

NORFOLK SOUTHERN CORP  
Form 10-Q  
October 25, 2012  
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the quarterly period ended SEPTEMBER 30, 2012

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-8339

NORFOLK SOUTHERN CORPORATION

(Exact name of registrant as specified in its charter)

Virginia	52-1188014
(State or other jurisdiction of incorporation)	(IRS Employer Identification No.)
Three Commercial Place	23510-2191
Norfolk, Virginia	(Zip Code)

(Address of principal executive offices)  
(757) 629-2680

(Registrant's telephone number, including area code)  
No Change

(Former name, former address and former fiscal year, if changed since last report)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at September 30, 2012
Common Stock (\$1.00 par value per share)	316,043,185 (excluding 20,320,777 shares held by the registrant's consolidated subsidiaries)

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## PART 1. FINANCIAL INFORMATION

## Item 1. Financial Statements

Norfolk Southern Corporation and Subsidiaries

Consolidated Statements of Income

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
	(\$ in millions, except per share amounts)			
Railway operating revenues	\$ 2,693	\$ 2,889	\$ 8,356	\$ 8,375
Railway operating expenses:				
Compensation and benefits	724	736	2,234	2,240
Purchased services and rents	403	403	1,186	1,191
Fuel	379	385	1,182	1,186
Depreciation	230	217	683	641
Materials and other	226	210	661	704
Total railway operating expenses	1,962	1,951	5,946	5,962
Income from railway operations	731	938	2,410	2,413
Other income – net	33	60	93	121
Interest expense on debt	124	114	366	339
Income before income taxes	640	884	2,137	2,195
Provision for income taxes	238	330	801	759
Net income	\$ 402	\$ 554	\$ 1,336	\$ 1,436

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Per share amounts:							
Net income:							
Basic	\$ 1.26	\$ 1.61	\$ 4.12	\$ 4.09			
Diluted	1.24	1.59	4.07	4.03			
Dividends	0.50	0.43	1.44	1.23			

*See accompanying notes to consolidated financial statements.*

Norfolk Southern Corporation and Subsidiaries

Consolidated Statements of Comprehensive Income

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
	(\$ in millions)			
Net income	\$ 402	\$ 554	\$ 1,336	\$ 1,436
Other comprehensive income, before tax:				
Pension and other postretirement benefits	33	28	97	85
Other comprehensive loss of equity investees	-	-	(4)	-
Other comprehensive income, before tax	33	28	93	85
Income tax expense related to items of other comprehensive income	(13)	(11)	(38)	(33)
Other comprehensive income, net of tax	20	17	55	52
Total comprehensive income	\$ 422	\$ 571	\$ 1,391	\$ 1,488

See accompanying notes to consolidated financial statements.



## Norfolk Southern Corporation and Subsidiaries

## Consolidated Balance Sheets

(Unaudited)

	September 30,			December 31,			
	2012			2011			
	(\$ in millions)						
Assets							
Current assets:							
Cash and cash equivalents		\$	693			\$	276
Short-term investments			15				25
Accounts receivable – net			1,078				1,022
Materials and supplies			236				209
Deferred income taxes			144				143
Other current assets			33				76
Total current assets			2,199				1,751
Investments			2,315				2,234
Properties less accumulated depreciation of \$9,859 and \$9,464, respectively							
			25,260				24,469
Other assets			66				84
Total assets		\$	29,840			\$	28,538
Liabilities and stockholders' equity							
Current liabilities:							
Accounts payable		\$	1,260			\$	1,092
Short-term debt			-				100
Income and other taxes			150				207
Other current liabilities			362				252
Current maturities of long-term debt			52				50
Total current liabilities			1,824				1,701
Long-term debt			8,428				7,390
Other liabilities			2,018				2,050
Deferred income taxes			7,803				7,486
Total liabilities			20,073				18,627
Stockholders' equity:							

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Common stock \$1.00 per share par value, 1,350,000,000 shares							
authorized; outstanding 316,043,185 and 330,386,089 shares,							
respectively, net of treasury shares			317				332
Additional paid-in capital			1,909				1,912
Accumulated other comprehensive loss			(971)				(1,026)
Retained income			8,512				8,693
Total stockholders' equity			9,767				9,911
Total liabilities and stockholders' equity		\$	29,840			\$	28,538

See accompanying notes to consolidated financial statements.

