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NSC - Q4 2017 Norfolk Southern Corp Earnings Call

EVENT DATE/TIME: JANUARY 24, 2018 / 1:45PM GMT

OVERVIEW:

Co. reported 4Q17 adjusted net income of $486m or $1.69 per diluted share.

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PRESENTATION

Operator

Greetings, and welcome to the Norfolk Southern Fourth Quarter 2017 Earnings Call.

(Operator Instructions) As a reminder, this conference is being recorded.

I'd now like to turn the conference over to Clay Moore, Director of Investor Relations.

Thank you. Mr. Moore, you may begin.

Clay Moore - *Norfolk Southern Corporation - Director Investor Relations*

Thank you, Rob, and good morning.

Before we begin, please note that during today's call, we may make certain forward-looking statements, which are subject to risks and uncertainties, and may differ materially from actual results.

Please refer to our annual and quarterly reports filed with the SEC for a full discussion of those risks and uncertainties we view as most important.

The slides of the presenters are available on our website at norfolksouthern.com in the Investors section along with our non-GAAP reconciliation. Additionally, a transcript and downloads will be posted after the call.

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

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

Good morning, everyone, and welcome to Norfolk Southern's fourth quarter 2017 earnings call.

Joining me on today's call are Alan Shaw, Chief Marketing Officer; Mike Wheeler, Chief Operating Officer; and Cindy Earhart, Chief Financial Officer.

Slide 4 shows the fourth quarter and full year highlights, excluding the impacts of tax reform, and I'm pleased to say that we continue to achieve record results through the successful execution of our strategic plan.

Net income for the fourth quarter was $486 million, up 17% from the prior year, and earnings per share increased 19% to $1.69. We were able to lower our fourth quarter operating ratio by 170 basis points to 67.7%. For the full year, net income increased 15% to $1.9 billion, and earnings per share increased 18% to $6.61.

We achieved a record 67.4% operating ratio, which was a 150 basis point improvement over 2016, demonstrating our focus on productivity, cost control and growth as we move forward under our strategic plan.

Each of these achievements is a testament to the hard work and dedication of our employees, whose determination has powered our successes of the past several years, and who I'm confident will make Norfolk Southern even stronger in 2018.

Moving to Slide 5. We remain committed to investing in our business as capital expenditures totaled over $1.7 billion in 2017, representing investment in our rail infrastructure and projects that grow our business, like the recently completed Portageville Bridge that will support economic vitality and jobs across New York's Southern Tier region.

We also realized new business in 2017 from 75 industries we had assisted in locating or expanding along our lines, representing over $1 billion invested by our customers.

Our portfolio of active industrial development projects is as a strong as it's been since the Great Recession, reflecting broad optimism in the economy and in doing business with Norfolk Southern for the long-term.

That optimism is mirrored in our continued commitment to a balanced capital allocation strategy that invests in our network's health and growth opportunities for our business, maintains a solid dividend targeting a 1/3 payout ratio over the long-term and returns capital to our shareholders through ongoing share repurchases.

Our board has underscored this commitment by authorizing a $1.8 billion capital budget in 2018, an 18% increase in the dividend to $0.72 per share and the continuation of our share repurchase program.

Slide 6 illustrates our unrelenting focus on productivity gains, which have enhanced resource utilization, while accommodating growth. The results can be seen throughout all areas in our organization. In terms of labor productivity, our full year volumes increased by 5%, yet we were able to lower our average headcount by 3% versus last year's levels.

2017 was also a record for fuel efficiency, as fuel consumption was lower than the prior year despite the increase in traffic. These measures highlight our ability to deliver results through cost-saving efforts, efficiencies and asset utilization. In total, we generated $150 million in productivity savings in 2017, on top of $250 million in 2016.

Moving to service. Our annual composite service metric declined compared to 2016. Our service levels last year were lower than we would have liked. As we recover from challenging operating conditions, we are focused on improving network stability and resilience, while continuing to drive productivity. We are fully committed to delivering on our long-term targets through a combination of growth and efficiency. And I'll update you on those targets after Alan, Mike and Cindy provide further details on our fourth quarter results and outlook as we head into 2018.

I'll now turn the program over to Alan.

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

Thank you, Jim, and good morning, everyone.

Beginning on Slide 8, 2017 finished strong with tightening truck capacity and increased export coal. Total revenue for the quarter improved 7% versus the same period in 2016, driven by volume gains and pricing improvement.

Merchandise revenue of $1.6 billion was up 5% as compared to last year, with the ISM Purchasing Managers Index near a 14-year high, strength in industrial production drove volume gains in both steel and plastics, while increased drilling activity benefited our frac sand market.

Export of soybeans declined primarily due to difficult comps related to the 2016 South American crop. Merchandise revenue per unit was up, reflecting pricing gains and higher fuel surcharge revenue. Intermodal had record volumes for the third consecutive quarter, and we delivered record intermodal revenue in the fourth quarter due to our market focus, tightened truck capacity and high demand for consumer goods. Higher fuel surcharges, positive mix and improved pricing increased RPU 8%.

Our coal business benefited from high seaborne prices, supporting export demand, which offset volume declines in the utility markets, resulting from low natural gas prices and mild temperatures.

Revenue per unit decreased 1%, as declines in our longer-haul southern utility franchise negatively impacted mix. Our fourth quarter results continue to demonstrate our market approach as winning business and delivering shareholder value.

As we turn to our full year results on Slide 9, the trends we experienced in the fourth quarter are reflective of our 2017 annual results. We achieved total revenues of $10.6 billion, representing a 7% increase. This growth was driven by a 5% increase in volume and a 2% increase in revenue per unit.

Merchandise volume for the year was flat compared to 2016. Improved steel production and drilling activity drove a 6% increase in metals and construction shipments, while declines in U.S. light vehicle production and pipeline activity negatively impacted our automotive and chemicals businesses, respectively.

Revenue per unit less fuel improved 1%, as positive pricing was partially offset by unfavorable changes in traffic mix. Growth in e-commerce and tightened capacity in the trucking industry led to a 5% increase in intermodal shipments.

Export coal volume rose 81% versus 2016 due to increased overseas demand for U.S. coals. As markets evolve, we have capitalized on favorable conditions and delivered improved bottom line results due to our adherence to our strategic plan.

Since the introduction of our strategic plan 2 years ago, we have consistently articulated the benefit of our superior customer touch, the continuity of our team and our approach, working with our customers, developing innovative service solutions and delivering value to the marketplace. Our 2017 results demonstrate the merits of this approach.

Moving to Slide 10. The strength of our fourth quarter has heightened our outlook for 2018, a prospective share by our customers and top economists, who continue to upwardly revise their expectations for this year.

For the full year, we expect opportunities for growth in our intermodal and merchandise markets, while coal is expected to decline.

In merchandise, strength in industrial production and construction activity provides support for increased business primarily in aggregates, coil, steel and plastics. In our energy markets, higher oil prices and drilling activity will drive greater volumes in crude oil and frac sands. Natural gas liquids are expected to decline in the second half of 2018 as the Mariner East 2 pipeline becomes fully operational.

We expect automotive volume to slightly trail U.S. vehicle production, with slower manufacturing at specific NS-served plants.

Our intermodal business will likely be positively impacted by capacity constraints in the trucking industry, as the ELD mandate is fully implemented, along with increasing consumer demand and continued shifts to e-commerce.

