

NORFOLK SOUTHERN CORP  
Form 10-Q  
October 29, 2010

**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, 2010**

OR

**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**  
(State or other jurisdiction of incorporation)

**52-1188014**  
(IRS Employer Identification No.)

**Three Commercial Place**  
**Norfolk, Virginia**  
(Address of principal executive offices)

**23510-2191**  
(Zip Code)

**(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.)

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

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

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 the 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  (Do not check if smaller reporting company)

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.

<u>Class</u>	<u>Outstanding at September 30, 2010</u>
Common Stock (\$1.00 par value per share)	363,372,120 (excluding 20,361,354 shares held by the registrant's consolidated subsidiaries)

**TABLE OF CONTENTS**

**NORFOLK SOUTHERN CORPORATION AND SUBSIDIARIES (NS)**

	Page	
Part I.	Financial Information:	
Item 1.	Financial Statements:	
	Consolidated Statements of Income	
	Three and Nine Months Ended September 30, 2010 and 2009	3
	Consolidated Balance Sheets	
	As of September 30, 2010, and December 31, 2009	4
	Consolidated Statements of Cash Flows	
	Nine Months Ended September 30, 2010 and 2009	5
	Notes to Consolidated Financial Statements	6
	Report of Independent Registered Public Accounting Firm	15
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	16
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	25
Item 4.	Controls and Procedures	25
Part II.	Other Information:	
Item 1.	Legal Proceedings	26

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

Item 1 A.	Risk Factors	26
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	27
Item 6.	Exhibits	27
Signatures		28
Exhibit Index		29

**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**Norfolk Southern Corporation and Subsidiaries**  
**Consolidated Statements of Income**  
**(Unaudited)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b><u>2010</u></b>	<b><u>2009</u></b>	<b><u>2010</u></b>	<b><u>2009</u></b>
	<i>(\$ in millions, except per share amounts)</i>			
<b>Railway operating revenues</b>	\$ 2,456	\$ 2,063	\$ 7,124	\$ 5,863
<b>Railway operating expenses:</b>				
Compensation and benefits	680	598	2,049	1,788
Purchased services and rents	377	352	1,086	1,041
Fuel	259	192	771	504
Depreciation	204	210	612	624
Materials and other	190	149	572	493
Total railway operating expenses	1,710	1,501	5,090	4,450
 <b>Income from railway operations</b>	 746	 562	 2,034	 1,413
Other income - net	81	37	118	90
Interest expense on debt	113	118	347	348
 Income before income taxes	 714	 481	 1,805	 1,155
Provision for income taxes	269	178	711	428
 <b>Net income</b>	 \$ 445	 \$ 303	 \$ 1,094	 \$ 727

**Per share amounts**

## Net income

Basic	\$	1.21	\$	0.82	\$	2.95	\$	1.97
Diluted	\$	1.19	\$	0.81	\$	2.91	\$	1.94
Dividends	\$	0.36	\$	0.34	\$	1.04	\$	1.02

*See accompanying notes to consolidated financial statements.*

**Norfolk Southern Corporation and Subsidiaries**  
**Consolidated Balance Sheets**  
(Unaudited)

**September 30,**  
**2010**

**December 31,**  
**2009**

(\$ in millions)

**Assets**

## Current assets:

Cash and cash equivalents	\$	1,129	\$	996
Short-term investments		229		90
Accounts receivable - net		908		766
Materials and supplies		179		164
Deferred income taxes		153		142
Other current assets		35		88
Total current assets		2,633		2,246
Investments		2,307		2,164
Properties less accumulated depreciation		22,893		22,643
Other assets		229		316
<b>Total assets</b>	\$	28,062	\$	27,369

**Liabilities and stockholders' equity**

## Current liabilities:

Accounts payable	\$	1,131	\$	974
Short-term debt		--		100
Income and other taxes		116		109
Other current liabilities		347		232
Current maturities of long-term debt		361		374
<b>Total current liabilities</b>		<b>1,955</b>		<b>1,789</b>
Long-term debt		6,574		6,679
Other liabilities		1,784		1,801
Deferred income taxes		6,960		6,747
<b>Total liabilities</b>		<b>17,273</b>		<b>17,016</b>

## Stockholders' equity:

Common stock \$1.00 per share par value, 1,350,000,000 shares authorized; outstanding 363,372,120 and 369,019,990 shares, respectively, net of treasury shares		364		370
Additional paid-in capital		1,890		1,809
Accumulated other comprehensive loss		(804)		(853)
Retained income		9,339		9,027
<b>Total stockholders' equity</b>		<b>10,789</b>		<b>10,353</b>
<b>Total liabilities and stockholders' equity</b>	\$	<b>28,062</b>	\$	<b>27,369</b>

*See accompanying notes to consolidated financial statements.*

**Norfolk Southern Corporation and Subsidiaries**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b><u>2010</u></b>	<b><u>2009</u></b>
	<i>(\$ in millions)</i>	
<b>Cash flows from operating activities</b>		
Net income	\$ 1,094	\$ 727
Reconciliation of net income to net cash provided by operating activities:		
Depreciation	617	630
Deferred income taxes	172	173
Gains and losses on properties	(38)	(13)
Changes in assets and liabilities affecting operations:		
Accounts receivable	(142)	(26)
Materials and supplies	(15)	22
Other current assets	50	111
Current liabilities other than debt	254	(184)
Other - net	136	(65)
Net cash provided by operating activities	2,128	1,375
<b>Cash flows from investing activities</b>		
Property additions	(907)	(919)
Property sales and other transactions	81	61
Investments, including short-term	(441)	(119)
Investment sales and other transactions	261	10
Net cash used in investing activities	(1,006)	(967)

**Cash flows from financing activities**

Dividends	(384)	(374)
Common stock issued - net	59	32
Purchase and retirement of common stock	(437)	--
Proceeds from borrowings - net	250	990
Debt repayments	(477)	(675)
Net cash used in financing activities	(989)	(27)
Net increase in cash and cash equivalents	133	381

**Cash and cash equivalents**

At beginning of year	996	618
At end of period	\$ 1,129	\$ 999

**Supplemental disclosure of cash flow information**

Cash paid during the period for:

Interest (net of amounts capitalized)	\$ 296	\$ 288
Income taxes (net of refunds)	\$ 498	\$ 234

*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, 2010, and December 31, 2009, and its results of operations for the three and nine months ended September 30, 2010 and 2009, and its cash flows for the nine months ended September 30, 2010 and 2009, 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**

In the first quarter of 2010, a committee of non-employee directors of Norfolk Southern's Board of Directors granted stock options, restricted stock units 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 expense was \$9 million during the third quarter of 2010 and \$19 million during the same period of 2009. For the first nine months of 2010 and 2009, stock-based compensation expense was \$60 million and \$34 million, respectively. The total tax effect recognized in income in relation to stock-based compensation were benefits of \$3 million and \$7 million for the quarters ended September 30, 2010 and 2009, respectively, and benefits of \$19 million and \$9 million for the first nine months of 2010 and 2009, respectively.

