THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

NSC - Q4 2018 Norfolk Southern Corp Earnings Call

EVENT DATE/TIME: JANUARY 24, 2019 / 9:30PM GMT

OVERVIEW:

NSC reported 2018 net income of $2.7b or $9.51 per share. 4Q18 net income was $702m or $2.57 per diluted share.

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

Clay Moore *Norfolk Southern Corporation - Director of IR*

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

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

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

CONFERENCE CALL PARTICIPANTS

Adam Kramer *Cowen and Company, LLC, Research Division - Associate*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

PRESENTATION

Operator

Ladies and gentlemen, greetings, and welcome to the Norfolk Southern Fourth Quarter 2018 Earnings Call. (Operator Instructions)

It is now my pleasure to introduce your host, Clay Moore, Director of Investor Relations. Thank you. You may begin.

Clay Moore - *Norfolk Southern Corporation - Director of IR*

Thank you, Adam, and good afternoon. Before we begin, please note that during today's call, we may make certain forward-looking statements, which are subject to risk 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 that we view as most important.

The slides of the presenters are available on our website at norfolksouthern.com in the investors section. Additionally, a transcript and downloads will be posted after the call.

For comparative purposes, the fourth quarter and full year 2017 results have been adjusted to exclude the remeasurement of deferred taxes due to the enactment of tax reform in 2017. And the 2018 comparisons are to the adjusted 2017 results. Please refer to our non-GAAP reconciliation, which is also available on our website.

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

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

Good afternoon, everyone, and welcome to Norfolk Southern's Fourth Quarter 2018 Earnings Call. Joining me today are: Alan Shaw, Chief Marketing Officer; Mike Wheeler, Chief Operating Officer; and Cindy Earhart, Chief Financial Officer.

In the fourth quarter, we once again delivered strong financial results. Slide 4 highlights the results for the quarter and full year 2018 compared to the prior year.

Income from operations was $1.1 billion, an increase of 27%, and an all-time quarterly record. Net income was $702 million, up 44% over the prior year. And EPS was $2.57, a 52% increase.

The operating ratio for the quarter was 62.8%. For the full year, we achieved record income from operations totaling nearly $4 billion, an increase of 17% from 2017. Net income increased 39% to $2.7 billion. And earnings per share increased 44% to $9.51. The full year operating ratio of 65.4% was a record for our company, and was our third consecutive year of OR improvement.

In addition to lowering the OR and boosting earnings, in 2018, we returned more than $3.6 billion to shareholders through share buybacks and dividends. And our Board of Directors yesterday increased the quarterly dividend by another 8%.

Looking ahead, we are determined to take Norfolk Southern to even greater heights. At our Investor Day on February 11, we will go over our new operational and financial targets, and discuss in detail all of the initiatives with which we will drive shareholder value.

Now to provide further details on our fourth quarter results, Alan will cover trends in revenue. Mike will cover operational performance. And Cindy will go over the financial results.

I'll now turn the call over to Alan.

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

Thank you, Jim, and good afternoon to everyone. As you can see on Slide 6, strength in all 3 business units drove the fourth quarter revenue increase of 9%. Each business unit posted a revenue per unit gain of 7%, reflecting both improved pricing and higher fuel surcharge revenue, as Norfolk Southern delivered fourth quarter year-over-year pricing increases that were the highest in over 6 years.

Merchandise revenue grew 7%, generating a fourth quarter revenue record on flat volume, as carload gains in chemicals and agriculture were offset by weakness in automotive and metals and construction. Our success in pursuit of pricing improvement combined with higher fuel prices resulted in a record merchandise revenue per unit.

Norfolk Southern's intermodal franchise, once again, delivered record-breaking revenue and volume results for the quarter. Our outstanding intermodal franchise combined with tightness in the trucking sector and high levels of consumer spending has generated 3 consecutive quarters of record intermodal volume.

Intermodal revenue reached an all-time high in the quarter, reflecting a combination of improved volume, pricing strength and increased fuel surcharge revenue.

Moving to coal. Revenue increased 7% with a corresponding 7% increase in revenue per unit as a result of pricing gains and fuel surcharge revenue. Volume increased 1% as our utility franchise benefited from increased winter demand and high natural gas prices in the fourth quarter, while export volume was limited by coal availability.

Moving to Slide 7. In 2018, Norfolk Southern achieved revenue growth in all 3 business units, including record revenue in both merchandise and intermodal, while handling record volumes. NS delivered 9% revenue growth in 2018 on top of 7% revenue growth in 2017, while improving the margins on our business through a combination of volume growth, pricing initiatives and efficiency improvements.

Our year-over-year pricing was the highest in 7 years with strength in all business units. Throughout the year, the trucking industry experienced capacity constraints and high truck rates, which supported strong growth in intermodal. In addition, consumer spending and industrial production both increased close to 4% in 2018, providing conditions that Norfolk Southern leveraged to drive merchandise growth.

In the energy sector, increased demand for U.S. coals and favorable fuel price differentials led to revenue gains in export coal and crude oil, respectively.

