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NSC - Q3 2019 Norfolk Southern Corp Earnings Call

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OVERVIEW:

Co. reported 3Q19 net income of $657m and EPS of $2.49.

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PRESENTATION

Operator

Greetings, and welcome to the Norfolk Southern Corporation Third Quarter 2019 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded. It is now my pleasure to introduce your host, Pete Sharbel, Director of Investor Relations. Thank you Mr. Sharbel, you may begin.

Peter Sharbel - *Norfolk Southern Corporation - Director of IR*

Thank you, Melissa, 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 norfolksourthern.com in the Investors section, along with our non-GAAP reconciliation. Additionally, a transcript and download will be posted after the call.

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

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

Good morning, everyone, and welcome to Norfolk Southern's third quarter 2019 earnings call. Joining me today are Alan Shaw, Chief Marketing Officer; Mike Wheeler, Chief Operating Officer; and Cindy Earhart, Chief Financial Officer.

Turning to our financial results for the third quarter, income from operations was approximately $1 billion, net income was $657 million, EPS was $249 million and the operating ratio improved to 64.9%. These results include the unfavorable impact of a $32 million write-off of a receivable resulting from a legal dispute, which effected the OR by 110 basis points and EPS by $0.09. As highlighted on Slide 4, these were record results, including a record third quarter and year-to-date OR.

Earlier this year, we outlined a dynamic flexible new operating plan, TOP21, capable of creating value in all market conditions. In the months since, particularly in the second half of this year, volumes across the transportation sector, including our volumes, turned sharply lower. In response, leveraging TOP21, our team doubled down on productivity and achieved major resource reductions. For example, in the third quarter, we reduced crew starts and recrews by 11% year-over-year. That was nearly double the rate of the volume decline, driving a 9% decrease in employment levels.

Following the first phase of TOP21, we swiftly moved to Phase II, which includes refunding of our yard and local plans, deployment of additional distributed power on load trains and blending of intermodal and unit trains, each with existing trains wherever feasible. These efforts are producing further reductions in crew starts, [searching] and load train models. And we've begun Clean Sheeting our intermodal terminals and preparing for the third phase of TOP21, using the formula we used to successfully overhaul the carload network while sustaining a high level of network performance and service.

Earlier in the year, I spoke about the momentum building across our organization and our commitment to enhancing operational and financial outcomes. This commitment is evidenced by significant expense reductions so far this year, which Cindy will describe in more detail later in the call.

With revenue trending below our expectation in the second half and some unusual costs expected in the fourth quarter, we continue to expect operating ratio improvement for the full year, but that improvement now seems likely to be less than our earlier forecast of at least 100 basis points. Nevertheless, we remain confident that we can achieve our goal of a 60 OR by 2021 through additional cost structural changes and future revenue growth. For example, we are pursuing savings opportunities in fuel, mechanicals and other aspects of operations about which Mike will speak shortly. And we continue to drive bottom line improvement with pricing increases commensurate with the value of our service, with the results evident in the third quarter and year-to-date in revenue per unit and revenue per revenue ton mile trends. Alan will speak further about those trends in a minute.

All of us at Norfolk Southern are committed to transforming our company to drive shareholder value creation. As I have said before, we are invoicing new ideas and positioning leaders throughout the organization who are champions for change. We are all working hard to operate as safely and efficiently as possible and deliver what we promise to our customers and shareholders. The results so far this year: improved service levels for our customers, a lower operating ratio and bottom line growth and the return of the yearly $2.3 billion to shareholders.

With that, I'll now turn the call over to Alan.

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

Thank you, Jim, and good morning, everyone. In the third quarter, we continued our focus on pricing to the value of our service product and delivering productivity gains, generating a record third quarter operating ratio despite difficult economic conditions. Trade uncertainty continues to influence the economic environment, which, coupled with lower spot truck and commodity pricing, negatively impacted volume during the quarter.

As we cycle through the headwind associated with the market, we have and will maintain our focus on margin improvements, driven by price, service and productivity while collaborating with our customers to provide a platform for growth.

As shown on Slide 6, a 6% decline in volume led to a 4% revenue decline in the quarter. Increased revenue per unit, which has improved year-over-year for 11 consecutive quarters partially offset the volume decrease. The consistent delivery of RPU growth highlights the effectiveness of our pricing strategy.

Third quarter revenue in our merchandise segment was flat year-over-year as continued strength in pricing offset volume declines. Volume declined 4% resulting from reduced fuel and natural gas shipments, while favorable fuel price differentials drove gains in crude oil to East Coast refineries. During the quarter, we experienced growth in automotive and aggregates as a result of increased production at NS-served auto plants and improved service respectively.

Intermodal revenue declined 5% due to reduced volume in our domestic franchise. Strong relationships with steamship lines and share shift to East Coast ports produced international volume growth year-over-year. Domestic intermodal declined due to lower spot truck pricing and a weakened manufacturing environment. Intermodal RPU was flat in the quarter as pricing increases were offset by the negative mix impact of increased international volume and lower fuel surcharge revenue.

Turning to coal, revenue was down 13% in the third quarter. Our utility portfolio was impacted by additional natural gas capacity and prices that suppress coal burn. Export thermal and metallurgical prices remain at low levels making it difficult for U.S. coals to compete globally. Improved pricing drove a revenue per unit increase of 2%.