## Norfolk Southern Corporation and Subsidiaries

## Consolidated Statements of Cash Flows

(Unaudited)

	Nine Months Ended			
	September 30,			
	2012		2011	
	(\$ in millions)			
Cash flows from operating activities:				
Net income	\$	1,336	\$	1,436
Reconciliation of net income to net cash provided by operating activities:				
Depreciation		688		646
Deferred income taxes		279		414
Gains and losses on properties and investments		(4)		(30)
Changes in assets and liabilities affecting operations:				
Accounts receivable		(56)		(222)
Materials and supplies		(27)		(43)
Other current assets		43		60
Current liabilities other than debt		183		402
Other – net		34		101
Net cash provided by operating activities		2,476		2,764
Cash flows from investing activities:				
Property additions		(1,522)		(1,433)
Property sales and other transactions		47		70
Investments, including short-term		(14)		(88)
Investment sales and other transactions		37		246

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Net cash used in investing activities		(1,452)			(1,205)
Cash flows from financing activities:					
Dividends		(467)			(432)
Common stock issued – net		77			95
Purchase and retirement of common stock		(1,150)			(1,611)
Proceeds from borrowings – net		1,291			396
Debt repayments		(358)			(592)
Net cash used in financing activities		(607)			(2,144)
Net increase (decrease) in cash and cash equivalents		417			(585)
Cash and cash equivalents:					
At beginning of year		276			827
At end of period	\$	693		\$	242
Supplemental disclosures of cash flow information:					
Cash paid during the period for:					
Interest (net of amounts capitalized)	\$	297		\$	296
Income taxes (net of refunds)		536			121

See accompanying notes to consolidated financial statements.

Norfolk Southern Corporation and Subsidiaries

Notes to Consolidated Financial Statements

(Unaudited)

In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly Norfolk Southern Corporation (Norfolk Southern) and subsidiaries' (collectively, NS) financial condition as of September 30, 2012, and December 31, 2011, and its results of operations and comprehensive income for the three and nine months ended September 30, 2012 and 2011, and its cash flows for the nine months ended September 30, 2012 and 2011, in conformity with U.S. generally accepted accounting principles.

These Consolidated Financial Statements should be read in conjunction with the consolidated financial statements and notes included in NS' latest Annual Report on Form 10-K.

1. Stock-Based Compensation

During the first quarter of 2012, a committee of non-employee directors of Norfolk Southern's Board of Directors granted stock options, restricted stock units (RSUs) and performance share units (PSUs) pursuant to the Long-Term Incentive Plan (LTIP) and granted stock options pursuant to the Thoroughbred Stock Option Plan (TSOP) as discussed below. Stock-based compensation was a benefit of less than \$1 million during the third quarter of 2012, compared with an expense of \$3 million during the same period of 2011. For the first nine months of 2012 and 2011, stock-based compensation expense was \$41 million and \$52 million, respectively. The total tax effects recognized in income in relation to stock-based compensation were a net expense of \$1 million and a net benefit of \$1 million for the quarters ended September 30, 2012 and 2011, respectively, and net benefits of \$13 million and \$17 million for the first nine months of 2012 and 2011, respectively.

Stock Options

In the first quarter of 2012, 567,300 options were granted under the LTIP and 210,300 options were granted under the TSOP. In each case, the grant price was \$75.14, which was the greater of the average fair market value of Norfolk Southern common stock (Common Stock) or the closing price of Common Stock on the effective date of the grant,

and the options have a term of ten years. The options granted under the LTIP and TSOP in 2012 may not be exercised prior to the fourth and third anniversaries of the date of grant, respectively. Holders of the 2012 options granted under the LTIP who remain actively employed receive cash dividend equivalent payments for four years in an amount equal to the regular quarterly dividends paid on Common Stock. Dividend equivalent payments are not made on TSOP options.

The fair value of each option award in 2012 was measured on the date of grant using a lattice-based option valuation model. Expected volatilities are based on implied volatilities from traded options on Common Stock and historical volatility of Common Stock. NS uses historical data to estimate option exercises and employee terminations within the valuation model. The average expected option life is derived from the output of the valuation model and represents the period of time that options granted are expected to be outstanding. The average risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. For options granted that include dividend equivalent payments, a dividend yield of zero was used. A dividend yield of 2.3% was used for LTIP options for periods where no dividend equivalent payments are made as well as for TSOP options, which do not receive dividend equivalents.

The assumptions for the 2012 LTIP and TSOP grants are shown in the following table:

Expected volatility range	27% - 29%
Average expected volatility	27%
LTIP average expected option life	8.9 years
TSOP average expected option life	8.8 years
Average risk-free interest rate	1.96%
LTIP per-share grant-date fair value	\$23.84
TSOP per-share grant-date fair value	\$19.55

During the third quarter of 2012, options relating to 703,231 shares were exercised, yielding \$19 million of cash proceeds and \$12 million of tax benefit recognized as additional paid-in capital. During the third quarter of 2011, options relating to 555,659 shares were exercised, yielding \$15 million of cash proceeds and \$11 million of tax benefit recognized as additional paid-in capital.

