outpaced available capacity in the supply chain ecosystem.

The combination of drayage shortages, warehouse productivity, equipment availability, labor force participation, and rail network fluidity pressured intermodal volume throughout the quarter, resulting in a 4% year-over-year decline. Overcoming these headwinds, we delivered revenue growth of 16% in the third quarter due to higher revenue from storage services, increased fuel surcharge revenue, and price strength.

Coal revenue increased 32% in the third quarter, as both domestic and global economies continued to recover from the pandemic and drive demand for electric power. Export coal shipments increased significantly, as strong demand and record high seaborne prices increased opportunities for US producers.

Utility volumes declined in the third quarter, as coal supply was limited and some crossover tons moved into the higher-rated export market. The mix shift from utility to export coupled with price gains led to a 20% increase in revenue per unit less fuel for coal in the third quarter, a new record for the franchise.

Moving to our outlook on slide 13, we expect the third quarter environment to continue through the end of the year. Strong consumer demand will continue while pressures from material shortages and labor issues remain, challenging global supply chains.

Inventory levels remain at historic lows despite the continued push to replenish stock, providing a boost to transportation demand. We remain confident in our ability to leverage our strengths in these market conditions and deliver robust revenue growth for the full year.

We expect merchandise business will continue to benefit from recovering economic activity, as conditions that limited business and recreational activities in the fourth quarter of last year have been much less impactful in the fourth quarter of 2021. We anticipate our markets for crude oil, natural gas liquids, and waste to experience higher volume as a result.

Ongoing demand for steel will also be a growth driver, with forecast for industrial production up more than 5% year over year in the fourth quarter and steel prices currently above $1,900 a ton. A projected 4% year-over-year fourth quarter decline in US light vehicle production will remain a headwind, as the industry remains challenged by the chip shortage.

Within intermodal, we continue to see strong demand from consumer spending and tightness in the truck sector. These favorable conditions are offset by constraints from supply chain congestion and equipment availability. We are working closely with our customers and our channel partners to mitigate these challenges. However, we do not see meaningful improvement in these headwinds before the end of the year.

Coal demand is expected to remain strong with extremely favorable market conditions, although coal supply will be the governor on year-over-year growth. Natural gas prices continue to climb, and declining inventory levels leading into the winter months are the current focus of utility customers. Seaborne prices are at decade-long highs in the export market, creating demand beyond capacity and supply abilities. Overall, we are optimistic about the opportunities in the fourth quarter and confident in our ability to execute our plan to generate value and grow our business.

Turning to slide 14, there are several factors impacting the supply chain in which we participate. This includes external factors, such as the chip shortage and intensifying congestion in the intermodal supply chain. Coal supply availability continues to be a constraint to meet the higher demand in every market, as both thermal and met production remain tight.

NS has taken action to mitigate some of these factors and effectively position us for revenue growth. As drayage challenges affected international intermodal, we provided an alternative storage solution to our customers. We're working diligently to add chassis capacity to support demand and alleviate shortages across the supply chain. Last quarter we outlined our plan to repair a portion of our chassis fleet that was impacted by a manufacturing defect. I appreciate the quick action and effort from our team. And I'm pleased to report that this issue is effectively behind us, as we have repaired and returned approximately 95% of the recalled chassis back to service.

We are also in the process of taking delivery of leased chassis to augment our fleet. We've added terminal capacity to support growth driven by e-commerce and a recovering economy as well as reduce terminal congestion and improve network fluidity.

We remain focused on growth opportunities across our network. We are continuously innovating to compete in the $800 billion-plus truck and logistics market, as shown by our Thoroughbred Freight Transfer, or TFT, service launched earlier this year. TFT is one of our initiatives to drive growth by targeting opportunities for highway conversions to rail. This service combines the efficiency of our intermodal trains, the capacity of our boxcar assets, and the last-mile flexibility of trucks to provide an innovative door-to-door service. We're also leveraging our sustainability advantage to propel long-term growth.

The choice of transportation mode is one of the most powerful levers any shipper has to reduce the size of its carbon footprint, and we are working closely with our customers to deliver additional value through sustainability. We have proven our ability to deliver results despite challenging market conditions by providing innovative solutions that our customers value and position us for future market demands.

I will now turn it over to Mark, who will cover our financial results.

Mark R. George

Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.

Thanks.

On slide 16, as Alan just detailed, revenues were up 14% on flat volumes. With operating expenses up 10%, we delivered strong incremental margins, leading to 230 basis points of operating ratio improvement, driving us to a Q3 record of 60.2%. The improvement Alan detailed in RPU coupled with strong productivity led to record Q3 operating income, with growth of 21% or nearly $200 million. And our free cash flow is also at record levels, a 33% increase during these nine months compared to last year.

Moving to slide 17, let's drill down into the change in operating expenses. While operating expenses grew $149 million or 10%, it's up only 4% or $67 million apart from fuel cost increases. The fuel cost increase of $82 million is driven mainly by price, but the 5% increase in GTMs also drove more consumption.

You'll see purchased services up $35 million, with the majority of the year-over-year increase in three areas. We have an increase in technology spend, which is consistent with our technology strategy, and you heard a couple project examples in Cindy's remarks. There are also headwinds from Conrail operating expenses, and there are increases in intermodal costs. More specifically, we had trucking costs associated with shuttling longer dwell containers to satellite parking lots in order to reduce congestion at our terminals and keep the freight moving.

Lift expenses were actually up in the quarter despite fewer lifts, and that is primarily because of inflation we absorbed on lift rates associated with contractor labor availability. This is an area we do expect to see continued inflationary pressure going forward. And we also absorbed costs in the quarter related to our chassis repairs.

Moving on to compensation and benefits, it is up 5%, but you'll note the $40 million in savings from 7% lower head count that more than offset increases in pay rates and overtime. Meanwhile, incentive compensation comparisons in the quarter are a headwind of $43 million, similar to what we reported in the second quarter, reflecting our strong 2021 financial outlook compared to lower accrual rates last year. Materials claims and other expenses were all down year over year.

