

NORFOLK SOUTHERN CORP
Form 10-Q
July 23, 2014

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 JUNE 30, 2014

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)

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 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 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 June 30, 2014
Common Stock (\$1.00 par value per share)	309,515,208 (excluding 20,320,777 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	
Second Quarters and First Six Months of 2014 and 2013	3
Consolidated Statements of Comprehensive Income	
Second Quarters and First Six Months of 2014 and 2013	4
Consolidated Balance Sheets	
At June 30, 2014 and December 31, 2013	5
Consolidated Statements of Cash Flows	
First Six Months of 2014 and 2013	6
Notes to Consolidated Financial Statements	7
Report of Independent Registered Public Accounting Firm	19
Item 2.	
Management's Discussion and Analysis of Financial Condition and Results of Operations	20
Item 3. Quantitative and Qualitative Disclosures About Market Risk	29
Item 4. Controls and Procedures	29
Part II. Other Information:	
Item 1. Legal Proceedings	30
Item 1A. Risk Factors	30
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	31
Item 6. Exhibits	31
Signatures	32
Exhibit Index	33

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

Norfolk Southern Corporation and Subsidiaries

Consolidated Statements of Income

(Unaudited)

	Second Quarter		First Six Months	
	2014	2013	2014	2013
	(\$ in millions, except per share amounts)			
Railway operating revenues	\$ 3,042	\$ 2,802	\$ 5,731	\$ 5,540
Railway operating expenses				
Compensation and benefits	715	726	1,455	1,506
Purchased services and rents	414	410	806	803
Fuel	408	391	840	820
Depreciation	238	226	475	453
Materials and other	248	213	469	431
Total railway operating expenses	2,023	1,966	4,045	4,013
Income from railway operations	1,019	836	1,686	1,527
Other income – net	18	29	44	164
Interest expense on debt	139	128	278	257
Income before income taxes	898	737	1,452	1,434
Provision for income taxes	336	272	522	519
Net income	\$ 562	\$ 465	\$ 930	\$ 915

Per share amounts

Net income:

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

Basic	\$ 1.81	\$ 1.47	\$ 2.99	\$ 2.90
Diluted	1.79	1.46	2.97	2.87
Dividends	0.54	0.50	1.08	1.00

See accompanying notes to consolidated financial statements.

Norfolk Southern Corporation and Subsidiaries

Consolidated Statements of Comprehensive Income

(Unaudited)

	Second Quarter		First Six Months	
	2014	2013	2014	2013
	(\$ in millions)			
Net income	\$ 562	\$ 465	\$ 930	\$ 915
Other comprehensive income, before tax:				
Pension and other postretirement benefits	7	36	306	72
Other comprehensive income of equity investees	7	1	10	2
Other comprehensive income, before tax	14	37	316	74
Income tax expense related to items of other comprehensive income	(4)	(14)	(118)	(28)
Other comprehensive income, net of tax	10	23	198	46
 Total comprehensive income	 \$ 572	 \$ 488	 \$ 1,128	 \$ 961

See accompanying notes to consolidated financial statements.

Norfolk Southern Corporation and Subsidiaries

Consolidated Balance Sheets

(Unaudited)

	June 30, 2014	December 31, 2013
	(\$ in millions)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,667	\$ 1,443
Short-term investments	-	118
Accounts receivable – net	1,122	1,024
Materials and supplies	251	223
Deferred income taxes	161	180
Other current assets	65	87
Total current assets	3,266	3,075
Investments	2,505	2,439
Properties less accumulated depreciation of \$10,634 and \$10,387, respectively	26,927	26,645
Other assets	342	324
Total assets	\$ 33,040	\$ 32,483
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 1,245	\$ 1,265
Short-term debt	-	100
Income and other taxes	359	225
Other current liabilities	331	270
Current maturities of long-term debt	433	445
Total current liabilities	2,368	2,305
Long-term debt	8,814	8,903
Other liabilities	1,122	1,444
Deferred income taxes	8,659	8,542
Total liabilities	20,963	21,194
Stockholders' equity:		
Common stock \$1.00 per share par value, 1,350,000,000 shares authorized; outstanding 309,515,208 and 308,878,402 shares,		

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

respectively, net of treasury shares	311	310
Additional paid-in capital	2,113	2,021
Accumulated other comprehensive loss	(183)	(381)
Retained income	9,836	9,339
Total stockholders' equity	12,077	11,289
Total liabilities and stockholders' equity	\$ 33,040	\$ 32,483

See accompanying notes to consolidated financial statements.

