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NSC - Q4 2016 Norfolk Southern Corp Earnings Call

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OVERVIEW:

NSC reported 4Q16 revenue of $2.5b, net income of $416m and diluted EPS of $1.42.

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PRESENTATION

Operator

Greetings and welcome to the Norfolk Southern Corporation fourth-quarter 2016 earnings call. (Operator Instructions). As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Katie Cook, Director of Investor Relations. Thank you, Ms. Cook, you may begin.

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

Thank you, Devon and good morning. Before we begin today's call, I would like to mention a few items. The slides of the presenters are available on our website at NorfolkSouthern.com in the Investors section along with our non-GAAP reconciliation. Additionally, transcripts and downloads of today's call will be posted on our website.

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

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

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

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

Our results summarized on slide 4 are a testament to the dedication of our employees. In 2016, their efforts were instrumental in the achievement of a record operating ratio for Norfolk Southern, as well as in meeting and exceeding our other financial and operational goals even in a tough economic climate.

We have stayed focused on our core mission of safety, service and productivity while also driving positive changes throughout our organization. The significant progress we achieved in 2016 will power Norfolk Southern's success in delivering shareholder value both in the near and the long term.

For the fourth quarter, our disciplined cost focus and successful initiatives to enhance efficiency drove a 69.4% operating ratio, yielding a 510 basis point or 7% improvement, compared to the fourth quarter of 2015. Even if you exclude last year's restructuring costs, the operating ratio improved by 310 basis points.

Earnings per share for the quarter increased to $1.42, up 18%, compared to the prior-year period as operating expenses came in 8% lower relative to a 1% decline in revenue. For the full year, we achieved a record 68.9% operating ratio, which was 370 basis points, or 5% better than 2015. Earnings per share increased 10% to $5.62. In recognition of these results, as well as the confidence we have in our strategy, the Board approved a $0.02 per share or a 3% dividend increase effective with our first quarter of 2017 dividend payment.

Slide 5 highlights the important components of our success in 2016. Our measure of network performance, the composite service metric increased to above 80% for the year versus 72% in 2015. We achieved this improved performance while accomplishing strategic network and organizational changes such as the line and yard rationalizations that Mike described on our last call, as well as divisional and regional consolidations, the reorganization of our Pocahontas Land Corporation subsidiary and proactive management of capital spending.

Asset utilization improved as we rationalized our locomotive fleet, improved the efficiency of our freight cars and increased utilization of other roadway assets. Simultaneously, we reduced our average employee count for the year by 7%, exceeding the 3% decline in carloads and we also reduced overtime by 38%. In total, these initiatives generated $250 million of productivity savings for the year.

We continued to invest in the health of the railroad, adapting to the economic environment by judiciously investing $1.9 billion in capital, well below our initial $2.1 billion plan. Over a year ago, we anticipated that Norfolk Southern would achieve a sub-70% operating ratio for 2016 and our team delivered producing a record 68.9% OR. Likewise, we are committed to delivering on our longer-term targets and I will update you on our strategic plan after Alan, Mike and Marta fill you in on the fourth-quarter results. Alan.

Alan Shaw *- Norfolk Southern Corporation - EVP & CMO*

Thank you, Jim and good morning, everyone. I thank you for joining us today. On slide 7, I will begin with an overview of our fourth quarter. Revenue of $2.5 billion was down 1% versus fourth-quarter 2015. Due to strong intermodal growth, our year-over-year volume grew for the first time this year in the fourth quarter. Both intermodal and coal revenue and volume increased sequentially over the third quarter.

The Triple Crown restructuring continued to impact year-over-year comparisons, though to a lesser extent in the fourth quarter. An increase in export coal tonnage softened the decline in coal volume and revenue, though utility volumes were negatively impacted by continued high stockpile levels. Merchandise revenue was affected by the ongoing decline of crude oil volume. Overall revenue per unit declined 3% in the fourth quarter as positive pricing was offset by mix associated with increased intermodal and decreased coal volume. Revenue per unit, excluding fuel, increased for both merchandise and intermodal, excluding Triple Crown.

Our merchandise revenue on slide 8 declined 1% to $1.5 billion as a result of a 3% decline in volume. Metals and Construction volume benefited from increased steel shipments. Agriculture shipments grew due to increased soybean export and corn volumes. Declines in our chemicals market were driven by lower crude oil volume. Automotive volume was negatively impacted by the previously-announced marketshare loss and flat year-over-year US vehicle production in the fourth quarter. Paper and forest products volumes declined as a result of increased truck competition.

Merchandise revenue per unit increased 2%, excluding fuel, reflecting solid pricing gains. Intermodal revenue, as shown on slide 9, increased 4% versus last year to $583 million with a 7% increase in volume. Excluding the impact of the Triple Crown restructuring, intermodal volume and revenue were both up 10%. Improved service and increased consumer spending resulted in a 10% increase in our domestic intermodal volume versus a soft fourth-quarter 2015.

Marketshare gains and increased import and export shipments via East Coast ports drove an 8% increase in international volume. Despite rate pressure from the trucking industry, intermodal revenue per unit, excluding Triple Crown and fuel, increased 1% in the fourth quarter. Coal revenue declined 7% to $403 million in the fourth quarter with an overall 4% volume decline versus last year. Coal revenue and volume increased sequentially for the second quarter in a row, primarily driven by fourth-quarter export gains.

We handled 16.9 million utility tons in the fourth quarter, in line with our recent guidance of slightly below 17 million tons, but 10% below fourth-quarter 2015 volumes due to continued stockpile overhang from the mild 2015, 2016 winter. We handled 4.7 million export tons in the fourth quarter as demand for US coals improved amid tightening international supply and greatly increased seaborne pricing.

Coal revenue per unit, excluding fuel, declined 2% in the fourth quarter compared to the prior year with positive pricing improvement offset by negative mix related to reduced volume to our longer haul Southern utilities and increased export volume via Baltimore. Revenue per unit was up sequentially versus the third quarter.

On slide 11, our full-year 2016 revenue of $9.9 billion was down 6% versus the prior year with a 3% decline in volume and a 3% decrease in revenue per unit. Utility coal volume and revenue decreased sharply due to the impacts of mild winter weather in late 2015 and early 2016 and low natural gas prices, which contributed to the buildup of stockpiles. These factors, coupled with global oversupply and weak seaborne coal prices in the export market, led to an 18% decline in coal revenue.

Fuel surcharge losses of $241 million were driven by depressed oil prices. Quarterly declines lessened sequentially throughout the year as we lapped higher oil prices in 2015 and we anticipate that the recent rise in oil and diesel prices will lead to increased fuel surcharge revenue in 2017.

The mid-November 2015 restructuring of our Triple Crown subsidiary also reduced revenue while improving our efficiency and productivity. Our 2016 pricing gains were offset by the negative mix impact of decreased coal volume and increased intermodal volume producing a 1% decline in revenue per unit less fuel.

Overall, 2016 was challenging for many of the markets we serve with depressed energy prices, weaker-than-anticipated economic growth, elevated inventory levels and increased truck capacity all impacting our top-line performance, although we saw stabilization as the second half progressed leading to volume growth in the fourth quarter. Recent improvements in manufacturing and consumer spending, as well as overall expectations for a stronger 2017 economic environment, provide upside potential for the year ahead.