Overall, Norfolk Southern delivered strong top line results and improved margins in 2018. And we look forward to building on that momentum in 2019. I am excited about our upcoming Investor Day and sharing with you our outlook and plan for growth.

I'll now turn it over to Mike for an update on operations.

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

Thank you, Alan. Today, I will update you on the state of the railroad. 2018 was a year in which we handled record volume, record gross ton miles and achieved a record operating ratio.

Moving to our network metrics on Slide 9, we are pleased that the velocity of our railroad accelerated at the end of the fourth quarter. And we drove further improvements in the first quarter of 2019. This has been achieved by the healthier T&E crew base, Clean Sheeting gaining further traction, the full implementation of our network operations center, and intense energy and execution by the field. We are operating from a position of strength as we go into the year, and are laying a good foundation for our operating plan changes that you will hear more about at our Investor Day next month.

Turning to some of our productivity initiatives on Slide 10, we are continuing to drive improvement in all areas. Record GTMs, combined with our ongoing locomotive strategy, resulted in record locomotive productivity for 2018, beating the prior record set in 2017. We stored over 300 locomotives throughout the quarter, and turned in 100 of our 180 leased locomotives. Fuel efficiency for 2018 tied a record performance from the previous year. Both of these measures have been driven by our improvements in train length, which was a quarterly record and for the full year. This is the third consecutive year we have either matched or exceeded record annual results for these key metrics.

In closing, our full attention is looking forward. We are excited about the momentum we are delivering in operations, and we expect our performance to continue to improve in 2019 and beyond.

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 afternoon, everybody. We delivered another strong quarter and finished the year with record financial results. I'll start with fourth quarter summarized operating results on Slide 12, which as Clay mentioned earlier, are compared to the adjusted 2017 results.

As a reminder, 2017 results have also been recast to reflect the required reporting reclassification of certain pension and postretirement costs. As Alan discussed, our strong revenue growth has continued into the fourth quarter. The 9% increase in revenues when combined with the slight decrease in railway operating expenses, resulted in all-time quarterly record for income for railway operations of $1.1 billion, 27% higher than last year. We also achieved an operating ratio of 62.8%, improving our last year's results by 550 basis points.

Let's take a look at the component changes in operating expenses in more detail on Slide 13. In total, operating expenses were $4 million lower than last year's expenses. Gains from the sale of operating properties more than offset higher inflationary and volume-related increases. The material and other category decreased $111 million or 66%. This quarter included $145 million in gains on the sale of operating properties as compared to approximately $25 million in the fourth quarter of 2017.

Property sales do fluctuate from quarter-to-quarter. The large sales in this quarter highlight our ongoing strategy to monetize assets that are no longer needed in our operations.

The variance in this line item also includes $20 million of rental income associated with operating property, which you will recall is now included in this expense category. This favorability was partially offset by higher casualty and claims expenses, which were $9 million higher than fourth quarter 2017.

We also incurred expenses associated with the dispatch center relocation, which was completed in December.

Compensation and benefits rose by $27 million or 4%. The largest driver of this change is related to increased pay rates of $13 million, primarily due to negotiated rate increases for our union employees that occurred in the second half of the year.

Incentive compensation expense was unfavorable by $12 million this quarter related solely to the timing of these approvals, as incentive compensation is about even for the year as compared to the amount earned in 2017.

Overtime and recrews also added $11 million of cost this quarter. Consistent with our experience in prior quarters, health and welfare rates resulted in savings of approximately $9 million. Purchased services and rents increased $30 million or 7% compared to prior year results. This increase was primarily attributable to higher expenses associated with our volume-related increase, higher technology costs and additional transportation and engineering activities. The remaining $8 million increase is related higher equipment rent expense, reflecting slower network velocity and the cost of additional short-term locomotive resources.

As we mentioned last quarter, we expected equipment rents to drop sequentially in the fourth quarter, and it did by $14 million.

Fuel rose by $36 million, primarily due to higher prices which added $29 million. Consumption was up 2% over the prior year. And as Mike mentioned, we held our fuel efficiency metric constant.

Slide 14 shows a summary of our fourth quarter results. As you can see on the other income earned for the quarter was fully offset by year-over-year negative returns on our corporate and life insurance and investment due to the decline in market performance experienced this quarter. Net income of $702 million was up 44% compared to last year's adjusted results, benefiting from a full year of the lower effective tax rate due to the enactment of tax reform.

Diluted earnings per share was $2.57, a 52% improvement over fourth quarter 2017. Full year results are shown on Slide 15. We set company records in both income from railway operations and operating ratio.

Income from railway operations of $4 billion was a 17% improvement over 2017. The full year operating ratio of 65.4% was a 270 basis point improvement as compared to last year's results, and was a record for full year OR.