Moving to Slide 7. We expect the same factors affecting third quarter volume to persist in the fourth quarter. Macroeconomic conditions, tariff uncertainty and global weakness continued to negatively influence business investment, manufacturing and exports. Lower commodity pricing will impact many of our markets, including coal and steel. Truck loadings are expected to be flat for the rest of 2019, with excess capacity keeping spot truck rates low. While we expect a challenging economic environment for the remainder of the year, we remain focused on our strategic plan to drive margin improvement. We're collaborating with our customers daily to fine tune our service product and identify long-term growth opportunities. Our strategic plan is producing pricing and efficiency gains, and we are fully committed to the execution of the plan while meeting our customers' expectations and establishing a platform for future profitable growth.

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

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

Thank you, Alan. Today, I will update you on the state of our operations and the efficiencies we are creating with our TOP21 plan.

In the third quarter, we delivered strong service for our customers, made further progress on the next generation of TOP21 and began implementing initiatives in TOP21 Phase II on a rolling basis. Our operational momentum is driving significant cost saving, and we are flexing our dynamic plan in accordance with market conditions. We continue realizing efficiencies while providing a superior service product to our customers.

Moving to Slide 9. We have continued our laser focus on the execution of our plan and principles for precision scheduled railroading. We substantially improved train speed and terminal dwell compared to the last year and delivered record quarterly performance. These achievements support our strategy to meet our customers' expectations while eliminating cost and prudently managing our assets. The operation continues to be resilient as evidenced by our ability to work through 2 recent major incidents in the fourth quarter, a bridge outage and a large derailment, with minimal disruption to our customer supply chains. This shows the strong resiliency of our operating model. These overall results are due to relentless execution by our operations team and other employees supporting them. We want to thank our field employees for their unwavering focus on safety, service and efficiency.

Turning to our service and productivity metrics on Slide 10. These metrics align with our strategic plan as they measure key productivity and customer service levels. We have been aggressively reducing our resources to meet our productivity goals [account] GTM's dropping by 9% in the quarter. Consistent with prior quarters, the blue bars represent our goals for 2019.

Starting with the service delivery index, which is the on-time delivery performance of our scheduled shipments indexed to 2018. This is a customer-facing metric that combines intermodal availability and shipment consistency, which measures trip plan adherence for general merchandise as well as automotive traffic. Strong service performance continued in the third quarter, and we expect to drive further improvement. We are trending ahead of where we thought we would be with our T&E productivity goal for 2019, and we anticipate this trend will continue for the remainder of the year.

We are at our lowest T&E headcount on record, having reduced by 13% versus third quarter 2018 while still providing exceptional service. We are already realizing the benefits of our TOP21 plan. The results are driving the comp and benefit improvements, to which Cindy will speak.

As mentioned during the last call, we are continuing to work on improving our train weight. The majority of our goal was back-end loaded as the first phase of the TOP21 operating plan was successfully implemented on July 1. We are seeing improvements in our general merchandise train weights, which were offset by headwinds associated with intermodal and coal volumes.

Locomotive productivity continues to be an important metric for NS. We are tracking to meet our goal for this year. We have been rationalizing our locomotive [fleet], which is 22% lower than the same period last year. We are also having an aggressive initiative to rationalize resources associated with the maintenance of these locomotives, including a reduction of 525 positions already this year. We will continue to focus on the remaining resources required to maintain this lower fleet size. And the cars online, which is down 20% versus our 2018 baseline, continues to trend very positively thanks to our fast and consistent service product. This includes cars in storage, which can be deployed as market conditions [warrant].

Turning to our progress on our TOP21 operating plan on Slide 11. As you may recall, our operating plan has 4 major objectives: operate as one network, execute a balanced train plan between terminals, serve our customers frequently and reduce dependence on major terminals. The first phase of TOP21 primarily focused on our general merchandise, COLT, an automotive business and was successfully implemented on July 1.

We have been aggressively implementing the next phase, which has an added emphasis on distributed power to drive further train consolidations. We have increased the number of DP trains per day by more than 2.5x with the expansion of this initiative since our TOP21 rollout. We will continue to add DP trains across the network, which will have the benefit of improving train weight and fuel efficiency. Regarding fuel efficiency, we have several other initiatives for improvement, specifically, one, ensuring a healthy energy management lead locomotive; two, compliance with horsepower per ton procedures; and three, compliance with usage of energy management technology.

We are also syncing up our local schedule and the new train plan. We are implementing these changes on a rolling basis and driving significant structural improvements. Specifically, total security for our general merchandise and auto traffic is down 27% versus pre-TOP21, and road train miles are down 13%. Additionally, we had been working to calibrate our local brand to maximize efficiency while continuing to provide good service to our customers. Together, these changes have helped to continue to drive down crew starts while keeping velocity and customer service high. We have also begun the process of Clean Sheeting our intermodal terminals and preparing for the third phase of TOP21, which remodels all traffic for additional opportunities. This will drive further cost and resource reductions and improve our fuel efficiency.

I will now turn it over to Cindy who will cover our financials.