Within intermodal, a strong service product will continue to enable highway conversions and drive organic growth. We expect intermodal volumes and RPU to benefit from tightening capacity within the trucking market due to improved demand and increased regulation, particularly later in the year. We expect weather-related normalization within utility coal, as well as a marketshare gain, to generate between 17 million and 19 million tons of utility coal per quarter in 2017. Our guidance is contingent upon normal weather conditions and natural gas prices consistent with the current forward curve.

Export coal tonnage growth will be driven by tightening international coal supply and improved seaborne pricing, which should support incremental production. We expect to handle 3.5 million to 4.5 million export tons on a quarterly basis with a significant amount of volatility, as evidenced by the benchmark price.

Merchandise volume is predicted to be relatively flat in 2017. Pipeline development will negatively impact crude oil and natural gas liquids shipments. Automotive volume will be affected by extended retooling efforts at several NS-served assembly plants and an expected 3% decline in US vehicle production in 2017. Improving construction activity will benefit lumber, steel, cement and other housing-related commodities.

As in 2016, we will focus intensely on our pricing efforts. The solid pricing improvement seen over the past year will benefit our 2017 revenue. We are confident in our ability to leverage the value of our service product to attain pricing in excess of rail inflation. We are well-positioned for growth and have the flexibility to align resources and service capabilities with demand. We are steadfast in our commitment to meet evolving customer expectations, which supports long-term growth and shareholder value.

I will now turn the presentation over to Mike for a discussion of our operational performance.

Mike Wheeler - *Norfolk Southern Corporation - EVP & COO*

Thank you, Alan and good morning to our listeners. Our charge for 2016 was to provide a high-level service product and aggressively pursue cost-cutting initiatives to drive productivity and efficiency. We accomplished this as evidenced by 2016 being the first year on record that we had both a service composite above 80% and an operating ratio below 70% and we believe we are well-positioned to leverage this momentum in 2017.

As shown on slide 14, there were significant milestones achieved in 2016 that were key drivers of our success. The efforts towards driving fuel efficiency, train length and locomotive productivity all helped to drive our record operating ratio. We accomplished this thanks to the hard work of our employees in executing our strategic plan.

Moving to safety on slide 15, while our injury ratio slightly increased in 2016 as compared to last year, our train accident rate improved 19% and, as previously noted, 2016 was our best year since the Conrail consolidation. Even more encouraging, this improvement was across the board in transportation, engineering and mechanical.

Turning to service on slide 16, you see we continued to execute at a very high level as evidenced by our service composite, train speed and terminal dwell. While dwell was higher in the fourth quarter as compared to the same period last year, this was a result of an extended holiday shutdown due to the majority of our customers observing December 26 as a holiday. This allowed us to control costs without affecting customer service, which was a charge we successfully executed on for the entire year.

Now on slide 17, our productivity initiatives, coupled with our ability to keep the railroad operating at a high level, continue to result in significant productivity savings. For the fourth quarter, as compared to the same period last year, we achieved a reduction in crew starts even with an increase in volume, which was driven in part by leveraging the capacity on our current trains. We also continued to improve on our overtime and train length, although recrews were affected by an earlier start to winter weather. Together, this resulted in continued improvement in employee productivity.

For the full-year 2016, we achieved our highest average train length on record, which also aided a record fuel efficiency. Even with this continuous improvement in train length, our velocity has been roughly as high as our record levels of 2012 and 2013. In all, we had a very successful year and we are confident in our ability to continue this momentum in 2017. I now will turn it over to Marta to cover the financials.

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Thank you, Mike and good morning, everyone. The fourth-quarter results demonstrated our continued efforts on cost control and execution of strategic initiatives. Let's take a look at the financial details starting with operating results on slide 19. While revenues were down slightly, operating expenses declined by $147 million or 8% resulting in a 69.4 operating ratio for the quarter, a 510 basis point improvement over last year's fourth quarter. As you will recall, the 2015 quarter included $49 million of restructuring costs, which added 200 basis points to the OR.

Slide 20 shows the expense reductions by income statement line item marking the fourth consecutive quarter of year-over-year reductions in overall operating expenses.

Now let's take a closer look at the components. Slide 21 depicts purchase services and rents, which was down $41 million or 9% year-over-year. The largest reduction was attributable to $21 million in lower Triple Crown costs associated with the curtailment of those operations in the fourth quarter of 2015. Next were $12 million of lower transportation and engineering-related purchase service costs. Finally, equipment rents decreased by $3 million, notwithstanding the 2% increase in traffic volume.

Slide 22 highlights the major drivers of the variance in compensation and benefits, which overall declined by $40 million or 6%. Reduced employment levels down over 2300 employees versus 2015, along with lower overtime, resulted in $42 million of year-over-year savings.

In addition, we lapped a lump sum payment of $13 million and had $10 million of lower pension expense. These items were partially offset by increases in bonus accruals of $21 million, wage inflation of $16 million and health and welfare rate increases of $12 million. The bonus variance was due to the fact that we had reversals of accruals in last year's fourth quarter. The wage and health and welfare inflationary increases were similar to the run rates experienced in the third quarter.

As we look to 2017, we expect that total headcount will remain steady despite the anticipated increases in volumes that Alan described. However, higher health and welfare rates, particularly in our unionized programs, will result in approximately $65 million of additional expense and as a result, we expect all-in wage and medical cost inflation of about 5% versus the 3.5% we guided to and experienced in 2016.

Slide 23 details our materials and other category, which decreased $38 million or 15%. Lower usage of locomotive and engineering materials totaled $16 million and travel costs were down by $6 million.

Next is fuel expense as shown on slide 24. Mike described how we improved fuel efficiency and you can see that consumption declined by 6% despite the 2% increase in traffic volume. The improvement in efficiency completely offset the 8% increase in diesel fuel price versus the fourth quarter of 2015.

Moving onto income taxes on slide 25, the effective rate for the quarter was 35.1% versus the 31.1% in the fourth quarter of 2015. The effective rate was slightly below the forecasted 36% due to the effects of stock-based compensation. For 2017, we expect an effective income tax rate of approximately 37%.

Summarizing our fourth-quarter earnings on slide 26. Net income was $416 million, up 15% versus 2015 and diluted earnings per share were $1.42, up 18%. Restructuring costs affected [2015's] net income by $31 million and EPS by $0.10.

Full-year results are shown on slide 27. While revenues were 6% lower than 2015, our focus on cost control and improving asset utilization allowed us to lower expenses by 11%. The resulting income from railway operations of $3.1 billion was a 7% improvement and, as Jim noted, led to a record full-year operating ratio of 68.9%. Earnings per share were $5.62, an increase of 10% over the prior year.

Slide 28 depicts our full-year cash flows. Cash from operations totaled $3 billion, amply covering capital spending and generating $1.1 billion in free cash flow. Returns to shareholders in 2016 totaled $1.5 billion through $700 million of dividends and $800 million in share repurchases. As Jim noted, our Board of Directors increased the quarterly dividend to $0.61 a share, a 3% increase. On stock repurchases, we plan currently to continue at about a $200 million per-quarter run rate in 2017.