For the first nine months of 2012, options relating to 1,476,527 shares were exercised, yielding \$40 million of cash proceeds and \$24 million of tax benefit recognized as additional paid-in capital. For the first nine months of 2011, options relating to 2,204,705 shares were exercised, yielding \$60 million of cash proceeds and \$33 million of tax benefit recognized as additional paid-in capital.

#### Restricted Stock Units

There were 140,000 RSUs granted in 2012, with an average grant-date fair value of \$75.14 and a five-year restriction period. The RSUs granted in 2012 will be settled through the issuance of shares of Common Stock.

During the third quarters of 2012 and 2011, no RSUs were earned or paid out. There were 311,900 RSU's earned and paid out during the first nine months of 2012. There were no RSUs earned or paid out during the first nine months of 2011. The total related tax benefit recognized as additional paid-in capital was less than \$1 million for the third quarter of 2012 and \$3 million for the first nine months of 2012. The total related tax benefit recognized as additional paid-in capital was less than \$1 million for both the third quarter of 2011 and the first nine months of 2011.

Performance Share Units

PSUs provide for awards based on achievement of certain predetermined corporate performance goals (total shareholder return, return on average invested capital, and operating ratio) at the end of a three-year cycle and are paid in the form of shares of Common Stock. During the first quarter of 2012, there were 468,850 PSUs granted with a grant-date fair value of \$75.14.

During the first nine months of 2012, 782,889 PSUs were earned and paid out in shares of Common Stock. The total related tax benefit recognized as additional paid-in capital was \$11 million for the first nine months of 2012.

During the first nine months of 2011, 850,595 PSUs were earned and paid out, one-half in shares of Common Stock and one-half in cash. These PSUs had a grant-date fair value of \$50.47 per unit and a fair value at payout of \$62.75 per unit. The total related tax benefit recognized as additional paid-in capital was \$2 million for the first nine months of 2011.



## 2. Income Taxes

There have been no material changes to the balance of unrecognized tax benefits reported at December 31, 2011. NS anticipates that the Internal Revenue Service (IRS) will complete its examination of NS' 2009 and 2010 federal income tax returns by the end of 2012. NS does not expect that the resolution of the examination will have a material effect on its financial position, results of operations, or liquidity.

## 3. Earnings Per Share

	Basic		Diluted	
	Three Months Ended September 30,			
	2012	2011	2012	2011
	(\$ in millions, except per share amounts)			
Net income	\$ 402	\$ 554	\$ 402	\$ 554
Dividend equivalent payments	(3)	(2)	(1)	-
Income available to common stockholders	399	552	401	554
Weighted-average shares outstanding	317.7	343.2	317.7	343.2
Dilutive effect of outstanding options and share-settled awards			4.1	5.8
Adjusted weighted-average shares outstanding			321.8	349.0
Earnings per share	\$ 1.26	\$ 1.61	\$ 1.24	\$ 1.59

	Basic		Diluted	
	Nine Months Ended September 30,			
	2012	2011	2012	2011
	(\$ in millions, except per share amounts)			
Net income	\$ 1,336	\$ 1,436	\$ 1,336	\$ 1,436
Dividend equivalent payments	(7)	(6)	(3)	(2)
Income available to common stockholders	1,329	1,430	1,333	1,434

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Weighted-average shares outstanding	322.9	349.8	322.9	349.8	
Dilutive effect of outstanding options and share-settled awards			4.5	5.8	
Adjusted weighted-average shares outstanding			327.4	355.6	
Earnings per share	\$4.12	\$4.09	\$4.07	\$4.03	

During the third quarters and first nine months of 2012 and 2011, dividend equivalent payments were made to holders of stock options and RSUs. For purposes of computing basic earnings per share, the total amount of dividend equivalent payments made to holders of stock options and RSUs were deducted from net income to determine income available to common stockholders. For purposes of computing diluted earnings per share, NS evaluates on a grant-by-grant basis those stock options and RSUs receiving dividend equivalent payments under the two-class and treasury stock methods to determine which method is the more dilutive for each grant. For those grants for which the two-class method was more dilutive, net income was reduced by the amount of dividend equivalent payments on these grants to determine income available to common stockholders. The diluted calculations exclude options having exercise prices exceeding the average market price of Common Stock as follows: 0.8 million in 2012 and zero in 2011.

#### 4. Stockholders' Equity

Common stock is reported net of shares held by consolidated subsidiaries (Treasury Shares) of Norfolk Southern. Treasury Shares at September 30, 2012 and December 31, 2011, amounted to 20,320,777 shares, respectively, with a cost of \$19 million as of both dates.