The export coal market is anticipated to be strong, although lower than year-ago levels, as we expect first quarter volumes to be in the 5 million to 6 million ton range, with an opportunity to push the higher end of that boundary. Benchmark pricing is backward-dated, giving some uncertainty to the length of these elevated volumes. In the utility market, impacts from the mild temperatures last summer and low natural gas prices are expected to produce volumes in the 15 million to 17 million ton range in the first quarter.

Turning to the overall pricing environment, we remain focused on price. And with continued strength in truck rates, we expect higher pricing in our truck competitive business. Pricing will be challenged in our export coal market as benchmark prices are expected to decline.

The extent of our pricing gains in 2018 will be limited by our contract structure, with approximately 45% of our business remaining to be renegotiated this year.

Revenue per unit will also benefit from expected increases in on-highway diesel and WTI prices that will raise our fuel surcharge revenue. We now have approximately 65% of our revenue tied to an on-highway diesel base fuel surcharge program.

We continue our initiatives to enhance our value proposition through collaboration with our customers and industry partners. We are developing more customer tools to give them the greater ability to manage their business with us and improve the efficiency and transparency of their supply chain. We are confident that our 2018 plan in the marketplace is highly achievable. Our approach balances productivity and cost control with service, providing the foundation to lean and to growth opportunities.

As we demonstrated at Norfolk Southern, we are analytical and deliberative in how and where we invest. We will not allow business that yields shareholder value to pass us by. We will stay close to our customers, hear what they're saying and proactively manage market opportunities. We look forward to a prosperous 2018.

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

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

Thank you, Alan, and good morning. Our operational leverage generated in 2017 allowed us to grow our business by providing a competitive service product to our customers, while simultaneously driving productivity initiatives.

As shown on Slide 12, we achieved significant milestones in 2017. Our reduction in train accidents, combined with our improvement in key productivity initiatives, helped to drive our record operating ratio.

Turning to the key drivers of our success on Slide 13. The safety of our employees and the communities we serve continues to be our top priority. Our reportable and serious injury ratios are stable, although we are not satisfied without continuous improvement in this area.

We achieved our lowest train accident frequency on record, beating last year's record low. For service, we experienced macro challenges in the fourth quarter that began with the last 3 hurricanes in October and ended with a historic snow storm in North Georgia, which shut down one of our most critical routes for 2 days, as over 350 trees were removed.

We worked through these challenges as we handled near record volumes by temporarily deploying our service fleet of locomotives. With respect to our overall service product, we are still working toward where we need to be for our customers. We fully recognize the expectations of our customers for a quality, consistent and competitive service product.

As Jim has mentioned, network stability and resiliency are our objectives. Moving to some of our key productivity initiatives on Slide 14, we are continuing to drive improvement in all areas. Our rationalization of our locomotive fleet resulted in a record locomotive productivity for the year, beating the prior year's record. These locomotives flow into our search fleet, which has the added benefit of improving that fleet's reliability. Not only do these improvements result in lower maintenance costs, they also enhance our fuel efficiency, which was an annual record as well, again, beating the prior year's record.

These measures have been driven by optimizing our train plan and our improvements in train length, which resulted in a quarterly record and for the full year. But we must balance these initiatives with good service.

In closing, we are confident we will continue to provide a competitive service product to our customers that will grow our business, while at the same time driving sustainable productivity savings and superior returns for shareholders.

We are proud of our accomplishments and continue to identify opportunities to drive additional efficiencies for the benefit of NS shareholders.

I will now turn it over to Cindy, who will cover our financial achievements.

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

Thank you, Mike, and good morning.

Turning to Slide 16. Our fourth quarter results show a continuation of the benefits from the sustained and successful execution of our strategic plan.

The fourth quarter and annual comparisons exclude the effects of tax reform, which I will detail on the next slide. As you can see, each quarter, we delivered revenue growth while improving our operating efficiency. This drove our operating ratio lower and, more importantly, delivered impressive gains in operating income that fell to the bottom line, producing record diluted earnings per share for the year.

Let's take a closer look at the fourth quarter on the next slide.

On Slide 17, you'll see our summarized operating results. The adjusted 2017 amounts in this presentation represent our GAAP results, less the adjustment for the enactment of income tax reform. For a detailed reconciliation, refer to our non-GAAP reconciliation posted on our website.

Today, I will focus on these adjusted results. Our fourth quarter reflects the revenue growth Alan described, which when coupled with our continued focus on operating efficiency and cost control, resulted in a 170 basis point improvement in OR and 13% growth in operating income.

Turning to Slide 18, let's take a closer look at the component changes in operating expenses. In total, adjusted operating expenses were higher by $77 million, reflecting both inflationary and volume-related expense increases. Compensation and benefits rose by $52 million or 8%. The primary driver of the increase is higher incentive compensation due to our strong operating results.

As in prior quarters, the large increase in premiums on union medical plans contributed an additional $16 million this quarter. We also experienced increased over time during the fourth quarter of $9 million. Partially offsetting these items were reduced employee levels, which saved $24 million. Headcount was approximately 1,100 employees, less than the fourth quarter of 2016 and down about 250 sequentially.

As we look ahead, we expect all-in wage and medical cost inflation of about 1% in 2018 versus the 4% we experienced in 2017. We expect that 2018 stock compensation expense will be consistent with 2017. However, due to planned changes, these amounts will be more evenly recognized throughout the first 3 quarters of 2018 as compared to the prior year.

Finally, for incentive compensation, as you would expect, our board raised the bar on expected performance for 2018 compensation. As you saw in 2017, the incentive accrual for the first and second quarters typically reflects a targeted payout.

As we move into the back half of the year, the accrual will adjust based on forecasted corporate performance compared to targets for the year.

Fuel expense rose by $45 million, primarily due to higher prices, which added $41 million. The average price per gallon for locomotive fuel was $1.95 this year versus $1.60 in fourth quarter 2016. Consumption was up only slightly over last year, which added $2 million in the face of a 5% increase in shipments. As Mike mentioned, we have continued to achieve record fuel efficiency metrics, and we expect our ongoing initiatives to continue to support improvement.

Purchased services and rents increased $20 million or 5% due to higher volume-related costs of $12 million and other miscellaneous expense increases, none of which were significant. The materials and other category decreased $48 million or 22%. This quarter included $25 million more from gains on the sale of operating properties than fourth quarter 2016. Casualties and claims expenses, including both environmental and personal injury, were $18 million lower. Finally, reduced equipment and roadway material usage also saved $7 million.

Moving to Slide 19. You can see the strong operating results fall to the bottom line, producing adjusted net income of $486 million, up 17% compared to 2016. Adjusted diluted earnings per share were $1.69, a 19% improvement.

Full year results are shown on Slide 20. We set records in both operating ratio and diluted earnings per share for the year. Adjusted for the impact of tax reform, we delivered a record operating ratio of 67.4%, and record diluted earnings per share of $6.61, an 18% improvement on our 2016 results.

Our full year effective tax rate, excluding the impacts of tax reform, was 35.4%. We expect our effective tax rate to be around 24% on a go-forward basis.

Slide 21 depicts our full year cash flow. Cash from operations totaled $3.3 billion, covering capital spending and generating $1.5 billion in free cash flow. Free cash flow increased by 33% over 2016, driven by our strong operating results and disciplined capital spending. Looking ahead, we expect cash taxes in 2018 to be approximately 25% lower than 2017 levels.