Moving on to this year's capital budget on slide 29, we project total spending of $1.9 billion, roughly even with 2016. This budget is supportive of the growth areas Alan described while continuing to invest in our core assets. We have expansions planned at various terminals and infrastructure targeted at increasing capacity on our network to provide high service levels to support long-term growth.

As you can see from the chart on the slide, the majority of our spending is on roadway and while at a dollar amount similar to the past few years, those dollars are stretching further in terms of units due to efficiency in our engineering forces. Locomotive capital includes new units, as well as the conversion of locomotives from DC to AC power. Thanks for your attention and I'll turn the program back to Jim.

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

Now, as promised, an update on our five-year strategic plan, which I conveyed in detail on last January's earnings call. You will recognize slide 31, which is the summary page of financial targets that I shared with you at that time. The employees of Norfolk Southern more than delivered on the 2016 targets.

Additionally, we are on track to reach our 2020 targets, including pricing above rail inflation, a sub-65% operating ratio and double-digit compound annual growth in earnings per share. 2016 demonstrated our flexibility as we adapted our approach to capital spending to the evolving business environment. The same proactive approach will allow us to manage our capital spending to 17% of revenue post the 2018 positive train control installation.

Throughout, we will return significant capital to our shareholders by targeting a 33% dividend payout ratio and we will continue to employ share repurchases as a significant component of our capital allocation strategy. Our management's adaptability, illustrated by our capital program, applies to all aspects of the railroad. Volumes for NS and the industry did not develop for 2016 as expected, particularly in the energy markets. As a result, we were swift in taking actions to streamline operations and enhance service, bolstering our productivity and supporting growth in certain opportune markets.

With this nimbleness and strong momentum, we are well-positioned to guide Norfolk Southern into the future. So with that in mind, I will update you on key aspects of our long-range plan. Slide 33 highlights our expectations for each of our major revenue groups. Overall merchandise is anticipated to track the economy generally in line with GDP. The forecast for intermodal growth is about 4% on a compound annual basis as our strong service product positions us for growth.

Coal is projected to increase in 2017 from our 2016 base as inventories and weather normalize, coupled with higher natural gas prices. It is then expected to decrease slightly from 2017 levels, resulting in a modest 1% increase on a compound annual basis over the combined period.

Slide 34 highlights some of the strategies that we have in place to support key resource flexibility as volumes develop. We will continue to proactively manage our workforce to right-size our resources as demand evolves. We have established minimum employee levels at certain core locations where it has been more difficult to recruit new hires in the past. In addition, we have an active hiring model that we are continuing to enhance.

On the locomotive side, we continue to invest in the reliability of our fleet. We will take receipt of 50 new locomotives beginning in late February with the majority of them coming online in March and April. In addition, our DC/AC rebuild program significantly accelerates in 2017.

Now moving on to slide 35 and expenses, we will build on 2016's productivity initiatives by, for example, rationalizing our locomotive fleet by increasing our reliance on AC units, by increasing utilization and efficiency of our freight cars through a more homogeneous and flexible fleet composition and utilizing technology to optimize distribution of empties, by continuing our line rationalization initiatives and by improving fuel efficiency.

Last year, we provided a framework for our overall $650 million five-year plan productivity target, as reflected on slide 36. With $250 million of productivity savings achieved in 2016 and $100 million targeted for 2017, I remain fully confident in our ability to deliver on our longer-term productivity objectives.

At the beginning of our journey, we designed an approach that would be dynamic and flexible and 2016 certainly put that to the test. Our achievement of $250 million in productivity in 2016 clearly demonstrated that we would take the measures necessary to achieve that goal, creating new paths to savings when needed. We will apply that same flexibility over the next four years in order to align resources with demand, achieve $650 million in productivity savings, provide quality service and drive shareholder value.

Wrapping up on slide 37. At Norfolk Southern, we know that the key to our success is world-class service that brings value to our customers thereby supporting profitable growth that leverages our improving cost structure, culminating in exceptional returns to our shareholders. Thank you for your attention and with that, we will now open the line for Q&A.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). Chris Wetherbee, Citi Investment Research.

Chris Wetherbee - *Citi Investment Research - Analyst*

Good morning. Wanted to touch base a little bit on the operating ratio as you look out for 2017. Jim, you just ran through some of the productivity opportunities that you see going forward and what you think that you can achieve in 2017. Just want to get a sense of maybe how that translates to an OR. You made nice progress this year. Should we expect similar type of stair-step progress in 2017, or any color would be helpful?

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

Good morning, Chris and thank you for your question. Before I answer it, I want to again emphasize how much we appreciate the contributions of our employees in 2016 to our outstanding performance. We are the efforts of our employees and we certainly recognize that.

Now, in 2016, we generated a record operating ratio. This morning, we outlined and reaffirmed our plan to achieve a sub-65% operating ratio by 2020. We expect to make progress toward that goal each year between now and then and we expect to produce an operating ratio in 2017 below 2016's operating ratio.

Chris Wetherbee - *Citi Investment Research - Analyst*

Okay. So improvement, but not necessarily ready to quantify at this point?

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

Correct.

Chris Wetherbee - *Citi Investment Research - Analyst*

Okay. And if I could just ask a follow-up; just when I think about the competitive environment in the Eastern half of the United States, we've heard over the course of the last couple of weeks of a couple of contracts moving back and forth and I think there is some regular jockeying of marketshare between railroads and also with the trucks, but wanted to get a sense of maybe how you view the competitive dynamic entering 2017. We haven't had a lot of volume growth. The volume is coming back. Do you see this changing, or is this normal, or is it a little bit more heightened?

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

Certainly, we operate in a competitive environment. We face modal competition across the spectrum of our volumes. Let me turn it over to Alan for some more specific commentary on the environment today.

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Chris, I would suggest that the share shifts that you've seen recently are not unusual. Ultimately, our firm goal is to provide a service product that allows us to compete for business and one that our customers value, which will allow us to continue our efforts to move business from the highway to rail. As we saw markets stabilize in the second half of the year, we saw growth in the fourth quarter and we expect that to continue into 2017.

Chris Wetherbee - *Citi Investment Research - Analyst*

Okay. Thanks for the time, guys. Appreciate it.

Operator

Amit Mehrotra, Deutsche Bank.

Amit Mehrotra - *Deutsche Bank - Analyst*

Thanks so much. Just had a quick question on some of the strategic discussions brewing in the Eastern rails over the last couple weeks. I know you guys can't comment probably directly, but if you look at what occurred at Canadian Pacific under the previous management team, there were a number of significant inefficiencies taken out of the system, things like the number of crew changes on certain routes, reductions in the number of hump yards and terminals. Just trying to understand how much of an opportunity that is for Norfolk today bearing in mind that you've already achieved so much in terms of productivity and whether there is maybe some scope to accelerate any of that to realize your OR targets even sooner. Thanks.

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

Good morning. We don't comment on market rumors. We are single-mindedly focused on driving shareholder value through successful execution of our strategic plan, which, as you know, does include significant additional productivity improvements. We view having achieved $250 million in productivity in 2016. We've set a goal of $100 million in productivity for 2017. We believe that number is achievable, realistic and sustainable and will allow us to continue providing an excellent level of customer service. If we discover additional productivity opportunities, we will certainly go after them.