Slide 16 depicts our full year cash flow. Cash from operations totaled $3.7 billion, covering capital spending and generating a record $1.8 billion in free cash flow, 16% higher than last year. We returned more than $3.6 billion to shareholders through dividends and share repurchases. Our previously announced $1.2 billion accelerated share repurchase program was completed during the quarter, and we continued our ongoing open-market purchases. Our share repurchases underscore our confidence in the business as we continue to drive growth and create shareholder value.

As Jim noted, our Board of Directors remain committed to returning capital to shareholders and approved an increase in our quarterly dividend to $0.86 per share, reflecting an 8% increase over the previous quarter's dividend. This marks the third increase in our dividend over the past year. We continue to deliver improving financial results and are excited about the momentum we have to drive ongoing shareholder value into the future.

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

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

Thank you, Cindy. Three years ago, we announced a strategic plan aimed at delivering value to our shareholders through growth, productivity and bottom line improvement. Thanks to the hard work and dedication of our employees, we did just that. We lowered our operating ratio over 700 basis points, improved operating income by 39%, and increased EPS 86% compared to 3 years ago. Building on these successes, we have been overhauling our operations from top to bottom in the quest for shareholder value. In short, we have been re-imagining Norfolk Southern. At our Investor Day next month, we will discuss our new financial targets, the initiatives that will propel us into the future, and the metrics you will use to assess our progress. Today, our focus will be our fourth quarter and 2018 results.

Thank you for your attention. And we will now open the line for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Allison Landry from Crédit Suisse.

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

I realize that you plan to share a lot more detail in a couple of weeks. But wondering if you could speak broadly to when you think network fluidity will start to improve in a material way, such that you can begin to eliminate the need for recrews and additional locomotives and other added costs?

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

Sure. Good afternoon, Allison. We will go into a lot more detail at Investor Day, not only about our new financial targets, but about the operating initiatives that will drive the financial results. And as I mentioned, we'll also be introducing some new metrics with which to gauge our progress. Today we are going to try to keep the focus on 2018. I do want to emphasize a couple of things that Mike pointed out in his portion of prepared remarks. We posted annual records in key productivity measures in 2018. Locomotive efficiency and train size, for example. We stored more than 300 locomotives in the fourth quarter, and we returned 100 leased locomotives. And that was while over the course of 2018, we handled record volume and record gross ton miles. In the latter part of the fourth quarter, we achieved our highest monthly network velocity for 2018. That was in December, with service and velocity continuing to improve in first quarter. So the point is, we have a lot of momentum early in 2019 as we head into our new plan period. We've gained traction through Clean Sheeting and full implementation of our network operations center. And we're operating from a position of strength as we implement the new operating plan.

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

Okay. And maybe a question for the quarter. Could you parse out the growth in domestic versus international intermodal? And maybe on the domestic side, I know you talked about tight capacity, but relative to Q3 or even if you went back a little further, has there been any change or sequential loosening in truck capacity because of lower spot rates?

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

Alan?

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

Good afternoon, Allison. Our International volumes were up 9%. And the fourth quarter and domestic volume was up 4%. And yes, we've seen some loosening in the truck market. Although the market is still tight, and we're encouraged by what we're seeing so far in bid season. And we're also encouraged by what we're hearing from our channel partners with respect to their outlook for both price and volumes as we move through 2019.

Operator

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

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

Wanted to just sort of make sure I understood how you guys are viewing the 2018 performance. So the 65.4% operating ratio obviously includes some gains. And there's going to be gains in probably losses to a degree when you make transactions in the portfolio, so I get that. I just want to get a sense, do you think sort of 65.4% is a good rate off of which sort of the future builds? Or maybe do we think about something that's adjusted ex of those gains? I just want to get a sense maybe how you guys think about the process.

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

Let me comment generally, Chris, on how we view our 65.4% annual operating ratio for 2018. And then I'll let Cindy address how we might want to think about that going forward. We started out 3 years ago with the goal of a sub-65% operating ratio by 2020. And here we are with the 65.4% operating ratio in 2018. So that represents excellent progress under our prior strategic plan. And we made many other financial improvements along the way. So we're pleased with our performance up to this point. We recognize that we have much more to do, and we are intent on continuing to drive financial results and shareholder value in the future. And we'll have a lot, lot more to say about that at Investor Day.

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

Yes, Chris, you know I mentioned this in my comments, we did have $145 million worth of gains of operating property this quarter, which is high, I mean, compared to $25 million in the fourth quarter of 2017. We are going to continue to look at these assets and try to monetize them. It's very, very difficult, as you know, to be able to predict what quarter sales may come in. I certainly think that we had a very large gain in the fourth quarter around some property in Atlanta, that's pretty unusual. But we're going to continue to sell property as we can. And it's going to continue to help from the operating ratio. Although, I will say that going forward, even though that we'll continue to do that, the benefits from the operating ratio are really going to come from improved revenue and continuing to push on productivity. And that's what's going to drive our operating ratio long term.

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

Okay, that's helpful. And then just maybe Alan, if I can switch gears onto the coal side just to get a sense. I know, again, trying to keep it relatively focused on the current period. But just sort of in the context on what you're seeing in the market today, maybe a comment on the utility side, what you see from an inventory perspective in early 2019? And then maybe some thoughts on the export side will be helpful.