Norfolk Southern Corporation and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

	First Six Months	
	2014	2013
	(\$ in millions)	
Cash flows from operating activities		
Net income	\$ 930	\$ 915
Reconciliation of net income to net cash provided by operating activities:		
Depreciation	478	456
Deferred income taxes	17	143
Gains and losses on properties and investments	(3)	(99)
Changes in assets and liabilities affecting operations:		
Accounts receivable	(98)	37
Materials and supplies	(28)	(12)
Other current assets	30	28
Current liabilities other than debt	144	6
Other – net	(33)	32
Net cash provided by operating activities	1,437	1,506
Cash flows from investing activities		
Property additions	(809)	(884)
Property sales and other transactions	44	68
Investments, including short-term	(3)	(7)
Investment sales and other transactions	121	16
Net cash used in investing activities	(647)	(807)
Cash flows from financing activities		
Dividends	(335)	(315)
Common stock issued – net	82	80
Purchase and retirement of common stock	(100)	(314)
Debt repayments	(213)	(216)
Net cash used in financing activities	(566)	(765)
Net increase (decrease) in cash and cash equivalents	224	(66)
Cash and cash equivalents		
At beginning of period	1,443	653
At end of period	\$ 1,667	\$ 587

Supplemental disclosures of cash flow information

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

Cash paid during the period for:

Interest (net of amounts capitalized)	\$ 255	\$ 244
Income taxes (net of refunds)	313	238

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, we, us, and our) financial condition at June 30, 2014, and December 31, 2013, our results of operations and comprehensive income for the second quarters and first six months of 2014 and 2013, and our cash flows for the first six months of 2014 and 2013 in conformity with U.S. generally accepted accounting principles (GAAP).

These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in our latest Annual Report on Form 10-K.

1. Stock-Based Compensation

During the first quarter of 2014, a committee of non-employee directors of our 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 expense was \$10 million and \$6 million during the second quarters of 2014 and 2013, respectively. For the first six months of 2014 and 2013, stock-based compensation was \$42 million and \$43 million, respectively. The total tax effects recognized in income in relation to stock-based compensation were net benefits of \$4 million and \$2 million for the second quarters of 2014 and 2013, and net benefits of \$14 million for the first six months of both 2014 and 2013.

Stock Options

In the first quarter of 2014, 515,240 options were granted under LTIP and 181,070 options were granted under TSOP. In each case, the grant price was \$94.17, 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 LTIP and TSOP in 2014 may not be exercised prior to the fourth and third anniversaries of the date of grant, respectively. Holders of the 2014 options granted under 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 2014 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, and historical volatility of, Common Stock. Historical data is used 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 all options granted are expected to be outstanding, including the branches of the model that result in options expiring unexercised. 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 2.29% 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 2014 LTIP and TSOP grants are shown in the following table:

Expected volatility range	23% - 27%
Average expected volatility	25%
Average risk-free interest rate	2.79%
Average expected option term LTIP	8.9 years
Per-share grant-date fair value LTIP	\$29.87
Average expected option term TSOP	8.8 years
Per-share grant-date fair value TSOP	\$24.38

For the second quarter of 2014, options relating to 353,327 shares were exercised, yielding \$16 million of cash proceeds and \$4 million of tax benefit recognized as additional paid-in capital. For the second quarter of 2013, options relating to 546,886 shares were exercised, yielding \$18 million of cash proceeds and \$7 million of tax benefit recognized as additional paid-in capital.

For the first six months of 2014, options relating to 1,234,071 shares were exercised, yielding \$56 million of cash proceeds and \$15 million of tax benefit recognized as additional paid-in capital. For the first six months of 2013, options relating to 1,571,500 shares were exercised, yielding \$53 million of cash proceeds and \$20 million of tax benefit recognized as additional paid-in capital.

Restricted Stock Units

During the first quarter of 2014, there were 113,505 RSUs granted with a grant-date fair value of \$94.17 and a five-year restriction period that will be settled through the issuance of shares of Common Stock. The RSU grants include cash dividend equivalent payments during the restriction period commensurate with regular quarterly dividends paid on Common Stock.

No RSUs were earned or paid out in the second quarters of 2014 and 2013. During the first six months of 2014, 318,150 of the RSUs granted in 2009 vested, with 187,449 shares of Common Stock issued net of withholding taxes. For the first six months of 2013, 298,400 of the RSUs granted in 2008 vested, with 178,250 shares of Common Stock issued net of withholding taxes. The total related tax benefits recognized as additional paid-in capital were less than \$1 million for the second quarters of both 2014 and 2013 and \$6 million and \$2 million for the first six months of 2014 and 2013, respectively.

Performance Share Units

PSUs provide for awards based on achievement of certain predetermined corporate performance goals at the end of a three-year cycle and are paid in the form of shares of Common Stock. During the first quarter of 2014, there were 399,530 PSUs granted. PSUs will earn out based on the achievement of a return on average invested capital target (a performance condition) and a total shareholder return target (a market condition). The grant-date fair values of the PSUs associated with the performance and market conditions were \$94.17 and \$50.31, respectively, with the market condition fair value measured on the date of grant using a Monte Carlo simulation model.