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

Thank you, Mike. Good morning, everyone. I'll begin with our operating results on Slide 13. The continued execution of our strategic plan is delivering tangible results that are flowing through to the bottom line. The structural changes we are making, including the implementation of our PSR-based operating plan, generated expense savings in compensation and benefits and equipment rents. These savings as well as lower fuel prices more than offset the decline in revenues. However, in the third quarter, we wrote off a $32 million receivable as a result of a legal dispute, which added 110 basis points to the operating ratio and lowered earnings per share by $0.09. Income from railway operations for the quarter was nearly $1 billion, and we reduced our third quarter operating ratio by 50 basis points, achieving a third quarter record of 64.9%.

Moving to Slide 14. We are delivering cost savings as evidenced in the $82 million decline in operating expenses. Our new operating plan has resulted in fewer trains on the network and reduced crew starts. Compensation and benefits expense declined as a result of the $47 million in savings due to lower employee levels and reduced overtime and recrews. We drove average headcount down by approximately 1,000 employees from last quarter and have reduced headcount by 2,400 compared to last year. We also remain intensely focused on improving asset utilization. By increasing the velocity of our network and improving fluidity, we have significantly reduced the need for locomotives and freight cars, resulting in equipment rental savings of $35 million.

We also achieved savings of $10 million in material expense due to fewer locomotives in service and freight cars online. Partially offsetting the efficiency gains that we delivered in the quarter was the $32 million write-off that I previously mentioned. We also experienced $17 million of additional expense due to increased pay rates. Finally, lower fuel price and a decrease in consumption drove the $48 million decline in fuel expense. Fuel efficiency continues to be an area of focus, and we know there are opportunities to generate savings through improved efficiency.

Slide 15 summarizes our third quarter results. Income from railway operations was slightly under last year's record and nonoperating items added an additional $16 million in expense. Third quarter net income was $657 million and diluted earnings per share was $2.49.

Recapping our year-to-date cash flows on Slide 16. Cash from operating activities was $3 billion and free cash flow for the first 9 months was $1.5 billion. We continued to return capital to shareholders as evidenced by the 9% increase in the quarterly dividend we announced in July. Dividends and share repurchases totaled almost $2.3 billion for the first 9 months.

As we head towards the conclusion of the year, I want to highlight a few specific items that will impact the fourth quarter. First, starting with headcount. We expect a continuation of position reductions in the fourth quarter. By year-end, we expect headcount to approximate 23,300, which is a reduction of over 3,200 positions compared to the same time last year.

Also, we expect incentive compensation to be favorable over prior year, but the magnitude will depend upon our full year results. However, as Mike mentioned earlier, there have been some specific incidents in the fourth quarter that will result in incremental expenses. We expect additional cost associated with detouring trains due to a bridge outage and lading damage resulting from a large derailment will approximate $25 million in additional expenses. Additionally, we expect that gains associated with the sales of operating property will be lower than last year. You'll recall that fourth quarter of 2018 included $145 million in gains of a sale of operating property, whereas we expect the current quarter to about -- be about 1/3 of that.

The execution of our strategic plan is delivering results and even in the face of obstacles unforeseen at the outset of this year, we are confident we will improve our full year operating ratio in 2019 and achieve our goal of 60% by 2021. We are seeing the benefits associated with our new operating plan and are actively identifying and implementing further measures that will produce improved financial results and drive shareholder value.

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

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

Thank you, Cindy. As we've outlined and as our third quarter results demonstrate, we continue to build momentum by executing planned initiatives and pushing well beyond many of the goals we set out earlier this year. We're hard at work, preparing for the third phase of TOP21, rightsizing our local and yard operations, further consolidating road trains and going after cost savings in fuel and mechanical operations.

While pursuing all of these efforts, the Norfolk Southern team continues to provide superior service to our customers, enabling us to price to our value in the marketplace while ensuring we are positioned at the leading edge of growth when it returns. These actions give us confidence we'll reach a 60% operating ratio by 2021.

Before we open the call for Q&A, I do want to recognize Cindy for her 34 years of service to Norfolk Southern and her support through her final day here at the company on November 1. I have valued the role she has played in pioneering new technologies at our company, developing our strategic plan and delivering shareholder returns. On behalf of the entire Board and management team, I thank Cindy for her many contributions and wish her well in retirement.

We'll now open the line for Q&A. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Justin Long with Stephens.

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

And congrats Cindy on the retirement. Maybe to start with the OR guidance for 2019, I just wanted to clarify something. Are you excluding the impact of the $32 million write-off in 3Q in that guidance?

And then Cindy, you mentioned the $25 million of unusual costs in the fourth quarter. So I'm just curious that if you exclude that $32 million write-off and the $25 million of unusual items in the fourth quarter, if that OR guidance of at least 100 basis points that you previously put out there would have been achievable?

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

Justin, it's Jim. Let me see if I can clarify for you what we have said this morning. Our guidance is that we expect to achieve a full year operating ratio improvement year-over-year. Even with the additional expenses and the trend in revenue and even with the receivables write-off that we discussed earlier. So -- but also including those things, we do not expect to be able to hit our goal of at least 100 basis points improvement in the operating ratio.