#### 5. Stock Repurchase Program

NS repurchased and retired 16.5 million shares of Common Stock in the first nine months of 2012, at a cost of \$1.2 billion. NS repurchased and retired 23.8 million shares at a cost of \$1.6 billion for the same period of 2011. On August 1, 2012, NS' Board of Directors authorized the repurchase of up to an additional 50 million shares of Common Stock through December 31, 2017. The timing and volume of purchases is guided by management's assessment of market conditions and other pertinent factors. Any near-term share repurchases are expected to be made with internally generated cash, cash on hand, or proceeds from borrowings. Since the beginning of 2006, NS has repurchased and retired 126.1 million shares at a total cost of \$7.4 billion.

#### 6. Investment in Conrail

Through a limited liability company, Norfolk Southern and CSX Corporation (CSX) jointly own Conrail Inc. (Conrail), whose primary subsidiary is Consolidated Rail Corporation (CRC). NS has a 58% economic and 50% voting interest in the jointly owned entity, and CSX has the remainder of the economic and voting interests. NS' investment in Conrail was \$991 million at September 30, 2012, and \$969 million at December 31, 2011.

CRC owns and operates certain properties (the Shared Assets Areas) for the joint and exclusive benefit of Norfolk Southern Railway Company (NSR) and CSX Transportation, Inc. (CSXT). The costs of operating the Shared Assets Areas are borne by NSR and CSXT based on usage. In addition, NSR and CSXT pay CRC a fee for access to the Shared Assets Areas. "Purchased services and rents" and "Fuel" include expenses for the use of the Shared Assets Areas totaling \$33 million and \$32 million for the third quarters of 2012 and 2011, respectively, and

\$99 million and \$97 million for the first nine months of 2012 and 2011, respectively. NS' equity in the earnings of Conrail, net of amortization, included in "Other income – net" was \$8 million for both the third quarters of 2012 and 2011, and \$23 million and \$21 million for the first nine months of 2012 and 2011, respectively.

“Accounts payable” includes \$161 million at September 30, 2012, and \$160 million at December 31, 2011, due to Conrail for the operation of the Shared Assets Areas. In addition, “Other liabilities” includes \$133 million at both September 30, 2012 and December 31, 2011, for long-term advances from Conrail, maturing 2035, that bear interest at an average rate of 4.4%.

## 7. Debt

In the first quarter of 2012, NS borrowed \$100 million and repaid \$200 million under its accounts receivable securitization facility. At September 30, 2012 and December 31, 2011, the amounts outstanding under the facility were \$100 million (at an average variable interest rate of 1.29%) and \$200 million (at an average variable interest rate of 1.35%), respectively. In October 2012, NS renewed its accounts receivable securitization facility with a 364-day term to run until October 2013. Also during the first quarter of 2012, NS issued \$600 million of 3.00% senior notes due 2022.

During the third quarter of 2012, NS issued \$600 million of senior notes at 2.90% due 2023 and paid \$115 million of premium in exchange for \$521 million of its previously issued notes (\$156 million at 7.25% due 2031, \$140 million at 5.64% due 2029, \$115 million at 5.59% due 2025, \$72 million at 7.80% due 2027, and \$38 million at 7.05% due 2037). The premium is reflected as a reduction of debt in the Consolidated Balance Sheet and within “Debt repayments” in the Statement of Cash Flows and will be amortized as additional interest expense over the term of the new debt. No gain or loss was recognized as a result of the debt exchange. Also during the third quarter of 2012, NS issued \$600 million of 3.95% senior notes due 2042.

NS has authority from its Board of Directors to issue an additional \$600 million of debt or equity securities through public or private sale.



## 8. Pensions and Other Postretirement Benefits

Norfolk Southern and certain subsidiaries have both funded and unfunded defined benefit pension plans covering principally salaried employees. Norfolk Southern and certain subsidiaries also provide specified health care and death benefits to eligible retired employees and their dependents. Under the present plans, which may be amended or terminated at NS' option, a defined percentage of health care expenses are covered, reduced by any deductibles, co-payments, Medicare payments, and in some cases, coverage provided under other group insurance policies.