Turning now to slide 18 and looking at the rest of the P&L below operating income, you'll see that other income of $14 million is $25 million unfavorable year over year, and that is due almost entirely to lower net returns from company-owned life insurance.

Our effective tax rate in the quarter was 23.6%, close to our federal and state statutory rates, but unlike Q3 last year where the rate was 21.9%, and benefited from tax advantages related to both COLI investment gains and higher stock-based compensation.

Net income increased by 17% while earnings per share grew by 22%, supported by 3.6 million shares we repurchased in the quarter.

Wrapping up with our free cash flow on slide 19, as I have mentioned, free cash flow is a record through nine months of 2021 at $2.3 billion, buoyed by very strong operating cash generation, and that translates into 102% free cash flow conversion. While property additions are trending a bit lower than run rate for our $1.6 billion guidance number, capital spend is never linear, and we expect fourth quarter property additions will get us close to the $1.6 billion. Shareholder distributions through nine months exceed $3.2 billion, an increase of over $1.5 billion versus prior year, thanks to a higher dividend and a meaningful increase in our share repurchase activity.

And with that, I'll turn it back over to Jim.

James A. Squires

Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

Thank you, Mark.

We first demonstrated our commitment to sustainability with our visionary appointment of a Chief Sustainability Officer back in 2007, the first in the industry, and our efforts to support a low-carbon supply chain have greatly accelerated since then. Building upon the momentum earlier this year with the approval of our science-based targets for greenhouse gas emissions reduction and our launch of $500 million in green bonds in the second quarter, we're excited to report another set of milestones on our sustainability journey.

In August, we released our 2021 ESG report, our 14th annual report on corporate responsibility, highlighting the transformational role sustainability is having on our business as we further integrate sustainable practices into daily operations.

We celebrated our 500th modernized locomotive unit in partnership with Wabtec in August and announced our collaboration with Progress Rail in September on a first of its kind Tier 4 locomotive prototype for yard and terminal operations. And just earlier this month, we announced our decision to purchase 100% renewable energy to power company operations in Altoona and Reading, Pennsylvania.

Our commercial and sustainability teams work hand in hand to provide demonstrable low-carbon solutions to a wide variety of current and prospective customers, providing a compelling value proposition as we convert more freight from truck to rail, simultaneously benefiting our customers, our communities, and our shareholders.

Before we open the call to Q&A, I'll take a moment to provide an update to our outlook based on the current economic environment. As shared previously, we expect to achieve an operating ratio improvement above 400 basis points for the full year versus our adjusted 2020 result. And there's likely upside to the 12% year-over-year revenue growth, as strength in our consumer-oriented and manufacturing markets drive the majority of the growth. Near-term upside in coal markets provides a boost for the balance of the year as well, though coal remains challenged in the long term.

We are delivering on our financial commitments and remain focused on creating long-term sustainable value for our customers and shareholders.

So with that, we'll open the call to your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: Thank you. We'll now be conducting a question-and-answer session. [Operator Instructions] Our first question comes from the line of Jason Seidl with Cowen. Please proceed with your question.

Jason H. Seidl
Analyst, Cowen & Co. LLC

Q

Thank you, operator. Good morning, everybody. I wanted to talk a little bit about the pricing side. Several of your peers have mentioned sort of rising costs, if you will, and the need to take pricing up another notch. I wanted to sort of get your opinion on that and what Norfolk Southern's plans are for 2022.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Thanks, Jason. Alan?

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

Hey, good morning, Jason.

Jason H. Seidl
Analyst, Cowen & Co. LLC

Q

Good morning.

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

As you know, Jason, we price to the market. And right now, the market opportunities for our ability to price are pretty strong. And you've seen that with respect to our yields. You saw it in the composition of our top line. Earlier this year, we were very confident in our ability to deliver 9% revenue growth. As the demand environment and the pricing environment strengthened, we bumped that up to at least 12%. Our primary competitor is truck, and you saw that spot rates in the truck market were up 21% year over year in the third quarter.

As we have an opportunity to revisit our contracts and the relative value of our product, we're going to price to the market as we've always done, which is why we've delivered our RPU ex-fuel increases in intermodal for 19 consecutive quarters and in merchandise 25 of the last 26. As commodity prices go up, Jason, it also means more demand for that product as well. So we feel good about the demand and the pricing environment.

Jason H. Seidl
Analyst, Cowen & Co. LLC

Q

So, Alan, maybe can you remind us of the percentage of your business that rolls over in 4Q and 1Q?

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

It's a majority of the business that rolls over in those two quarters, Jason. And as you know, about 50% of it rolls over every year. It's a good environment for us to revisit our price plan.

Jason H. Seidl
Analyst, Cowen & Co. LLC

Q

It seems to be. Listen, I appreciate the time, as always, nice quarter.

Operator: Thank you. Our next question comes from the line of Jordan Alliger with Goldman Sachs. Please proceed with your question.

Jordan Alliger
Analyst, Goldman Sachs & Co. LLC

Q

Hi. You talked a little bit about need to hire crews in the tough environment. Can you maybe sort of – one question, of course, is where does head count go from here. But maybe the right question is in an optimal environment, how much head count do you think you need? Are you okay where you're at, or would you like 1,000 more people, 500 more people? Thanks.

Cynthia M. Sanborn
Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.

A

Good morning, Jordan, thanks for the question. I think broadly – let me just put a broad perspective on it. We're really managing through a very disruptive labor market. And it's been a challenge from the beginning of this year. But we've been able to really continue to find productivity improvements up to this point that the team I think has done a great job of. And really, you're seeing it flowing through our financial results.