This is less than the drop in the effective rate, largely because cash taxes in 2017 benefited from the accelerated deduction of interest expense generated from our 2 debt exchanges.

Now turning back to 2017 results. Return to shareholders totaled $1.7 billion through $703 million of dividends and $1 billion in share repurchases. As Jim noted, our Board of Directors remains committed to returning capital to shareholders and approved an increase in our quarterly dividend to $0.72 per share, reflecting an $0.11 or 18% increase over the previous quarter's dividend.

Our capital allocation strategy remains the same: first, reinvest in the business and our network with our adequate returns; second, pay a solid dividend, targeting a payout ratio of 1/3 of net income over the longer term; and third, return capital to shareholders through buybacks.

Moving to this year's capital budget on Slide 22. We project total spending of $1.8 billion, higher than 2017. This year's budget supports growth and the continuation of investment in our core assets. We're investing in the expansion of various terminals and infrastructure to ease capacity constraints, and we're acquiring freight cars in support of our volume growth.

Similar to prior years, the roadway category represents our programs to replace track, bridges and communication systems. In 2018, locomotive capital will be focused on the rebuild and conversion of locomotives from DC to AC power. To improve customer service and further enhance the productivity of our employees and the reliability of our assets, we have also increased our technology spend.

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

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

Thank you, Cindy. And now let me provide you an update on our 5-year strategic plan.

Slide 24 shows the financial targets that we committed to by 2020 and outlined as part of our strategic plan a little over 2 years ago. As you may recall, our plan was a comprehensive one, built on disciplined cost control and asset utilization, while balancing revenue growth through a combination of volume growth and pricing.

As the economic environment has evolved, we have been dynamic in our response to changing market conditions, and remained well positioned to achieve our financial goals. So let's take a look at the results so far.

Through 2017, we've made substantial progress that has translated into shareholder value, and Slide 25 shows some of our accomplishments, achieving pricing gains over rail inflation, a focus that will continue in our approach to the market; improving our operating ratio on a year-over-year basis for 8 consecutive quarters and to an annual record for 2017, with a plan to achieve a sub-65% OR by 2020 or sooner; achieving double-digit earnings per share growth in each of the last 2 years, a trend we expect to continue; making substantial capital investments each year to maintain the safety of our rail network, enhance service, improve operational efficiency and support growth, with a plan to invest 16% to 18% of revenue going forward; and rewarding shareholders by returning capital in a balanced, disciplined way through both dividends and share repurchases.

Much has been accomplished by Norfolk Southern and its employees since the inception of our plan, and we remain determined to deliver upon our commitments. Slide 26 highlights our path forward as we balance productivity with top line growth. Our overall outlook on volume in the current economic environment is for a 2% growth on a compound annual basis. Volume growth in our intermodal and merchandise commodity groups offset a softer demand for coal. We expect that revenue per unit will grow about 2% on a compound annual basis through 2020.

We are open for opportunities to grow, and we will be unwavering in our commitment to productivity and efficiency. We will continue to build on our initiatives to date as we look for further improvements in fuel efficiency and leverage investments in technology to make our organization leaner. We will continue the effective stewardship of our resources, ensuring we have the appropriate workforce as demand evolves, and continuing to invest in the reliability of our locomotive fleet.

Wrapping up on Slide 27. At Norfolk Southern, we know we can deliver upon our strategic plan, focus on the core principles of safety, service, productivity and growth. As we head into 2018, we are optimistic about the current economic environment, and I remain fully confident in our ability to deliver an operating ratio of sub-65% by 2020 or sooner, while delivering over $650 million in productivity savings.

With that, thank you for your attention, and we'll now open the line for Q&A.

Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Matt Reustle with Goldman Sachs.

Matthew Edward Reustle - *Goldman Sachs Group Inc., Research Division - Fixed Income Analyst*

Just in terms of putting it all together, it sounds like the 2018 outlook includes a lot of varying trends between the truck competitive business, contract structure, remaining mix. Can you just talk about the expectations for '18 regarding further OR improvements? And should we expect another year where the OR improves? Or is it -- is there a possibility where there's a short-term stall in the longer-term story?

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

We do expect a lower operating ratio for the full year 2018, and that will be driven by a combination of productivity initiatives and growth. Alan, why don't you talk a little bit about the truck environment and the opportunities we see for growth on the top line?

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

Matt, we are increasingly optimistic about the macro environment in which we're operating in the competitive environment that we're facing. Truck expectations have continued to tighten over the last 45 to 60 days. The economists are revising upwards their economic outlook for many of the markets that are important to us. So as we head into 2018, we're very confident in our ability to price into this market and secure growth. The one pause that we have, which I tried to outline, is particularly within our coal network. And the coal indices for export are backward-dated, although they, too, have risen in the first half of this month. So there's some uncertainty in the export coal market. And then natural gas prices, although they're relatively high for February delivery, the forward curve drops off pretty sharply after that. So that could put added pressure on our utility coal market.

Matthew Edward Reustle - *Goldman Sachs Group Inc., Research Division - Fixed Income Analyst*

Understood. So if I isolate merchandise and intermodal and just look at the RPU growth there x fuel, should we think about that business rolling over at rates that are higher than that 3% to 4% range that you're showing, and it's just a small percentage of the business rolling over at those rates that are much higher? Or is it something to do with longer-haul business or anything in mix that's there? Can you discuss that?

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

Well, Matt, we will get some strong rate increases in business that is truck competitive. And certainly, that would include intermodal, but there's also a lot of merchandise business that's truck competitive. That's one of the great things about our franchise and our strategic plan. As our -- we have a great geographic footprint. Our strategic plan to pull business off the highway is underscored within this economic environment.

Operator

Our next question comes from the line of Allison Landry with Crédit Suisse.

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

I just wanted to talk about the service metrics. They've deteriorated to basically the 2014 levels. And I think just 6 weeks ago, you guys talked about either sort of turning the corner with respect to that. So I just wanted to sort of understand what drove the deterioration in December. And then sort of from a broader perspective, thinking about the 2014 levels in absolute terms, we know that was a difficult period of time for the network. And obviously, the productivity results currently don't reflect any sort of meltdown. So if you could help to walk through the differences between then and now and how that translates into the train speed and dwell metrics that we're currently seeing.

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

Sure. Well, let me start, and then I'll turn it over to Mike to talk a little bit more about the specifics. But in general, I want to begin by emphasizing that we remain steadfast in our commitment to delivering quality service that our customers value. So that's our goal. Last year -- late last year, the composite service metric did decline, and we did not live up to all of our customers' expectations. But the commitment to do so is there and ever present at Norfolk Southern. We believe we have the resources in place necessary to meet demand now and in the future. So whether it's crews or locomotives or other resources, we believe that we have no systemic shortages and adequate resources on hand. And that as the network recovers and service recovers, we will be able to continue driving both growth and productivity.

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

That's exactly right, Jim. From the service, I will say, Allison, that our terminals and line of road are fluid. However, the customer-facing metrics and our network metrics lag these and is taking longer to get those metrics back to where we had been. But we're going to do it. And Jim is correct. We are confident. We have all the right resources. We don't have resource issues, both from the T&E standpoint and from the locomotives and freight cars. So we feel comfortable about where we're going. And that is our charge this year, and we're all over it. We're confident of where we're going.

