

NORFOLK SOUTHERN CORP  
Form 10-Q  
October 25, 2007

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington , D.C. 20549**

**FORM 10-Q**

(X) QUARTERLY REPORT PURSUANT TO SECTION 13  
OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the quarterly period ended **SEPT. 30, 2007**

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**

**23510-2191**

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Norfolk , Virginia

(Address of principal executive offices)

Zip Code

Registrant's telephone number, including area code

**(757) 629-2680**

**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 (X) No ( )

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

Yes ( ) No (X)

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 Sept. 30, 2007</u>   |
|---------------------------------|--|
| Common Stock (par value \$1.00) | 387,240,494 (excluding 20,683,686 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 Sept. 30, 2007 and 2006                                   | 3  |
|         | Consolidated Balance Sheets   |    |
|         | As of Sept. 30, 2007, and Dec. 31, 2006   | 4  |
|         | Consolidated Statements of Cash Flows   |    |
|         | Nine Months Ended Sept. 30, 2007 and 2006   | 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   | 26 |

Part II. Other Information:

|         |                   |    |
|---------|-------------------|----|
| Item 1. | Legal Proceedings | 26 |
|---------|-------------------|----|

|               |   |    |
|---------------|---|----|
| Item 1A.      | Risk Factors  | 27 |
| Item 2.       | Unregistered Sales of Equity Securities and Use of Proceeds | 29 |
| Item 6.       | Exhibits  | 29 |
| Signatures    |   | 30 |
| Exhibit Index |   | 31 |

## 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><u>Sept. 30,</u></b>                           |                    | <b><u>Sept. 30,</u></b>  |                    |
|   | <b><u>2007</u></b>                                | <b><u>2006</u></b> | <b><u>2007</u></b>       | <b><u>2006</u></b> |
|   | <i>(\$ in millions, except per share amounts)</i> |                    |                          |                    |
| <b><i>Railway operating revenues:</i></b> |   |                    |                          |                    |
| Coal                                      | \$ 578  | \$ 595             | \$ 1,714                 | \$ 1,738           |
| General merchandise                       | 1,291   | 1,283              | 3,839                    | 3,872              |
| Intermodal                                | 484   | 515                | 1,425                    | 1,478              |
| Total railway operating revenues          | 2,353   | 2,393              | 6,978                    | 7,088              |
| <b><i>Railway operating expenses:</i></b> |   |                    |                          |                    |
| Compensation and benefits                 | 619   | 624                | 1,929                    | 1,982              |
| Materials, services and rents             | 505   | 502                | 1,498                    | 1,507              |
| Depreciation                              | 194   | 186                | 578                      | 551                |
| Diesel fuel                               | 258   | 257                | 726                      | 748                |
| Casualties and other claims               | 33  | 50                 | 131                      | 168                |
| Other                                     | 63  | 59                 | 217                      | 189                |
| No Change                                 |   |                    |                          | 6                  |

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|                                       |               |               |                 |                 |
|---------------------------------------|---------------|---------------|-----------------|-----------------|
| Total railway operating expenses      | 1,672         | 1,678         | 5,079           | 5,145           |
| <b>Income from railway operations</b> | 681           | 715           | 1,899           | 1,943           |
| Other income – net                    | 31            | 41            | 59              | 109             |
| Interest expense on debt              | 107           | 120           | 333             | 361             |
| Income before income taxes            | 605           | 636           | 1,625           | 1,691           |
| Provision for income taxes            | 219           | 220           | 560             | 595             |
| <b>Net income</b>                     | <b>\$ 386</b> | <b>\$ 416</b> | <b>\$ 1,065</b> | <b>\$ 1,096</b> |
| <b><i>Per share amounts:</i></b>      |               |               |                 |                 |
| Net income                            |               |               |                 |                 |
| Basic                                 | \$ 0.99       | \$ 1.04       | \$ 2.71         | \$ 2.68         |
| Diluted                               | \$ 0.97       | \$ 1.02       | \$ 2.66         | \$ 2.62         |
| Dividends                             | \$ 0.26       | \$ 0.18       | \$ 0.70         | \$ 0.50         |