Now with that said, that does not diminish our confidence in any way that we can get to a 60% operating ratio by 2021. And to back that up, I just want to take a minute to recap what we have achieved to date because those achievements are the foundation of further improvements that we will make to get to the 60% operating ratio. And I'll just touch again on our operating plan because that, in many ways, is the bedrock of the improvements we have made and will continue to make. All right. Phase I, as of July 1, we cut over. It's seamless. We see an immediate reduction in train starts and active trains on the network as we have shown you previously. We see a sharp decline in crew starts as we showed you today. There is no disruption to service as a result of the cutover.

In Phase II, we pursue additional train consolidations. We blend more intermodal, bulk and carload traffic. We accelerate distributed power. By now, we have more than doubled the number of DP trains per day operating on the network. We pursue further rationalization of equipment. We work to sync up the local operating plan with the new network plan, and that results in additional crew start reductions. As you can see on Mike's Slide 11, crew start reductions actually accelerate coming out of the initial cutover as we move through Phase II. And then we pursue intermodal Clean Sheeting, the analog, if you will, to the Clean Sheeting we did in the merchandise network, and we are hard at work on fuel efficiency initiatives where we know we have some ground to make up. So these are the things that are operative today.

In Phase III of TOP21, we will remodel all traffic to unlock additional efficiencies. Now what have been the results in terms of resources of these various phases of TOP21? So we'll start with T&E productivity. As Mike mentioned, T&E down 13% versus third quarter 2018, giving us the lowest T&E headcount on record for our company. In terms of locomotive productivity, we have reduced the number of locomotives out there by 22% versus last year. And that reduction in locomotives operating on the network, along with the reduction in cars online, yielded an additional reduction of 525 mechanical positions already in this year, which together with the T&E reductions, which together with other employment reductions we have made, gave us 9% lower overall headcount in the third quarter, with more to come in the fourth quarter. Cars online, down 20% versus the 2018 benchmark, yielding significant equipment rent savings along with the locomotive reductions. Cindy went through the different expense categories, the compensation and benefit savings, the material savings, the equipment rent savings that were the results of these resource reductions.

In TOP21 Phase III, there will be more o the same. We will see through additional train consolidations, additional reductions in crew starts, and we would expect to see T&E reductions follow. We'll have continued rationalization of the locomotive fleet, we will see lower maintenance spending and so on and so forth. And lastly, we will stay very focused on our pricing plan, our yield up strategy, which showed excellent results in the third quarter and for the full year to-date. We are determined to price to the value of our service in the marketplace.

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

Thanks, Jim. That's a great and comprehensive answer. I think secondly, I just wanted to ask a bigger picture question. Obviously, we're dealing with a more challenging demand backdrop right now. As we think about that guidance to get to a 60% OR in 2021, do you think that's still achievable if the demand environment stays around current levels and the coal environment stays around current levels? Or do we need to see a positive inflection in demand in order to hit that 60% OR?

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

We are determined to achieve the 60% OR goal by 2021 in any foreseeable revenue environment, including the one that we are in now. But, yes, ours is a balanced plan, and we have said that all along. We are pursuing growth. We believe we will see the fruits of our efforts in the form of a resumption of growth during the remaining years of our current strategic plan. But if we don't, we will push even harder on efficiency measures, on the productivity measures to get to the 60% OR.

Operator

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

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

So now that you're in Phase II of TOP21 and as you move into Phase III, should we start to expect a meaningful acceleration in the year-over-year OR improvement? I guess just as you're talking about all the trains you're eliminating and the increasing train weights and adding the DPU, why wouldn't you be able to move below a 60% OR more quickly as we've seen with many of your peers?

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

If we can get to a 60% OR sooner, Allison, we will continue to push. We are determined to do all we can to generate shareholder value through growth and through a lower operating ratio. 60% is our goal by 2021. If we can do better than that, we certainly will.

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

Okay. And then I was hoping maybe you could offer some thoughts on the recent addition to the Board by Claude Mongeau. What role would you expect him to play? And how is that materializing so far?

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

Claude, as you know, brings a great deal of experience in our industry having served as CEO of Canadian National. He brings in-depth knowledge of railroad operations, of railroad finances. He served as CN's CFO for a number of years. And so he is a most welcomed addition to our Board. We are looking forward to having him advise and counsel us as we pursue all of the initiatives that we intend to pursue for the next few years and beyond.

Operator

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

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

So Alan, maybe one for you on coal. I was a little surprised to see that RPU was up sequentially ex fuel. So maybe you can give some color behind that. And where do you think this goes in 4Q '19 and 2020? Obviously, the export markets are telling us things are going to get worse before they get better again, so just wanted to see if there's any other offsets that you might have from a pricing or yield perspective considering it was a bit stronger this quarter than we expected?

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

Yes. Absolutely, Brian. As I've noted in my prepared remarks, we continue to deliver strong pricing across all of our business units. Coal is no exception. Coal will be pressured in the fourth quarter with the reduction in the seaborne coking coal price. So you should see a sequential decline in export coal pricing as we move into the fourth quarter, and that's going to be running up against some difficult comps because of the same -- this time last year, we were seeing a sequential improvement at export coal pricing. So that will be a headwind for us. Throughout all of this, we are continuing to focus on pricing to the value of our product, and we are delivering a very good product to our customers.