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

Okay. And then in terms of the 2% yields CAGR through 2020, could you talk about the components that are embedded within that? I would assume it includes fuel, perhaps some negative mix from the outsized growth in intermodal. So if we sort of think about the different components within this, should we assume core price is around the 3% mark? Any sort of color on the different buckets that would make up the 2% would be helpful.

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

Alan, why don't you take that one?

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

Happy to. Allison, good question, and I'm glad you brought that up. The 2% RPU growth is not analogous to 2% pricing growth. You noted some of the negative mix that we've got in terms of strength in the intermodal market declines within export. And frankly, our export volumes for 2020, I look at them now, are very similar to the export volumes for 2020 that we had last year when we updated the plan. The difference is we had a huge run-up in export coal this year, which as you know at least through Lamberts Point has a higher than average RPU. So as that pulls back and the indices pull back, that creates some negative mix for us. We are leaning into price. This is a great opportunity to price for us. We've got a very strong truck market, and we're going to price according to the market.

Operator

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

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

I wanted to focus a little bit on the commentary on coal. It sounds like your concern is going to be more for the back half of the year because it seems like the indices, as you pointed out, are still looking favorable at least in the near term. Am I reading the tea leaves right on my own?

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

Yes, Jason. I think we're having continued strength within our export market. I guided the, what, 5 million to 6 million tons for export in the first quarter with an opportunity to exceed that. Last year, we had 6.3 million tons in the first quarter. And then as the year progressed, it moved up a little bit over 7 million tons in the fourth quarter. So I think there's continued strength in our export market. I am concerned about the natural gas prices in the dispatched and the utility market. So we guided to 15 million to 17 million tons in utility for the quarter.

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

That sounds fair enough. Can we focus a little bit about some of the business that you picked up late last year? Your Eastern counterpart sort of confirmed that a lot of the business that they lost is gone, so at least one-year contracts. When should we see the bulk of those roll over? And how confident are you in retaining that business that you took?

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

Jason, let me take that one first, and then I'll turn it over to Alan again. I want to emphasize that we're focused on enhancing our value proposition and creating value at NSC. And we're confident that we can do that by providing that competitive service product to our customers that will grow our business. So it's all about the product, the service that we can provide to our customers. And we also view our primary form of competition is truck. And so our goal is to provide truck-like service, and that means that the customer who is perhaps trucking today will find our value proposition more attractive and will go by rail. Alan?

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

Yes. Jason, we were pretty clear and we continue to be clear that the business that we were looking to bring into our network last year would be ones that customers who valued service and weren't buying capacity from us. We're looking for customers who are long-term growth opportunities. So long term's the key word in there. We're looking for a long-term relationship. And as Jim noted, our primary gains and our primary growth in 2017 is reflective of the market and the strengthening truck economy, and our customer approach and our ability to pull business off the highway. And we think that will continue and are confident that will continue as we move into 2018.

Operator

Our next question's from the line of Ravi Shanker with Morgan Stanley.

Ravi Shanker - *Morgan Stanley, Research Division - Executive Director*

Just a follow-up on something that was maybe touched upon earlier. I'm kind of looking at the 2020 targets. How do you offset the mix drag from the growing intermodal versus coal? And does that make it harder to get to the long-term OR targets?

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

So let's start here. The plan is dynamic and flexible. And that plan with its dynamism and flexibility has consistently delivered strong performance for the last 2 years, as I went through 8 straight quarters of lower operating ratios year-over-year, double-digit EPS growth. So the plan is clearly working. And we're going to continue to push. We've got a balanced approach to the market. We're going to -- we're definitely trying to grow where we can. We are emphasizing productivity as well. With that balance of drivers, OR and earnings drivers, we're confident that we can get into a sub-65% operating ratio by 2020 or sooner.

Ravi Shanker - *Morgan Stanley, Research Division - Executive Director*

Okay, got it. And just a follow-up on the intermodal side for 2018. You clearly highlighted the tightness in trucking as a catalyst. When do you expect to start to see the benefits? You said that you still have about 45% of contracts left negotiated for the year. Is that something that shows up in the first half? Or do you wait for the second half to see that benefit to start to flow in?

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

It will continue to move through the year. We started to see pricing improvement in that market in August of last year. It accelerated as we moved through the fourth quarter. And as we have an opportunity to move into bid season, which is in March-April this year, that will offer continued support.

Operator

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

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

So I just wanted to ask one question on the CapEx budget for 2018. If I look back a year ago in terms of what your initial CapEx plans were, the increase is really not that significant. It looks like $75 million or so excluding the PTC spend. And within that, there's actually spending declines even in infrastructure. So just can you help us think about that, specifically, why 2018 CapEx doesn't need to be even higher, given the declines in the service metrics? And maybe what's the risk there that there may be some revisions higher?

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

So Cindy went through the 2018 plan, $1.8 billion spread across a variety of categories, basic infrastructure, locomotives, technology and so on. We're open for growth. If our customers are investing in this economy, we will invest as well. So in the past, we've shown flexibility with the capital budget. We've cut where business conditions did not meet our expectations. We would be prepared to spend additional amounts if the returns are there in a growing economy as well.

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

Okay. Let me just ask one follow-up if I could on tax reform, I guess. I mean, we've obviously seen a lot of companies talk about passing some of that onto employees in the form of maybe onetime bonuses. If you could just help us think about how much of the increase in cash flow or earnings will drop to the bottom line from tax reform if there are any changes to some of your inflation expectations with wagers or something like that, that we should be thinking about this year. And then just related to that, what are the uses of the proceeds from the cash flow that will actually accrue to net earnings over and above, I guess, the dividend announcement? Should we expect any acceleration in the share repurchase activity?

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

So let me talk about our capital allocation priorities in general, then I'll turn it over to Cindy maybe to go through some more of the specifics, which she covered in her presentation. But ours is a balanced capital allocation plan. We're going to start out the year with capital spending above what we spent -- planned to spend above what we spent in 2017, and we're open for growth investments. We -- reflecting their confidence in our company and in our future, our Board of Directors increased our dividend significantly, and we will have a robust share repurchase program in 2018 as well. Cindy, why don't you go through some of the specifics of tax reform and its impact on our bottom line?

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

Sure. Yes. as, I said, we expect that our effective tax rate going forward will be about 24%. I also mentioned that for 2018 that you should expect the cash taxes should be about 25% less than they were in 2016 -- or sorry, 2017, which may not seem like quite enough, and there were some things going on in 2017 that had a positive impact on cash flow, and that was primarily around the debt exchanges. So we've...

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

I understand the rates, but the question was really related to the absolute dollar amounts -- well, some of those dollar amount savings. I mean, I understand the rates, but are the absolute dollar amount savings going to 100% drop to the bottom line? Or do you expect some of that will be competed away or actually accrue to the employee base as well? That was really the question.

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

We don't necessarily expect that we'll see wage changes as a result of this if that's your question.

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

We're always interested in attracting and retaining the best and the brightest. And we're constantly looking at our benefit plans, at our compensation scales to enable us to stay competitive in the market. And that will be our approach in the future as well.