*See accompanying notes to consolidated financial statements.*

## NORFOLK SOUTHERN CORPORATION AND SUBSIDIARIES

## Consolidated Balance Sheets

(Unaudited)

-

Sept. 30,  
2007Dec. 31,  
2006

(\$ in millions)

*Assets*

## Current assets:

|  |    |        |    |        |
|--|----|--------|----|--------|
| Cash and cash equivalents                | \$ | 405    | \$ | 527    |
| Short-term investments                   |    | 13     |    | 391    |
| Accounts receivable, net                 |    | 1,013  |    | 992    |
| Materials and supplies                   |    | 173    |    | 151    |
| Deferred income taxes                    |    | 188    |    | 186    |
| Other current assets                     |    | 59     |    | 153    |
| Total current assets                     |    | 1,851  |    | 2,400  |
| Investments                              |    | 1,934  |    | 1,755  |
| Properties less accumulated depreciation |    | 21,345 |    | 21,098 |
| Other assets                             |    | 830    |    | 775    |
| <b>Total assets</b>                      | \$ | 25,960 | \$ | 26,028 |

*Liabilities and stockholders' equity*

## Current liabilities:

|                                      |    |       |    |       |
|--------------------------------------|----|-------|----|-------|
| Accounts payable                     | \$ | 1,127 | \$ | 1,181 |
| Income and other taxes               |    | 245   |    | 205   |
| Other current liabilities            |    | 267   |    | 216   |
| Current maturities of long-term debt |    | 383   |    | 491   |
| Total current liabilities            |    | 2,022 |    | 2,093 |



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|   |                  |                  |
|---|------------------|------------------|
| Long-term debt  | 5,764            | 6,109            |
| Other liabilities   | 1,930            | 1,767            |
| Deferred income taxes   | 6,365            | 6,444            |
| <b>Total liabilities</b>  | <b>16,081</b>    | <b>16,413</b>    |
| Stockholders' equity:   |                  |                  |
| Common stock \$1.00 per share par value,<br>1,350,000,000                     |                  |                  |
| shares authorized; issued 407,924,180 and<br>418,200,239 shares, respectively | 408              | 418              |
| Additional paid-in capital  | 1,471            | 1,303            |
| Accumulated other comprehensive loss  | (353)            | (369)            |
| Retained income   | 8,373            | 8,283            |
| Less treasury stock at cost, 20,683,686 and<br>20,780,638                     |                  |                  |
| shares, respectively  | (20)             | (20)             |
| <b>Total stockholders' equity</b>   | <b>9,879</b>     | <b>9,615</b>     |
| <b>Total liabilities and stockholders' equity</b>                             | <b>\$ 25,960</b> | <b>\$ 26,028</b> |

*See accompanying notes to consolidated financial statements.*

**NORFOLK SOUTHERN CORPORATION AND SUBSIDIARIES**

**Consolidated Statements of Cash Flows**

**(Unaudited)**

-

Nine Months Ended

**Sept. 30,**

**2007**

**2006**

(\$ in millions)

***Cash flows from operating activities***

|  |    |       |    |       |
|--|----|-------|----|-------|
| Net income   | \$ | 1,065 | \$ | 1,096 |
| Reconciliation of net income to net cash provided by operating activities: |    |       |    |       |
| Depreciation   |    | 587   |    | 560   |
| Deferred income taxes  |    | 19    |    | (42)  |
| Gains and losses on properties and investments                             |    | (36)  |    | (40)  |
| Changes in assets and liabilities affecting operations:                    |    |       |    |       |
| Accounts receivable  |    | (21)  |    | (96)  |
| Materials and supplies   |    | (22)  |    | (26)  |
| Other current assets   |    | 80    |    | 84    |
| Current liabilities other than debt  |    | 67    |    | 146   |
| Other – net  |    | 72    |    | 35    |
| Net cash provided by operating activities                                  |    | 1,811 |    | 1,717 |

***Cash flows from investing activities***

|                                       |  |       |  |         |
|---------------------------------------|--|-------|--|---------|
| Property additions                    |  | (895) |  | (862)   |
| Property sales and other transactions |  | 105   |  | 86      |
| Investments, including short-term     |  | (568) |  | (1,504) |