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

Yes, absolutely. On the utility front, stockpiles have declined in the north and in the south by 17 days over the past year. And talking to some of our coal producing customers, it's pretty clear that utilities are screaming for coal at this point. And that's kind of the factor that we're seeing right now, limiting both volumes in the utility franchise and on the export side is coal availability, particularly, thermal coal availability.

Operator

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

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

So wanted to ask about incremental margins. If we look at the gains on sale impact this quarter and what it was last quarter and kind of back that out as it can get to low 40s kind of incremental margins, which I think is below what we've come to expect from a lot of the rails, especially with some of the productivity initiatives in place. Could you give us some sense of the incremental margins you expect going forward? And what you view as a more normalized number?

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

Sure. Again, let me address that generally, then I'll invite Cindy to add to my comments. I think -- you think about incremental margin as being a reflection of the lower marginal cost of additional volume in part, the price -- the impact of pricing on the bottom line and productivity, those 3 key components. Incremental margin will be a significant objective and output of the initiatives we undertake in all 3 areas, in our new strategic plans. So recognizing the importance, the critical importance of incremental margin, that will certainly be a big part of the plan.

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

Justin, I would just say that, I think we've said in the past, 50% incremental margin is kind of -- we've talked about in the past. The percentage is going to vary from quarter to quarter. We did have, in this quarter, increased cost, particularly, in comp and benefits around incentive comps, based on the business results that we had. So I mean, I think that's sort of the way that we think about it.

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

Okay. And maybe for my second question. I know that you're going to give more details about the specific financial targets here at the Investor Day. But just bigger picture, as it relates to the OR performance. We've heard from a variety of other Class 1 rails that they want to lead the industry or be near the top of the pack. I know, like I said, we're not going to get the details today, but just from a high level, is there any reason why Norfolk can't progress from what is now the worst OR in the industry to something that's at least in the middle of the pack? Just curious how you're thinking about the OR performance relative to the rest of the industry.

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

We will do what we need to, to create shareholder value, Justin. And so we understand the importance of operating ratio. And that is certainly front and center as we think about the future. So we're going to continue to push on operating ratio, we'll get there. As well as operating income and other key financial metrics, we'll get there through a combination of growth and efficiency.

Operator

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

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

If we take out the $145 million noncash gain in the quarter, the core operating ratio is more like 67.8%, unless I'm calculating something incorrectly. That's an improvement year-over-year, but not nearly that impressive in the context of best pricing environment in 7 years, which I think was a comment that was earlier made. So -- and also, obviously, still far away from your peers. So what are the issues, I guess, either from a cost or volume side that maybe is not allowing you to make that type of progress on the profitability side in the context of pricing. And I guess just -- maybe you can also address in this answer the fact that you have CSX out there that is in a much better profit position and has taken out significant cost, and may be in a position to drive a little bit of a market share shift?

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

I think, if you step back, we have produced over 700 basis points operating improvement -- operating ratio improvement under our old strategic plan. We've made significant progress on operating ratio. And we've -- that's been accompanied by very strong earnings growth and shareholder returns as well. We have taken that cash that we have generated, we have reinvested it in our company and we have returned it to shareholders in the form of dividends and share repurchases. So it's been a strong performance for the last 3 years. Now we recognize that we have more room to increase shareholder value, and that's obviously our objective in the new plan. So we're going to continue to push. Operating ratio is front and center, as I mentioned. And we'll pull out all the stops to generate shareholder value in the coming years.

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

Okay, just one follow-up, if I could, on the balance sheet, really on the cash flow side. Every rail now, I mean, UNP just brought their number down to 13.5% of sales in terms of their CapEx. CSX has been there. I think you guys are still up in that kind of much higher level. Is CapEx and leverage levels -- really CapEx, is there an ability to kind of bring down CapEx towards where the rest of the industry is as part of this evaluation? Just any update or thoughts there as you guys look at that.

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

The level of Capex going forward will obviously be dependent on the returns that the capital spending can generate. In our view, 16% to 18% of revenue has been a solid range. That's what we've been doing for the last several years, and likely will continue to, again, depending on the returns. We believe at that level of capital spend, we can generate excellent shareholder returns.

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

So it's 16% to 17% for the next several years. Is that the way -- or is that going to be updated in February?

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

We'll talk more about that at Investor Day for sure. But we've previously said that we believe 16% to 18% is an appropriate zone for capital spending because it can drive the shareholder returns that we're trying to drive.

Operator

Our next question comes from the line of Tom Wadewitz from UBS.

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

Wanted to get a thought on the -- you talked about Clean Sheeting, you unidentified some of the metrics that saw some benefit from that in terms of some of the productivity metrics. Just wondering to see if you could give us a sense of where you're at in that process. I know that's focused on, I guess, the local yards. So I'm sure there's a lot more to go that you'll tell us about in February. But maybe just some thoughts on where you're at in the work on the local yards in the Clean Sheeting process?