Operator

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

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

I wanted to -- and congratulations on a strong year as well. I wanted to ask you a bit about -- maybe for Cindy or Jim, on some of the moving parts on the expenses in 2018. I know you don't give specific guidance on these things, but just kind of directionally. So the incentive comp, a $55 million rise year-over-year in the fourth quarter, obviously, that's a bit of a cost pressure. On a full year basis, would you think that incentive comp is likely down in '18 and potentially a tailwind? Or would you think of that as flat? Operating property sales were a bit of a benefit in 2017. I just wanted to see if that's also something that we should think of as kind of flat when we model next year or is that potentially a headwind? So I guess, those 2 in terms of modeling -- broader modeling question.

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

Go ahead, Cindy.

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

Okay. Oh, yes, so in terms of incentive comp, and I mentioned this in my comments, certainly, 2017, we had higher than probably average incentive comp than we've had over the last few years. We've talked about, in 2016, it was lower. In 2015, obviously, it was 0. So when you think about incentive comp, I said our board has raised the bar in performance. And you'll see us in the first 2 quarters, we'll be accruing to a target as we look at what operating results are actually doing throughout the year. The back half of the year will really depend on our operating results. And if we're exceeding the targets that have been set, you'll see incentive comp accruals growing. And if not, they won't be growing. So that's hard to predict. But it will very much depend on operating results.

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

Outlook for wage inflation?

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

Yes, and I also guided to overall all-in wage and health and welfare inflation of 1% in 2018. Now in terms of the sales on operating property, we have been looking very, very hard at our properties. And we're going to continue to do that. And you did see that in the fourth quarter. We had an additional $25 million of gains on operating sales. And we also had -- we had increases the last quarter. Those are really -- they're very hard to predict. If we have properties that we're not using in operations and that we're not getting good returns for, we're going to look to get rid of it. And I can't really give you a guidance necessarily into next year and certainly not quarter-by-quarter, but I will tell you that we're going continue the same program we've been on for the last year or so.

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

Monetizing excess real state is part of our strategy. Long-term, we will drive lower operating ratios and higher income through improvements in rail revenue and productivity and expenses.

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

Okay. For the second question, Jim, you very clearly focused at -- or indicated your focus on truck competition, that the way you're looking at the business, truck market's tighter. How would I think about that translation to your pricing? I mean, truck market, if you look at spot rates up 25%, 30% year-over-year is not a little tight, it's dramatically tight, right? And so truck contract rates potentially could be up 10%. For brokers, they could be up 15%. So it seems unusual in the truck market just in terms of the magnitude of rate increases. Given your comments about how truck-focused you are, could you see unusually strong increases maybe versus historical and intermodal? Is that a reasonable way to look at it? Or would you say, well, maybe you see unusually strong volume growth or just how you think about that dynamic? Because it does seem that the truck market is unusually tight, and rate increases could be just bigger than we've seen for quite a while.

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

Well, let me start by saying that ours is a balanced approach to revenue growth combining price increases with volume growth, where that makes sense, for the bottom line. So Alan will talk some more about the conditions out there and the opportunity for rate increases on truck competitive business.

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

Tom, we're really encouraged about the opportunities, the price into this market. And frankly, a lot of our channel partners are similarly encouraged about their opportunity to price. But it's not -- it doesn't just stop at intermodal. We had RPU growth of 2% to 7% in all of our groups in the fourth quarter, except for coal, reflecting broad strength. And as I noted earlier, pricing accelerated as we moved into the fourth quarter and through the fourth quarter. So we're encouraged about the opportunities that are in front of us, both from a macro standpoint and from a competitive standpoint.

Operator

Our next question comes from the line of Chris Wetherbee with Citi.

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

I wanted to ask about productivity in 2018, just sort of how we think about that relative to the $150 million in 2017. And Jim, maybe taking a step back and thinking about sort of where we are towards those 2020 targets, how do you feel like the progress is being made? Are you ahead of schedule, behind schedule, right where you thought you might? So just trying to get some perspective on sort of the progress.

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

Okay. Well, productivity performance has been great for the first 2 years of this 5-year plan, $250 million right out of the gate in 2016, demonstrating the flexibility of our plan and our intense focus on productivity as a driver of improvement. Another $150 million in 2017. So we're $400 million toward our goal of $650 million in the next couple of years. We're confident we can get that additional $250 million through a combination of productivity drivers that we have seen thus far, labor, materials, fuel and so forth. So we're going to stay focused on that. That's a key part of our plan. We've demonstrated the results thus far, and we're confident that we can get the full $650 million over the next couple of years. That's a big enabler along with growth of our sub-65% operating ratio by 2020 or sooner.

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

Okay. But no specific number for '18 is what you're saying right now?

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

As I said, we're very confident we're going to get the additional $250 million on the way to that sub-65% operating ratio by 2020 or sooner.

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

Okay, that's helpful. And then maybe a follow-up. Just on the intermodal business, so obviously, a tight market. And so there seems like there's a lot of opportunity there. I guess, I just wanted to maybe understand how you think about sort of capacity allocation of the network. So we've seen some service issues as volume has surged probably above and beyond expectations. As you look out into 2018, is there a way to think about sort of how much capacity you actually do want to allocate to sort of that truck competitive business? Do you put a capital on that because you don't want to go too far and spend too much money in sort of a shorter-term period and sort of kind of taking the cycle into consideration? How do you think about that?

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

Again, I think I go back to the balance in the plan. We are working hard to drive shareholder returns through a combination of growth and productivity. That makes -- that means making smart targeted investments, where those investments make sense on the network, in order to capture both productivity and growth going forward. And so that's what the capital budget is all about this year. As I said, we're open for growth, and you could see additional investments if the returns are there. We'll take our time. We'll do it right. We'll make sure that we maximize the returns from each and every dollar we put into the network going forward.

Operator

Next question's from the line of Barry Oglenski with Barclays.

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

So I just wanted to circle back. Did we get any guidance on land sale or expected land sale gains in 2018? And I only asked because that does swing the model, and I think Tom might have alluded to that. And then, also, can we get some expectations on headcount looking forward?

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

Sure. Cindy, you want to go back over the guidance with respect to land sales, and then talk about headcount for 2018?

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

Sure, Brandon. In terms of land sales, as I said before, we are looking very, very closely at our properties and trying to make sure that there's a business use for them or they're -- we're getting returns on them, and we're going to continue our program to monetize where we need to and where we do no longer need them in operations. So in terms of a quarter-to-quarter or annual rate, it's very difficult to predict that, but I will say that we're going to continue the strong program that we've had. In terms of headcount, we expect headcount to be stable going into 2018 compared to 2017. Obviously, we expect to continue to get productivity out of our workforce, and we will do that. You may see the headcount vary from quarter-to-quarter because we will be hiring T&E employees ahead of like peak season. So -- but overall, in terms of the entire year, you should see the headcount remain stable.

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

So flat headcount, growing volumes equals labor productivity and a human resources platform for growth.

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

Okay. That's actually quite helpful. And then, Jim, I guess, maybe are we just all looking at the wrong service metrics? I mean, because we're all focused on dwell and velocity. I think it came up earlier on this call. Are things on the ground maybe not quite as bad as they would -- or at least as we perceive from those metrics?