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|   |    |         |    |         |
|---|----|---------|----|---------|
| Investment sales and other transactions                         |    | 758     |    | 1,739   |
| Net cash used for investing activities                          |    | (600)   |    | (541)   |
| <b><i>Cash flows from financing activities</i></b>              |    |         |    |         |
| Dividends   |    | (276)   |    | (207)   |
| Common stock issued – net                                       |    | 166     |    | 240     |
| Purchase and retirement of common stock                         |    | (769)   |    | (916)   |
| Debt repayments   |    | (454)   |    | (312)   |
| Net cash used for financing activities                          |    | (1,333) |    | (1,195) |
| Net decrease in cash and cash equivalents                       |    | (122)   |    | (19)    |
| <b><i>Cash and cash equivalents</i></b>                         |    |         |    |         |
| At beginning of year  |    | 527     |    | 289     |
| At end of period  | \$ | 405     | \$ | 270     |
| <b><i>Supplemental disclosures of cash flow information</i></b> |    |         |    |         |
| Cash paid during the period for:                                |    |         |    |         |
| Interest (net of amounts capitalized)                           | \$ | 279     | \$ | 300     |
| Income taxes (net of refunds)                                   | \$ | 386     | \$ | 483     |

*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 financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly Norfolk Southern Corporation and subsidiaries' (NS) financial condition as of Sept. 30, 2007, its results of operations for the three and nine months ended Sept. 30, 2007 and 2006, and its cash flows for the nine months ended Sept. 30, 2007 and 2006, in conformity with U.S. generally accepted accounting principles.

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

**1. Stock-Based Compensation**

In the first quarter of 2007, a committee of non-employee directors of NS' 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 \$14 million during the third quarter of 2007 and a benefit of \$1 million for the same period of 2006. For the first nine months of 2007 and 2006, stock-based compensation expense was \$82 million and \$100 million, respectively. The total tax effect recognized in income in relation to stock-based compensation was a benefit of \$5 million and an expense of less than \$1 million for the quarters ended Sept. 30, 2007 and 2006, and benefits of \$27 million and \$34 million for the first nine months of 2007 and 2006, respectively.

**Stock Options**

In the first quarter of 2007, 1,203,300 options were granted under the LTIP and 251,000 options were granted under the TSOP. In each case, the grant price was \$49.56, which was the fair market value of Norfolk Southern Corporation Common Stock (Common Stock) on the date of grant, and the options have a term of ten years but may not be exercised prior to the third anniversary of the date of grant. Holders of the options granted under the LTIP receive cash dividend equivalent payments for five years commensurate with dividends paid on Common Stock.

The fair value of each option award in 2007 was measured on the date of grant using a lattice-based option valuation model. Expected volatilities are based on implied volatilities from traded options on Common Stock and historical volatility of Common Stock. NS uses historical data to estimate option exercises and employee terminations within the valuation model. The average expected option life is derived from the output of the valuation model and represents the period of time that options granted are expected to be outstanding. The average risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. For options granted that include dividend equivalent payments, a dividend yield of zero was used. The assumptions for the 2007 LTIP grant are shown in the following table:

| <b><u>2007</u></b>              |               |
|---------------------------------|---------------|
| Expected volatility range       | 26.1% - 33.3% |
| Average expected volatility     | 33%           |
| Average expected option life    | 5.6 years     |
| Average risk-free interest rate | 4.9%          |
| Per-share grant-date fair value | \$19.82       |

The grant-date fair value of the 2007 TSOP grant was \$17.88 using the same assumptions as the 2007 LTIP grant, except a dividend yield of 1.5% was used because no dividend equivalents are paid on these options and the average expected option life was 6.5 years.

For the first nine months of 2007, 4,611,841 options were exercised yielding \$114 million of cash proceeds and \$52 million of tax benefits recognized as additional paid-in capital. For the first nine months of 2006, option exercises resulted in \$170 million of cash proceeds and \$70 million of tax benefits.

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

There were 321,450 restricted stock units granted in 2007, with an average grant-date fair value of \$50.01 and a five-year restriction period. There were no restricted shares granted in 2007; however, the restricted stock units granted in 2007 will be settled through the issuance of shares of Common Stock.