Amit Mehrotra - *Deutsche Bank - Analyst*

Okay. I thought I would try to ask that question anyways. I appreciate the answer. Let me ask you one maybe you can answer a little bit more directly is related to your comments about being more dynamic and flexible. I may be wrong, but I feel like you are really talking about maybe making the cost structure a little bit more dynamic and flexible so you can flex down and flex up as volumes change. First of all, is that correct and second of all, I guess would that imply that essentially your cost structure is in fact becoming more variable, which may impact perspective incremental margins and where do you think those incremental margins could go under this maybe new dynamic and flexible cost structure? Thank you.

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

We certainly demonstrated our flexibility and adaptability in changing business conditions in 2016 by producing record results despite some headwinds from the economy and we will continue to adhere to that very flexible and adaptable approach going forward, particularly in our use of our resources. Let me turn it over to Mike to talk about some of the resource strategies we have in place for 2017 and then maybe Marta can comment on the incremental margin question.

Mike Wheeler - *Norfolk Southern Corporation - EVP & COO*

Sure, Jim. Well, we stay in close contact with marketing and they let us know what's going on out in the marketplace and on our volumes and we are quick to adapt to where the business is going up to make sure we handle that, or if we are seeing areas that are not coming online like we thought, we are going to take the costs out. We are very flexible in that.

On the resource side, two big drivers are locomotives. We continue to look at rationalizing our locomotive fleet. We've got a lot of good plans in place. We still have some surge units out there, so we are comfortable that we could handle any upside as well, but we continue to look at what we can take out and reduce costs on the locomotive fleet.

On the resource side of manpower, we have committed to making sure we protect the T&E train crews to ensure that we have the service product we need and again, going back to our conversations with marketing, we are very flexible on what's happening with what they are telling us. On the rest of the railroad, we continue to look at every opportunity where we can take costs out, but still protect safety and service.

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

Marta, would you address the question about incremental margin?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Yes, Alan described how we expect some growth in 2017. We do expect to have very good incremental margins on all of that business. As you may know, our incremental margins depend on which segment of our business they come in. All of them, as I said, have good margin. The hierarchy though is we have the highest incremental margins on merchandise because those travel largely on existing trains and don't have too many incremental variable costs. Next is coal and then intermodal as it has the highest proportion of variable costs.

Amit Mehrotra - *Deutsche Bank - Analyst*

But is it safe to say that on a blended basis at least incremental margins should at least be -- $0.50 of every incremental revenue dollar should drop to the bottom line? Is that a good number on a blended basis?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

We haven't guided to a specific number, but we do expect very good incremental margins on all of our business.

Amit Mehrotra - *Deutsche Bank - Analyst*

Okay. Great. Thanks for taking my question. Congrats on a good quarter.

Operator

Allison Landry, Credit Suisse.

Danny Schuster - *Credit Suisse - Analyst*

Good morning. This is Danny Schuster on for Allison. Thank you for taking our questions this morning. So we wanted to dig in a little bit to coal. You are now guiding to a coal growth CAGR of 1% over the next few years with a stepup this year and a deceleration thereafter. So we just wanted to get a sense, does this imply that you are expecting something like a 4% or 5% stepup this year and a decline from there and then from there, we would love to dig in a little bit to see if we can get a little bit more color on what the split across your different coal businesses are. Thank you.

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

Sure. Alan provided some specific guidance with respect to our coal volumes as projected in 2017. Alan, why don't you go back over that and then provide a little bit of additional commentary?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Danny, we talked about utility coal volumes of 17 million to 19 million tons per quarter for the year dependent upon normalized weather patterns and natural gas prices following the forward curve. I will note that today natural gas prices are about $1 per million BTU above where they were at this time last year. And as you are aware, from February to May of last year, natural gas was below $2 a million BTU. So that in and of itself will provide more support for our coal-fired utility customers and would provide year-over-year growth in our coal markets.

We've also talked about export coal volumes between 3.5 million to 4.5 million tons quarterly resulting from improved seaborne pricing and demand for US coals. There's a lot of volatility in that. As you have seen, the benchmark pricing for hard coke and coal shift from $92.50 a metric ton in the third quarter up to $285 a metric ton in the first quarter and then the latest spot price was about $185 a metric ton. So that is going to be one that we are watching closely and we'll be sure to update our outlook for that on our next call.

Danny Schuster - *Credit Suisse - Analyst*

Okay, great. That's very helpful. And then within utility coal, how should we think about the mix between your Southern utility customer base and Northern utility customer base and is there a length-of-haul mix we should be thinking about associated with the growth within that line this year? Thank you.

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

In the fourth quarter, we saw a somewhat slight mix shift from our Southern utility base to our Northern utility base. We expect that to continue in 2017 as a result of stockpiles generally being lower in the North right now than they are in the South.

Danny Schuster - *Credit Suisse - Analyst*

Okay. So would that infer a negative RPU mix just from that phenomenon?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Danny, generally, our Southern utility shipments have a longer life of haul.

Danny Schuster - *Credit Suisse - Analyst*

Great, great. That's very helpful. Thank you very much for my questions. Thank you.

Operator

Ravi Shanker, Morgan Stanley.

Ravi Shanker - *Morgan Stanley - Analyst*

Good morning. So you've said that you are expecting RPU of about 2.5% through 2020 versus CPI of 2.2%. That's closed a little bit from your prior guidance. And also just wanted to check if that is going to be a similar gap for 2017 just given some of Marta's comments on labor seemed like inflation could be a little higher for 2017.

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

Let's talk about the projected RPU trend in the five-year plan going forward first. Alan, would you take that one?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Yes, absolutely. We are going to continue to price above rail inflation. We are committed to doing that. We are confident in our ability to leverage the value of our service product, so you will continue to hear us talk about that. We had a lot of negative mix shifts in 2016 as we talked about the declines in utility coal and the declines in crude oil and the declines in natural gas liquids and frac sand. So we have started to see stabilization on that front; it's one of the reasons our volumes grew in the fourth quarter and we expect that stabilization and some improvement in truck and energy markets to manifest itself into growth in RPU in 2017.

Ravi Shanker - *Morgan Stanley - Analyst*

Got it. And as a follow-up, I apologize if I missed this, but did you give us your natural gas price assumptions for 2017 and through 2020? I just wanted to see where that is and how much that will help move the needle on coal for you.

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Yes, we talked about paying very close attention to the forward curve; that's what we are looking at now. Right now, that's about $1.20 above gas prices that we experienced in the first and second quarters of last year.

Ravi Shanker - *Morgan Stanley - Analyst*

Got it. Is there a breakeven level that you would like to see before your coal volumes start to really move?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Well, we saw coal dispatch mix improve relative to natural gas in the fourth quarter, particularly in December as natural gas prices got up into $3.50. We started to see support for some of our more efficient plants at $3 natural gas and maybe even a little bit lower. It's dependent upon sourcing patterns. It depends on weather patterns. The higher the better, obviously, but we are already seeing support for our coal franchise at $3.20 natural gas.

Ravi Shanker - *Morgan Stanley - Analyst*

Great. Thank you.

Operator

Bascome Majors, Susquehanna Financial Group.