So when I think about where head count should be, it's really a function of volume that we have on the network as well as our productivity initiatives, of which we have quite a few with longer trains and other opportunities for productivity. So I think from where we are right now, we'd like to see head count up maybe a little bit to take out some of the lumpiness of what we're seeing. But longer term, we're going to be focusing on using technology and other things, focusing on continuing to bring that down. But at this point with where we are, we'd like to see it come up.

Jordan Alliger
Analyst, Goldman Sachs & Co. LLC

Q

Thank you.

Operator: Thank you. Our next question comes from the line of Tom Wadewitz with UBS. Please proceed with your question.

Thomas Wadewitz
Analyst, UBS Securities LLC

Q

Good morning. I wanted to get your thoughts on capacity expansion. I guess we could talk about intermodal or if you want to talk about broader network, and how that would translate to your view on volume growth in 2022. It seems to me that there are certainly areas where if you had more capacity or the system had more capacity, you'd have stronger volume, and intermodal is obvious on that. But how do you think about capacity additions in the network capacity? And is it reasonable to expect volume growth in 2022, supported by more capacity?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Cindy, why don't you take the network side of that, the line of road side of the capacity question? And then, Alan, talk about terminal capacity – intermodal terminal capacity a little bit.

Cynthia M. Sanborn
Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.

A

Sure. So from a line of road perspective, as you know, Tom, we have had a discussion on these calls around siding extensions. We've gotten our first siding extension in service in the third quarter. I mentioned that in my prepared remarks. And we have about four or five more that are underway, and then studying some others to make sure, we have good capability in our single-track locations, predominantly in the southern part of our network, to be able to drive longer trains and improve the capacity overall in the network by taking the total number of trains down because we can run longer trains. The technology of distributed power has been an enabler for that.

And also, as you know, we're doing DC to AC conversions that increase the fleet size or the capability of our fleet to do more of that. So we really see some good opportunities to continue to allow for great throughput on our work.

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

Tom, with respect to the intermodal terminals, we absolutely need to improve the throughput through the terminals. There's some self-help there. That's running trains on time. That's making sure that we've got the right amount of labor in the terminals with our terminal contractors. It's the chassis issue. That was a headwind for us in the third quarter with the safety recall. We've addressed that. However, we're still short chassis. And so we're taking delivery of 1,100 leased chassis in the fourth quarter of this year.

Our customers are short chassis too. So is the international community as well. And that's really driven by the dislocation in the drayage and in the warehousing community. If you look at the record – there's a record number of job openings in warehousing and trucking for each of the last 3 months. And so that has put a lot of pressure on throughput through the intermodal terminals.

We're working on things we can fix ourselves. As I talked about, our own mitigation efforts, whether that's reopening a couple of the terminals, leasing chassis, offering dual-mission incentives to make the drayage network more productive. And we're also working with our customers to see how we can help mitigate some of their own issues.

Thomas Wadewitz
Analyst, UBS Securities LLC

Q

So I guess to bring that to a point, though, are you optimistic about intermodal volume growth, given what you see on the capacity side in 2022?

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

Yes, because we've taken some very concrete steps to address what is under our control. And we're hopeful that at some point, the drayage community gets a little healthier and the warehousing community gets healthier as well.

Thomas Wadewitz
Analyst, UBS Securities LLC

Q

Great, thank you.

Operator: Our next question comes from the line of Jon Chappell with Evercore ISI. Please proceed with your question.

Jonathan Chappell
Analyst, Evercore Group LLC

Q

Thank you, good morning. Alan, sticking with you, you mentioned improving revenue quality, which I know has been a big focus for you guys over the years. And capacity is clearly at a premium, not just on the rails, but in every part of the transport supply chain right now. Are you being increasingly more selective in the freight that you're willing to move right now in an attempt to maximize your capacity and the mix of margin associated with that? And if so, how does that kind of play into your long-term volume outlook, sacrificing yield potentially for volume?

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

Hey, Jon, part of yield up is – really the heart of it is allocating resources to the market signals that we get, which would indicate where the best home for those resources is. So that involves making sure that we're onboarding the right type of business onto our network, to make sure that we're not adding complexity, and it involves making sure that we are being compensated for the value of the product that we're delivering.

And as you noted, our primary competitor is extremely stressed, and truck just does not have the overflow capacity that rail does. Add into that environment more interest from our customer base on sustainability. I was talking to a customer the other day about it and effectively cut me off mid-sentence and said yes, we all know that rail is much more sustainable than truck, and we're doing everything we can to shift more towards rail.

So I think there's a prolonged opportunity to make sure that we continue to post improvements in our yields. I will tell you that one area in which I'm a little concerned is within the coal network with export prices at record highs. I think it would be irresponsible for us to feel like they're going to continue to rise into next year. And so that might be an area in which you see a decline in yields.

Jonathan Chappell
Analyst, Evercore Group LLC

Q

Okay, that makes sense. Thanks, Alan.

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

You're welcome.

Operator: Thank you. Our next question comes from the line of Ravi Shanker with Morgan Stanley. Please proceed with your question.

Ravi Shanker
Analyst, Morgan Stanley & Co. LLC

Q

Thanks. Good morning, everyone. I apologize if I missed this, but can you unpack the yield growth you saw in the quarter in terms of core price versus ancillary charges versus mix?

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

Ravi, certainly the storage solutions that we provide in the international community was a driver of RPU growth, as was fuel surcharge. We also saw a much better pricing environment in the third quarter than in the second, which is no surprise, and we've got a lot of momentum with respect to the price.

Ravi Shanker
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And maybe as a follow-up, just switching gears a little bit, how do you see the regulatory environment next year, particularly around price?