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

Well, there's no question the network has slowed down. And when it snows in the south, it's tough. People can't get to work, school's closed, and there's no doubt about it. The network slows down, and we did not deliver the velocity or terminal dwell that we or our customers expect late in the fourth quarter because of those winter conditions. We are very focused on network stability and resilience. That is our goal as we move through the first quarter, restoring that, so that we'll have the service platform for growth for our customers and for ourselves. We don't believe we have any systemic resource ripples. And that means we have enough people. Cindy just went through our headcount outlook for the year, flat headcount, and we think we have enough other resources as well once we get the networks pulled back up.

Operator

Our next question comes from the line of Ken Hoexter with Merrill Lynch.

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

So Jim, just maybe following on a lot of the discussions that focus on the yield side of your 2020 targets. But if you look at the volume CAGR, maybe it's for Alan as well, but your volume CAGR of 2%, you did 6% growth in intermodal. Given the tight market, merchandise is only 2% outlook as well, I guess, intermodal have been 4%. But if you're -- Alan's talking about an accelerating economy. I guess, how do you think about the cost maybe falling behind a bit? I guess, maybe Chris was focused before on the intermodal side. But looking at your merchandise target, and given the accelerated economic targets, how do you then -- do you ramp up in the near term on that cost side to counter that?

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

Well, I don't think there's any big ramp up in costs involved, and we are going to continue to focus on productivity. And as I've said, we believe we have the resources in place to handle volume growth -- foreseeable volume growth in the merchandise network. We're also constantly working on business process at ground level. We are working on some things that we think will improve the consistency and efficiency of local customer service going forward. That's going to take a while. We're doing it in collaboration with our customers. But you roll it all up, and we think that we have the capacity to grow. Alan, you want to add anything on the -- sort of the intermodal yield side of that?

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

Ken, that's a good opportunity for us. And we will continue to push price. It'll play out over a period of time, starting with transactional business in the -- in mid-third quarter. It will ramp up with bid season in the second quarter or early -- late first quarter. And I'll remind you that truck pricing declined overall in 2017, and yet our yields moved up. And so...

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

No, I have no doubt about the pricing side and what you've given us, I was more focused on the volume. Just if you were looking at 2% CAGR volume, and yet you're talking about accelerating volumes in the near term, your ability to handle that, that was the focus more on the merchandise given your 2% target in an accelerating economy.

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

Ken, what we've talked about in the past is we're focused on adding business that fits into our network. And as you add business into the intermodal network and into the merchandise network, generally, you're running -- you're putting it onto the tail end of scheduled trains. And so that creates a lot of leverage for us, and it gives us the opportunity to add business without adding compensatory expenses.

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

Yes, it works very well.

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

Yes. So just as a follow-up question then. The shift to pension accounting, obviously, a much bigger issue for the Canadians, but, Cindy, any impact to operating ratio as you go forward especially given your OR targets?

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

Yes. Good question, Ken. If you look at 2017, the impact that the change in the pension geography would make, obviously, now, we'll only be able to keep service cost in the pension expense -- or in the compensation and benefits line. So for 2017, that would have had about a $64 million unfavorable impact on compensation and benefits and favorable down another net. So that gives you kind of a feel for that.

Operator

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

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

So I wanted to start with a question on PTC. It seems like the Western rails are a little bit further along in the implementation. So I was wondering if you could just update us on your plans to roll out that technology. And as this plays out over the next few years, do you see risk to service and train speeds during this rollout?

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

Yes. This is Mike. We are on track to have all the equipment -- signal-type equipment installed in the ground as well as our locomotives equipped by the end of 2018, and also be running on over 50% of our railroad. We're at 44% today, so we feel very confident of meeting that goal. That will give us the legislated extension to 2020, which we've always said we were going to do. So we're on track with that. What are the impacts to the operation? Obviously, they are some of these signal cutovers. And there's thousands of these things to do, take several 6 to 8 hours of the time that we shut down the railroad and do the cutover and all that. So there is some impact. Long-term, once we get it all installed, working reliably, we don't see any significant service issues related to that.

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

Okay, great. And secondly, you gave first quarter guidance for coal, but is there anything you'd be willing to share as it relates to the quarterly cadence you're expecting over the remainder of the year? Alan, I think you mentioned concerns with natural gas competition and export coal. So I just wanted to potentially put some numbers around the moderation and tonnage that we could see over the course of the year.

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

Justin, with the first quarter, we're looking at 15 million to 17 million tons of utility coal compared to about 17.6 million tons of utility coal in the first quarter of last year. How we move forward is going to be highly dependent upon weather patterns and natural gas. So that's -- we're looking at that very closely, similarly with export coal. There's a lot of strength both in met and in thermal export coal. And in fact, our split between met and thermal export was 50-50 in the fourth quarter of last year. As you're aware, typically, it's more heavily weighted towards metallurgical coal. Now the indices are backward-dated for those, but they've been that for a while. And we're continuing to have conversations with our customers to ensure that we've got the resources in place to handle that business. It has legs. All I can do is point you to the same market factors that we're looking at.

Operator

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

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

So just a couple of follow-ups on the labor line. Cindy, I think you said you're -- for incentive comp, you're accruing to a target for the first half of the year. I just don't know if that means incentive comp in the first half of the year is a year-over-year headwind, tailwind, how much? You made a comment about timing of stock comp, and I wasn't sure I followed what you were trying to say. And then just big picture on the OR. When you talk about OR improvement, that's -- is that inclusive of the headwind for moving the pension? I know it's 40 basis points, not much, but I just want to make sure that that's inclusive of that headwind.

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

It's okay. Yes, Scott, so on the incentive comp, as I said, that 2017, obviously, was a strong year for incentive comp. And going into 2018, the board raised the bar on our performance. And so, typically, we will be accruing a target level for the first 2 quarters. Going forward into the back half of the year, it's really going to -- it's going to depend on what our operating results are and whether we're exceeding the targets or not. So that's what the incentive compensation was. In terms of the stock compensation, we typically, and if you look back at our 10-Qs, you'll see that the first quarter's expense for stock compensation is much higher than the second and the third and certainly the fourth quarter. There was a change that has been made to our plans that changes the vesting period. So now, the expense is going to be recognized, spread more similarly across the first 3 quarters. And then, of course, you'll have a similar -- similar, I guess, to 2017 fourth quarter expense. So that's what the stock compensation was. You also asked a question about OR and pension and what the impact will be. We still -- we're very confident we're going to improve our OR year-over-year even with the pension adjustment.

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

So our OR guidance is inclusive of that reclassification.

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

Okay. And then I'm still not clear what you're trying to say on incentive comp. I understand you can't tell us back half of the year. But when you say you're accruing to a target for the first half of the year, does that mean that first half incentive comp is higher or lower than what you did first half of '17? Meaning, you've given us a very helpful guidance the last couple of quarters of, it's going to be a $50 million year-over-year headwind in the fourth quarter, which it was. Can you give us anything like that to help? Because it can -- and in quarters be a pretty meaningful swing.

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

If you look back on the Qs, in the first quarter and the second quarter of '17, you'll see we're accruing to target there. And so that would give you -- I think it'd give you an idea of what you could -- you should expect in '18 for the first and second quarters.

Operator

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

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

And so it's 2 quick ones. First one, Alan, I guess, perhaps, Cynthia, can you give us a reminder of the fuel surcharge tied to WTI? You mentioned it seems like you're shifting a little bit more away from the revenue that's tied to WTI, where the prices are right now. We can start to see that become a meaningful contribution in the next couple of quarters. So can you just give us an update on when we should see that come in, and rough ideas of how much? That would be helpful.