	Pension Benefits		Other Benefits	
	Three Months Ended September 30,			
	2012	2011	2012	2011
	(\$ in millions)			
Service cost	\$ 8	\$ 7	\$ 3	\$ 3
Interest cost	22	23	14	14
Expected return on plan assets	(34)	(35)	(4)	(4)
Amortization of net losses	19	16	14	11
Amortization of prior service cost	-	1	-	-
Net cost	\$ 15	\$ 12	\$ 27	\$ 24

	Pension Benefits		Other Benefits	
	Nine Months Ended September 30,			
	2012	2011	2012	2011
	(\$ in millions)			
Service cost	\$ 25	\$ 21	\$ 11	\$ 11
Interest cost	66	69	41	43
Expected return on plan assets	(103)	(105)	(11)	(11)
Amortization of net losses	57	50	40	33
Amortization of prior service cost	-	2	-	-
Net cost	\$ 45	\$ 37	\$ 81	\$ 76





## 9. Fair Value

### Fair Value Measurements

The Financial Accounting Standards Board (FASB) Accounting Standards Codifications (ASC) 820-10, "*Fair Value Measurements*," established a framework for measuring fair value and a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels, as follows:

Level 1 Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that NS has the ability to access.

Level 2 Inputs to the valuation methodology include:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in inactive markets;
- Inputs other than quoted prices that are observable for the asset or liability;
- Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset's or liability's fair value measurement level within the hierarchy is based on the lowest level of any input that is significant to the fair value measurement. There were no assets or liabilities measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011.

### Fair Values of Financial Instruments

NS has evaluated the fair values of financial instruments and methods used to determine those fair values. The fair values of "Cash and cash equivalents," "Short-term investments," "Accounts receivable," "Accounts payable," and "Short-term debt" approximate carrying values because of the short maturity of these financial instruments. The carrying value of

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corporate-owned life insurance is recorded at cash surrender value and, accordingly, approximates fair value. The carrying amounts and estimated fair values for the remaining financial instruments, excluding investments accounted for under the equity method, consisted of the following:

	September 30, 2012		December 31, 2011	
	Carrying	Fair	Carrying	Fair
	Amount	Value	Amount	Value
	(\$ in millions)			
Long-term investments	\$ 141	\$ 177	\$ 151	\$ 186
Long-term debt, including current maturities	(8,480)	(10,869)	(7,440)	(9,469)

Underlying net assets were used to estimate the fair value of investments with the exception of notes receivable, which are based on future discounted cash flows. The fair values of long-term debt were estimated based on quoted market prices or discounted cash flows using current interest rates for debt with similar terms, company rating, and remaining maturity.

The following table sets forth the fair value of long-term investment and long-term debt balances disclosed above by valuation technique level, within the fair value hierarchy (there were no level 3 valued assets or liabilities).

	September 30, 2012		
	Level 1	Level 2	Total
	(\$ in millions)		
Long-term investments	\$43	\$134	\$177
Long-term debt, including current maturities	(10,578)	(291)	(10,869)

Sales of available-for-sale securities were zero and \$173 million (which included current maturities) for the nine months ended September 30, 2012 and 2011, respectively.

## 10. Commitments and Contingencies

### Lawsuits

Norfolk Southern and/or certain subsidiaries are defendants in numerous lawsuits and other claims relating principally to railroad operations. When management concludes that it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated, it is accrued through a charge to earnings. While the ultimate amount of liability incurred in any of these lawsuits and claims is dependent on future developments, in management's opinion, the recorded liability is adequate to cover the future payment of such liability and claims. However, the final outcome of any of these lawsuits and claims cannot be predicted with certainty, and unfavorable or unexpected outcomes could result in additional accruals that could be significant to results of operations in a particular year or quarter. Any adjustments to the recorded liability will be reflected in earnings in the periods in which such adjustments are known.

One of NS' customers, DuPont, has a rate reasonableness complaint pending before the Surface Transportation Board (STB) alleging that the NS tariff rates for transportation of regulated movements are unreasonable. NS disputes these allegations. Since June 1, 2009, NS has been billing and collecting from DuPont amounts based on the challenged tariff rates. Management presently expects resolution of the case to occur in 2013 and believes the estimate of reasonably possible loss will not have a material effect on NS' financial position, results of operations, or liquidity. With regard to rate cases, management records adjustments to revenues in the periods, if and when, such adjustments are probable and estimable.

On November 6, 2007, various antitrust class actions filed against NS and other Class 1 railroads in various Federal district courts regarding fuel surcharges were consolidated in the District of Columbia by the Judicial Panel on Multidistrict Litigation. On June 21, 2012, the court certified the case as a class action. The defendant railroads have appealed such certification, and a decision by the court to either reject the appeal outright or proceed with ruling on its merits is pending. NS believes the allegations in the complaints are without merit and intends to vigorously defend the cases. NS does not believe that the outcome of these proceedings will have a material effect on its financial position, results of operations, or liquidity. A lawsuit containing similar allegations against NS and four other major railroads that was filed on March 25, 2008, in the U.S. District Court for the District of Minnesota was voluntarily dismissed by the plaintiff subject to a tolling agreement entered into in August 2008.