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

Okay. And we will talk a lot more about that in a few weeks. But let me turn it over to Mike for some thoughts on what we're doing right now.

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

Yes, so the initial phase of the Clean Sheeting process is going to be completed essentially across the railroad early summer. And it is going very well. We're really pleased with it, that's why we're really focusing a lot on it. But the idea of using good industrial engineering practices to look the way we do business in our local serving yards, and really, any of our yards is going to kind of come the way we're going to do business, the NS way of the future. But once we get the Clean Sheeting initially done, we'll be rolling out the new operating plan on top of that in midsummer as well. But I'll tell you, we're taking the opportunities we see now. When we see an operating plan change that works now, we're going to ahead and implementing it. But Clean Sheeting will be done by midsummer and then we'll be implementing the new operating plan then.

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

Okay, great. And then a question for you on the export coal side -- or maybe on the broader coal side. Alan, you mentioned that supply issues are a constraint. Is that a temporary constraint? Is that just kind of near-term issues at existing mines? Or is that something where you say, they just kind of tapped out where they're running, and you'd have to bring new mines online in order to produce more coal?

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

Tom, good question. And thank you for allowing me to clarify that. That is our perception as a temporary constraint from speaking with our partners on the production site. Something that we feel like it's going to cycle off by the end of the first quarter. There's very strong demand out there both overseas and domestically.

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

Okay. So you could see tonnage growth given the markets, but just probably not in first quarter given the mine constraints?

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

Yes, the production is going to be our limiting factor here in the near term.

Operator

Our next question comes from the line of Ravi Shanker from Morgan Stanley.

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

Just to clarify on the Clean Sheeting. Did you say that you're working on the plan just now and will be implemented over the summer? I just wanted to check if you've already started implementing certain actions. And if there are any kind of cost drags in the fourth quarter as a result of that?

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

We have been implementing Clean Sheeting for some time now. In fact, for much of 2018, we were Clean Sheeting the railroad. And we are making some changes in the operating plan even as we speak, with more of that to come in 2019.

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

Got it. So are there any particular cost items you'd like to point out as being a drag as well there?

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

No, not as a result of Clean Sheeting or implementation of the high-velocity plan.

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

Okay, got it. And just a follow-up. I mean, just given the pricing environment that you mentioned, just going ahead in 2019, and the potential loosening of truck markets and maybe a broader macro slowdown. Can you just clarify your broader strategy on pricing going forward? Are you happy to push for more pricing gains even if that means a loss of volumes and shippers switching from rail to truck?

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

Yes, Ravi, our strategy is one that drives shareholder return. And this is a great environment to push on price. And we're going through bid season right now in the intermodal network, and we're seeing continued strength there. So I'm very confident in our ability to continue to price through 2019. We've talked about that basically for -- over the past year that 2019 was lining up to be a strong pricing year and we still see that. And we're expecting the momentum that we created in 2018 to carry over into 2019.

Operator

Our next question comes from the line of Matt Reustle from Goldman Sachs.

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

Just back to the intermodal business. You did see deceleration in volume and pricing in the fourth quarter. It sounds like the environment is still strong. Is that purely a case of lapping tough comps? Is there anything else there in terms of competition picking up, loosening truck market that's driving that deceleration?

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

We actually saw an acceleration of pricing in the fourth quarter, Matt. And I'll point you back to the fact to your point that fourth quarter 2017 at the time was a record volume and a record revenue quarter for us in intermodal. We've got a great intermodal franchise, we've got the best intermodal franchise in the east, and there is great opportunity for highway to rail conversions going forward. We're going to take advantage of...

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

Okay. Yes, I'm looking at RPU on an ex fuel basis, and it looks like 3Q to 4Q, it came down a bit. But understood.

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

Yes, we had talked about a shift, international intermodal grew 9%, domestic intermodal grew 4% in the quarter. So that's a negative mix within intermodal. You'd expect some of that, we had a great pricing quarter and fourth quarter in intermodal and expect that to continue. And based on that we're seeing so far with bid season, we're very confident it will.

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

Understood, okay. And then just more of a philosophical question. Looking back at 2018, you mentioned a couple of times, coming off a year where operating income is up in the high teens. It's at the high end of the peer group. You showed OR improvement. So when you look at 2018 results, what drives the need to shift to a new operating plan? What is it that stands out that was disappointing, which requires a full new operating strategy versus the progress that you've been making over the past couple of years?

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

Financial results were good. Network performance and customer service were not what they should have been in 2018. And so it's a push to achieve higher levels of network performance, customer service and greater efficiency as well, of course, that has us taking another look at the operating plan.

Operator

Our next question comes from the line of Brandon Oglenski from Barclays.

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

Jim, I get it that you guys have the land sale gains and we include those for other carriers too, but it was pretty chunky. I guess, I want to circle back because the OR is trailing your peers now. I mean, is there a sense of urgency inside the organization that says, clearly there is an operating model that can drive [lower cost and a system] better service? I mean, how are you guys incentivizing, I guess, the organization to go and achieve these goals?