Bascome Majors - *Susquehanna Financial Group - Analyst*

Good morning. Can you update us on how much of your book of business is now including fuel surcharge mechanisms that are still below that recovery threshold and remind us how far those are from being in the money where you start to get rising revenues as fuel prices rise?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Bascome, we are now at about 40% of our fuel surcharge revenue is tied to WTI. That is generally out of the money. The rest of it is generally tied to on-highway diesel or is in a tariff that doesn't have a fuel surcharge program and on-highway diesel has a strike price that is on average close to where we are now.

Bascome Majors - *Susquehanna Financial Group - Analyst*

Okay. So maybe one time -- this to Marta -- how much of a bottom line or margin drag from diesel costs are you baking into your 2017 outlook as we see higher fuel prices on this portion of your business, but you aren't seeing a revenue offset?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Well, as you saw in our 2016 results, we had -- of course, they were going the other way -- but, in our 2016 results, you saw both in the fourth quarter and in the year that our fuel revenues were down. For the full year, you could see that the reduction in the fuel expense line about equaled the reduction in fuel charge revenue. So looking forward to 2017, as Alan has already mentioned and you noted, the fuel curve is up and indeed through January where oil prices are quite a bit higher than they were in the first quarter of last year.

So as long as we stay below $64 a barrel and the curve, even though now it's projecting to be up, it is not expected to go currently above that, so we will expect to see less of an increase in our fuel surcharge revenue than we have in fuel expense. However, I would note that we do not expect it to have a significant effect on our operating income. Where you will see it have more of an effect will be on the operating ratio simply because of the math. Because the numerator and the denominator will be moving by similar numbers.

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

I will add that, generally, higher energy prices are going to lift many of the markets we serve and expand the value proposition of rail relative to truck. So it's not just a fuel surcharge discussion; it will drive volume growth and pricing ability for us.

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Yes.

Bascome Majors - *Susquehanna Financial Group - Analyst*

I appreciate the comprehensive answer. Thank you.

Operator

Ken Hoexter, Bank of America Merrill Lynch.

Ken Hoexter - *Bank of America Merrill Lynch - Analyst*

Great, good morning and congrats on a record OR and good to see the progress continue, but I want to focus on that, Jim, if we can because I want to get your thoughts on the $100 million in savings and perhaps define what is in there and understand where you are focused on this year and see the ramp. Last year, you raised that target up to $250 million, see what the possibility to improve on that and is it as simple as taking that $100 million and saying that's 60 basis points of improvement so you are really targeting something like a 68% OR this year, or would you suggest there's more to it?

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

So as I went through, Ken, we produced $250 million in productivity savings in 2016 and a record operating ratio for the full year. That $250 million was above our original projection of productivity savings in 2016. In 2017, we are targeting $100 million in additional productivity savings. That number we view as realistic, achievable and sustainable even while we run our network at a high service level. Again, if we see additional opportunities for productivity savings, just as we did in 2016, we will go after them and we could see them in all of the areas in which we achieved productivity savings in 2016.

Ken Hoexter - *Bank of America Merrill Lynch - Analyst*

I got that, but that wasn't -- I understand that's what you said before. I just want to try and understand what's in there. Last year, you talked about the coal network shutting down some yards integrating divisions. Can you talk to us about what is in the target so we can understand where upside leverage can come from like you saw last year?

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

Sure. We are going to continue to push on all of those areas in which we achieved productivity savings in 2016. Mike, why don't you comment?

Mike Wheeler - *Norfolk Southern Corporation - EVP & COO*

Yes, it's across the board, like Jim notes. First of all, it's in our fleet rationalization, both the locomotives that we talked about, continuing to make sure we are getting the most out of those assets and looking at ways to take locomotives out of the fleet even though we are handling greater volumes.

On the freight car fleet, while we are bringing some new freight cars online, overall net, we are planning on reducing the size of the fleet. That's a fleet rationalization; still being able to protect our customer service. Continue to look at ways to take costs out of the branch lines without hurting service. Fuel efficiency. We've got a big push on fuel efficiency, both from technology and the locomotive productivity that we talked about. And the last thing is we continue to look at optimizing our train plan, whether it's to improve customer service or to get productivity in the network. We do that every day and all of those things are baked into that $100 million.

Ken Hoexter - *Bank of America Merrill Lynch - Analyst*

Wonderful. And just a cleanup. Alan, you mentioned on coal inventory, it came off a bit. Can you talk about where they are now?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Yes, coal inventories are still elevated above target. They are at about 86 days at this point; I would say target is probably closer to 60 days. Importantly, they have come down about 20 days since their high of last year. The South is about at 82 days; North is about 90 days. The North has declined a little bit more as of recent and importantly, PJM power pricing is up about 15%, or was up about 15% in December, which has really supported coal burn and coal deliveries in that area.

Ken Hoexter - *Bank of America Merrill Lynch - Analyst*

Wonderful. Appreciate the time. Thank you.

Operator

Brian Ossenbeck, JPMorgan.

Brian Ossenbeck - *JPMorgan Chase - Analyst*

Good morning. Thanks for taking my question. Alan, just going back to the mix impact for a second; obviously, it was negative for the year if you just look at RPU less fuel. And you talked about some of the reasons why -- the mix within export coal, length of haul. Just wanted to circle back to confirm why you thought it might be positive or at least improving into next year if we look at intermodal being one of the only three big segments to really grow. Sounds like you still have some more export coal to go and maybe you can factor in how you see auto into that as well. I think you mentioned it was going to track production, which you thought was a 3% decline or so?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

We do believe our automotive franchise will decline with US automotive production declining 3% and then there are some specific plants that we serve that are taking some retooling. Importantly, we are continuing to get price. We are pricing above rail inflation. That will benefit 2017. We are going to see growth in our coal network, which, as you are aware, put pressure on our RPU in 2016. And we are going to continue to price in our intermodal network reflecting the value of our service product. So we see growth in RPU.

Brian Ossenbeck - *JPMorgan Chase - Analyst*

Okay. Got it. So it sounds like some of the buckets are changing a bit mostly from price. But I guess the other factor just to follow up on overall volume and for next year the outlook, how do you see FX playing into the strength of the dollar in some of your markets? You had some pretty good numbers in MetCon this quarter. The dollar is off a bit, but I was wondering how much you think that needs to move and be sustainably moving before you would see some relief in some of those areas that have been pressured for the last couple of years?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Well, our imports were up more than our exports in 2016 resulting in part from the foreign exchange issues. You talked about our metals and construction. Our steel customers are feeling pretty positive right now and they are looking for growth. Steel prices are up year-over-year. Capacity factors are up year-over-year. Our exports, we think, are going to be supported at least in the near term by export coal volumes, so we are going to closely watch the dollar. It impacts trade and we are heavily tied to trade. There are some things going on that are going to support international volumes for us, at least in the near term.

Brian Ossenbeck - *JPMorgan Chase - Analyst*

Okay. Thanks for taking my call.

Operator

Tom Wadewitz, UBS Securities.

Tom Wadewitz - *UBS Securities - Analyst*

Good morning. Wanted to ask you, Alan, a little bit about price. I think you've had some commentary on pricing, but what would you say the progression has been if you look at 2016 (inaudible)? Did you see much change in pricing through the year? I think some marketshare wins in intermodal and coal beg the question of whether you are being a little more aggressive on certain pieces of business. So if you want to comment on that, but also just the market dynamic overall, [whether] you saw change in pricing and what you think on 2017, whether you just need to see truck markets tighten a bit and that will be a key driver, or just how you look on pricing overall. And then in particular related to some of the wins you've had on intermodal and coal. Thanks.