And maybe as a related question, you and all the other rails have been cutting head count a fair bit over the last several years. What would you say to like shippers and other folks in the industry who say that you cut too deep and now that you're – like you and everybody else are kind of struggling to hire again that you maybe shouldn't have been in this situation to begin with? Obviously, hindsight 20/20, like, who knew how the recovery would work out and such, but just again, I'm trying to figure out from a regulatory perspective. Thanks.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Let me take the second part of that first and the first part second. We've been hiring aggressively since the beginning of the year, and we've ramped that program up throughout the year. So we are putting a lot of people into the pipeline, through the pipeline and into the field even as we speak. And we'll continue to do so, recognizing that at least in some locations, we are short of people and we need more help.

In terms of the regulatory environments, I think it's worth emphasizing that there is a good deal of overlap between what we do and what the administration and Congress are seeking. That overlap is in the area of sustainability. It's widely recognized in Washington today on both sides of the aisle that rails are the sustainable ground transportation. And so we see eye-to-eye with the administration on that. We're all about economic development and creating good jobs for people and helping the American economy grow. That lines up very well with what the administration and Congress are trying to do as well.

Now, we don't see eye-to-eye on everything. Where we disagree with policymakers, we maintain a very active dialogue, and we make sure that our point of view that our needs, that our importance to the American economy are widely understood.

Ravi Shanker
Analyst, Morgan Stanley & Co. LLC

Q

Very helpful, thank you.

Operator: Thank you. Our next question comes from the line of Brandon Oglenski with Barclays. Please proceed with your question.

Brandon R. Oglenski
Analyst, Barclays Capital, Inc.

Q

Hey, good morning, everyone, and thanks for taking my question. Jim, I guess following up from that, given that you guys are hiring, I guess that speaks to a pretty positive economic outlook in 2022, if I'm hearing that correctly. And I guess, as you guys talk about improving to industry level of profitability, is there still a lot of leverage on the labor line looking forward? Is it fuel efficiency? I guess where do you guys see the biggest opportunity there? Thank you.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Sure, let me say first that we're proud of the progress our employees have achieved so far this year. We still have a quarter to go, but we're definitely on pace to hit our goals, a 60 OR run rate for the full year.

Now, the work isn't done. We recognize that we have more room to run, and we're very excited about the margin opportunities, the top line growth we see ahead. We will continue to drive the OR lower over time and continue to narrow the gap. We'll do that with a combination of revenue growth and continuing emphasis on productivity and sustainability throughout our company. That includes fixed costs. That includes employee productivity. That includes fuel efficiency and so on and so forth. Cindy, anything to add?

Cynthia M. Sanborn
Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.

A

And I would add, Brandon, I put it in my prepared remarks, technology is really very helpful to us, whether it's mobile applications that allow employees to be in the field as opposed to managing the input of information through a traditional keyboard and computer, whether it's predictive analytics, or whether it's pure automation. So there's plenty of opportunity out there in addition to train length and then some of the other items that I've already talked about so far.

Brandon R. Oglenski
Analyst, Barclays Capital, Inc.

Q

Thank you.

Operator: Thank you. Our next question comes from the line of Chris Wetherbee with Citi. Please proceed with your question.

Christian Wetherbee
Analyst, Citigroup Global Markets, Inc.

Q

Hey, thanks. Good morning. Maybe a question about sort of service and the broad chain dynamics. Cindy, you talked about some of the efforts that you guys are undertaking to improve service and kind of bounce back a little bit here. Obviously, the quarter you saw some pretty decent metrics as well. But maybe mixed with what Alan was sort of talking about in terms of the supply chain, I guess when do we see sort of Norfolk service improve in a meaningful way, which may be sort of a precursor to a broader improvement in the supply chain? I think Alan, you talked about maybe nothing before the end of the year. But maybe what are some early indicators that sort of the process is turning and maybe some of this congestion can clear and we can kind of improve fluidity a little bit more, which could be, like I said, the precursor to broader congestion alleviation?

Cynthia M. Sanborn
Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.
A

As far as where we are with service levels that are public and that I talked through, I really see the big linchpin obviously being people. I talked about it. This is fairly disrupted labor environment. We are hiring people, as Jim has noted. But bringing on people is a long lead time. We have streamlined our process of hiring and also our training process, taking advantage of technology to do so.

Obviously, we're not going to compromise safety in anything that we do with that regard. And we doubled our class size since July and other type issues. But that is going to be what helps us to see our service levels improve. But this is a national issue. And as you know, it's at the heart of the supply chain overall. And it's been building for a while, building for months, and it will probably take a few months for us to clear through it. Alan, I don't know if you have anything you want to add.

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.
A

With respect to the entire supply chain ecosystem, Chris, warehouses are full. That's what we're hearing from the BCOs. And I think you need about 25% more warehouse capacity than what's available right now. There's just not enough labor. And frankly, a lot of the e-commerce giants are just now in the process of starting to hire for the holiday season. So I think that's going to further stress things going forward. We've actually seen in Chicago a degradation in street dwell on international chassis over the last couple weeks, which would indicate more stress in that first mile/last mile component of the ecosystem.

Christian Wetherbee
Analyst, Citigroup Global Markets, Inc.
Q

Okay. Alan, when you talk to your customers, it's sort of maybe next year is what they're talking about. Any indication from them in terms of timing and when they feel a little bit better?

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.
A

We're not, because it's reliant on so many different components. And frankly, they're asking about the same questions that Cindy addressed too. We've got to improve our piece of it. We're having those discussions with them. But they also recognize there are a lot of things out there that are well outside of our control that I just don't have a timeline as to when the drayage community and the warehouse community start to get healthy. Of the top 20 drayage markets, most of them are in our footprint. That's a great thing that tells you how strong our intermodal franchise is. It also indicates that when the drayage community is stressed, it puts stress on our network.

Christian Wetherbee
Analyst, Citigroup Global Markets, Inc.
Q

Got it. That's helpful, thank you.

Operator: Thank you. Our next question comes from the line of Brian Ossenbeck with JPMorgan. Please proceed with your question.