**Stock Options**

In the first quarter of 2010, 824,900 options were granted under the LTIP and 259,800 options were granted under the TSOP. In each case, the grant price was \$47.76, which was the greater of the average fair market value of Norfolk Southern common stock (Common Stock) or the closing price of the 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 2010 may not be exercised prior to the fourth and third anniversaries of the date of grant, respectively. Holders of the 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 2010 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. A dividend yield of zero was used for LTIP options during the four-year period in which dividend equivalent payments are made. A dividend yield of 2.89% 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 2010 LTIP and TSOP grants are shown in the following table:

**2010**

Expected volatility range	29% - 32%
Average expected volatility	32%
Average expected option life	8.3 years
Average risk-free interest rate	3.63%
LTIP per-share grant-date fair value	\$18.54
TSOP per-share grant-date fair value	\$14.91

During the third quarter of 2010, options relating to 497,375 shares were exercised, yielding \$11 million in cash proceeds and \$6 million of tax benefits recognized as additional paid-in capital. During the third quarter of 2009, options relating to 241,754 shares were exercised, yielding \$6 million in cash proceeds and \$3 million of tax benefits recognized as additional paid-in capital.

For the first nine months of 2010, options relating to 1,655,271 shares were exercised, yielding \$37 million of cash proceeds and \$20 million of tax benefits recognized as additional paid-in capital. For the first nine months of 2009, options relating to 1,082,657 shares were exercised, yielding \$30 million of cash proceeds and \$6 million of tax benefits recognized as additional paid-in capital.

### **Restricted Stock Units and Restricted Shares**

There were 168,250 restricted stock units granted in 2010, with an average grant-date fair value of \$47.76 and a five-year restriction period. The restricted stock units granted in 2010 will be settled through the issuance of shares of Common Stock. There were no restricted shares granted in 2010.

During the third quarter of 2010, there were no restricted stock units or restricted shares earned and paid out. For the third quarter of 2009, 3,023 restricted stock units were earned and paid out in cash with a weighted-average fair value of \$41.32. Also earned and distributed were 4,535 restricted shares with a weighted-average grant-date fair value of \$34.10. The total related tax benefit recognized as additional paid-in capital was less than \$1 million during the third quarter of 2009.

During the first nine months of 2010, 286,709 restricted stock units were earned and paid out in cash with a weighted average fair value of \$48.88. Also earned and distributed were 433,236 restricted shares with a weighted-average grant-date fair value of \$34.10. The total related tax benefit recognized as additional paid-in capital was \$2 million for the first nine months of 2010.

During the first nine months of 2009, 351,755 restricted stock units were earned and paid out in cash with a weighted-average fair value of \$36.32. Also earned and distributed were 368,158 restricted shares with a weighted-average grant-date fair value of \$47.54. The total related tax expense recognized as a reduction to additional paid-in capital was \$1 million for the first nine months of 2009.

### **Performance Share Units**

PSUs provide for awards based on achievement of certain predetermined corporate performance goals at the end of a three-year cycle. During the first quarter of 2010, there were 824,900 PSUs granted with a grant-date fair value of \$47.76. The PSUs granted in 2010 and 2009 will be paid in the form of shares of Common Stock; however, one-half of the 2008 PSU grants earned will be paid in the form of shares of Common Stock, with the other half to be paid in cash.

During the first nine months of 2010, 851,893 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 \$49.56 per unit and a fair value at payout of \$47.76 per unit. The total related tax expense recognized as a reduction to additional paid-in capital was less than \$1 million for the first nine months of 2010.

For the first nine months of 2009, 983,965 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 \$49.43 per unit and a fair value at payout of \$38.71 per unit. The total related tax expense recognized as a reduction to additional paid-in capital was \$2 million for the first nine months of 2009.

## 2. Income Taxes

During the first quarter of 2010, the Patient Protection and Affordable Care Act, and the Health Care and Education Reconciliation Act of 2010 were signed into law. Provisions of the Acts eliminate, after 2012, the tax deduction available for reimbursed prescription drug expenses under the Medicare Part D retiree drug subsidy program. As required by the Financial Accounting Standards Board Accounting Standards Codification (ASC) 740, "Income Taxes," NS recorded a \$27 million charge to deferred tax expense.

During the third quarter of 2010, NS submitted claims to the IRS seeking refunds of federal income taxes for the years 2005 - 2008, and expects to file a similar claim for 2009, the effects of which increased unrecognized tax benefits by approximately \$30 million.

## 3. Earnings Per Share

The following tables set forth the calculations of basic and diluted earnings per share:

<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
<b>September 30,</b>		<b>September 30,</b>	
<b><u>2010</u></b>	<b><u>2009</u></b>	<b><u>2010</u></b>	<b><u>2009</u></b>

*(in millions except per share amounts)*

Basic earnings per share:

Net income	\$ 445	303	\$ 1,094	\$ 727
Less: Dividend equivalent payments	(2)	(2)	(6)	(6)
Income available to common stockholders	443	\$ 301	1,088	721
Weighted-average shares outstanding	366.3	367.3	368.5	366.8
Basic earnings per share	\$ 1.21	\$ 0.82	\$ 2.95	\$ 1.97

As required under the provisions of ASC 260-10, "Earnings Per Share," income available to common stockholders reflects reductions from net income for the effect of dividend equivalent payments made to holders of stock options.

<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
<b>September 30,</b>		<b>September 30,</b>	
<b><u>2010</u></b>	<b><u>2009</u></b>	<b><u>2010</u></b>	<b><u>2009</u></b>

*(in millions except per share amounts)*

## Diluted earnings per share:

Net income	\$	445	\$	303	\$	1,094	\$	727
Less: Dividend equivalent payments		(2)		(2)		(6)		(6)
Income available to common stockholders		443		301		1,088		721
Weighted-average shares outstanding		366.3		367.3		368.5		366.8
Dilutive effect of outstanding options and share-settled awards		5.3		5.2		5.3		4.9
Adjusted weighted-average shares outstanding		371.6		372.5		373.8		371.7
Diluted earnings per share	\$	1.19	\$	0.81	\$	2.91	\$	1.94

As required under the provisions of ASC 260-10, "Earnings Per Share," diluted earnings per share for the three and nine months ended September 30, 2010 and 2009, were calculated under the more dilutive two-class method (as compared to the treasury stock method) and accordingly, income available to common stockholders for all periods reflect reductions from net income for dividend equivalent payments. The diluted calculations exclude options having exercise prices exceeding the average market price of Common Stock as follows: zero for each quarter in 2010, but in 2009, 4.1 million for the third quarter, and 5.6 million for both the second and first quarters.