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

We are committed to pricing above rail inflation. I'm completely confident in the ability of our team to continue to deliver a strong service product and the ability of our team to price to the value of that service product. If there is anywhere where we were aggressive in 2016 it was on our service product. Our pricing throughout the year was consistently above rail inflation. We saw our trucking market start to tighten in the fourth quarter. Some of our other markets stabilized and energy prices moved up, which allowed us to grow in the fourth quarter and we expect that momentum to continue into 2017.

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

Tom, I too would like to emphasize our commitment to pricing above rail inflation based on an excellent service product.

Tom Wadewitz - *UBS Securities - Analyst*

Okay. Yes, great. What about the thought in terms of just -- 2017, 2018 the path on pricing. Is it reasonable to say that this is just, at the end of the day, you are primarily going to be driven by capacity and demand in the market, so if we really see the truck spot market tightening and pricing rising, that that will help you accelerate pricing and if you do see some better volume overall on rail through 2017, is it reasonable to see the pricing accelerate along with that?

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

The key to higher prices in our view is excellent service and we operate in a competitive marketplace. We believe we provide an outstanding service and our goal is to obtain above rail inflation pricing going forward.

Tom Wadewitz - *UBS Securities - Analyst*

Okay. Great. Thank you.

Operator

Scott Group, Wolfe Research.

Scott Group - *Wolfe Research - Analyst*

Good morning, everyone. So I know you don't have earnings guidance for this year, but you've got multiyear guidance of double-digit earnings growth. If coal is going to be up high single, low double digits this year and then down in the subsequent years, is there a reason why we shouldn't have double-digit earnings growth this year? Is there something that we need to consider?

Along those lines, Marta, you gave us last year just very helpful margin commentary on the coming quarter. Any thoughts on first-quarter operating ratio just given the tough comp versus a year ago?

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

Let me go back over, Scott, first our overall outlook. We outlined and reaffirmed our plan to get to a sub-65% operating ratio by 2020 and we expect to make progress each year toward that goal. And therefore, we expect to post an operating ratio in 2017 that is below 2016's full-year operating ratio and we do not give quarterly guidance.

Scott Group - *Wolfe Research - Analyst*

Is there anything that you would want us to consider in our models? If this is a normal year of productivity and it's the one year where you expect coal volume growth and you have a multiyear double-digit earnings growth expectation, it would seem that this should be a year where you are at least double digit, maybe even above trend. Is there something you want us to contemplate on why it might not be that way?

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

Certainly, coal volume above the range that we have projected would provide additional upside to our plan.

Scott Group - *Wolfe Research - Analyst*

Okay. And then, Alan, just on the coal yields, so CSX reported a pretty meaningful sequential increase in coal yields in the fourth quarter and you guys have just a small increase. Can you just walk us through how your export coal pricing works? Is there a reason why you are not going to see that bump, or is it more that the way you guys price we will see that bump more so in the first quarter than what we saw in the fourth quarter?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Scott, we talked on the third-quarter call about how we felt like our growth in export volumes in the fourth quarter would come at the lower length of haul Baltimore business as opposed to Lambert's Point and effectively that's exactly what happened. Our growth in the fourth quarter in export volumes was associated with Baltimore, not Lambert's Point. And so as a result, we had a negative mix with our export coal RPUs. We looked at our pricing on export in the fourth quarter as we said we would. We told you we would do it in the first quarter, which we did and then we are closely monitoring the benchmark price and the demand going forward.

Scott Group - *Wolfe Research - Analyst*

Maybe a better way to ask it, do you think you'll see coal revenue per car sequentially higher or lower in the first quarter than the fourth?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

I think ultimately that's going to depend upon mix. I talked a little bit about how our volumes in the North would probably increase at a higher rate than our volumes in the South, which will put pressure on our coal RPU, but offsetting that is going to be some strong pricing in our export volumes.

Scott Group - *Wolfe Research - Analyst*

Okay. All right, thank you.

Operator

Brandon Oglenski, Barclays Capital.

Brandon Oglenski - *Barclays Capital - Analyst*

Good morning, everyone and thanks for getting me in. So Jim, I just want to come back to the structural opportunity on the cost structure because you guys have been running consistently with let's call it a 27%, 28% OR on labor costs. A lot of the rest of the industry is now closer to 20% on a labor OR and when I look at your results for the past decade, you have run with headcount between 28,000 and 30,000 folks and your productivity -- and sorry I am getting nerdy here, but I do like to quantify this stuff -- I think your productivity is about 13 million GTMs per head per year right now. CSX, which is a similar size network, arguably maybe little a bit bigger, running 15 million GTMs per head. Can you talk about -- is there something structural on the network where you can let attrition take headcount down and grow volume and grow productivity on the labor line because, as we look at it and I think as a lot of investors look at it, that's a big opportunity for you guys going forward?

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

We certainly made progress on labor productivity in 2016. That was a key driver of our $250 million in productivity savings. In 2017, as we have been through, we are targeting an additional $100 million in productivity savings, a number that we view as sustainable and a component of that will be additional labor savings. We have guided to basically flat headcount for the full-year 2017. We think that's a level of human resources that will allow us to continue driving productivity and serve as a foundation for growth as well.

Brandon Oglenski - *Barclays Capital - Analyst*

But is there anything in the network, Jim, that you look at that you think going forward, hey, we need to restructure the way we are looking at the world because we used to be more coal-focused and commodity-focused and now we want to be a little bit more nimble around intermodal? Is there something in the terminal infrastructure where you could see attrition rates, not necessarily layoffs or reductions, but really reducing the size of the employee base going forward relative to revenue?

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

In 2016, we demonstrated our nimbleness and our agility in responding to business conditions with respect to the labor resource, as well as otherwise and we have additional opportunities going forward as well. Labor productivity, specifically, is the largest component of our overall $650 million by 2020 and we will continue to work on that.

Brandon Oglenski - *Barclays Capital - Analyst*

Okay. Appreciate it.

Operator

Justin Long, Stephens.

Justin Long - *Stephens Inc. - Analyst*

Thanks. Good morning and I wanted to ask about intermodal. First, could you give us some sense for the level of intermodal volume growth you are expecting in 2017 and, second, I know you guided for consolidated pricing above inflation, but do you think above inflation pricing is achievable within intermodal this year?

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

As we have been through our goal and our plan is to produce above rail inflation pricing for the duration of the plan period based on excellent customer service. Now let me ask Alan to comment specifically on the dynamics within the intermodal sector.

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Sure. Justin, truck capacity, while it has tightened, is still relatively loose, particular compared to where we were in 2014. So we think that as truck capacity tightens, particularly towards the second half of the year, then we are going to start to see more and more intermodal growth. So Jim had talked about 4% CAGR on intermodal growth over our next four years and we think that's within the ballpark of where we will be in 2017 and that's going to support that tightening truck market and reduced inventory levels will support more pricing in 2017.