Brian P. Ossenbeck
Analyst, JPMorgan Securities LLC
Q

Thank you, good morning. I just wanted to maybe follow up on that last question with you, Alan. Just thinking about the pace of truckload conversion, industrial development project wins, clearly there's a ton of demand but challenging across the board, as you've been talking about. Can you go into the TFT product you mentioned a little bit more? Is that something you feel like you need to expand to get more of a door-to-door service longer term and to make some of these wins really sticky? And do you think you have to do any more investment there in terms of maybe looking at some more non-rail assets?

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.
A

Brian, TFT for us is a pilot program. We're in our early stages, but it seems to be working pretty well. We're testing it with a number of customers who have been displaced out of the LTL market. It uses a lot of the principles of PSR; i.e., you're putting boxcars on intermodal trains. And then we're using a partnership with a drayage company to provide first mile/last mile.

It's all part of kind of our core competency of innovating to provide solutions that will drive highway-to-rail conversions in that $800 billion-plus truck and logistics market. The regulatory agency over us took notice of it and was complimentary of our efforts to try and drive truck conversions. So we're happy with the way it's going so far. We're testing it in a number of markets, and it's indicative of our overall strategy.

Brian P. Ossenbeck
Analyst, JPMorgan Securities LLC
Q

And is this something you think could scale pretty rapidly in 2022, or was this more of a pilot born sort of out of necessity of the current market?

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.
A

I think long term, there's going to be opportunity for this because e-commerce isn't going away. And e-commerce itself is a benefit to us as well because it's highly intermodal intensive. So it's something that we're going to continue to look to add dots on the map in a low-risk manner to drive incremental margins.

Brian P. Ossenbeck
Analyst, JPMorgan Securities LLC
Q

All right, that's helpful. Thanks, Alan.

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.
A

You're welcome.

Operator: Thank you. Our next question comes from the line of Scott Group with Wolfe Research. Please proceed with your question.

Scott H. Group
Analyst, Wolfe Research LLC
Q

Hey, thanks. Good morning, guys. Mark, maybe can you give us some thoughts on operating ratio sequentially in fourth quarter and any thoughts on specific cost items in fourth quarter heading into next year?

And then, Jim, it feels like we haven't heard anything from the rails this earnings season with respect to vaccine mandates. I'm just curious your thoughts there and what you guys are doing there,

---

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.
A

Okay. Thanks, Scott. I'll tell you what, why don't I take that one first and then we'll turn it over to Mark for some color on the expense trends. With respect to the vaccine mandate, I want to say first that we sincerely hope we won't lose a single Norfolk Southern employee as a result of that government mandate; that our employees will consider vaccination, those who aren't vaccinated, or will seek an accommodation to which they're entitled under the law.

And this was not our idea. This was not our initiative. This is a mandate. We reviewed it. We studied it, we went over with a fine-toothed comb. We determined that we are federal contractors subject to the executive order because of the business we do for the Department of Defense principally.

So we are now in the process of implementing it. It's a tough decision that's being imposed on some of our employees as a result, and we do regret that. However, we will follow the law. It clearly applies to us and we must comply.

So what's next? All right, we get the information out there. We owe it to our employees to be clear about where we stand and what happens next leading up to the December 8 deadline for compliance. And people have time to go out because we announced we would comply with the law. We've given people time to get vaccinated or to seek accommodations. And we're keeping a very close eye on the impact.

As I said, I hope we don't lose a single person. We will probably lose some employees as a result of this. And we will work very hard to retain them first, but second, if not backfill the positions with all of the measures that Cindy went through. So, Mark, talk a little bit about the expense trends.

Mark R. George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.
A

Okay. Scott, first, I think your question was on sequential OR as we look to Q4. Q3 we did see pretty much stable OR from Q2 when you back out the land sale, the outsized land sale that we had last quarter. I think we were about 10 basis points better in Q3. And then we expect to see basically more of the same here in Q4. Some of that will depend on the volume outlook as we navigate through Q4. I do expect that the expense side of the equation should also be roughly consistent with what we've experienced here this quarter. So it just feels like more of the same as we close out the year and that we'll stay on this run rate, like we talked about earlier in the year.

Scott H. Group
Analyst, Wolfe Research LLC
Q

That's helpful. Jim, if I can just follow up on the vaccine for one second, it feels like everyone in the supply chain thinks that this is a bad idea or at least a big risk to further supply chain disruptions. Is there any sense that maybe some of this could get pushed out or get rid of altogether? Just everyone seems to think it's a big risk.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.
A

Our strategy there is to communicate clearly with policymakers about the risks associated with this mandate. And we are doing that actively, making sure that those who are in a position to shift policy understand what the consequences could be. So whether we agree with the policy or not, we are implementing it as we are required to do. Meanwhile, we are been very vocal about the possible consequences to the supply chain and to the economy.

Scott H. Group
Analyst, Wolfe Research LLC Q

Okay. Thank you, guys. I appreciate it.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp. A

Thank you.

Operator: Thank you. Our next question comes from the line of Walter Spracklin with RBC Capital Markets. Please proceed with your question.

Walter Spracklin
Analyst, RBC Dominion Securities, Inc. Q

Thanks very much. Good morning, everyone. I'd like to go back to the regulatory question. I just wonder if there's a bit of a silver lining here with the supply chain issues and the very delicate capacity environment that this has proven our entire transportation network has.

And my question I guess for Jim here is, are things like reciprocal switching, which eat up capacity with a different objective in mind, but the consequence being that it eats up capacity, do you think the White House is aware of this? Do you think the regulator recognizes that messing around with regulations that have one intended consequence could have a very detrimental one when it comes to capacity and some of the indications that we've seen with where our capacity is puts that at significant risk? Do you think that's lost on regulators, or is it something that they become acutely aware of now and will rethink when potentially designing new forms of regulation for the railroad industry?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp. A

I think you summarized it pretty well. And there is growing sensitivity and awareness on the part of regulators and policymakers regarding the state of affairs in the supply chain and the risks associated with policy changes at this stage. So my message is, at the very least, consider gathering additional facts and evidence.