**4. Stockholders' Equity**

Common stock is reported net of shares held by consolidated subsidiaries of Norfolk Southern, which at September 30, 2010, and December 31, 2009, amounted to 20,361,354 and 20,443,337 shares, respectively, with a cost of \$19 million as of both dates.

**5. Stock Repurchase Program**

In March 2007, NS' Board of Directors amended NS' share repurchase program, increasing the authorized amount of share repurchases from 50 million to 75 million shares and shortening the term of the program from 2015 to 2010. On July 27, 2010, NS' Board of Directors authorized the repurchase of up to an additional 50 million shares of Common Stock through December 31, 2014. The timing and volume of purchases is guided by management's assessment of market conditions and other pertinent facts. Any near-term purchases under the program are expected to be made with internally generated cash. NS repurchased and retired 7.8 million shares in the first nine months of 2010, at a cost of \$437 million. There were no shares repurchased under this program in the first nine months of 2009. Since inception of this program, NS has repurchased and retired 72.5 million shares of Common Stock at a total cost of \$3.7 billion.

**6. Investments****Short-Term Investments**

**September 30,**                      **December 31,**  
**2010**                                      **2009**

*(\$ in millions)*

Short-term investments with average remaining maturities:

Available-for-sale:

Certificates of deposit, 7 months	\$	75	\$	10
Federal government notes, 3 months		30		60
Corporate bond, 5 months		25		20
Commercial paper, 8 months		25		--
Total available-for-sale		155		90

Held-to-maturity:

Corporate bonds, 6 months		43		--
Federal government bond, 12 months		31		--
Total held-to-maturity		74		--
Total short-term investments	\$	229	\$	90

#### **Investment in Conrail, Inc.**

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 \$940 million at September 30, 2010, and \$924 million at December 31, 2009.

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 \$30 million and \$32 million in the third quarters of 2010 and 2009, respectively, and \$88 million and \$92 million for the first nine months of 2010 and 2009, respectively. NS' equity in earnings of Conrail, net of amortization, included in "Other income - net" was \$3 million and \$7 million in the third quarters of 2010 and 2009, respectively, and \$16 million and \$24 million for the first nine months of 2010 and 2009, respectively.

"Accounts payable" includes \$128 million at September 30, 2010, and \$104 million at December 31, 2009, due to Conrail for the operation of the Shared Assets Areas. In addition, "Other liabilities" includes \$133 million at both September 30, 2010, and December 31, 2009, for long-term advances from Conrail, maturing 2035, that bear interest at an average rate of 4.4%.

#### **Investment in Pan Am Southern LLC**

During the second quarter of 2009, NS and Pan Am Railways, Inc. (Pan Am) formed a joint venture, Pan Am Southern LLC (PAS), a railroad company in which each has a 50% equity interest. As of September 30, 2010, NS had contributed cash and other property with a combined value of approximately \$109 million and has committed to contribute an additional \$31 million in cash over the next two years. A significant portion of NS' contributions has and will continue to be used for capital improvements to the PAS lines and the related construction of new intermodal

and automotive terminals.

## 7. Debt

In the first nine months of 2010, NS repaid \$100 million under its accounts receivable securitization facility. At September 30, 2010, and December 31, 2009, the amounts outstanding under the facility were \$100 million (at an average variable interest rate of 1.96%) and \$200 million (at an average variable interest rate of 2.22%), respectively. In October 2010, NS renewed its accounts receivable securitization facility with a 364-day term to run until October 2011.

During the third quarter of 2010, NS issued an additional \$250 million of 6.00% Senior Notes due 2105.

NS has authority from its Board of Directors to issue an additional \$1 billion 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 is covered, reduced by any deductibles, co-payments, Medicare payments and, in some cases, coverage provided under other group insurance policies.

### Pension and Other Postretirement Benefit Cost Components

	<b>Three Months Ended September 30,</b>			
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
	<u>Pension Benefits</u>		<u>Other Benefits</u>	
	<i>(\$ in millions)</i>			
Service cost	\$ 7	\$ 7	\$ 3	\$ 4
Interest cost	24	26	16	15
Expected return on plan assets	(36)	(39)	(4)	(4)
Amortization of prior service cost	1	--	--	--
Amortization of net losses	12	6	15	8
Net cost	\$ 8	\$ --	\$ 30	\$ 23

### **Nine Months Ended September 30,**

	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
	<u>Pension Benefits</u>		<u>Other Benefits</u>	
	<i>(\$ in millions)</i>			

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

Service cost	\$	20	\$	20	\$	11	\$	12
Interest cost		72		76		46		43
Expected return on plan assets		(107)		(116)		(11)		(11)
Amortization of prior service cost (benefit)		2		2		--		(1)
Amortization of net losses		36		19		39		26
Net cost	\$	23	\$	1	\$	85	\$	69

**9. Comprehensive Income**

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
	<i>(\$ in millions)</i>			
Net income	\$ 445	\$ 303	\$ 1,094	\$ 727
Other comprehensive income	16	10	49	30
Total comprehensive income	\$ 461	\$ 313	\$ 1,143	\$ 757

"Other comprehensive income" in 2010 and 2009 reflects primarily, net of tax, the amortization of the actuarial net losses and prior service costs (benefits) for the pension and other postretirement benefit plans.

**10. Fair Value**

**Fair Value Measurements**

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; and
- 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. At September 30, 2010, and December 31, 2009, for assets measured at fair value on a recurring basis, there were \$155 million and \$90 million of available-for-sale securities as valued under level 2 of the fair value hierarchy, respectively. There were no such assets valued under level 1 or level 3 valuation techniques.

### Fair Values of Financial Instruments

In accordance with ASC 825, "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 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 derivatives and investments accounted for under the equity method, consisted of the following:

	September 30, 2010		December 31, 2009	
	Carrying <u>Amount</u>	Fair <u>Value</u>	Carrying <u>Amount</u>	Fair <u>Value</u>
	<i>(\$ in millions)</i>			
Investments	\$ 286	\$ 320	\$ 237	\$ 260
Long-term debt	\$ (6,935)	\$ (8,427)	\$ (7,053)	\$ (8,048)

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 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.

Carrying amounts of available-for-sale securities reflect immaterial unrealized holding losses on September 30, 2010, and December 31, 2009. Sales of "available-for-sale" securities were \$160 million and immaterial for the nine months ended September 30, 2010 and 2009, respectively.

## 11. 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.

### 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, SC. NS is currently engaged in arbitration with one of its insurance carriers that failed to respond to an insurance claim submitted by NS. NS believes these expenses are covered by the insurance policy and that recovery of the contested portion (\$43 million) of the recorded recoveries is probable. During the first quarter of 2010, NS settled an arbitration claim with another insurance carrier with no adverse effect on NS' financial position, results of operations, or liquidity.