For the first nine months of 2007, 270,839 restricted shares were vested and 167,027 restricted units were paid out with a grant date fair value of \$23.11 and \$22.22 per share, respectively, and a fair value at vesting of \$48.21 and \$47.82 per share, 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. There were 1,203,300 PSUs granted with a grant-date fair value of \$49.56 in 2007. One-half of any PSUs earned will be paid in the form of shares of Common Stock with the other half to be paid in cash.

For the first nine months of 2007, 717,554 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 \$22.02 per unit and a fair value at pay out of \$49.56 per unit.

## 2. Income Taxes

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48). This Interpretation clarifies accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Under the guidelines of FIN 48, an entity should recognize a financial statement benefit for a tax position if it determines that it is more likely than not that the position will be sustained on examination.

Norfolk Southern adopted the provisions of FIN 48 on Jan. 1, 2007. As a result of the implementation, NS recognized a \$10 million increase to equity, \$2 million of which related to investments accounted for under the equity method of accounting. The balance for unrecognized tax benefits at Jan. 1, 2007, was \$179 million, of which \$44 million (net of the federal tax benefit) would affect the effective tax rate if recognized. Primarily due to changes in estimates upon the filing of 2006 tax returns, the Jan. 1, 2007, balance for unrecognized tax benefits has declined by \$19 million, principally for tax positions for which only the timing of deductibility is uncertain. NS does not expect a significant change in the remaining Jan. 1, 2007, unrecognized tax benefits between now and the end of 2007.

NS recognizes interest related to unrecognized tax benefits in "Other income – net" and penalties related to tax matters in "Provision for income taxes." At Jan. 1, 2007, the balance of interest accrued on unrecognized tax benefits and any penalties related to tax matters was \$17 million and zero, respectively.

NS' consolidated federal income tax returns for 2004 and 2005 are being audited by the Internal Revenue Service (IRS). The IRS completed its examination of the 2002 and 2003 consolidated federal income tax returns during the third quarter of 2006 and NS appealed certain adjustments proposed by the IRS.

In the third quarter of 2007, Illinois enacted tax legislation that modifies the way in which transportation companies apportion their taxable income to the state. The change resulted in an increase in NS' deferred income tax liability in the third quarter, as required by Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes," which increased deferred tax expense by \$19 million.

### 3. Earnings Per Share

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

|   | <b>Three Months Ended</b>                                    |                    | <b>Nine Months Ended</b> |                    |
|---|--|--------------------|--------------------------|--------------------|
|   | <b>Sept. 30,</b>   |                    | <b>Sept. 30,</b>         |                    |
|   | <b><u>2007</u></b>   | <b><u>2006</u></b> | <b><u>2007</u></b>       | <b><u>2006</u></b> |
|   | <i>(\$ in millions except per share, shares in millions)</i> |                    |                          |                    |
| Basic earnings per share:               |  |                    |                          |                    |
| Income available to common stockholders | \$ 384   | \$ 414             | \$ 1,061                 | \$ 1,092           |
| Weighted-average shares outstanding     | 389.0  | 402.0              | 392.3                    | 409.3              |
| Basic earnings per share                | \$ 0.99  | \$ 1.04            | \$ 2.71                  | \$ 2.68            |

Income available to common stockholders reflects a reduction for the after-tax effect of dividend equivalent payments made to holders of vested stock options as follows: for the third quarters of 2007 and 2006, \$2 million, and for the first nine months of 2007 and 2006, \$4 million.

|  | <b>Three Months Ended</b>                                    |                    | <b>Nine Months Ended</b> |                    |
|--|--|--------------------|--------------------------|--------------------|
|  | <b>Sept. 30,</b>   |                    | <b>Sept. 30,</b>         |                    |
|  | <b><u>2007</u></b>   | <b><u>2006</u></b> | <b><u>2007</u></b>       | <b><u>2006</u></b> |
|  | <i>(\$ in millions except per share, shares in millions)</i> |                    |                          |                    |