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

Okay. Then one on fuel and train weights for you, Mike. We've seen some pretty good progress on fuel, in particularly from the rest of the class ones. But looking at Norfolk, it looks like fuel efficiency in the gallons per thousand GTM is actually getting a bit worse sequentially and year-over-year. So clearly, we're seeing train weights aren't moving up as fast as you'd think throughout the course of the plan. But what can you offer on -- I know you've got some initiatives there, but it seems to be a pretty big factor for efficiency gains that others have realized but you haven't been able to hit that sort of stride.

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

Yes so on the fuel efficiency side, we are seeing an increase in the general merchandise train weights. So that was part of the TOP21 plan. We're getting those benefits, but they're offset by the headwinds of the lower train weights on the intermodal and bolt trains. And we're making -- we're taking actions to address that. You'll see more of that in Phase II as we go forward and then some of that in Phase III as well. But we also have a very aggressive initiative on utilizing the energy management technology that we've been rolling out. And so this an all hands on deck thing, and we've got folks down in our new consolidated network operations center really staying on top of this, so -- making sure we got the right locomotive on the head-end that's got the working energy management and then making sure that we're using the right horsepower per tonnage for our trains, being very aggressive with that, and then making sure that we're compliant with the energy management technology. So big initiative, and we expect that to be paying off as we go forward.

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

Brian, I'd like to weigh in -- in on this as well. We benchmark our peers' performance all the time and do so extensively, and we're aware of the ground that we have to make up in fuel efficiency. We have -- because we have not made progress despite best efforts in the last couple of quarters in terms of [fuel]. That's going to change. We are focused on all of the things that Mike has outlined. Running longer and heavier trains is certainly a part of it, onboard energy management, real-time fuel monitoring, horsepower per trailing ton, compliance and so forth. A host of initiatives in place, which we believe will bear fruit, which we believe will bear fruit and I am holding our operations team strictly accountable to that goal.

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 I want to go to Justin's first question because I'm not sure if I understood the answer. So you guys said there's $32 million of legal cost in the third, and you talked about $25 million of bridge cost in the fourth. So that's 50 basis points to OR. If we were to exclude those, would you have been hitting the OR targets or not? I get -- we're are all trying to understand is this a small margin miss that's arguably understandable? Or is this a bigger margin miss?

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

Cindy, why don't you give it a try?

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

Okay. So Scott, as Jim said previously, the $32 million and the additional cost of $25 million, which were not only bridge costs but also lading cost associated with derailment, our guidance to a miss on the 100 basis point OR improvement, we don't exclude either one of those, and we're going to continue to push this as hard as we can to improve the OR. But those have not been excluded in that guidance today.

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

No. No, I understand...

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

You're (inaudible).

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

I understand they're not excluded. I'm just saying as we do the -- as we play with our models, if we were to exclude them, would you be hitting that OR target or not? I think that's what we're all trying to understand.

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

I think that I would say that we will miss our target. The extent of it is probably not material. It's not a big miss, but it will be a miss.

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

Again, that does not diminish our confidence in any way that we will get to a 60% operating ratio by 2021.

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

Okay. And then, Jim, so, I think -- I mean all the rails are dealing with the same volume issues. I looked so far -- I think every rail has had better margin improvement than you so far in the third quarter, even though you're at a lower starting point. So do you feel like you're going fast enough? Do you feel like you've got the right people to get us here? So -- and then another difference is sort of on the capital front. Is there -- with volume's weaker, are there opportunities to sort of change the capital spend?

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

We are controlling the things that we can control and doing so aggressively. So we've been through all of the expense saving initiatives, which [fall] through in the third quarter and for the year-to-date. And we will continue to push on all of those things as hard as we must to get to that 60% operating ratio by 2021. We've got a great team in place and everybody is aligned around our bottom line shareholder value goals.

Let's see. The second part of your question, Scott, I'm sorry, was? The capital. Yes.

So we have previously talked about a range of 16% to 18% of revenue for capital spending. What really matters here, obviously, is shareholder returns and return on capital. That's what we're managing to. That's why we are targeting that level of capital spend because we believe that it is the optimal range of capital spending relative to revenue, to generate the return on capital and the shareholder returns we're seeking to generate. It's a range, and in the lean times, we may take it down somewhat within that range. But again, it really gets back to return on capital and our goal of generating superior shareholder value.

Operator

Our next question comes from the line of Jordan Alliger with Goldman Sachs.

Jordan Robert Alliger - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Question. So I know you've reiterated the 60% operating ratio in 2021. I'm just sort of curious if volumes stay kind of soft for at least the first part of next year. I mean can you give some sort of sense for how much you think OR and PSR benefits can push things in 2020, even with the, let's say, first half continuing softness environment?

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

We've spent a good deal of time already this morning talking about the efficiency initiatives. Those that are well underway in Phase II of TOP21, those will come to fruition in 2020, so we will see the full year benefit of expense savings from all of those initiatives, which we're pushing so hard on in 2019. And then we get into Phase III of TOP21, which will result in additional cost structural savings in 2021. And those will be, again, the drivers of further expense savings on the road to a 60% operating ratio.