**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 the 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. Recent actuarial studies have reflected favorable claims development and accordingly, those changes in estimates have reduced the liability related to casualty claims by \$2 million and \$7 million for the third quarter of 2010 and 2009, respectively, and by \$19 million and \$34 million for the first nine months of 2010 and 2009, respectively. 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 in the amount of \$34 million at September 30, 2010, and \$32 million at December 31, 2009 (of which \$12 million is classified as a current liability at the end of each period). At September 30, 2010, the liability represents NS' estimate of the probable cleanup and remediation costs based on available information at 149 known locations. As of that date, 12 sites accounted for \$18 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 33 locations, one or more Norfolk Southern subsidiaries, usually in conjunction with a number of other parties, have been identified as potentially responsible parties by the Environmental Protection Agency (EPA) or similar state authorities under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, or comparable state statutes, which often impose joint and several liability for cleanup costs.

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, 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 and its subsidiaries work diligently to minimize. In addition, several NS 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 costs for dealing with those environmental matters of which NS is aware. Further, management believes that it is unlikely that any known environmental 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 \$25 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, 2010, NS had outstanding purchase commitments of approximately \$762 million primarily for railroad equipment, including locomotives, RoadRailer® units, covered hoppers, and box cars in connection with its capital programs through 2014, long-term service contracts through 2019, as well as track material.

**Report of Independent Registered Public Accounting Firm**

The Stockholders and Board of Directors  
Norfolk Southern Corporation:

We have reviewed the accompanying consolidated balance sheet of Norfolk Southern Corporation and subsidiaries as of September 30, 2010, the related consolidated statements of income for the three month and nine month periods ended September 30, 2010 and 2009 and the related consolidated statements of cash flows for the nine-month periods ended September 30, 2010 and 2009. 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, 2009, 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 17, 2010, 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, 2009, 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 29, 2010

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

**Norfolk Southern Corporation and Subsidiaries  
Management's Discussion and Analysis of  
Financial Condition and Results of Operations**

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

**OVERVIEW**

NS' third quarter 2010 net income was 47% higher than the prior year due to increased income from railway operations that resulted from a 15% increase in volumes and higher average revenue per unit. The railway operating ratio (a measure of the amount of operating revenues consumed by operating expenses) improved to 69.6%, compared with 72.8% for the third quarter of 2009.

Cash provided by operating activities for the first nine months of 2010 was \$2.1 billion, which allowed for capital expenditures, share repurchases, dividends, and debt maturities (net of proceeds). In the third quarter of 2010, 5.8 million shares of Norfolk Southern Corporation common stock (Common Stock) were repurchased at a total cost of \$323 million. Since inception of the stock repurchase program in 2006, NS has repurchased and retired 72.5 million shares of Common Stock at a total cost of \$3.7 billion. At September 30, 2010, cash, cash equivalents, and short-term investments totaled \$1.4 billion.

**SUMMARIZED RESULTS OF OPERATIONS**

Third quarter 2010 net income was \$445 million, up \$142 million, or 47%, compared with the same period last year. The increase primarily resulted from higher income from railway operations that reflected a 19% improvement in railway operating revenues, offset in part by a 14% increase in railway operating expenses. In addition, nonoperating income improved \$44 million, principally due to increased gains on the sale of property.

For the first nine months of 2010, net income was \$1.1 billion, up \$367 million, or 50%, compared with the same period last year. Income from railway operations increased 44% reflecting a 22% improvement in railway operating revenues that was partially offset by a 14% rise in railway operating expenses. In addition, nonoperating income improved \$28 million, principally due to increased gains on the sale of property.

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 and first nine months of 2010, excluding the effect of increased consumption, the increase in fuel surcharge revenue was greater than the increase in fuel expense. Future changes in oil prices may cause volatility in operating results that could be material to a particular period.

**DETAILED RESULTS OF OPERATIONS**

**Railway Operating Revenues**

Third quarter 2010 railway operating revenues were \$2.5 billion, up \$393 million, or 19%, compared with the third quarter of 2009. For the first nine months of 2010, railway operating revenues were \$7.1 billion, up \$1.3 billion, or

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

22%, compared with the same period last year. As shown in the following table, the increases were the result of higher traffic volumes and improved average revenue per unit which was driven by higher fuel surcharges and rate increases, offset in part by the effects of changes in the mix of traffic. Fuel surcharges amounted to \$179 million in the third quarter (up \$80 million) and \$537 million for the first nine months (up \$282 million).

	<b>Third Quarter</b>	<b>First Nine Months</b>
	<b>2010 vs. 2009</b>	<b>2010 vs. 2009</b>
	<b><u>Increase</u></b>	<b><u>Increase</u></b>
	<i>(\$ in millions)</i>	<i>(\$ in millions)</i>
Traffic volume (units)	\$ 312	\$ 889
Revenue per unit	81	372
Total	\$ 393	\$ 1,261

Many of Norfolk Southern's 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 computing WTI Average Price coupled with the change in fuel prices had an immaterial impact on fuel surcharge revenue for the quarter or the first nine months.

Revenues, units and average revenues per unit by market group were as follows:

	<b>Third Quarter</b>					
	<b>Revenues</b>		<b>Units</b>		<b>Revenue per Unit</b>	
	<b><u>2010</u></b>	<b><u>2009</u></b>	<b><u>2010</u></b>	<b><u>2009</u></b>	<b><u>2010</u></b>	<b><u>2009</u></b>
	<i>(\$ in millions)</i>		<i>(in thousands)</i>		<i>(\$ per unit)</i>	
Coal	\$ 709	\$ 571	402.7	351.3	\$ 1,762	\$ 1,627
General merchandise:						
Agriculture/consumer/gov't	331	296	154.5	141.6	2,146	2,097
Chemicals	340	297	106.9	95.9	3,176	3,090
Metals and construction	264	205	167.4	139.4	1,576	1,471
Paper/clay/forest	185	169	84.9	79.3	2,180	2,123
Automotive	163	136	74.0	74.6	2,202	1,825
General merchandise	1,283	1,103	587.7	530.8	2,183	2,078
Intermodal	464	389	762.2	640.1	609	608

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

Total	\$ 2,456	\$ 2,063	1,752.6	1,522.2	\$ 1,401	\$ 1,355
	<b>First Nine Months</b>					
	<b>Revenues</b>		<b>Units</b>		<b>Revenue per Unit</b>	
	<b><u>2010</u></b>	<b><u>2009</u></b>	<b><u>2010</u></b>	<b><u>2009</u></b>	<b><u>2010</u></b>	<b><u>2009</u></b>
	<i>(\$ in millions)</i>		<i>(in thousands)</i>		<i>(\$ per unit)</i>	
Coal	\$ 2,034	\$ 1,684	1,161.4	1,064.0	\$ 1,752	\$ 1,583
General merchandise:						
Agriculture/consumer/gov't	978	861	465.7	407.0	2,100	2,117
Chemicals	988	778	309.5	256.7	3,193	3,030
Metals and construction	775	559	481.1	377.5	1,609	1,482
Paper/clay/forest	536	500	248.6	227.9	2,158	2,193
Automotive	488	358	216.9	197.3	2,248	1,814
General merchandise	3,765	3,056	1,721.8	1,466.4	2,186	2,084
Intermodal	1,325	1,123	2,172.1	1,859.7	610	604
Total	\$ 7,124	\$ 5,863	5,055.3	4,390.1	\$ 1,409	\$ 1,336