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

Brian, as I noted, about 2/3 of our revenue is now on an OHD-based fuel surcharge program. The remainder of that would effectively be public pricing. And that, which is under contract, that's tied to a WTI-based program. And within that WTI-based program, there are different triggers. So the primary focus is on the OHD-based program. And we saw a $40 million increase in our fuel surcharge revenue just in the fourth quarter reflecting that.

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

Okay. And then the trigger for WTI, is that still $64 a barrel? Because -- and for how long? Because we're sitting right at about that number right now.

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

Brian, we are. And as I noted, there are different triggers within the WTI-based program as there are within OHD. $64 is the predominant one within WTI, but it's well less than 1/3 of our fuel surcharge program. Does that make sense?

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

Yes. And if I can just ask a quick follow-up, Alan, on coal. The RPU is down about 1% ex fuel, as you noted, but export coal volume were up well above expectations. Looking back over the year, it looks like this was sort of the trend for the full year. So I'm not sure if there's been -- there really was a big mixed shift to more thermal perhaps, but it looks like it's really only volumes that are driving the export -- or the coal line, rather. And with exports being so strong, I thought you might have seen a little bit more price on that as well. So is it a mixed shift? Or is there some other structural change that's going on, given what was a pretty supportive backdrop from last year? And it looks like we're on the same pace at least for the first early part of this year.

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

Brian, I'm glad you brought that up. So let me take a little time to clarify that. So there are 2 things that are going on. As we noted, in the fourth quarter, we had a significant decline in our longer-haul Utility South business. And you'll see that, actually, our overall length of haul within coal declined year-over-year in the fourth quarter. Now as a result, in the fourth quarter of 2017, our Utility North business was -- we have more volume in that franchise than we did in the Utility South. Typically, our mix is about 55% to 60% Utility South and 40% to 45% Utility North. That flipped a little bit, and we had about 52% Utility North in the fourth quarter. So that, in and of itself, is a drag on RPU. Secondly, you talked about that mix between met and steam. And then I talked about we have about 50%, 51% of our export volume in the fourth quarter was steam. Contrast that to fourth quarter of 2016 and 30% of our export volume was within steam. We've got and we secured significant rate increases up particularly within our metallurgical export volume throughout 2017. We started to see those increases in the fourth quarter of 2016. So we got market-based rate increases. We're just dealing with a shift in mix, which drives more steam coal, which is typically lower-rated, and more Utility North than less Utility South. And Utility North is typically lower length of haul.

Operator

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

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

I just want to follow up with one more on incentive comp. It looks like from what you disclosed this year that the full-year headwind was well over above $100 million in 2017. Just to kind of put a finer point on some of the earlier questions, if we go back to target levels for 2018, can you quantify what that tailwind would be?

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

Cindy -- I think we need to let the year play out and see how the results trend. That ultimately will drive the compensation expense accruals. But I think as Cindy has stated, you should see some favorability in incentive compensation in the first half of the year at least. And then later in the year, it will depend on the results. And we'll mark up or down the incentive comp accruals depending on the results.

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

But it sounds like you're unable to quantify how much 2017 was above a target level?

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

Well, the incentive comp is volatile, I'd give you that, and it varies from year-to-year depending on performance. So that's the way it's supposed to work, and that's the way it's designed. When we do well operationally, and shareholders benefit, then incentive comp increases, as you saw in 2017. Going back to 2015, the company didn't pay a bonus because results were nowhere near our expectations. And 2016 was a lower bonus year as well, and you see that reflected in incentive comp accruals throughout 2016. So what I would suggest is that you examine that pattern of expense accruals in those 3 years. That would give you some sense of where the balance lies and what would be a target incentive compensation amount.

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

Yes, I think that's right. Let me -- just one other thing that -- just to make sure I emphasize them. We talked about the first 2 quarters. I think you're going to see the first 2 quarters of '18 will look very similar to the first 2 quarters of '17. And also, we'll announce our -- the actual payout of our incentive comp, a percentage in the proxy, which will be coming out soon. So you'll get -- you can get a better sense of it than I think as well.

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

As my follow-up, I don't want to beat a dead horse on service levels and capacity, but I think today's backdrop, where you've got flat headcount and rising volumes and some recent challenges to service metrics, was just bringing back memories of 2014 and '15 in investors' minds. How can you get shareholders comfortable that we're not on the cusp of what could be a multi-quarter resource catch-up in investment cycle like we saw a couple of years ago? And with what we can see externally, what signpost of progress should we watch for?

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

You should see improvement in the public metrics. You should see velocity pick up and terminal dwell decline. Those are not the only metrics we use to manage service, obviously, and to monitor network performance, but those are valid and important metrics. So watch for improvements in those areas. We will keep you updated on other service improvements that we're seeing. We remain confident that we have the resources we need to get to that stable, more resilient service pattern.

Operator

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

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

Yes, mixing all the service and capacity metrics together, I was wondering if you might be able to talk about some of the lines or product segments that you're seeing that were hardest hit, and if you've seen any -- you mentioned your customers that -- might have not lived up to the customer expectations. And have you seen any movement on the part of the customers away from -- in those lines that we're seeing the tightest capacity and lower service?

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

The capacity is tighter in the Southern part of our network than it is in the Northern part. We have less double track, less siding capacity in the South. So that's where the trains have tended to slow down and where we're facing the most challenging operating conditions today. In the North, quite fluid. We have double track -- lots of double track capacity. We made capacity improvements in the Northern region going back a couple of years. So it's in the South where we're facing the challenge. We're hard at work on facing that. As noted,we do believe we have the resources long-term to provide the service our customers expect.

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

Yes. And that's where the weather hit, and that's where we were holding traffic for the hurricanes. It really came up from the South. So yes, that's where we feel that.

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

Is there any structural impediments to that geography that will make it harder to achieve some of the capacity increases that you're looking to build out either through double stacking or double tracking?

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

Double stacking's really not a concern. We're almost completely double-stacked in our core routes in the South and in the North. So that's not really the issue. It's siding capacity, it's double track in the South, which historically we lack. Where it makes sense to shift that balance a little bit through targeted investments, we will do so, but this is really all about good process and making sure that we're getting the trains over the road with the capacity that we have available.

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

Okay. And then the flip side of the customer -- on the customer question, you've got a new salesperson over at your competitor, who obviously brings a different approach to how they sell in -- or how he sells into your customer base. Are you noting any major changes in how that is -- how the competitive landscape is playing out? And are you seeing any -- as a result, any disruptive shifts in customers over to your network? And any magnitude that you can provide to that would be also helpful.

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

Yes, Walter. As I've said, our focus is on enhancing value at Norfolk Southern. And we are confident that we can do that by providing a competitive service to our customers that will allow them to grow. So it's all about our customers and our service. Moreover, we do view trucks as our primary form of competition. That's why we're working so hard to provide a truck-like service to our customers.

Operator

Our next question comes from the line of Cherilyn Radbourne with TD Securities.

Cherilyn Radbourne - *TD Securities Equity Research - Analyst*

If I look at your 2018 year-to-date carloads, they would suggest that you continue to experience difficult seasonal operating conditions. So I just wondered if you could give some color on that and what that implies relative to returning service to target levels?