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## Casualty Claims

Casualty claims include employee personal injury and occupational claims as well as third-party claims, all exclusive of legal costs. To aid in valuing its personal injury liability and determining the amount to accrue with respect to such claims during the year, NS' management utilizes studies prepared by an independent consulting actuarial firm. Job-related accidental injury and occupational claims are subject to the Federal Employers' Liability Act (FELA), which is applicable only to railroads. FELA's fault-based system produces results that are unpredictable and inconsistent as compared with a no-fault workers' compensation system. The variability inherent in this system could result in actual costs being different from the liability recorded. While the ultimate amount of claims incurred is dependent on future developments, in management's opinion, the recorded liability is adequate to cover the future payments of claims and is supported by the most recent actuarial study. In all cases, NS records a liability when the expected loss for the claim is both probable and estimable.

The Consolidated Balance Sheets reflect long-term receivables for estimated recoveries from NS' insurance carriers for claims associated with the January 6, 2005, derailment in Graniteville, S.C. In the first quarter of 2011, NS received an unfavorable ruling for an arbitration claim with an insurance carrier, and was denied recovery of the contested portion (\$43 million) of the claim. As a result, NS recorded a \$43 million charge during the first quarter of 2011 for the receivables associated with the contested portion of the claim and a \$15 million charge for other receivables affected by the ruling for which recovery was no longer probable.

**Employee personal injury claims** – The largest component of casualties and other claims expense is employee personal injury costs. The independent actuarial firm engaged by NS provides quarterly studies to aid in valuing its employee personal injury liability and estimating its employee personal injury expense. The actuarial firm studies NS' historical patterns of reserving for claims and subsequent settlements, taking into account relevant outside influences. The actuary uses the results of these analyses to estimate the ultimate amount of liability, which includes amounts for incurred but unasserted claims. NS adjusts its liability quarterly based upon management's assessment and the results of the study. The estimate of loss liabilities is subject to inherent limitation given the difficulty of predicting future events such as jury decisions, court interpretations, or legislative changes and as such the actual loss may vary from the estimated liability recorded.

**Occupational claims** – Occupational claims (including asbestosis and other respiratory diseases, as well as conditions allegedly related to repetitive motion) are often not caused by a specific accident or event but rather allegedly result from a claimed exposure over time. Many such claims are being asserted by former or retired employees, some of whom have not been employed in the rail industry for decades. The independent actuarial firm provides an estimate of the occupational claims liability based upon NS' history of claim filings, severity, payments, and other pertinent facts. The liability is dependent upon management's judgments made as to the specific case reserves as well as judgments of the consulting independent actuarial firm in the periodic studies. The actuarial firm's estimate of ultimate loss includes a provision for those claims that have been incurred but not reported. This provision is derived by analyzing industry data and projecting NS' experience into the future as far as can be reasonably determined. NS adjusts its liability quarterly based upon management's assessment and the results of the study. However, it is possible that the recorded liability may not be adequate to cover the future payment of claims. Adjustments to the recorded liability are reflected in operating expenses in the periods in which such adjustments become known.

**Third-party claims** – NS records a liability for third-party claims including those for highway crossing accidents, trespasser and other injuries, automobile liability, property damage, and lading damage. The independent actuarial firm assists with the calculation of potential liability for third-party claims, except lading damage, based upon NS' experience including number and timing of incidents, amount of payments, settlement rates, number of open claims, and legal defenses. The actuarial estimate includes a provision for claims that have been incurred but have not yet been reported. Each quarter, NS adjusts its liability based upon management's assessment and the results of the study. Given the inherent uncertainty in regard to the ultimate outcome of third-party claims, it is possible that the actual loss may differ from the estimated liability recorded.

## Environmental Matters

NS is subject to various jurisdictions' environmental laws and regulations. It is NS' policy to record a liability where such liability or loss is probable and its amount can be estimated reasonably. Claims, if any, against third parties for recovery of cleanup costs incurred by NS are reflected as receivables (when collection is probable) in the Consolidated Balance Sheets and are not netted against the associated NS liability. Environmental engineers regularly participate in ongoing evaluations of all known sites and in determining any necessary adjustments to liability estimates. NS also has an Environmental Policy Council, composed of senior managers, to oversee and interpret its environmental policy.