Jordan Robert Alliger - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Okay. And then just a quick follow-up on intermodal. Comps obviously get pretty easy by middle of next year. If we get some truck capacity tightening and maybe spot pricing turns the other way a little bit, would you expect or can you potentially anticipate some sort of inflection, especially given where your network is on rail intermodal volumes? I mean is that something that's conceivable as we move through next year. Again, assuming the economy is reasonably okay.

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

Alan?

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

Yes. Certainly. Jordan, we are aligned with the best channel partners in the business, and we're aligned with the steamship lines that are adding capacity to the East Coast as you see a shift from the West Coast to the East Coast. So we've got some strategic advantages to our intermodal franchise, which make it the best in the East, and so absolutely. As the economy turns and we deliver a very strong service product to our customers, we anticipate that intermodal is going to remain a growth engine for Norfolk Southern. Intermodal revenues, as you know, grew by 11% in 2017 and then followed that with an 18% growth last year. We've got a great franchise, great customers. It's going to continue to pay dividends for our shareholders.

Operator

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

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

Can you just clarify your current go-to-market strategy on price? Are you at a point where you guys can command the price you need to make the yield up targets without losing volume? Or do you think that's more of a 2020 or 2021 thing when there are more changes made [in the network]?

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

Alan?

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

Ravi, we are very confident in our ability to price to a vastly improved service product, and we're providing our customers with a platform for growth. Take a look at our merchandise network, in which the year-over-year rate of increase in price has improved for 9 consecutive quarters. And you also see it reflected in RPU trends and revenue per ton mile trends, so we are intently focused on price even in this weak economic backdrop because we've got a great franchise and a great service product.

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

Got it. Then as a follow-up. You guys recently appointed Sir Claude Mongeau to your Board. At this point in your PSR strategy, kind of what are you looking for from him and kind of what role is he likely to play?

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

As I mentioned earlier, Claude is an outstanding addition to our Board with his extensive experience in the industry, in-depth operations, knowledge and experience, same on the finance side, so he will be a welcome addition. He is a welcome addition to our Board, and will bring all of that and more as we proceed through our PSR journey for the next couple of years and beyond.

Operator

Our next question comes from the line of Fadi Chamoun with BMO Capital Markets.

Fadi Chamoun - *BMO Capital Markets Equity Research - MD & Analyst*

Maybe Alan, if the pricing in the intermodal business doesn't really improve, like truck pricing competition remains intense, can intermodal margin improve to the level needed to achieve a 60% OR over the next couple of years? And if you're looking on the operating side, are there steps, meaningful steps that can be taken in the intermodal network to improve the OR, if you can maybe outline those?

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

Alan?

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

You take a look at the cyclical nature of the trucking industry. We saw a weakness in the spot truck market in 2011 and 2015 and 2019. And through all of that, we continued to deliver year-over-year rate increases in intermodal every single quarter. So we are very confident in the strength, the unique strength of our intermodal franchise, our alignment with the best channel partners in the business, and we're going to cycle through this. As I -- as we noted before, we grew our revenue by 11% in 2017 and 18% in 2018. We've got a very strong franchise. The spot market will recover, and we're going to be positioned for growth because of the very strong service product that we're delivering.

Fadi Chamoun - *BMO Capital Markets Equity Research - MD & Analyst*

Okay. And maybe just follow-up on the operational side. You mentioned Clean Sheeting in intermodal. What does that exactly entail and if you can describe to us what is going on on the operating side that would kind of improve the margin performance of that business?

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 of Government Relations & COO*

So on the intermodal terminals, just like we did the Clean Sheeting of our merchandise terminals, we're looking at each terminal and making sure that we have the best practices across all the terminals in our intermodal network. We've got all the right processes and procedures. And then once we do that, we'll sync that up with the train plan for more efficiencies going forward and continue to deliver good service product at the same time. So it's kind of that deep dive into each one of the intermodal terminals using good industrial engineering practices to make them as efficient as possible and, more importantly, consistent best practices across all the intermodal terminals.

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

Mike, I'm very encouraged by this process because we and our customers saw the benefits in the merchandise network as we Clean Sheeted the merchandise network. You saw it reflected in a reduction in dwell. You saw it reflected in an increase in train speed, and you saw it reflected in an improvement in our SDI, our customer-facing service metrics. And so I'm confident that we're going to continue to deliver the same as we apply these same principles to our intermodal franchise.

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

Yes. Great point.

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 & Senior Research Analyst*

I wanted to talk a little bit about your T&E productivity. You've shown a slight improvement in 2019, and you put a check there saying you're sort of on track. But if we look out to your 2021 goal, that's a much larger step up. Could you walk us through how you guys plan on getting there?

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

Mike?

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

Yes. It's going to be the continuation of the things that we've done, where we continue to look at increasing the size of the trains, and that drives crew starts down; continuing the distributed power strategy. We're going to do more and more of that, and that will drive train consolidations. And then continue to look at our local and yard network and making sure we're as efficient as possible there. So you know, as we go through all this, we uncover more opportunities. And when we uncover those more opportunities, we get into that. We take the benefits of it, and then we go the next step. So this has been a very good process for us to continue down that path. And we will continue to do that. We've got more in the gas tank with all these phases that we're talking about. So yes, we're going to get there.