Justin Long - *Stephens Inc. - Analyst*

Okay, that's helpful. But just to clarify, you do feel like intermodal pricing can be above rail inflation this year?

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

For the planned period going forward, we will certainly strive for above rail inflation pricing based on our excellent service.

Justin Long - *Stephens Inc. - Analyst*

Okay. Secondly, sticking on intermodal, I wanted to ask about the progression of intermodal margins over the course of the longer-term strategic plan. Does that longer-term outlook assume that intermodal margins improve to the point where they are in line with consolidated averages at some point before 2020? And if so, what's a realistic timeframe to think about when this can occur?

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

Marta, why don't you go back over the basic incremental margin characteristics of each of the businesses and then address the question with regard to intermodal?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

All right. Justin, intermodal, and although I mentioned earlier that it is third in the hierarchy of incremental margins, it is still very good incremental margins and to answer your specific question, we definitely expect improving intermodal margins throughout the four-year plan period that Jim described.

Justin Long - *Stephens Inc. - Analyst*

Okay. But you are not willing to say if those intermodal margins will be on par with consolidated margins at some point over the plan?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

We have never split our incremental margin numbers between the three groups.

Justin Long - *Stephens Inc. - Analyst*

Okay. I will leave it at that. I appreciate the time today.

Operator

Jason Seidl, Cowen Securities.

Jason Seidl - *Cowen Securities - Analyst*

Real quickly, looking out at your expected CAGR on the intermodal side, you said international growth above GDP. Is there anything built in for a continued share shift for the West Coast ports and some of the buildout to some of the Eastern ports?

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

Alan, why don't you take out one?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Sure, Jason, that has been a support for our volumes over the last couple years. It's been a continuing trend. We look for it to continue moving forward. But we are looking at GDP-plus growth within the international space. There won't be a big hockey stick there. We are looking for sustainable organic growth.

Jason Seidl - *Cowen Securities - Analyst*

Okay, so there is a little bit built in there, but probably not too much that we have seen like say the past couple years?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Correct.

Jason Seidl - *Cowen Securities - Analyst*

Okay. That's all I have. Guys, appreciate the time.

Operator

Ben Hartford, Robert W. Baird.

Ben Hartford - *Robert W. Baird - Analyst*

I guess I will just build on that last point. Alan, on the intermodal side, the international intermodal side specifically, you had emphasized organic. So when we think about some of the rhetoric around trade, exiting TPP, etc., perhaps if you could expound upon the opportunity from share shift in the context of perhaps rising trade protectionism over that four-year period and to what degree do you think that might present risk to your ability to grow international intermodal above GDP over the next four years? Thanks.

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Yes, if there were something that impacted international trade, that would certainly have an impact on our business levels. I will note that the impact -- the headwinds that we faced in 2016 around inventory levels seem to be normalizing. Trucking markets seem to be firming up and as a result, we saw growth in the fourth quarter. So there is going to be puts and takes, but clearly we are watching anything that would impact international trade.

Operator

David Vernon, Sanford Bernstein.

David Vernon - *Sanford Bernstein - Analyst*

Good morning and thanks for taking the question. Maybe just, Marta, if you could talk a little bit about what we should expect about the cadence of the inflation, the stepup in inflation for next year? I think you guided to something closer to a 5% than the 3.5% we saw in the current year.

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Yes, and that 5%, David, is specifically just to the comp and benefits line. For the remaining items in our income statement, those lines will increase inflation with just general economic inflation, so at a lower rate than that 5%.

David Vernon - *Sanford Bernstein - Analyst*

Okay. And then as far as the cadence of how that should be coming in, is there anything we should be thinking about in terms of incentive comp or specific timing of payments, or things like that?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Yes, generally speaking -- that's a good point for you to bring up. Generally speaking, the comp line is weighted somewhat to the first quarter of the year and that is because the incentive comp, as you mentioned. So if you look at the cadence last year of the comp, that should be a general guideline. With regard to the health and welfare inflation, those new rates for the industry did start on January 1.

David Vernon - *Sanford Bernstein - Analyst*

Okay. Thanks. And then, Mike, maybe just a question for you. The fuel productivity got to an all-time high in the winter quarter, like a 5% jump. I'm just wondering what is it that's driving that? Is it some sort of change in locomotive fleet? I know you have done some things around line rationalization and you mentioned also something about maybe holiday timing, running that [work] a little lighter. Is this a new run rate from which we should be building our expectations on fuel productivity and can you talk a little bit what is driving the significant improvement in that particular metric in terms of fuel consumption?

Mike Wheeler - *Norfolk Southern Corporation - EVP & COO*

Sure. So the biggest driver is the fact that we continue to reduce the locomotive fleet; that is a big push there. In addition, we've got a lot of technology, the fuel management technology, that we put out there and really leveraging that. And in addition, we really focused on fuel shutdown compliance, other rules that we've put on the operations to make sure that we are getting the best fuel efficiency. All those pieces go into our record fuel efficiency and we see more opportunity going forward this year as well.

David Vernon - *Sanford Bernstein - Analyst*

It just sounds like it's a little bit of execution and some of the prior investments around the fuel technology? There's nothing structural in terms of the change in mix of the fleet or anything like that?

Mike Wheeler - *Norfolk Southern Corporation - EVP & COO*

Structurally, yes. The reduced fleet; we told you last year about how much yard and local engines that we pulled out of the fleet and still was able to protect service. That was a big driver of that. We are continuing to look at that. So that is the structural piece is reducing our yard and local fleet and then being able to handle increasing gross ton miles with the current fleet gives you even more productivity. So that's the structural piece in addition to all the technology and execution that we focus on.

David Vernon - *Sanford Bernstein - Analyst*

Thanks.

Operator

Cherilyn Radbourne, TD Securities.

Cherilyn Radbourne - *TD Securities - Analyst*

Good morning. So the dividend increase was a bit of a surprise to me anyway. Can you talk a little bit about your comfort level for being above your long-term target payout ratio for a period of time and whether you think there might be room for that payout target to increase?

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

Let me begin by saying that shareholder distributions, including dividends and regular dividend increases, are a major component of our capital allocation strategy and I will turn it over to Marta to discuss your payout ratio question.

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Absolutely. We definitely believe, as Jim said, that the shareholders should benefit as the Company's profitability improves and the Board did raise the dividend by that 3%. As you mentioned, we have a long-term payout target of 33%. The Board believes that we can provide modest dividend increases as we manage that payout ratio to that one-third target. As you will recall, last year had a 46% target. So even with this increase, we are moderating the payout in total.

Cherilyn Radbourne - *TD Securities - Analyst*

Okay, but 33% remains the long-term target?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Yes, that's correct.

Cherilyn Radbourne - *TD Securities - Analyst*

That's all for me. Thank you.

Operator

Walter Spracklin, RBC Capital Markets.