## Diluted earnings per share:

|  |    |       |    |       |    |       |    |       |
|--|----|-------|----|-------|----|-------|----|-------|
| Income available to common stockholders  | \$ | 386   | \$ | 416   | \$ | 1,065 | \$ | 1,096 |
| Weighted-average shares outstanding per above  |    | 389.0 |    | 402.0 |    | 392.3 |    | 409.3 |
| Dilutive effect of outstanding options, PSUs and restricted shares (as determined by the application of the treasury stock method) |    | 8.4   |    | 7.9   |    | 8.2   |    | 8.8   |
| Adjusted weighted-average shares outstanding   |    | 397.4 |    | 409.9 |    | 400.5 |    | 418.1 |
| Diluted earnings per share   | \$ | 0.97  | \$ | 1.02  | \$ | 2.66  | \$ | 2.62  |

The diluted calculations exclude options having exercise prices exceeding the average market price of Common Stock as follows: none in the third, second and first quarters of 2007 and, for 2006, 1 million in the third quarter, none in the second quarter and 1 million in the first quarter.

#### 4. Stock Purchase Program

In March 2007, NS' Board of Directors amended NS' share repurchase program authorizing the repurchase of up to 75 million shares of Common Stock through the end of 2010. The timing and volume of any purchases will be guided by management's assessment of market conditions and other pertinent facts. Near-term purchases under the program are expected to be made with internally generated cash; however, future funding sources could include proceeds from financings.

NS purchased and retired 15.1 million shares of its common stock under this program in the first nine months of 2007 at a cost of \$769 million, of which \$702 million was charged to retained income. Since inception, NS has purchased and retired 36.9 million shares at a total cost of \$1.7 billion under this program.

#### 5. Investment in Conrail

Through a limited liability company, Norfolk Southern Corporation ( 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 \$874 million at Sept. 30, 2007, and \$849 million at Dec. 31, 2006.

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. "Materials, services and rents" includes expenses for amounts due to CRC for operation of the Shared Assets Areas of \$30 million in each of the third quarters of 2007 and 2006, and \$94 million and \$93 million, respectively, for the first nine months of 2007 and 2006. NS' equity in the earnings of Conrail, net of amortization, included in "Other income – net" was \$10 million and \$9 million in the third quarters of 2007 and 2006, respectively, and \$21 million and \$20 million for the first nine months of 2007 and 2006, respectively.

"Accounts payable" includes \$76 million at Sept. 30, 2007, and \$68 million at Dec. 31, 2006, due to Conrail for the operation of the Shared Assets Areas. In addition, "Other liabilities" includes \$133 million in long-term advances from Conrail, maturing 2035, entered into in 2005 that bear interest at an average rate of 4.4%.

## **6. Derivative Financial Instruments**

All derivatives are recognized in the financial statements as either assets or liabilities and are measured at fair value. Changes in fair value are recorded as adjustments to the assets or liabilities being hedged in "Other comprehensive loss," or in current earnings, depending on whether the derivative is designated and qualifies for hedge accounting, the type of hedge transaction represented and the effectiveness of the hedge.

NS has used derivative financial instruments in the past to reduce the risk of volatility in its diesel fuel costs and currently to manage its overall exposure to fluctuations in interest rates. NS does not engage in the trading of derivatives. Management has determined that its derivative financial instruments qualify as either fair-value or cash-flow hedges, having values that highly correlate with the underlying hedged exposures, and has designated such instruments as hedging transactions. Credit risk related to the derivative financial instruments is considered to be minimal and is managed by requiring high credit standards for counterparties and periodic settlements.

### **Diesel Fuel Hedging**

In 2001, NS began a program to hedge a portion of its diesel fuel consumption. The intent of the program was to assist in the management of NS' aggregate risk exposure to fuel price fluctuations, which can significantly affect NS' operating margins and profitability, through the use of one or more types of derivative instruments. No new hedges have been entered into since May 2004, and the last remaining contracts were settled in the second quarter of 2006, bringing an end to this program. There was no reduction in diesel fuel expense in the third quarter of 2006, but a \$20 million benefit, from fuel hedging activities, for the first nine months of 2006. There was no fuel hedging activity in

2007.