The supply chain is clearly in flux right now. It's in the process of reorganizing itself, and we don't know exactly what future freight supply chains will look like. So given that the record in the relevant STB proceedings predates all of that, let's at least take a look at the current state of play and understand how freight is moving in today's economy and may move in the future before we make any significant policy changes.

Walter Spracklin
Analyst, RBC Dominion Securities, Inc. Q

And just on that, Jim, as the supply chain reorganizes, do you think that railroads will either play an increasing role outside of their railroad focus? In other words, despite your best efforts and successful efforts to manage your own house, if there are problems outside of your control, outside of your rail network that you could address if you had ownership of those pieces further up or down the supply chain, would that be something Norfolk Southern would consider? Would you be willing to or interested in going outside of your rail focus if it means addressing some of these items that are outside of your control?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

I would put it this way. We see so many opportunities within our core business today, so many opportunities for organic growth by converting freight from road to rail within our existing franchise that we don't see a need to pursue businesses or approaches outside our core because there are always risks associated with M&A risks. And we've tried that before. If you look back in history, as a company, we have owned trucking companies, and it didn't end well. So our approach will be to stick to what we know best and what we can execute best in light of all of the growth opportunities we have there.

Walter Spracklin
Analyst, RBC Dominion Securities, Inc.

Q

Great, I appreciate the time. Thank you.

Operator: Thank you. Our next question comes from the line of Amit Mehrotra with Deutsche Bank. Please proceed with your question.

Amit Mehrotra
Analyst, Deutsche Bank Securities, Inc.

Q

Thanks, operator. Hi, everybody. Thanks for squeezing me in here. Alan, I just wanted to follow up on the intermodal growth questions. Obviously, we fully appreciate the challenges around drayage capacity and labor at warehouses. But just looking from the outside in, it's pretty clear that there have been some market share shifts in intermodal with your direct competitor. The chassis issue explains some of it, and we've seen a little bit of an uptick in weekly intermodal carloads, but there seems to be some market share shifts. I don't know if you think that's a fair characterization. And if it is, what the root cause is and you can address it. But if you can, just talk about that.

And then my second question, Mark, you used to provide this great slide that talked about fixed versus variable cost structures that spoke to the underlying operating leverage in the business. The cost structure is very different today given all the good work that Cindy and her team have done and the whole team have done. So I was wondering if you can baseline where you think incrementals for the business are given maybe a more volume variable cost structure than maybe you had a couple years ago. Thanks a lot.

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

Amit, I'll cover the first part. In the third quarter, there were some international customer-specific actions with respect to inland positioning of containers that impacted our volumes. That's starting to unwind itself, and so we should see a lift there, although ultimately international volumes are going to be limited by the drayage community and the warehouse community.

Look, we've got the most powerful intermodal franchise in the East. It is a key component of our plan going forward to lever that and to grow. We've proven we can do it over time. In 2017, our revenue was up 11%. In 2018, it was up 18%. In 2019, it was only down 2% in a freight recession, and it pivoted back to growth in the fourth quarter of 2019. This year, our revenue in intermodal is up 21%. And compared to 2016, our revenue in intermodal is up 43%, so we know it's a growth driver for us.

We've done a lot to improve the productivity there. Just in the third quarter, our train weight in intermodal was up 4%, and yet our train length was down 3%. So we've got some things that we need to do to provide our customers with a better service product. They deserve that. We also have some things that we need to do at the interface with our customers to help make the – to collaborate with them on making the whole supply chain efficient.

Mark R. George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.

A

And, Amit, I'll talk to you about the incrementals. We had 57% incremental this quarter. I just want to point out, that would be about 70% if not for the headwind that higher fuel cost and surcharge gave to us this quarter. So I think 70% core incremental margins are pretty good. I think we've done a very good job absorbing a lot of the volume growth that we've seen this year without adding on the resource side.

In some areas, like you mentioned, the incremental costs have risen in some lines, and in other lines they've held flat. We have changed our cost structure quite a bit in the past year, and so some of those drivers have varied. But I do think net-net, if we can continue, our goal here is to continue holding costs while we absorb incremental volume and certainly the drop-through from other revenue contributors. We're going to be in a good place to help drive this down on the OR side.

Amit Mehrotra
Analyst, Deutsche Bank Securities, Inc.

Q

Got it. Okay, very helpful. Thank you very much.

Mark R. George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.

A

Thank you.

Operator: Thank you. Our next question comes from the line of Ken Hoexter with Bank of America. Please proceed with your question.

Kenneth Hoexter
Analyst, BofA Securities, Inc.

Q

Thanks. Good morning, Jim and team, great job on the improvement. Just to follow on the – you gave before the fourth quarter outlook on operating ratio. I want to make it maybe just a little bit bigger. Your initial thoughts on 2022, just given your 400 basis points at least improvement in the OR, maybe the scale of gains. And I know you're not necessarily going to give a number and you don't typically. But maybe, Cindy, can you talk about the additional cost programs that you're looking at? Alan, maybe your thoughts on growth off of this higher base and the sustainability? Just maybe some general thoughts to put a picture onto 2022 as we close out 2021.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Sure. Okay, Ken. Thanks. Let me take the first part of that. As we look ahead to 2022 and beyond, as I said, we are committed to driving the OR lower. And we will do that with a combination of emphasis on productivity and efficiency measures and top line growth, and there's a lot of opportunity for us there. We will get more specific with our 2022 guidance in January when we come back to you with our fourth quarter results.

In terms of a new set of goals for the longer term, look for an Investor Day on our part sometime next year. We'll get more specific with regard to dates in the near future, but it's clearly time for us to update our longer-range goals as well.

Cynthia M. Sanborn
Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.