Walter Spracklin - *RBC Capital Markets - Analyst*

Good morning, everyone. So I just want to focus a little bit -- perhaps this is for Marta -- on the comp and benefit line. I know, Jim, you mentioned that there was $100 million and in a normal year, you would have most of that productivity savings coming from the comp and benefit or the labor line. but with the 5% increase all in that you are pointing to and, yes, on flat headcount, I'm just wondering if the $100 million this year is factoring in perhaps a much lower component of labor productivity than in the years over your forecast period? Am I right in seeing that for this year?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Generally speaking, the ratios of reductions are similar to the full plan, so Jim showed in the $650 million roughly 65% of that is comp and benefits and that percentage holds true for the $100 million. So we do expect the lion's share of the $100 million of productivity improvements to come in the comp line and one of the things we mentioned I think -- Mike and I both mentioned -- with the keeping the headcount level, but managing extra volumes, there is some productivity there. In addition to just looking at the headcount, we also have productivity in that line in overtime, in recrews, in extra boards. So there's other specific areas other than just the count that also lead to productivity in the comp line.

Walter Spracklin - *RBC Capital Markets - Analyst*

So when we look at that line, we should offset the 5% increase with changes in other components of that line item being, like you said, over time and so on. So it is not necessarily last year's labor times 5% higher average comp. We should also reflect it in for overtime and other aspects and do you have any sense of order of magnitude? If that's the case, what impact that would be on the comp and benefit line in 2017 of everything excluding the 5% and the flat labor count that you had already mentioned?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

How you described it is just the right way to look at it. You are going to look at it in those components. You look at the compensation benefits that we had last year. We do have the inflationary growth, which is one component and then separate from that, we have the productivity, which will bend the curve the other way.

Walter Spracklin - *RBC Capital Markets - Analyst*

But order of magnitude?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Order of magnitude, it is about the same percentage in the year as we guided to for the entire five-year period. It is the lion's share of the $100 million of productivity.

Walter Spracklin - *RBC Capital Markets - Analyst*

Okay. Okay, thank you very much.

Operator

Scott Schneeberger, Oppenheimer.

Scott Schneeberger - *Oppenheimer - Analyst*

Thanks for fitting me in. I will just ask one. Could you please elaborate on slide 33, the long-term outlook? The expected pipeline-related headwinds in crude oil and natural gas liquids pertaining to the merchandise segment. And then if you could hone in on your chemical segment view for 2017. Any additional color. Thanks.

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Scott, that is directly related to the Dakota Access Pipeline and the Mariner East II Pipeline. Dakota Access will impact Bakken crude to the East Coast, although we will still participate in some heavy Canadian crude and the Mariner East will impact our NGL shipments out of Utica and Marcellus.

Scott Schneeberger - *Oppenheimer - Analyst*

Thanks very much.

Operator

Jeff Kaufman, Aegis Capital.

Jeff Kaufman - *Aegis Capital - Analyst*

Thank you very much and congratulations. Most of my questions have been answered. Marta, can I focus a little bit on the pension component of the labor cost increase? You mentioned pensions become a tailwind versus a headwind. I know there was a sharp uptick in rates post-election. When was your pension expense releveled and what does that look like in terms of a tailwind for 2017?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

So our pension expense we think for 2017, to answer your last question first, we think it's going to be about flat with 2016 and you are correct that the interest rate change would push that up a little bit. However, we also had asset gains in the plan. So net-net for 2017, we see pension expense staying relatively even.

Jeff Kaufman - *Aegis Capital - Analyst*

Okay. And just a quick follow-up, if I run the utility coal and export coal numbers that you provided for 2017, it looks like we are going to be up double digit in both of those areas. Number one, am I thinking through that right in terms of 2017 volume and, number two, can I assume that is going to be more heavily weighted in the first two quarters of the year?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

I am not seeing the double-digit growth in export coal in the guidance that we provided.

Jeff Kaufman - *Aegis Capital - Analyst*

Okay, but the utility side?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

The utility side, we've given you the guidance. That's our best look right now.

Jeff Kaufman - *Aegis Capital - Analyst*

Okay. All right, well, thank you very much.

Operator

Rick Paterson, Loop Capital.

Rick Paterson - *Loop Capital - Analyst*

Good morning. Could you please update us on the number of furloughed train crews and stored locomotives? And with regard to crews, when you recall furloughed employees, what percentage typically come back? I would imagine that percentage also erodes over time as we move further away from furloughed dates. How should we think about that?

Mike Wheeler - *Norfolk Southern Corporation - EVP & COO*

Yes, so on the furlough, we still have right around 100 employees furloughed on the T&E side and it is primarily in the coalfields, though if there is continued upswing in coal, we could handle that, but it's down to about 100. We started recalling them in the middle of last year across the network to handle the sequential volume increase and protect service, so we did that.

And on the recalls, you are right. When we first start out, we get up into the high 90% recall rate when we recall furloughs and the longer it goes, it starts declining after that. Although with some of the things we've put in place with our extra boards over the last year, overall, we got a higher return rate, which we are real pleased with.

On the locomotive side, we still have about 350 locomotives stored available to us.

Rick Paterson - *Loop Capital - Analyst*

Perfect. Thank you.

Operator

Brian Konigsberg, Vertical Research Partners.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Appreciate you fitting me in. It's been a long call; a lot of questions have been answered. I have a couple small ones. Marta, actually you mentioned in response to the pension question asset gains. Is that asset gains within the pension plan, or are you expecting to have asset sales in 2017 elsewhere within the network itself?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

That was within the pension plan that I was describing.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Okay. With the productivity initiatives going on, you did have an asset sale in 2016. Would you anticipate some assets to break loose as you work through rationalization of the network?

Marta Stewart - *Norfolk Southern Corporation - EVP & CFO*

Our real estate department is always taking a look at where we have assets that we can sell. We especially described in the third quarter where we had a large operating asset sale. In 2017, they will continue to look at it. As you know, looking over the last three years, that number can be somewhat variable, but two years before that, it was smaller, varying $10 million to $20 million and this year was a little bit higher, over $30 million. So that will depend on the properties that they come up with. Alan, do you have anything to add to that?

Alan Shaw - *Norfolk Southern Corporation - EVP & CMO*

Yes, they are distinct transactions and as we all know with real estate, the closing date can move forward or move back. So it's an initiative of ours. It's been an initiative for several years. It provided benefit in 2016 and we expect that it's going to do even more so in 2017.

Brian Konigsberg - *Vertical Research Partners - Analyst*

But it's not explicitly in the plan, is that right?

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

We always do budget for a certain level of gain from sale of both operating and non-operating properties, so that's a standard item in our budgets.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Okay. If I could just add one more quick one maybe for Mike. So you had a good -- I guess you did very well on lengthening or expanding the train lengths and actually keeping up the velocity. Maybe just talk about what the opportunity is on lengthening more in 2017 and how do you balance that with the velocity and the service metrics?

Mike Wheeler - *Norfolk Southern Corporation - EVP & COO*

Yes, sure. It's something we focus on a lot. We feel like we've got -- not feel -- we know we've got capacity on our trains, particularly on the intermodal and merchandise networks, so we will continue to see it grow, a lot of work going on there to make that happen. But we are doing it very thoughtfully so that, one, we keep our terminals fluid and be able to keep the overall velocity of all the assets to the railroad flowing and we also spend time with our customers on working with them on how we can increase train lengths as well and we both benefit. So a lot of initiative there and still opportunity going forward.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Thank you.

Operator

There are no further questions at this time. I would like to turn the floor back over to Mr. Squires for closing comments.

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

Thank you very much for your time this morning. We will continue to push hard to drive shareholder value through successful execution of our strategic plan. Thank you.

Operator

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