## Interest Rate Hedging

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. NS had \$65 million and \$83 million, or about 1%, of its fixed rate debt portfolio hedged as of Sept. 30, 2007, and Dec. 31, 2006, using interest rate swaps that qualify for and are designated as fair-value hedge transactions.

The effect of the swaps was to reduce interest expenses by less than \$1 million in the third quarter and first nine months of 2007 as well as the same periods in 2006, respectively. These swaps have been effective in hedging the changes in fair value of the related debt arising from changes in interest rates and there has been no impact on earnings resulting from ineffectiveness associated with these derivative transactions.

## Fair Values

Fair values of interest rate swaps at Sept. 30, 2007, and Dec. 31, 2006, were determined based upon the present value of expected future cash flows discounted at the appropriate implied spot rate from the spot rate yield curve. Fair value adjustments are noncash transactions and, accordingly, are excluded from the Consolidated Statements of Cash Flows. The total net asset position of NS' outstanding derivative financial instruments was comprised of a gross fair value asset position of \$1 million at both Sept. 30, 2007, and Dec. 31, 2006.

## 7. 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

| Three months ended Sept. 30, |             |                       |             |
|------------------------------|-------------|-----------------------|-------------|
| <u>2007</u>                  | <u>2006</u> | <u>2007</u>           | <u>2006</u> |
| <u>Pension Benefits</u>      |             | <u>Other Benefits</u> |             |

No Change

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*(\$ in millions)*

|  |         |        |       |       |
|--|---------|--------|-------|-------|
| Service cost                                 | \$ 6    | \$ 6   | \$ 5  | \$ 5  |
| Interest cost                                | 23      | 21     | 11    | 10    |
| Expected return on plan assets               | (42)    | (39)   | (2)   | (2)   |
| Amortization of prior service cost (benefit) | 1       | 1      | (2)   | (2)   |
| Amortization of net losses                   | 2       | 3      | 7     | 7     |
| Net (benefit) cost                           | \$ (10) | \$ (8) | \$ 19 | \$ 18 |

**Nine months ended Sept. 30,**

|                                |                    |                              |                    |
|--------------------------------|--------------------|------------------------------|--------------------|
| <b><u>2007</u></b>             | <b><u>2006</u></b> | <b><u>2007</u></b>           | <b><u>2006</u></b> |
| <b><u>Pension Benefits</u></b> |                    | <b><u>Other Benefits</u></b> |                    |

*(\$ in millions)*

|  |         |         |       |       |
|--|---------|---------|-------|-------|
| Service cost                                 | \$ 18   | \$ 21   | \$ 16 | \$ 15 |
| Interest cost                                | 69      | 66      | 34    | 32    |
| Expected return on plan assets               | (126)   | (119)   | (8)   | (8)   |
| Amortization of prior service cost (benefit) | 2       | 2       | (6)   | (6)   |
| Amortization of net losses                   | 7       | 9       | 21    | 19    |
| Net (benefit) cost                           | \$ (30) | \$ (21) | \$ 57 | \$ 52 |

The estimated amortization of certain items from accumulated comprehensive income (loss) into periodic benefit cost is as follows:

|  | <b>Nine Months<br/>Ended<br/><u>Sept. 30, 2007</u></b> | <b>Fourth<br/>Quarter of<br/><u>2007</u></b> | <b>Year<br/>Ending<br/><u>Dec. 31, 2007</u></b> |
|--|--|--|---|
|  | <i>(\$ in millions)</i>                                |  |   |
| Defined benefit pension plans:         |  |  |   |
| Estimated net losses                   | \$ 7   | \$ 2   | \$ 9  |
| Prior service cost                     | \$ 2   | \$ --  | \$ 2  |
| Defined benefit post retirement plans: |  |  |   |
| Estimated net losses                   | \$ 21  | \$ 7   | \$ 28   |
| Prior service benefit                  | \$ (6)   | \$ (2)                                       | \$ (8)  |