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

Okay. And I want to jump a little bit tack on to Scott's CapEx question going forward. Jim, I think you mentioned a range of 16% to 18%. Given what we've seen in the overall demand environment and the competitive truck market, should we look at 2020 as probably being towards the lower end of that range?

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

Jason, we'll give you some more guidance on CapEx, expected CapEx when we meet again in January. But let me say this. The majority of our capital budget, as you well know, the great majority is replenishment capital spending, including our DC to AC conversion program, which is meant to and will rejuvenate our locomotive fleet. So for us, that's a pretty significant line item in and of itself in the capital budget, under the category of sustaining capital spending. And then, of course, there is everything else that goes into sustaining the franchise, rail cost, ballast, so on and so forth.

The growth piece of it, we will protect. We will protect. It's relatively small compared to the sustaining CapEx, but it needs to be part of the plan because we do aspire to grow. And we believe we have growth prospects that will generate excellent shareholder returns down the road.

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 you about headcount. Obviously, you made some progress here and target further progress in the fourth quarter. I wanted to get a sense of maybe how you feel like the workforce is calibrated to the volume environment. Assuming some degree of stabilization, how much more is there to go as you kind of run through Phase II and Phase III of TOP21? Should we be thinking about -- how should we be thinking about sort of headcount as we move through the beginning or at least the first half of 2020?

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

Cindy, why don't you go back over what we are expecting in the fourth quarter, reflecting end-of-the-year versus or average headcount in the fourth quarter versus fourth quarter last year and then talk a little bit about where we go from there?.

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

Yes. Well, Chris, as I said, we expect the year end headcount to be at 20 -- around 23,300, which is about 3,200 less than the end of last year of 2018. So we've made obviously significant progress. I think our original estimate for headcount reduction this year were 500, so that has really been accelerating. And obviously, a big part of that structural, there's been [infections] associated with volume, and you could moderate that as volume goes up or down. But we certainly expect going into next year -- you've heard all the initiatives that Mike has talked about, both in terms of T&E as well as mechanical, that we expect headcount to continue to come down.

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

Yes. We also want to be sure we are prepared for when growth [returns]. So that's a balancing act, and we want to be sure that we operate as optimally as we can in a declining volume environment like we're in now. But we also want to be confident that we can handle the business when it comes back. We believe that we have the right formula for that, for just that and that it -- responding appropriately in the current volume environment, but we are also protecting our ability to handle the business when it returns down the road.

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

Okay. That's helpful. I appreciate it. And then if I could turn to purchase services. It was up sequentially, although volumes were down. I wanted to get a sense -- it's a big, obviously, line item on the cost side for you guys. When you think about sort of the plan as it continues to roll out over the next few phases, how big an opportunity is that, were there anything specific in the third quarter and just kind of how can you go from here?

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

Cindy?

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

Well, Chris, as we talked before about purchase services, well, I will say, if you look at purchase services and rents, we have seen big improvements as I mentioned before on the equipment rent side, a $35 million improvement year-over-year. And that's really been associated with just the improved velocity of the network as well as getting a lot of these cars off-line. So that has been favorable. We expect that to continue to be favorable going forward.

On purchase services and rents, there's just a lot of different things that are in that category. Some is volumes, dependent, although not as much as you would think. We have pointed out in the prior quarters that we've had additional spending on the IT side. We're going to continue to invest in IT, and we've seen that on capital spending as well as in this particular item. We think that, that's really prudent investment to be making because it's focused on things that are going to improve the productivity of the workforce, the reliability of our equipment and so forth. We did have -- we've had a little bit additional expenditure in purchase services and rents associated with freight cars as we've taken freight cars off-line and we've had to turn them back into leases. We've had some additional and pure cost associated with that. So there's some puts and takes there, but overall, I think you'll see purchase services continue similarly as we move forward sequentially.

Operator

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

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

Just a quick one. The first one, at least, will be quick. Was there any impact in the quarter from the strike at General Motors? I know auto volumes were actually up in the quarter and yield was kind of flat, but I didn't know if there was anything to call out there with respect to stranded or unabsorbed cost related to that or even in the fourth quarter?

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

Alan, why don't you take that?

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

Yes. The timing of that work stoppage will more impact our volumes in the fourth quarter.

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

Any stranded costs associated with that, that we should think about for the fourth quarter? Or not enough to call out?

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

No.

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

Okay. And then Jim, I wanted to just, if I could, just follow up, I think, on the -- one of the very first questions. And I think it's really the most important one with respect to your OR targets for 2021, at least, and [there's] obviously used in the context of you guys walking back this year's OR improvement. So when we look back in February or February 11 when you did the Investor Day in Atlanta, you guys were very explicit about your revenue targets, 5% compounded annual growth rate for the entire business, 10% revenue growth in intermodal. I was hoping that you could be as specific now 10 months later or so or a little bit less than that given what's happened in the revenue framework, how the revenue side of the business rolls up to your OR target. And I understand you're not going to use revenue as an excuse and there's a lot of productivity, but given how specific you were in February, we'd appreciate it, I think, if you can give us some sense of what that revenue roll up looks like now relative to the 5% and 10% growth you did in February to get to that 60% target -- 60% by 2021 target?