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

Oh, no, I think that's fair. We've had a tough start to the year in terms of the weather and operating conditions. It just becomes all the more difficult, particularly in the Southern part of the network, when we see the kind of weather that we have had. No excuses. We know what we need to do. We're hard at work on it, and we believe that we will see a restoration of service levels and network performance as we get a little further into the first quarter. So the volumes are what they are, but the outlook is very bright. The economic conditions are excellent right now, and we see lots of opportunities for growth.

Cherilyn Radbourne - *TD Securities Equity Research - Analyst*

Okay. And then separately, in terms of the customer engagement strategy that you kind of introduced in early 2017, I think you had a focus on dialogue with customers during 2017 to better understand how they defined service and how you could better meet their needs. What, if anything, do you have planned in 2018 to kind of move that into a next phase?

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

Well, the first thing we are focused on is service as the customer defined service. So we've talked a lot about network performance metrics, velocity, terminal dwell and so forth this morning, and we do monitor those things as important indications of network performance. But from the customer standpoint, what really matters, our consistency, grounded availability, order field, depending on the line of business, much more tailored customer service metrics, that's our ultimate goal, is to drive those metrics and earn customer satisfaction by delivering the service that they want as they define it.

Operator

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

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

A question for the broader team. When we look at the 12% growth and income from railway operations, is there any additional color or guidance you can give us around how much of that growth is attributable to the stronger export coal market? We get a lot of questions about what are we buying here with Norfolk? Is this railroad earnings or is this commodity inflation? And anything you could give us that would help us to understand how much that tighter global coal market has impacted operating profit would be very helpful.

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

Sure. Well, the -- you saw the increase in export coal volume. We've talked about some of the drivers of that in terms of our results, and that definitely did contribute to excellent results in 2017. I might remind you that in 2016, we faced very difficult conditions in the coal market, and yet we delivered a record operating ratio and record results in 2016. So the hallmark of our plan is flexibility in the face of changing market conditions. Alan?

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

David, it's a good point. It's a valid point. Export is important to us. We're focused on it. Although recognize, it's 3% of our volume.

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

I totally understand it's 3% of the volume. But I mean, you can go back to the 60s and 70s and see parts of that, that Norfolk Western line running at like a 50% OR. And it's a relatively short haul down the Lamberts Point, and it does have a lot of commodity inflation. I'm just trying to understand where -- what -- like how impactful was it, several hundred basis points? Is it a smaller basis points? I mean, you guys have done an awesome job on the OR, that's not the question. The question's really how much of a headwind can we expect based on these commodity markets to earnings for next year? And I'm just trying to get a sense for any additional data points you could use to help us -- we could use to help understand that better.

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

David, recognize what Jim said. We had a very difficult coal year in 2016, and yet posted year-over-year operating ratio improvements in each of the 4 quarters of the year. That's the beauty of our plan. Ultimately, our plan is designed to take trucks off the highway, and our read of the tape right now in economic conditions in the truck market is that it's pretty positive. And so we are looking for growth in both price and in volume in our intermodal and our merchandise markets.

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

And finally, David, I would just add that if you're looking to sensitize your projections based on assumptions about commodities, ours is a very broad-based portfolio. Our top line is highly diversified. We have a lot of customer-facing lines of business. Yes, commodity is part of the portfolio, but it's broad and diverse.

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

Okay. And then maybe, Cindy, just as a follow-up question on the 24% on tax rate you guys are expecting. If you were to think about an effective cash tax rate to use as a discount to that 24%, what's the right range that we should be modeling? I know you're going to be expensing the CapEx excess of depreciation, but are there other tax yields that would drive that number? Like how low of a cash tax rate number should we expect in relation to that 24% guide on the book rate?

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

Well, for 2018, I think what we said was for cash taxes, you should expect them to be about 25% less than the cash taxes were in 2017, and that's going forward, however. And the reason for that is that if you look at 2017, we had some things going on that helped cash taxes primarily around the debt exchanges. So going beyond 2018, if you use current taxes as a proxy for cash taxes and you look at that as a percentage of pretax net income, historically, that number for us has been in the mid-20%. And I think if you look beyond 2018, that number will probably be closer to the high teens for cash taxes. So that's a way to approximate it.

Operator

Our next question's from the line of Ben Hartford with Robert W. Baird.

Benjamin John Hartford - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

A couple of quick follow-ups. On the fuel surcharge program, now that we are above $64 WTI accrued, any change in the emphasis toward continuing to migrate the programs over to on-highway diesel? And I guess, in that same vein, is there a target of the percent of revenue by the end of the year that you expect the fuel surcharge programs to be on highway diesel arrangements as a percent of revenue?

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

Ben, our primary focus is on pricing to the market reflecting the value of our service. And fuel surcharge is just one of the terms and conditions that we'll negotiate with our customer base. So I cannot offer a target on that because our primary target and our primary focus is on driving shareholder value through pricing and through volume growth.

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

Alan and his team have done a great job of migrating our fuel surcharge program from WTI to OHD. That's something we set out to do a couple of years ago. But as Alan points out, the ultimate goal is price.

Benjamin John Hartford - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay. And then as it relates to the NAFTA discussion, what percent of your traffic interchange is at either the Northern or the Southern border?

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

It's a modest amount, although I'll tell you that overall, international business is, for us, kind of approximates international business for the United States. But NAFTA itself is a modest amount.

Operator

Our final question this morning comes from the line of Tyler Brown with Raymond James.

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Jim, we've heard anecdotes about the drayage capacity issues, particularly in the long haul dray market. I mean, obviously, I realized you're not a dray company, but do you think that dray capacity could mute modal conversion opportunities this year? And second, are any of your intermodal markets kind of in that 100-mile watermark?

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

Certainly, tightness in dray is a sentiment with tightness in truck capacity generally. Alan, what about the specifics on the length of haul factor?

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

We've got -- we touched over 50% of the population in our network. We touched over 50% of the manufacturing and 50% of the energy consumption. One of the great things about our network is it's very close to population centers. That's why we're confident that our plan will allow us to pick up business from the highway as truck capacity tightens. We have seen tightness in some markets within the drayage community. And in some respects, that impacted our volume growth in the fourth quarter.

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay, that's great. And in the capital plan, is there any contemplation of adding capacity to the EMP fleet or maybe the chassis pool to support growth? And -- or would you just expect your channel partners to make those investments?

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

We are projecting that we will add capacity in our chassis fleet in 2018.

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

In fact, that's already included in our 2018 capital budget, the one we went through today. So yes, additional chassis in the supply chain would be helpful going forward.

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

EMP?

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

We're revisiting that. We're taking a look at the evolving truck market. Right now, we don't have anything in there, as you know.

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

We're a multichannel intermodal provider, and the EMP is one of our channels, and we have a number of others as well.

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Right. And then just real quick. Cindy, I could wait on the K, but can you give us exactly what the '17 cash tax paid was?

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

It was around -- hold on one second.

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

If you look in the...

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

Yes, it's around $700 million.

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

That's footnoted in the analyst book that we just put out.

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

Yes.

Operator

At this time, I'll turn the floor back to Mr. Jim Squires for closing comments.

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

All right. Thank you, everyone, for lots of excellent questions and feedback. We look forward to talking to you throughout the year.

Operator

This concludes today's teleconference.