## 8. Comprehensive Income

NS' total comprehensive income was as follows:

|                                   | <b>Three Months Ended<br/>Sept. 30,</b> |                    | <b>Nine Months Ended<br/>Sept. 30,</b> |                    |
|-----------------------------------|---|--------------------|--|--------------------|
|                                   | <b><u>2007</u></b>                      | <b><u>2006</u></b> | <b><u>2007</u></b>                     | <b><u>2006</u></b> |
|                                   | <i>(\$ in millions)</i>                 |                    |  |                    |
| Net income                        | \$ 386                                  | \$ 416             | \$ 1,065                               | \$ 1,096           |
| Other comprehensive income (loss) | 4                                       | 2                  | 16                                     | (10)               |
| Total comprehensive income        | \$ 390                                  | \$ 418             | \$ 1,081                               | \$ 1,086           |

“Other comprehensive income (loss)” in 2007 reflects primarily, net of tax, the amortization of the actuarial net losses and prior service costs for the pension and other postretirement benefit plans and unrealized gains and losses on available-for-sale securities. “Other comprehensive income (loss)” in 2006 reflects primarily, net of tax, unrealized gains and losses on available-for-sale securities and the fair value adjustments to certain derivative financial instruments.

## **9. Commitments and Contingencies**

### **Lawsuits**

Norfolk Southern and 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. NS engages an independent consulting actuarial firm to aid in valuing its liability for these claims. 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 very 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.

In 2005, NS recorded a liability related to the Jan. 6, 2005 derailment in Graniteville, SC. The liability, which includes a current and long-term portion, represents NS' best estimate based on current facts and circumstances. The estimate includes amounts related to business property damage and other economic losses, personal injury and individual property damage claims as well as third-party response costs. NS' commercial insurance policies are expected to cover substantially all expenses related to this derailment above NS' self-insured retention, including NS'

response costs and legal fees. Accordingly, the Consolidated Balance Sheets reflect a current and long-term receivable for estimated recoveries from NS' insurance carriers. While it is reasonable to expect that the liability for covered losses could differ from the amount recorded, such a change would be offset by a corresponding change in the insurance receivable. As a result, NS does not believe that it is reasonably likely that its net loss (the difference between the liability and future recoveries) will be materially different than the loss previously recorded. NS expects at this time that insurance coverage is adequate to cover potential claims and settlements above its self-insurance retention.

Employee personal injury claims – The largest component of casualties and other claims expense is employee personal injury costs. The 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 to the actuarially determined amount on a quarterly basis. 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 actuarial estimate.

Occupational claims – Occupational claims (including asbestosis and other respiratory diseases, as well as repetitive motion) are often not alleged to be caused by a specific accident or event but rather are alleged to 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 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 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 to the actuarially determined amount on a quarterly basis. 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 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 to the actuarially determined amount. Given the inherent uncertainty in regard to the ultimate outcome of third-party claims, it is possible that future settlement costs 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) on the balance sheet 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 included liabilities for environmental exposures in the amount of \$47 million at Sept. 30, 2007, and \$54 million at Dec. 31, 2006 (of which \$12 million was accounted for as a current liability at the end of each period, respectively). At Sept. 30, 2007, the liability represented NS' estimate of the probable cleanup and remediation costs based on available information at 155 known locations. On that date, 13 sites accounted for \$25 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 32 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.

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, can 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 financial condition, results of operations or liquidity in a particular year or quarter.

However, 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 matters, either individually or in the aggregate, will have a material adverse effect on NS' financial condition, results of operations or liquidity.



On Oct. 19, 2006, the Pennsylvania Department of Environmental Protection (PDEP) issued an assessment of civil penalties against NS and filed a complaint for civil penalties with the Pennsylvania Environmental Hearing Board (EHB) requesting that the EHB impose civil penalties upon NS for alleged violations of state environmental laws and regulations resulting from a discharge of sodium hydroxide that occurred as a result of the derailment of a NS train in Norwich Township, Pennsylvania, on June 30, 2006. PDEP's actions sought to impose combined penalties of \$8,890,000 for alleged past violations and \$46,420 per day for alleged continuing violations of state environmental laws and regulations. NS appealed the fines to the EHB. The Pennsylvania Fish and Boat Commission sought financial restitution for damages alleged to have been caused by this accident. In addition, the Pennsylvania Attorney General and the McKean County District Attorney filed three misdemeanor charges for alleged violations of state environmental and aquatic resource protection laws and regulations. NS has reached a settlement agreement with all Commonwealth of Pennsylvania parties, subject to execution of a written agreement and the passage of statutory comment and appeal periods. Pursuant to that agreement, which will resolve all claims by the Commonwealth for civil liability resulting from the derailment and spill, NS will pay approximately \$7.35 million in restitution to compensate for all natural resource damages and the agencies' response costs caused by the derailment and spill. NS has also reached a verbal agreement with the Pennsylvania Attorney General and the McKean County District Attorney, under which NS will plead no contest and pay a fine of approximately \$250,000 to the Attorney General's office to resolve the misdemeanor charges brought against it as a result of the derailment.