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

Yes. Yes, fair enough. Fair enough. I'm going to say this, first of all, about the strategic plan. As with any such plan, the assumptions they are in are good for about as long as it takes the ink to dry on the strategic plan. So conditions change. Business conditions change. The revenue picture, the volume picture has changed rather dramatically since we issued the 3 year plan in February. You adjust. We've always said that one of our hallmarks is flexibility and adjustability. That's what we did in 2016 when we saw a significant volume decline. And we've responded with additional productivity initiatives in order to hit our goals. That's what we will do again this time around.

Now we will review with you our revised macro assumptions in January when we report out on the fourth quarter results. And we give you our productivity goals, our Tier 1 metrics going forward for the next couple of years. We'll give you some high-level assumptions with regards to revenue, and it's part of our plan as well.

Operator

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

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

So Alan, I wanted to get your thoughts on the export coal framework for 2020. If you could just -- maybe if you could give us a sense about at current prices, you should expect tonnage to be down pretty meaningfully? Or if you look at seaborne prices, do you think it's more of a hit to your -- the revenue per ton that you're achieving? Just maybe some broader thoughts about that. And I don't know if you want to tie it to met coal levels and where you really have the sensitivity to a tonnage decline.

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

Tom, as I talk about, at current prices, it makes it very difficult for U.S. coals to compete in the market both on the -- with respect to thermal and metallurgical. We've talked before about some of the thermal contracts are effectively hedged but not -- the contracts between the producers and the receivers are effectively hedged through 2019. And so you'll see pressure in the thermal market as we roll into 2020, and the met market is going to follow demand overseas in the global economy and seaborne coking coal pricing. And I'll provide a lot more color on that on our fourth quarter earnings call as we start talking about 2020.

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

Is -- I guess if you look back just to kind of look at levels of export coal on Norfolk in the 2015, '16 area, you were kind of 15 million, 16 million tons. I think 2019, you're running at a rate of like, something like 24 million tons. So do you think this feels like '15, '16? Or would you say, hey, we haven't fallen to that level. It feels better than that. So just trying to get a sense of the right framework to consider given that there's obviously pressure on the export market.

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

Yes. There is pressure, and we've been pretty clear about that. Let's just talk about coal broadly. Right now, coal is about 12% of our volume, and export coal is about 25% of our coal volume. So there, you're talking about a little bit less than 3% of our overall volume. It's important to us. It's important to our franchise. But we've got a very diverse franchise as we've built out our intermodal network. So it's -- I'll provide more color and more historical context on the outlook for export coal on the fourth quarter call. The important thing to consider is that we've got a great merchandise network, a great intermodal franchise, and we are securing price reflecting the value of our product.

Operator

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

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

On the receivables write-off you took for the September jury ruling on the German coal (inaudible) price contract, is there any accruing revenue for liquidated damages in that this year? And is there any go-forward impact associated with that ruling?

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

Cindy?

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

Yes, Bascome. We've recognized what we think is the probable financial impact of that legal dispute.

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

Was that all backward looking? Or is there some ongoing impact included in that charge?

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

No. That was backward.

Operator

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

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

And I know OR has been hit a lot, but in an environment where you're supposed to be significantly cutting cost and walking away from the 100 basis point improvement and your peer is doing 400 better -- basis points better, excluding the real estate sales and you've got employees down 9%, cars and trains are down Jim, maybe talk about why is this not getting better? Or Michael, why are we not seeing a stairstep improvement at this point given the changes you've made? Is it just the coal margins are impacting so much, overwhelming the gains? Or is there something else that's constraining the ability to get that stairstep improvement?

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

Well, Ken, certainly, we're dealing with a different sort of revenue and volume context than we were in the first half. So that's been a major change. We have responded aggressively to that change with the resource reductions we've been through this morning. Positions, locomotives, freight cars, materials, all favorable in expenses. So you're seeing the momentum in expense reductions from our acceleration of the various initiatives with more to come. Now we still do expect to see operating ratio improvement for the full year. But because of the additional expenses that we've been through this morning in the fourth quarter, we don't expect to meet the -- at least 100 basis points goal. But that does not diminish our confidence. We can get to a 60% operating ratio by 2021.

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

And then I guess maybe, Alan, given that volumes have gotten worse now here sequentially and seemingly in an accelerating pace, I don't know if there was -- if this is related to the derailments that you've talked about, but you're now down 8% quarter-to-date, and I know it's only a couple of weeks in the fourth quarter, but you're down from 5% to 6%. Coal seems to be staying down mid-teens, but Alan, you mentioned things are still ugly, but are things getting worse at an accelerating pace just looking at intermodal and ag and some of the other commodities outside of kind of autos from the strike? It just seems like we're accelerating on the downside. Maybe your view on the economic side.

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

Ken, what we're not really seeing is much of a peak within the intermodal franchise. And so that is certainly having an impact on volumes in year-over-year comps.

Operator

Thank you. Ladies and gentlemen, this does conclude our question-and-answer session. I'll now turn the floor back to Mr. Squires for any closing comments.

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

I want to thank you all for your questions and for participating in today's call, and we look forward to speaking with you again in January. Thank you.

Operator

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