**Coal**

Coal revenues increased \$138 million, or 24%, in the third quarter and \$350 million, or 21%, in the first nine months, compared with the same periods last year. Both increases reflect higher traffic volumes (up 15% for the quarter and 9% for the first nine months). Average revenue per unit increased 8% in the third quarter and 11% in the first nine months, reflecting higher rates and increased fuel surcharges. For both periods, tonnage handled increased. Coal tonnage by market was as follows:

**Total Coal, Coke, and Iron Ore Tonnage**

	<b>Third Quarter</b>		<b>First Nine Months</b>	
	<b><u>2010</u></b>	<b><u>2009</u></b>	<b><u>2010</u></b>	<b><u>2009</u></b>
	<i>(tons in thousands)</i>			
Utility	31,607	29,146	89,151	93,112

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

Export	5,206	4,795	17,592	11,538
Domestic metallurgical	5,501	3,232	14,839	8,205
Industrial	1,879	1,885	5,726	5,583
	44,193	39,058	127,308	118,438

Utility coal tonnage increased 8% in the third quarter but decreased 4% in the first nine months. The quarter benefited from increased demand for electricity and a replenishment of utility coal stockpiles, whereas the first nine months reflected relatively high utility coal stockpiles and reduced electricity demand in the industrial sector. Export coal tonnage increased 9% for the third quarter and 52% for the first nine months, reflecting increased global demand for coal used in steel production. Domestic metallurgical coal, coke, and iron ore tonnage was up 70% in the third quarter and 81% in the first nine months, as domestic steel production improved due to an increase in steel demand. Other coal tonnage (principally steam coal shipped to industrial plants) was essentially flat in the third quarter but increased 3% in the first nine months, primarily due to new business.

Coal revenues for the remainder of the year are expected to increase compared with last year due to higher traffic volumes and average revenue per unit, including fuel surcharges.

### General Merchandise

General merchandise revenues increased \$180 million, or 16%, in the third quarter, compared with the same period last year, reflecting an 11% increase in traffic volumes and a 5% improvement in average revenue per unit, including fuel surcharges. For the first nine months, general merchandise revenues increased \$709 million, or 23%, reflecting a 17% increase in traffic volumes and a 5% improvement in average revenue per unit, including fuel surcharges.

Agriculture, consumer products, and government volumes increased 9% in the third quarter and 14% for the first nine months, primarily reflecting increased shipments of corn and sweeteners due to continued strength in the demand for ethanol; higher soybeans volumes linked to an early harvest and strong export demand; more shipments of fertilizer due to increased demand; and, increased feed volumes due to a strong export market. Chemicals traffic volumes increased 11% for the third quarter and 21% for the first nine months. Both periods reflect more shipments of petroleum, waste, plastics, and industrial intermediates. Metals and construction volumes were up 20% in the third quarter and 27% for the first nine months, reflecting more shipments of iron and steel, coil, and scrap metal due to increased steel and automotive production, as well as higher shipments of fractionating sand for natural gas drilling. The quarter also benefited from more shipments of aggregates linked to increased highway construction and paving projects. Paper, clay, and forest products volumes were up 7% for the third quarter and 9% for the first nine months, reflecting increased pulpboard, lumber, kaolin, woodpulp, and newsprint shipments as a result of improvements in the domestic and global economies. Automotive volumes decreased 1% in the third quarter but increased 10% for the first nine months. Reloadings of approximately 8,300 carloads for the quarter and 22,400 carloads for the first nine months were eliminated as a result of the 2009 year-end design changes in the automotive network. This reduction in carloadings was offset in part for the quarter but completely for the first nine months by higher traffic volumes associated with increased production of North American light vehicles (increases of 25% and 53%, respectively).

General merchandise revenues for the remainder of the year are expected to be higher than 2009, reflecting increased traffic volumes and average revenue per unit, including fuel surcharges.

### Intermodal

Intermodal revenues increased \$75 million, or 19%, in the third quarter, and \$202 million, or 18%, for the first nine months, compared with the same periods last year, reflecting higher traffic volumes (up 19% in the third quarter and 17% for the first nine months). Average revenue per unit was flat for the quarter but increased 1% for the first nine months, including the effect of fuel surcharges.

Domestic volumes (which include truckload and intermodal marketing companies' volumes) increased 30% in the third quarter and 29% for the first nine months as a result of improvements in the economy and continued conversions of truckload business from highway transport to rail. International traffic volumes improved 11% in the third quarter and 8% for the first nine months, reflecting inventory replenishment by U.S. retailers, as well as more empty repositions. The Premium business, which includes parcel and less-than-truckload (LTL) carriers, increased 23% for the quarter and 16% for the first nine months, due to general economic improvements and continued growth in the LTL over-the-road conversions. Triple Crown Services Company, which provides a service with rail-to-highway trailers, experienced volume improvements of 2% for the third quarter and 5% for the first nine months, primarily driven by an increase in non-automotive related traffic as retailers replenished inventory levels.

Intermodal revenues for the remainder of the year are expected to be above last year, reflecting increased traffic volumes and average revenue per unit, including fuel surcharges.

### **Railway Operating Expenses**

Third-quarter railway operating expenses were \$1.7 billion in 2010, up \$209 million, or 14%, compared with the same period last year. For the first nine months, expenses were \$5.1 billion, up \$640 million, or 14%. Both increases were largely the result of higher traffic volumes and fuel prices.

Compensation and benefits expenses increased \$82 million, or 14%, in the third quarter and \$261 million, or 15%, in the first nine months. The rise for both periods was principally the result of higher:

- employee activity levels associated with higher traffic volumes (up \$34 million for the quarter and \$60 million for the first nine months),
- health and welfare benefit costs for active and retired employees (up \$20 million for the quarter and \$48 million for the first nine months),
- incentive compensation (up \$13 million for the quarter and \$52 million for the first nine months),
- pension expenses (up \$8 million for the quarter and \$22 million for the first nine months),
- payroll taxes (up \$7 million for the quarter and \$11 million for the first nine months), and
- wage rates (up \$6 million for the quarter and \$44 million for the first nine months).

The increases for the quarter were partially offset by decreased stock-based compensation (down \$10 million), whereas the first nine months reflected increased stock-based compensation (up \$26 million).