A

Ken, I don't want to be a broken record, but we do have opportunities for train size and train length with our siding extensions, but also with growth being able to add into existing trains. We see great opportunity there to continue productivity and great drop-through on that revenue. We've got extra board consolidations with district and crew segments, those types of activities, continued improvement in yard processes, and I can't underemphasize technology. I made some remarks about that earlier, so I won't repeat those. But the technological advances that will help us be much more efficient in how we go about our business. So there's a great pipeline, and I'm real excited about getting it on the railroad.

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

Ken, with respect to the macro environment, it's unique. It's uniquely strong. You take a look at inventory sales ratios, historic lows. And the consumer has a healthy balance sheet and retail sales are continuing to increase. And so that inventory replenishment cycle is going to be a boost to transportation demand well into 2022.

PMI is at 61.1%, which is well into expansionary phase right now. Demand is really high, everything that indicates that the only thing holding it back are supply chain challenges, which we need to help solve for our customers. Steel prices are at record highs in a really weak auto environment. So think about what happens when auto starts to rebound next year. And then potentially, you sprinkle on a little bit of an infrastructure package before the midterms and we expect to have a robust environment for our product, our consumer-facing franchise next year as well.

Kenneth Hoexter
Analyst, BofA Securities, Inc.

Q

Really helpful. I appreciate the insight. Jim, can I just get one quick clarification? The impact on KCS/CP on the Meridian Speedway. I presume there is no impact to your network and your ability to run and everything. I just wanted if you have any quick thoughts on that.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

Let me say this, we will be active participants in that STB proceeding, making sure that our customers' interests and our shareholders' interests are protected throughout that. We expect to continue to utilize the Meridian Speedway as part of our joint venture and to grow traffic on that line. It's a great route, the best in the business from LA/Long Beach to the Southeast. So we think that the transaction you mentioned gives us every opportunity to grow our business over that line.

Kenneth Hoexter
Analyst, BofA Securities, Inc.

Q

All right. I appreciate the time, everyone. Thank you very much.

Operator: Thank you. Our next question comes from the line of Justin Long with Stephens. Please proceed with your question.

Justin Long
Analyst, Stephens, Inc.

Q

Thanks, good morning. Mark, I wanted to clarify a statement you made earlier about volumes in the fourth quarter. Were you saying your expectation is for fourth quarter volumes to be relatively flat sequentially?

And then on the head count topic, Cindy, you mentioned that you'd like to see head count up a little bit, so similar clarification question. Is the expectation that head count will be up slightly in the fourth quarter on a sequential basis? And thinking about next year, is the view that if hypothetically we see volume growth in the low to mid-single digits, head count is probably up a little, but not up as much as volumes?

Mark R. George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.

A

Justin, I'll tackle your volume question first. If you do look at the weekly trends on volumes, you'll see it's kind of going sideways, and we expect that trend to carry out for the full quarter.

Cynthia M. Sanborn
Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.

A

On head count, Justin, what I would basically say is that we're still seeing attrition and replenishment as our challenge. So we'll probably see head count kind of come down a little bit more. I would like to see it stabilize and come up because we are replenishing for attrition. So that's what my comments earlier, what that meant. Still, our long-term opportunities, again, on train size and other process improvements in our terminals and a few of the other things I mentioned are very, very beneficial to us to bring head count down longer term.

Justin Long
Analyst, Stephens, Inc.

Q

Okay. So headed into 2022, just hypothetically, if you saw low to mid-single-digit volume growth, do you feel like you could keep head count relatively flat sequentially given the productivity opportunity?

Cynthia M. Sanborn
Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.

A

I think it would be along those lines, maybe up slightly, but yes, along those lines.

Justin Long
Analyst, Stephens, Inc.

Q

Okay, great. Thank you so much.

Cynthia M. Sanborn
Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.

A

Not one for one, Justin, I guess is what I'm getting at.

Justin Long
Analyst, Stephens, Inc.

Q

Understood, thanks for the time.

Operator: Thank you. Our next question comes from the line of Ben Nolan with Stifel. Please proceed with your question.

Benjamin Joel Nolan
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thanks. I wanted to circle back a little bit on the coal front and appreciating that next year could be very different than the market is at the moment. But if natural gas prices were to stay high internationally and there's good demand, I was just curious if you could maybe frame in sort of what your potential to grow is within the coal franchise, if the market conditions persist as they are currently?

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

Ben, as you know, the market is white-hot in coal, whether it's domestic or export, and really where our volumes are limited right now is on the production side. There just has been a severe underinvestment, frankly, in anything that generates BTUs over the last 18 months.

The export market, prices are at record highs. China, the early indications are that China will need to import more coal next year than it did this year. China's trade tensions with Australia are certainly driving some of the demand and higher prices. But China hasn't shown any indication to unwind that. And with steel prices so high, China can afford to pay the higher input prices. So we're watching it very closely. We're continuing to talk to our customers about it. We're hopeful that production improves, and we would certainly be a beneficiary of that.

Just if you take a look at in the utility market, coal burn is up 73 million tons this year. Coal shipments are up 16 million tons. So that kind of tells you what's going on there. Stockpiles at least in our region are down 55% year over year. So there just is not enough production to satisfy the demand with all the geopolitical issues that are going on and then as substitute fuels being priced so high right now, as you noted.

Benjamin Joel Nolan
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Right. Perfect, I appreciate the color. Thanks guys.

Operator: Thank you. Our next question comes from the line of Bascome Majors with Susquehanna. Please proceed with your question.

Bascome Majors
Analyst, Susquehanna Financial Group LLLP

Q

Thanks for taking my questions. One point of clarification. Can you share the current sense of vaccination rate across the network?

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

A

We're gathering that information as we speak, but it's really too soon to tell. We will have a better sense of that in the next month or so. And we'll be better positioned to understand what the impact could be, what the attrition as a result of the government mandate might be. So we're keeping a very close eye on that.