No PSUs were earned or paid out in the second quarters of 2014 and 2013. During the first six months of 2014, 374,099 of the PSUs granted in 2011 were earned, with 223,253 shares of Common Stock issued net of withholding taxes. For the first six months of 2013, 577,585 of the PSUs granted in 2010 were earned, with 348,189 shares of Common Stock issued net of withholding taxes. The total related tax benefits recognized as additional paid-in capital were \$5 million for the first six months of both 2014 and 2013.

2. Income Taxes

There have been no material changes to the balance of unrecognized tax benefits reported at December 31, 2013. IRS examinations have been completed for all years prior to 2011. Our consolidated federal income tax returns for 2011 and 2012 are currently being audited by the IRS.

3. Earnings Per Share

	Basic		Diluted	
	Second Quarter			
	2014	2013	2014	2013
	(\$ in millions, except per share amounts, shares in millions)			
Net income	\$ 562	\$ 465	\$ 562	\$ 465
Dividend equivalent payments	(2)	(1)	(1)	(1)
Income available to common stockholders	\$ 560	\$ 464	\$ 561	\$ 464
Weighted-average shares outstanding	309.5	314.1	309.5	314.1
Dilutive effect of outstanding options and share-settled awards			3.3	3.7
Adjusted weighted-average shares outstanding			312.8	317.8
Earnings per share	\$ 1.81	\$ 1.47	\$ 1.79	\$ 1.46

	Basic		Diluted	
	First Six Months			
	2014	2013	2014	2013
	(\$ in millions, except per share amounts, shares in millions)			
Net income	\$ 930	\$ 915	\$ 930	\$ 915
Dividend equivalent payments	(4)	(3)	(2)	(2)
Income available to common stockholders	\$ 926	\$ 912	\$ 928	\$ 913
Weighted-average shares outstanding	309.5	314.3	309.5	314.3
Dilutive effect of outstanding options and share-settled awards			3.2	3.6

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

Adjusted weighted-average shares outstanding			312.7	317.9
Earnings per share	\$ 2.99	\$ 2.90	\$ 2.97	\$ 2.87

During the second quarters and first six months of 2014 and 2013, dividend equivalent payments were made to holders of stock options and RSUs. For purposes of computing basic earnings per share, 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, we evaluate 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 dividend equivalent payments to determine income available to common stockholders. The dilution calculations exclude options having exercise prices

exceeding the average market price of Common Stock as follows: 0.7 million and 0.8 million in the first quarters of 2014 and 2013, respectively, and zero for the second quarters of both 2014 and 2013.

4. Stockholders' Equity

Common Stock

Common Stock is reported net of shares held by our consolidated subsidiaries (Treasury Shares). Treasury Shares at June 30, 2014, and December 31, 2013, amounted to 20,320,777 shares, with a cost of \$19 million at both dates.

Accumulated Other Comprehensive Loss

“Accumulated other comprehensive loss” reported in the Consolidated Balance Sheets consisted of the following:

	Pensions and Other Postretirement Benefits (\$ in millions)	Other Investees	Accumulated Other Comprehensive Loss of Equity	Accumulated Other Comprehensive Loss
Second Quarter March 31, 2014	\$ (125)	\$ (68)		\$ (193)
Other comprehensive income:				
Amounts reclassified into net income	7	(1)	-	7
Net gain	-		7	7
Tax expense	(3)		(1)	(4)
Other comprehensive income	4		6	10
June 30, 2014	\$ (121)	\$ (62)		\$ (183)

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

	Benefits	Investees	Loss
	(\$ in millions)		
Second Quarter			
March 31, 2013	\$ (977)	\$ (109)	\$ (1,086)
Other comprehensive income:			
Amounts reclassified into net income	36	(1)	-
Net gain	-	1	1
Tax expense	(14)	-	(14)
Other comprehensive income	22	1	23
June 30, 2013	\$ (955)	\$ (108)	\$ (1,063)

	Pensions and Other Postretirement Benefits (\$ in millions)	Accumulated Other Comprehensive Loss of Equity Investees	Accumulated Other Comprehensive Loss
First Six Months			
December 31, 2013	\$ (310)	\$ (71)	\$ (381)
Other comprehensive income:			
Prior service benefit	367	-	367
Amounts reclassified into net income	19 (1)	-	19
Net gain (loss)	(80)	10	(70)
Tax expense	(117)	(1)	(118)
Other comprehensive income	189	9	198
June 30, 2014	\$ (121)	\$ (62)	\$ (183)

	Accumulated Other Comprehensive Loss of Equity Investees (\$ in millions)	Accumulated Other Comprehensive Loss
Pension and Other Postretirement Benefits (\$ in millions)		