Purchased services and rents increased \$25 million, or 7%, for the third quarter and \$45 million, or 4%, for the first nine months. The increases were driven by higher costs associated with volume-related services. The increases for the first nine months were partially offset by a favorable settlement with a freight car supplier in the first quarter.

Fuel expense, which includes the cost of locomotive fuel as well as other fuel used in railway operations, increased \$67 million, or 35%, for the third quarter, and \$267 million, or 53%, for the first nine months. The increases were principally the result of higher fuel prices (locomotive fuel prices increased 18% and 38%, respectively), which had an impact of \$42 million in the third quarter and \$213 million for the first nine months, as well as increased fuel consumption (locomotive fuel consumption rose 14% and 12%, respectively), which had an impact of \$25 million and \$54 million, respectively.

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

Depreciation expense decreased \$6 million, or 3%, for the third quarter and \$12 million, or 2%, for the first nine months, reflecting the results of the equipment depreciation study that was completed in the first quarter of 2010, which more than offset the effects of an increased capital base.

Materials and other expenses (including the estimates of costs related to personal injury, property damage, and environmental matters) increased \$41 million, or 28%, in the third quarter and \$79 million, or 16%, for the first nine months. The increases reflected higher costs associated with locomotive and roadway materials, property taxes, travel, and derailments, in addition to lower favorable personal injury claims development and higher environmental remediation costs. The increase for the first nine months also reflected the absence of the \$21 million favorable settlement of a multi-year tax dispute that benefited 2009. The following table shows the components of materials and other expenses:

	Third Quarter		First Nine Months	
	<u>2010</u>	<u>2009</u>	<u>2010</u>	<u>2009</u>
	<i>(\$ in millions)</i>			
Materials	\$ 90	\$ 72	\$ 259	\$ 237
Casualties and other claims	32	23	105	80
Other	68	54	208	176
	\$ 190	\$ 149	\$ 572	\$ 493

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, SC. NS is currently engaged in arbitration with one of its insurance carriers that failed to respond to an insurance claim. NS believes these expenses are covered by the insurance policy and that recovery of the contested portion (\$43 million) of the recorded recoveries is probable.

During the first quarter of 2010, NS settled an arbitration claim with another insurance carrier with no adverse effect on NS' financial position, results of operations, or liquidity.

#### Other Income - Net

Other income - net increased \$44 million in the third quarter and \$28 million for the first nine months of 2010, compared with the same periods in 2009. Both periods reflect higher gains on the sale of property, including a \$35 million gain on the sale of land to the City of Virginia Beach, VA, and a \$13 million favorable coal royalty rate settlement. These increases were offset in part by decreased equity in the earnings of Conrail (down \$4 million for the third quarter and \$8 million for the first nine months).

#### Provision for Income Taxes

The third quarter and year-to-date effective income tax rates were 37.7% and 39.4% in 2010, respectively, compared with 37.0% and 37.1%, for the same periods last year. The increase for the third quarter was primarily due to the absence of tax credits that expired in 2009 and lower equity in earnings of Conrail. The increase for the first nine months was primarily the result of a \$27 million deferred tax charge in the first quarter of 2010 attributable to the enactment of the Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act, which together, effective in 2013, eliminate the tax deduction available for prescription drug expenses reimbursed under the Medicare Part D retiree drug subsidy program.

#### FINANCIAL CONDITION AND LIQUIDITY

Cash provided by operating activities, NS' principal source of liquidity, was \$2.1 billion for the first nine months of 2010 compared with \$1.4 billion for the same period of 2009, reflecting the improvement in operating results, in addition to a reduction in working capital investments. Operating cash flows in the first nine months of 2010 also benefited from the favorable settlement of an insurance claim related to the 2005 Graniteville derailment. NS had working capital of \$678 million at September 30, 2010, compared with \$457 million at December 31, 2009. NS' portfolio of cash, cash equivalents, and short-term investment balances totaled \$1.4 billion at September 30, 2010 and was invested in accordance with NS' corporate investment policy as approved by the Board of Directors. The portfolio contains securities that are subject to market risk. There are no limits or restrictions on NS' access to the assets. NS expects that cash on hand combined with cash flows from operations will be sufficient to meet its ongoing obligations. In addition to the contractual obligation amounts contained in NS' Form 10-K for the year ended December 31, 2009, NS (1) issued \$250 million of 6.00% unsecured notes, (2) repaid \$300 million of 8.625% senior notes at maturity, and (3) has entered into an additional \$530 million of unconditional purchase obligations related to equipment. There were no material changes to the information on NS' future obligations related to uncertain tax positions contained in NS' Form 10-K for the year ended December 31, 2009.

Cash used for investing activities was \$1.0 billion in the first nine months of 2010, compared with \$967 million in the same period last year, reflecting an increase in investment purchases, net of sales. NS expects total capital expenditures for 2010 to be approximately \$1.5 billion. Furthermore, NS expects the implementation of positive train control to result in additional capital expenditures of at least \$700 million in the years 2011 through 2015. In addition, another \$400 million of upgrades to systems and track structure, required for the Federal Railroad Administration approved implementation of positive train control, will be accelerated from future years' spending to meet the 2015 legislative deadline.

The CREATE project is a public-private partnership to reduce rail and highway congestion and add freight and passenger capacity in the metropolitan Chicago area. NS and other railroads have agreed to participate in CREATE. A portion of the public funding has been approved. The parties have developed a list of projects to be included in Phase I of CREATE. A total of \$91 million in federal funding has been secured for Phase I. The railroads have contributed an additional \$100 million and expect to complete Phase I by the end of 2012. In addition, \$133 million from the High Speed Rail Program and \$100 million from the TIGER Stimulus Program have been committed to specific CREATE projects. The State of Illinois and City of Chicago have also committed to additional funding. As currently planned, the total CREATE project is estimated to cost \$3.1 billion with city, state, and federal support. If additional public funding is secured, the railroads are expected to contribute a total of \$169 million towards the entire project. NS expects to spend up to \$4 million for the remainder of 2010 related to the CREATE projects.

The Crescent Corridor consists of a program of projects for infrastructure and other facility improvements geared toward creating a seamless, high-capacity intermodal route spanning 11 states from New Jersey to Louisiana and offering truck-competitive service along several major interstate highway corridors, including I-81, I-85, I-20, I-40, I-59, I-78, and I-75. Based on the public benefits that stand to be derived in the form of highway congestion relief, NS plans to implement certain elements of the Crescent Corridor program of projects through a series of public-private partnerships. Although there is not yet a single, integrated plan for the Crescent Corridor, preliminary work has begun and will continue throughout 2010, including continued infrastructure improvements and other design and engineering work along the Virginia portion of the Corridor consistent with NS' matching obligation with respect to funds provided by the Commonwealth of Virginia. Additionally, the Crescent Corridor has received or expects to receive a total of \$210 million in public capital funding commitments from the Commonwealth of Pennsylvania, the states of Alabama and Tennessee, the federal TIGER Stimulus Program and other federal funding sources related to projects in Alabama, Pennsylvania, Tennessee, and North Carolina. NS currently estimates spending up to \$210 million for the substantial completion of work on these projects which is expected in 2012, including planned capital expenditures through 2010 as high as \$67 million.