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

Sure, absolutely. There is a lot of urgency around here. And a lot of enthusiasm, energy and excitement about this new mode of operations we are adopting based on precision schedule railroading. So we talked about that on the third quarter call, about the people that we have brought into the organization to help us drive PSR practices. And it's working. You see it in the service metrics, thus far, in the first quarter and in the latter part of the fourth quarter as well. So it's clearly taking hold. We feel like there's a lot of momentum. And yes, there is a great deal of urgency here about the new plan. We'll talk a lot more about it at Investor Day.

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

Well, and I get that you want to save a lot of discussion for Atlanta. But the headcount line, we saw headcount move up a little bit in the fourth quarter. And I think a key tenet, when we've seen these PSR implementations work, is a very rapid reduction in employee count because productivity gets that much better. So how do we think about, just in the context of heading into '19, the movement between volume and the network and headcount and the ability to drive incremental labor productivity?

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

Significant improvement in operating ratio, which is our goal, will be premised on a combination of growth and productivity. Productivity in turn is a function of better efficiency with respect to labor, locomotives, fuel and other resources in the business. So that's the foundation, all of that is the foundation of our new strategic plan and we'll get into a lot more detail on those things in February.

Operator

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

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

Just going back on your characterization. I'm a little surprised by, Jim, your characterization of your operating ratio given how significant the gains were. I'm just curious whether there -- how much gain was predicated in the sub-65% OR that you had anticipated compared to what actually came to play? And should we bank on continued gains to this level over the next few years? Or maybe some guidance around what gains -- what level of gains you expect?

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

Well, Walter, I can't give you good guidance on real estate gains except to say that they will occur from time to time, and in some quarters, they will be significant as they were in the fourth quarter. Monetizing real estate and all underutilized property is part of our strategy. And that results in better results for shareholders. That will not be the driver of our success as a company going forward. What will make the difference for shareholders and will drive shareholder value will be railroad operations, pricing and growth. And so that will be the focus. From time to time, there will be significant gains, and sure enough there were in the fourth quarter.

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

So you did compare your quarter to sub-65%. So you did, obviously, have an assumption for gains for that sub-65% level. How do they compare to what you're realizing this year?

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

We've known all along that real estate gains would occur from time to time. It's very difficult to predict when you will book the more significant gains. But certainly, that's part of the strategy, part of the plan, and we saw a lot of it in the fourth quarter.

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

Okay. Just on coal, you had done a good job just to kind of characterizing a quarter-to-quarter kind of expectation for how your domestic volumes would come in. Any -- I know it's uncertain, obviously, but any move toward giving -- contextualizing the sequential quarter going forward with regards to domestic utility coal?

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

Alan?

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

We'll talk more about that on the 11th. Demand is strong, stockpiles have declined, and our customers are searching for coal. So depending upon availability of thermal coal, it could be a pretty strong quarter.

Operator

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

Adam Kramer - *Cowen and Company, LLC, Research Division - Associate*

This is Adam on for Jason. I guess just a couple of quick questions on precision, the railroading and Clean Sheeting. First in terms of Clean Sheeting. How many locations were you guys able to attack in the fourth quarter and kind of go after with the Clean Sheeting process?

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

Mike, why don't you take that one.

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

Yes, well we ramped it up in the fourth quarter as we planned to do because we were excited about what results we're getting out of it. And we've even ramped it up a little bit more going into this year to get it done early into the summer. So we are moving ahead of pace on what we wanted to get done in Clean Sheeting. But I'll tell you, in addition to putting teams out there that were doing Clean Sheeting from location to location, we've embedded people into the field to just make this the part of the way of life at NS. So while we are Clean Sheeting across the railroad, we're also building it into just the daily operating practices at the railroad. So early summer, when this thing's all done, we'll be ready to go with our new operating plan.

Adam Kramer - *Cowen and Company, LLC, Research Division - Associate*

Got it. And I guess just a quick follow-up as well. You guys cited the customer service is kind of one of the drivers here for improvements and for what you're looking to do. I guess maybe just a little bit on your conversations with the shippers and with your customers concerning PSR. What have those been like? What are the back-and-forth spin? What have shippers been telling you guys about PSR? And the effects it's had on them, either positive or negative?

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

Ours has been and will continue to be a consultative approach. We are working with our customers as we overhaul our network. Let me turn it over to Alan to talk a little bit about the dialogue with customers as we go through Clean Sheeting.

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

Absolutely. Our approach with our customers has been highly collaborative. They want us to succeed, and they want a supply chain partner that can support their growth. And so their goals are aligned with ours. We're focused on improving service, and also putting a product out there that lets them compete. And we're seeing that, we've got 9% growth in 2018 on top of 7% growth in 2017. And we're very excited about the growth opportunities that we see in 2019.

Operator

Our next question comes from the line of Brian Ossenbeck from JPMorgan.