Bascome Majors
Analyst, Susquehanna Financial Group LLLP

Q

Thanks for that, Jim. I wanted to clarify some of the labor situation more broadly. Cindy, is there any way you could frame how the attrition is picking up? And focus on any regions or functions where it's been most acute, and any feedback you're getting as to why people are leaving or where they're going, just to kind of understand the problem you're dealing with. Thank you.

Cynthia M. Sanborn
Executive Vice President & Chief Operating Officer, Norfolk Southern Corp.

A

Bascome, that's coming in a couple of buckets. One bucket is where we have a very, very tight labor market broadly in the region. And that is affecting both tenured employees finding alternative places to work as well as being very difficult to find new conductor trainees. And then there's a corridor or two that is affecting us more broadly in the Midwest part of our network in that particular scenario. And then there's the scenario where we're able to generate trainees and bring them in, though not quite at the numbers that we'd like. And we have some attrition of those trainees a little higher than our historical norm. So that has affected us being able to continue that replenishment pipeline like we'd like.

So we saw this starting in the third quarter, and we've increased the number of people in our pipeline in those locations where we're able to attract folks to our really good company here by about 240%. And we've also seen conductor trainees increase by about – actual trainees on the property increase by about 53%. So that's a different kind of bucket. Now we have doubled the class size since probably June. And we expect to also add additional class size and classes by the end of the year to again attract folks in the door and allow for that training process to occur. But there's a lag time here is what I'm really telling you. And so we see that persisting into the first part of 2022.

Bascome Majors
Analyst, Susquehanna Financial Group LLLP

Q

Thank you.

Operator: Thank you. Our next question comes from the line of David Vernon with Bernstein. Please proceed with your question.

David Vernon
Analyst, Sanford C. Bernstein & Co. LLC

Q

Thanks, operator, and good morning, team. Mark, I'd like to talk a little bit about intermodal profitability. I want to make sure I understand kind of what the drop-through is on some of the fee revenue. Should we be thinking that's cost neutral right now? And then if you think about where rates are sort of ex-surcharges, are you getting enough to cover some of those cost callouts you mentioned around terminal costs and things like that?

What I'm really trying to get at here is if we think about contribution from intermodal today, should we be expecting that to be limited by some of these supply chain disruptions and fee issues and that it will accelerate from here, or are we already starting to see some of that improvement sort of and contribution from intermodal in the OR development despite the fact that we have these supply chain disruptions?

Mark R. George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.

A

Thanks, David. So look, I think one thing – one way to think about intermodal is we've increased our profitability considerably over the past decade as we've grown volumes, and we've been able to demonstrate value to our customers and basically bring our pricing up to where it should be. So I would say that incremental intermodal business brings with it accretive OR, and we feel like that will continue. It will continue to accrete to the business as we grow our intermodal business. We're providing more and more solutions to our customers, including the storage service solutions that we've really built up during this period of intense supply chain congestion. So we are finding new ways to make that business even more profitable.

David Vernon
Analyst, Sanford C. Bernstein & Co. LLC

Q

And should we expect that to accelerate as things start to loosen up across the supply chain into 2022 and 2023?

Mark R. George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.

A

Yes, I think as we get more fluidity in that network and we can take on more volume because I think the volume is out there, we just need the entire ecosystem to start moving again and loosen up. And I think we have the capacity, we can start moving more and more volume. And there will be changes perhaps between – you might not have quite as much storage revenue, but you'll have more on the volume side. And so overall, we feel good about our intermodal prospects for the future. It's a great franchise. We've got the capacity. We've got terminals in the right locations, and we've got great partners, channel partners on the intermodal side. So we're feeling good about our position.

David Vernon
Analyst, Sanford C. Bernstein & Co. LLC

Q

All right. Thanks for the time, guys.

Mark R. George
Executive Vice President-Finance & Chief Financial Officer, Norfolk Southern Corp.

A

Thank you.

Operator: Thank you. Ladies and gentlemen, our final question this morning comes from the line of Cherilyn Radbourne with TD Securities. Please proceed with your question.

Cherilyn Radbourne
Analyst, TD Securities, Inc.

Q

Thanks very much and good morning. On international intermodal, could you talk about whether you're seeing volumes start to divert to the East Coast to avoid the congestion in LA/Long Beach currently, whether customers are planning to do more of that as the union contract negotiations on the West Coast gets closer, and just if that creates different capacity challenges when you get the volume directly on the East Coast versus via interchange with the Western roads?

Alan H. Shaw
Chief Marketing Officer & VP-Intermodal Operations, Norfolk Southern Corp.

A

Cherilyn, as you know, customers are seeking optionality, both short-term and long-term, on their supply chain, and port diversity is an approach that retailers are employing. We've seen a prolonged shift from West Coast to

East Coast over the last 10 to 15 years such that a majority of our international business either originates or terminates on an East Coast port.

The East Coast ports right now are faring much better than LA/Long Beach. I saw something the other day where LA/Long Beach had 96 vessels stacked up outside. So yes, we'll see some more business move over to the East Coast. We've proven the ability to handle that and handle that well. Take a look at our inland port up at Greer. We pulled 760,000 trucks off the highway since that opened in 2013. And one of our highest volume corridors is between Atlanta and Savannah, so two short-haul moves.

However, with that added revenue density and incremental volume on existing train service that Mark and Cindy talked about earlier, it's proven successful for us and for our customers.

Cherilyn Radbourne
Analyst, TD Securities, Inc.

Q

Thank you, that's all for me.

Operator: Thank you. Ladies and gentlemen, that concludes our question-and-answer session. I'll turn the floor back to Mr. Squires for any final comments.

James A. Squires
Chairman, President & Chief Executive Officer, Norfolk Southern Corp.

Thank you, everyone, for your questions today. We look forward to talking to you again next quarter.

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