During the second quarter of 2009, NS and Pan Am Railways, Inc. (Pan Am) formed a joint venture, Pan Am Southern LLC (PAS), a railroad company in which each has a 50% equity interest. As of September 30, 2010, NS

had contributed cash and other property with a combined value of approximately \$109 million and committed to contribute an additional \$31 million in cash over the next two years. A significant portion of NS' contributions has and will continue to be used for capital improvements to the PAS lines and the related construction of new intermodal and automotive terminals.

Cash used for financing activities was \$989 million in the first nine months of 2010, compared with \$27 million for the same period of 2009. The change reflected lower borrowings, net of debt repayments, in addition to \$437 million used in 2010 for the repurchase and retirement of Common Stock as part of NS' share repurchase program. On July 27, 2010, NS' Board of Directors authorized the repurchase of up to an additional 50 million shares of Common Stock through December 31, 2014. The timing and volume of future share repurchases will be guided by management's assessment of market conditions and other pertinent factors. Near-term purchases under the program are expected to be made with internally generated cash. NS' debt-to-total capitalization ratio was 39.1% at September 30, 2010, compared with 40.9% at December 31, 2009.

As of September 30, 2010, NS has authority from its Board of Directors to issue an additional \$1 billion of debt or equity securities through public or private sale. NS has on file with the Securities and Exchange Commission a Form S-3 automatic shelf registration statement for well-known seasoned issuers under which securities may be issued pursuant to this authority.

NS also has in place and available a \$1 billion, five-year credit agreement expiring in 2012, which provides for borrowings at prevailing rates and includes covenants. NS had no amounts outstanding under this facility at September 30, 2010, and NS is in compliance with all of its covenants. In October 2010, NS renewed its \$350 million accounts receivable securitization program with a 364-day term to run until October 2011. There was \$100 million and \$200 million outstanding under this program as of September 30, 2010, and December 31, 2009, respectively (see Note 7).

## **APPLICATION OF CRITICAL ACCOUNTING ESTIMATES**

The preparation of financial statements in accordance with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. These estimates and assumptions may require significant judgment about matters that are inherently uncertain, and future events are likely to occur that may require management to make changes to these estimates and assumptions. Accordingly, management regularly reviews these estimates and assumptions based on historical experience, changes in the business environment, and other factors that management believes to be reasonable under the circumstances. Management regularly discusses the development, selection, and disclosures concerning critical accounting estimates with the Audit Committee of its Board of Directors.

There have been no significant changes to the Application of Critical Accounting Estimates disclosure contained in NS' Form 10-K as of December 31, 2009.

## **OTHER MATTERS**

### **Labor Agreements**

More than 80% of NS' railroad employees are covered by collective bargaining agreements with various labor unions.

These agreements remain in effect until changed pursuant to the Railway Labor Act (RLA). NS largely bargains nationally in concert with other major railroads. Moratorium provisions in the labor agreements govern when the railroads and the unions may propose changes.

On or after November 1, 2009, NS and the nation's other major railroads represented by the National Carriers Conference Committee (NCCC) served new proposals to begin the current round of bargaining. The NCCC and a

coalition of six unions led by the Transportation Communications Union (TCU) are currently negotiating with the assistance of a mediator from the National Mediation Board. The outcome of any of the negotiations cannot be determined at this point.

The current agreements with the Brotherhood of Locomotive Engineers and Trainmen (BLET) and the American Train Dispatchers Association (ATDA) extend through 2014. Because NS has reached separate agreements with the BLET and the ATDA, only the health and welfare provisions from the national agreements apply to NS' locomotive engineers and the ATDA-represented dispatchers. NS bargains separately with longshoremen, who are represented by the International Longshoremen's Association (ILA), at Ashtabula (Ohio) Docks and do not participate in national bargaining.

### **Market Risks and Hedging Activities**

NS manages its overall exposure to fluctuations in interest rates by issuing both fixed- and floating-rate debt instruments and by entering into interest-rate hedging transactions to achieve an appropriate mix within its debt portfolio.

At September 30, 2010, NS' debt subject to interest rate fluctuations totaled \$100 million. A 1% increase in interest rates would increase NS' total annual interest expense related to all its variable debt by approximately \$1 million. Management considers it unlikely that interest rate fluctuations applicable to these instruments will result in a material adverse effect on NS' financial position, results of operations, or liquidity.

One of NS' capital leases, which carries an approximate fixed rate of 6%, was effectively converted to a variable rate obligation using an interest rate swap agreement. On September 30, 2010, the approximate pay rate under this agreement was 1%, and the approximate receive rate was 6%. During the third quarter and first nine months of 2010 and 2009, the effect of the swaps on interest expense was immaterial in all periods. A portion of the lease obligations is payable in Japanese yen. NS eliminated the associated exchange rate risk at the inception of the lease with a yen deposit sufficient to fund the yen-denominated obligation. The deposit is held by a Japanese bank. As a result, NS is exposed to financial market risk relative to Japan. The counterparty to the interest rate swap and the Japanese bank holding the yen deposits are major financial institutions believed by management to be creditworthy.

### **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 in the amount of \$34 million at September 30, 2010, and \$32 million at December 31, 2009 (of which \$12 million is classified as a current liability at the end of each period). At September 30, 2010, the liability represents NS' estimate of the probable cleanup and remediation costs based on available information at 149 known locations. As of that date, 12 sites account for \$18 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 33 locations, one or more subsidiaries of NS, usually in conjunction with a number of other parties, have been identified as potentially responsible parties by the Environmental Protection Agency (EPA) or similar state authorities under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, or comparable state

statutes, which often impose joint and several liability for cleanup costs.

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, 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.

Based on an assessment of known facts and circumstances, management believes that it is unlikely that any known environmental matters, either individually or in the aggregate, will have a material adverse effect on NS' financial condition, results of operations, or liquidity.

### **Inflation**

In preparing financial statements, U.S. generally accepted accounting principles require the use of historical cost that disregards the effects of inflation on the replacement cost of property. NS, a capital-intensive company, has most of its capital invested in such property. The replacement cost of these assets, as well as the related depreciation expense, would be substantially greater than the amounts reported on the basis of historical cost.

### **FORWARD-LOOKING STATEMENTS**

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements that may be identified by the use of words like "believe," "expect," "anticipate" and "project." Forward-looking statements reflect management's good-faith evaluation of information currently available.