NS' Consolidated Balance Sheets include liabilities for environmental exposures of \$34 million at September 30, 2012, and \$35 million at December 31, 2011 (of which \$12 million is classified as a current liability at the end of each period). At September 30, 2012, the liability represents NS' estimate of the probable cleanup and remediation costs based on available information at 142 known locations and projects. As of that date, seven sites accounted for \$17 million of the liability, and no individual site was considered to be material. NS anticipates that much of this liability will be paid out over five years; however, some costs will be paid out over a longer period.

At 22 locations, one or more Norfolk Southern subsidiaries in conjunction with a number of other parties, have been identified as potentially responsible parties under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, or comparable state statutes that impose joint and several liability for cleanup costs. NS calculates its estimated liability for these sites based on facts and legal defenses applicable to each site and not solely on the bases of the potential joint liability.

With respect to known environmental sites (whether identified by NS or by the EPA, or comparable state authorities), estimates of NS' ultimate potential financial exposure for a given site or in the aggregate for all such sites are necessarily imprecise because of the widely varying costs of currently available cleanup techniques, the likely development of new cleanup technologies, unpredictable contaminant recovery and reduction rates associated with available clean-up technologies, the difficulty of determining in advance the nature and full extent of contamination and each potential participant's share of any estimated loss (and that participant's ability to bear it), and evolving statutory and regulatory standards governing liability.

The risk of incurring environmental liability – for acts and omissions, past, present, and future – is inherent in the railroad business. Some of the commodities in NS' traffic mix, particularly those classified as hazardous materials, pose special risks that NS works diligently to minimize. In addition, several Norfolk Southern subsidiaries own, or have owned, land used as operating property, or which is leased and operated by others, or held for sale. Because environmental problems may exist on these properties that are latent or undisclosed, there can be no assurance that NS will not incur environmental liabilities or costs with respect to one or more of them, the amount and materiality of which cannot be estimated reliably at this time. Moreover, lawsuits and claims involving these and potentially other unidentified environmental sites and matters are likely to arise from time to time. The resulting liabilities could have a

significant effect on NS' financial position, results of operations, or liquidity in a particular year or quarter.

Based on its assessment of the facts and circumstances now known, management believes that it has recorded the probable and reasonably estimable costs for dealing with those environmental matters of which NS is aware. Further, management believes that it is unlikely that any known matters, either individually or in the aggregate, will have a material adverse effect on NS' financial position, results of operations, or liquidity.

## Insurance

Norfolk Southern obtains on behalf of itself and its subsidiaries insurance for potential losses for third-party liability and first-party property damages. NS is currently self-insured up to \$50 million and above \$1 billion per occurrence for bodily injury and property damage to third parties and up to \$25 million and above \$175 million per occurrence for property owned by NS or in NS' care, custody, or control.

## Purchase Commitments

At September 30, 2012, NS had outstanding purchase commitments totaling approximately \$515 million for long-term service contracts through 2019, as well as locomotives, freight cars, and track material in connection with its capital programs through 2014.

## 11. New Accounting Pronouncements

In the first quarter of 2012, NS adopted Accounting Standards Update (ASU) No. 2011-05, "*Comprehensive Income (Topic 220): Presentation of Comprehensive Income.*" This update requires that the total of comprehensive income, the components of net income, and the components of other comprehensive income be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. This update does not change what items are reported in other comprehensive income or the requirement to report reclassification of items from other comprehensive income to net income.

In the first quarter of 2012, NS adopted ASU No. 2011-04, "*Fair Value Measurements (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.*" This update provides clarification about the application of existing fair value measurements and disclosure requirements, and expands certain other disclosures requirements.





Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Norfolk Southern Corporation:

We have reviewed the accompanying consolidated balance sheet of Norfolk Southern Corporation and subsidiaries as of September 30, 2012, the related consolidated statements of income and comprehensive income for the three-month and nine-month periods ended September 30, 2012 and 2011 and the related consolidated statements of cash flows for the nine-month periods ended September 30, 2012 and 2011. These consolidated financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Norfolk Southern Corporation and subsidiaries as of December 31, 2011, and the related consolidated statements of income, changes in stockholders' equity and cash flows for the year then ended (not presented herein); and in our report dated February 15, 2012, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2011, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/KPMG LLP

KPMG LLP

Norfolk, Virginia

October 25, 2012

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Norfolk Southern Corporation and Subsidiaries

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements and Notes.

OVERVIEW

NS' third quarter net income was \$402 million in 2012, a decline from \$554 million in 2011, primarily a reflection of depressed coal volumes and lower fuel surcharge revenue. Earnings per share declined to \$1.24 from \$1.59 in the prior year, despite fewer shares outstanding as a result of share repurchases (see below). The railway operating ratio (a measure of the amount of operating revenues consumed by operating expenses) rose to 72.9%, compared with 67.5% for the third quarter of 2011.