[

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

So Mike, just going back to some of the performance in the quarter. I know we'll get to see some more metrics in the next couple of weeks. But last call, you mentioned network velocity measured at the car level was near the highest for the year and crew productivity was also strong. So I was hoping you can give us an update as to where those metrics were in the fourth quarter? And did they also improve through the middle of January?

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

The answer is yes, they've continued to improve. We saw our terminals really get fluid at the end of the third quarter going into the fourth quarter. And that's where I was referring to, that was getting the cars through the terminals. And then at the end of the fourth quarter, our main lines really became fluid, so yes. And it's continued on even into the first quarter. So both of those are doing well going forward. So pretty excited.

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

All right. Jim, I see there's especially more tariffs and credits going into effect on the network next month. And these have always been used to incentivize compliance with service design changes and their aspects of PSR at different networks. But with the STB starting to looking at these demurrage in accessorial fees, do you think that approach has to change this time around? I'd appreciate some context in terms interaction with the regulators, some of the shipper response to these items, and how you might plan to utilize them in the future.

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

I'll ask Alan to talk about the specifics of our demurrage changes. But let me say that we are in regular dialogue with our regulators, including the STB. As you know, Chairwoman Begeman sent a letter to all of the Class 1s about changes in demurrage programs to which we responded. And we will continue to keep up that dialogue, that open relationship with our regulators. Alan, some more specifics on our changes in accessorials.

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

Brian, our accessorial program is designed to align our interest and our customer's interest with our mutual benefit. And really it complements the efforts of our operating department to improve our service and efficiency, and we're delivering that. As Mike has said, and you can see in the public metrics, our train speed is improving, our dwell is declining and customers are seeing improvements in our service. That's ultimately what they're looking for.

Operator

Our next question comes from the line of Bascome Majors from Susquehanna.

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

As we look into the first part of next year, and I realize the need of the guidance is going to come in a couple of weeks here. But other than the gain and maybe some elevated incentive comp expenses, is there anything abnormal about the fourth quarter results when we think about what they mean on a run rate or seasonal basis going forward?

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

Cindy went through the particulars in the expense lines and flagged the things that stood out in the fourth quarter. Cindy, other things that...

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

No, I will just say that, you noticed in my comments I did talk about, we still had some additional cost associated with recrews and overtime and some equipment rent associated with this slower -- somewhat slower network velocity. So there were some of those but nothing else.

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

Okay. And with the headquarters move from an economic perspective, should we expect anything lumpy over the next couple of years, be it in labor with packages for people who don't decide to relocate? Or rent additions for new facilities? Or capital costs? Just anything financially from the headquarters move that could move the needle on an enterprise basis.

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

We'll begin relocating employees in 2019, in the middle of the year, and we'll relocate the majority of the employees in 2021. Tallying up all the costs associated with those moves, we would not expect them to be material over that period of time. So the purpose of the headquarters relocation, I might add, is closer alignment, and so we're very excited about that. We think that having all of our folks in one headquarters building will be a very good thing.

Operator

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

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

Cindy, you noted the incentive comp boosted salaries and benefits. Do you include the gains in that to get to your -- or to your OR target? Are the gains included to get to that incentive comp? And then were there any other real estate gains throughout this year? Or only in the fourth quarter?

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

In terms of the gain on the sales of operating property, as you know, Ken, it adds up to operating income and operating ratio. Those are 2 key components of our incentive comp, so it did add to incentive comp. We obviously have had property sales this year throughout the year, not to the extent of the fourth quarter, and we've had them in, obviously, in previous years as well. So it does add, it does add to the incentive comp.

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

Ken, as Cindy mentioned, incentive compensation for the full year 2018 was roughly comparable to 2017.

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

No, I just asked because if I look at the largest full year gains for CP was $95 million, CSX was $140 million. So your one quarter was here bigger than full year that both those companies included. So is there any -- you mentioned there were others earlier in the year, but I don't think they got called out. Can you give us the total for what they were for the quarters?

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

Yes. So Ken, in total, they were probably $10 million to $15 million for the 3 quarters.

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

Okay, all right. And then, I guess, Mike, if we can -- just on the -- your KPIs that you talked about. Jim noted you're taking out locomotives, and I presume that's accelerating as your performance improves or you plan to improve that. But your gross ton miles per locomotive chart that you had there was flat year-over-year. Just wondering, as you step back and think about that given the Clean Sheeting, should -- is that something we should have seen improvement? That we should going forward see more improvement? I guess, is that something you focus on with, I don't know, whether it's train length growing or improved sidings? How you think about that metric?

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

Yes, it is absolutely one of our KPIs now and going forward. But if you look at the fourth quarter, you'll see that in December, it really changed, it was a big step function up in the quarter. So we took the locomotives out near the end of the quarter. We've continued to take locomotives out even into this year. So absolutely. Train length, train weight are all part of the operating plan changes we're putting in place. And again, we're not waiting when we see opportunities, we're taking advantage of it. But the more holistic operating plan will be the next quarter or 2.