However, such statements are dependent on and, therefore, can be influenced by a number of external variables over which management has little or no control, including: legislative and regulatory developments; transportation of hazardous materials as a common carrier by rail; acts of terrorism or war; general economic conditions; impacts of environmental regulations on utility coal customers and/or the value of certain NS assets; competition and consolidation within the transportation industry; the operations of carriers with which NS interchanges; disruptions to NS' technology infrastructure, including computer systems; labor difficulties, including strikes and work stoppages; results of litigation; natural events such as severe weather, hurricanes, and floods; unavailability of qualified personnel due to unpredictability of demand for rail services; fluctuation in supplies and prices of key materials, in particular diesel fuel; and changes in securities and capital markets. For a discussion of significant risk factors applicable to NS, see Part I, Item 1A "Risk Factors." Forward-looking statements are not, and should not be relied upon as, a guarantee of future performance or results, nor will they necessarily prove to be accurate indications of the times at or by which any such performance or results will be achieved. As a result, actual outcomes and results may differ materially from those expressed in forward-looking statements. NS undertakes no obligation to update or revise forward-looking statements.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The information required by this item is included in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" under the heading "Market Risks and Hedging Activities."

### **Item 4. Controls and Procedures**

#### **(a) Evaluation of Disclosure Controls and Procedures**

Norfolk Southern's Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of NS' disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities

Exchange Act of 1934, as amended (the "Exchange Act")) as of September 30, 2010. Based on such evaluation, such officers have concluded that, as of September 30, 2010, NS' disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to NS (including its consolidated subsidiaries) required to be included in NS' periodic filings under the Exchange Act.

(b) Changes in Internal Control Over Financial Reporting

During the third quarter of 2010, management did not identify any changes in NS' internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, NS' internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

On June 25, 2010, the Ohio Attorney General filed a complaint in the Ashtabula Court of Common Pleas alleging certain violations of water laws by NS' coal dock in Ashtabula, Ohio and seeking injunctive relief and civil penalties. The complaint was filed simultaneously with a Consent Order for Preliminary Injunction that governs the installation of additional pollution control equipment at the dock. This matter relates to previously disclosed enforcement activity initiated by the Ohio Environmental Protection Agency in early 2008 and a recently settled citizen suit filed by the City of Ashtabula in federal court. The Pennsylvania Department of Environmental Protection has submitted to NS a proposed Consent Assessment of Civil Penalty with respect to several alleged environmental releases from September 2007 to January 2009. Although NS will contest liability and the imposition of any penalties, because these governmental proceedings with respect to environmental laws and regulations involve potential fines, penalties or other monetary sanctions in excess of \$100,000, we describe them here consistent with SEC rules and requirements. NS does not believe that the outcome of these proceedings will have a material effect on its financial position, results of operations, or liquidity.

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. 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.

On March 3, 2010, NS received a Shareholder Litigation Demand Letter alleging that NS officers and directors breached fiduciary duties by causing NS to engage in anti-competitive practices relating to the use of fuel surcharges, which have harmed or will ultimately harm NS. The allegations in the letter relate to those contained in the ongoing fuel surcharge class action litigation. In response to the letter, pursuant to Virginia law, the Board of Directors has created a Special Litigation Committee to review and evaluate the facts and circumstances surrounding the claims made in the Demand Letter. On September 28, 2010, the shareholder filed a shareholder derivative complaint in United States District Court in the District of Columbia against NS, each of the current members of the Board of Directors, and David Goode. NS does not believe that the outcome of these proceedings will have a material effect on its financial position, results of operations, or liquidity.

**Item 1A. Risk Factors**

The risk factors included in NS' 2009 Form 10-K remain unchanged and are incorporated herein by reference.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

**ISSUER REPURCHASES OF EQUITY SECURITIES**

(a) Total Number	(b) Average	(c) Total Number of Shares (or Units) Purchased as Part of Publicly	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that may yet be
------------------	-------------	--	--

<b>Period</b>	<b>of Shares (or Units) Purchased <sup>(1)</sup></b>	<b>Price Paid per Share (or Unit)</b>	<b>Announced Plans or Programs <sup>(2)</sup></b>	<b>Purchased Under the Plans or Programs <sup>(2)</sup></b>
July 1-31, 2010	854,300	\$54.17	854,300	57,428,250
August 1-31, 2010	2,754,321	\$54.72	2,751,900	54,676,350
September 1-30, 2010	<u>2,159,291</u>	\$58.47	<u>2,157,200</u>	52,519,150
Total	<u>5,767,912</u>		<u>5,763,400</u>	

1. Of this amount, 4,512 represents shares tendered by employees in connection with the exercise of stock options under the Long-Term Incentive Plan.
2. On November 22, 2005, the Board of Directors authorized a share repurchase program, pursuant to which up to 50 million shares of Common Stock could be repurchased through December 31, 2015. On March 27, 2007, the Board of Directors amended the program so as to increase the number of shares that may be repurchased to 75 million, and shortened the repurchase term by five years to December 31, 2010. On July 27, 2010, NS' Board of Directors authorized the repurchase of up to an additional 50 million shares of Common Stock through December 31, 2014.

#### **Item 6. Exhibits.**

See Exhibit Index beginning on page 29 for a description of the exhibits filed as a part of this report.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**NORFOLK SOUTHERN CORPORATION**

Registrant

Date: October 29, 2010

/s/ Howard D. McFadden  
Howard D. McFadden  
Corporate Secretary (Signature)

Date: October 29, 2010

/s/ C. H. Allison, Jr.  
C. H. Allison, Jr.  
Vice President and Controller  
(Principal Accounting Officer) (Signature)

**EXHIBIT INDEX**

- 4.1 Twelfth Supplemental Indenture, dated August 26, 2010, between the Registrant and U.S. Bank Trust National Association, as Trustee, is incorporated by reference to Exhibit 4.2 to Norfolk Southern Corporation's Form 8-K filed on August 26, 2010.
- 10.1\* Amendment No. 6, dated as of August 30, 2010, to Transfer and Administration Agreement dated as of November 8, 2007, with respect to the Registrant's receivables securitization facility.
- 10.2 Amendment No. 7, dated as of October 21, 2010, to Transfer and Administration Agreement dated as of November 8, 2007, with respect to the Registrant's receivables securitization facility, is incorporated by reference to Exhibit 99 to Norfolk Southern Corporation's Form 8-K filed on October 22, 2010.
- 15\* Letter regarding unaudited interim financial information.
- 31\* Rule 13a-14(a)/15d-14(a) Certifications.
- 32\* Section 1350 Certifications.
- 101\* The following financial information from Norfolk Southern Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2010, formatted in Extensible Business Reporting Language (XBRL) includes (i) the Consolidated Statements of Income for each of the three-month and nine-month periods ended September 30, 2010 and 2009; (ii) the Consolidated Balance Sheets as of September 30, 2010, and December 31, 2009; (iii) the Consolidated Statements of Cash Flows for each of the nine-month periods ended September 30, 2010 and 2009; and (iv) the Notes to Consolidated Financial Statements.

\* Filed herewith.