Cash provided by operating activities for the first nine months of 2012 was \$2.5 billion, which along with proceeds from borrowings and cash on hand allowed for property additions, share repurchases, dividends, and debt repayments. In the first nine months of 2012, 16.5 million shares of Norfolk Southern Corporation common stock (Common Stock) were repurchased at a total cost of \$1.2 billion. Since the beginning of 2006, NS has repurchased and retired 126.1 million shares of Common Stock at a total cost of \$7.4 billion. At September 30, 2012, cash, cash equivalents, and short-term investments totaled \$708 million.

SUMMARIZED RESULTS OF OPERATIONS

Third quarter 2012 net income was \$402 million, down \$152 million, or 27%, compared with the same period last year. The decrease resulted from a \$207 million decline in income from railway operations and reduced nonoperating income items, which were partially offset by a \$92 million decrease in income taxes. The decrease in income from railway operations reflected a \$196 million, or 7%, decline in railway operating revenues and an \$11 million, or 1%, increase in railway operating expenses.

For the first nine months of 2012, net income was \$1.3 billion, down \$100 million, or 7%, compared with the same period last year, driven by lower nonoperating income items and increased income tax expense. Income from railway operations was relatively flat, reflecting slightly lower railway operating revenues partially offset by slightly lower operating expenses (which reflects the absence of the prior year's \$58 million unfavorable insurance arbitration ruling).

Oil prices affect NS' results of operations in a variety of ways and can have an overall favorable or unfavorable impact in any particular period. In addition to the impact of oil prices on general economic conditions, traffic volume, and supplier costs, oil prices directly affect NS' revenues through market-based fuel surcharges and contract escalators (see "Railway Operating Revenues") and also affect fuel costs (see "Railway Operating Expenses"). For the third quarter of 2012, excluding the impact of decreased consumption, fuel surcharge revenue decreased while fuel expense increased. For the first nine months of 2012, the increase in fuel surcharge revenue was less than the increase in fuel expense. Future changes in oil prices may cause volatility in operating results that could be material to a particular year or quarter.

## DETAILED RESULTS OF OPERATIONS

## Railway Operating Revenues

Third quarter railway operating revenues were \$2.7 billion in 2012, down \$196 million or 7%, compared with the third quarter of 2011. For the first nine months of 2012, railway operating revenues were \$8.4 billion, down

\$19 million compared with the same period last year. As shown in the following table, the decrease for the quarter was the result of lower average revenue per unit (which includes the effects of fuel surcharges) and lower traffic volume. For the first nine months, lower average revenue per unit was partially offset by higher traffic volume. Fuel surcharges amounted to \$286 million in the third quarter (down \$72 million) and \$976 million for the first nine months (up \$8 million).

	Third Quarter	First Nine Months
	2012 vs. 2011	2012 vs. 2011
	Increase (Decrease)	
	(\$ in millions)	
Revenue per unit	\$ (156)	\$ (30)
Traffic volume (units)	(40)	11
Total	\$ (196)	\$ (19)

Many of NS' negotiated fuel surcharges for coal and general merchandise traffic are based on the monthly average price of West Texas Intermediate Crude Oil (WTI Average Price). These surcharges are reset the first day of each calendar month based on the WTI Average Price for the second preceding calendar month. This two-month lag in applying WTI Average Price coupled with the change in fuel prices decreased fuel surcharge revenue by approximately \$21 million for the third quarter, but increased fuel surcharge revenue by approximately \$14 million for the first nine months. In 2011, this two-month lag increased fuel surcharge revenue by approximately \$52 million for the third quarter and had an insignificant impact for the first nine months.

One of NS' customers, DuPont, has a rate reasonableness complaint pending before the Surface Transportation Board (STB) alleging that the NS tariff rates for transportation of regulated movements are unreasonable. NS disputes these allegations. Since June 1, 2009, NS has been billing and collecting from DuPont amounts based on the challenged tariff rates. Management presently expects resolution of the case to occur in 2013 and believes the estimate of

reasonably possible loss will not have a material effect on NS' financial position, results of operations, or liquidity. With regard to rate cases, management records adjustments to revenues in the periods, if and when, such adjustments are probable and estimable.

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Revenues, units and average revenue per unit for NS' market groups were as follows:

	Third Quarter					
	Revenues		Units		Revenue per Unit	
	2012	2011	2012	2011	2012	2011
	(\$ in millions)		(in thousands)		(\$ per unit)	
Coal	\$ 701	\$ 899	348.2	405.1	\$ 2,014	\$ 2,219
General merchandise:						
Agriculture/consumer/gov't	344	357	142.6	143.2	2,415	