Operator

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

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

So couple of things for you, Cindy. Can you give us any guidance on other income going forward? Can you give us some thoughts on how much of an increase we should expect in accessorial revenue? And, I guess, since you don't report other revenue, will that be just put in revenue per car? So two questions. And then, I guess, maybe just a comment, Cindy, like in the future, if we ever have some, like, really big gains just in the 8-K, like, let us know about it in advance would be helpful.

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

Scott, in terms of other net. I think from a run rate perspective, we would say that probably about $80 million annually is a good run rate for that. In terms of the accessorial, you're right, I don't know that we're expecting there would be big changes in that, and it just becomes part of the normal revenue car. So that answer your question?

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

Yes, I guess, why wouldn't there be big changes? Like, we saw a pretty meaningful increase in that other revenue for CSX, this year has made many changes. Are your changes different than what they did?

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

Alan wants to, I think.

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

Scott, our changes are designed to improve our efficiency and our network velocity. So we're not counting on additional revenue with these. What we're doing is we're collaborating with our customers on our service changes. They're being brought in on the front end of this because we want to make this smooth for them and smooth for us. They can help us, we can help them and we can both grow together. That's the overall intent.

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

And are you seeing compliance with it right away?

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

Yes. You can see improvements, as Mike talked about, we were storing locomotives at the end of December while volumes were accelerating. And our train speed was improving.

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

Yes, the customers are really engaged in this. And they want to -- as Alan noted, they want to see us and this process succeed.

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

Yes, and we've gotten off, Scott, to a very strong start to January in terms of both volume and service product. Now the storms in the Northeast have had an impact on our volumes and our velocity so far this week. But we're very confident in the product that we're delivering and the demand out there for our product.

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

Okay. And then I know we're going to get long-term sort of labor productivity headcount guidance. But in the interim, can you just give us some guidance on 1Q for headcount?

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

I think if you can hold out for just a couple of more weeks, Scott, we'll give you as much forward-looking guidance as possible. I know that's obviously going to be a big focus of Investor Day to give you the longer term and shorter term -- in some cases, shorter term financial goals and the resource components thereof.

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

Okay, that makes sense. I know I'm going over but just to help us getting ready for next month. Should we be thinking 5-year targets? 3-year targets? I just want to get prepared.

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

We'll get into the plan period, duration of the new plan period in February along with everything else.

Operator

Our next question comes from the line of David Vernon from Bernstein.

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

Alan, when you look at the intermodal per unit for the revenue per unit for intermodal, up 7% with fuel, up 4% without fuel coming off from sort of mid-teens increase in truck rates. Should we be expecting that number to creep up a little bit as a lag effect kind of comes into the business? Or is that a good kind of 15%, gets you 7% kind of ratio to be thinking about for the pricing leverage you guys can take out of the truck rate inflation that's happening in the market?

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

David we've -- as I said, our pricing improved throughout the year. We feel very good about where we're headed as we move into 2019. Bid season has started for us pretty well, and the feedback that we're getting from our channel partners is there's continued strength in intermodal pricing. We're seeing strength everywhere. As you know, our RPU was up 7% in every single one of our business units. You'd have to go back 7 years to find that. So we're very confident in our pricing strategy and our approach. It will continue into 2019.

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

Is it reasonable to think that it could approach those sort of levels that you saw in truck? Or is that going to be -- is that just kind of asking too much from intermodal?

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

We're going to push it as hard as we can. And you saw that this year, we got -- we delivered 18% revenue growth in our intermodal franchise in 2018 on top of 11% growth in 2017 while improving margins. We understand exactly what we need to do.

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

All right, that's helpful. And then, Cindy, just to clarify a comment you made before. I think you said other net should be about 80%. Is that inclusive of the reclassification of some of the rental income of the above the line? Or because -- I'm just trying to reconcile the 0 in 4Q this year to expecting like an 80% for the full year of '19 on that other net line.

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

Yes, the 80% is -- we would expect for an annual run rate. I mentioned in my comments in the fourth quarter, we had about $25 million decrease year-over-year in returns on our company in life insurance. So that's what you're seeing in the fourth quarter. That was pretty unusual, it was tied very much to just the market performance in the fourth quarter.

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

Okay. And then just in that other -- in the offset to the other line that moved above the line, I'm assuming the coal royalties will be included in that. And can you give us any sense for how much of an increase you might have gotten in the fourth quarter this year on that number?

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

Yes, it's not significant.

Operator

Ladies and gentlemen, we have no further questions in queue at this time. I'd like to turn the call back over to Jim Squires for closing comments.

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

Thank you. We are proud of what we have accomplished and are excited about our prospects for future success. In a few weeks, we will discuss the strategic initiatives we have underway, which will further strengthen our company and deliver even more value to our shareholders. And we look forward to discussing them with you at our Investor Day on February 11. Thank you.

Operator

Thank you, ladies and gentlemen, this does conclude our teleconference for today. You may now disconnect your line at this time. Thank you for your participation, and have a wonderful day.