## **Insurance**

NS obtains on behalf of itself and its subsidiaries insurance for potential losses for third-party liability and first-party property damages. Specified levels of risk are retained on a self-insurance basis (up to \$25 million per occurrence for bodily injury and property damage to third parties and \$25 million per occurrence for property owned by NS or in NS' care, custody or control).

## **Purchase Commitments**

At Sept. 30, 2007, NSR had outstanding purchase commitments of approximately \$415 million primarily for coal hoppers, locomotives, RoadRailer® trailers, track material and gondolas in connection with its capital programs through 2009.

**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, 2007, the related consolidated statements of income for the three-month and nine-month periods ended September 30, 2007 and 2006 and the related consolidated statements of cash flows for the nine-month periods ended September 30, 2007 and 2006. These consolidated financial statements are the responsibility of the Company's management.

We conducted our reviews 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 reviews, 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.

As discussed in note 2 to the consolidated financial statements, Norfolk Southern Corporation adopted Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, effective January 1, 2007.

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, 2006, 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 20, 2007, we expressed an unqualified opinion on

those consolidated financial statements. Our report refers to Norfolk Southern Corporation's adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, effective January 1, 2006, and Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, effective December 31, 2006. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2006, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

Norfolk , Virginia

October 25, 2007

**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**

**OVERVIEW**

NS' third quarter 2007 results reflected continued weakness in the overall economy that dampened freight transportation demand. Railway operating revenues decreased 2% as a 4% reduction in traffic volume was only partially offset by higher average revenue per unit. Railway operating expenses were about even with the third quarter of 2006, and the railway operating ratio (a measure of the amount of operating revenues consumed by operating expenses) rose to 71.1% compared with 70.1% for the third quarter of 2006.

Cash provided by operating activities for the first nine months was \$1.8 billion and provided funding for capital expenditures, debt maturities and dividends. Cash and short-term investment balances were used to fund third-quarter repurchases of 6.7 million shares of Common Stock at a total cost of \$341 million. At Sept. 30, 2007, cash and short-term investment balances totaled \$418 million.

**SUMMARIZED RESULTS OF OPERATIONS**

Third-quarter 2007 net income was \$386 million, down \$30 million, or 7%, compared with the same period last year. The decline primarily resulted from a \$34 million decrease in income from railway operations and a \$10 million decline in nonoperating income which were partially offset by a \$13 million reduction in interest expense. In addition, third quarter net income was reduced by a \$19 million increase in deferred tax expense resulting from an Illinois tax law change.

For the first nine months of 2007, net income was \$1.1 billion, down \$31 million, or 3%, compared with the same period of 2006. A \$44 million decrease in income from railway operations, lower nonoperating income and the effects of the Illinois tax law change were partially offset by lower interest expense and a \$9 million increase in net benefits from synthetic fuel-related investments.

**DETAILED RESULTS OF OPERATIONS****Railway Operating Revenues**

Third-quarter railway operating revenues were \$2.4 billion in 2007, down \$40 million, or 2%, compared with the third quarter of 2006. For the first nine months, railway operating revenues were \$7.0 billion in 2007, down \$110 million, or 2%, compared with the same period of 2006. As shown in the following table, the decreases were the result of lower traffic volume (down 4% for both periods) offset in part by increased average revenue per unit (up 2.5% for the third quarter and 2.7% for the first nine months).

|                        | <b>Third Quarter</b>              | <b>First Nine Months</b>          |
|------------------------|-----------------------------------|-----------------------------------|
|                        | <b>2007 vs. 2006</b>              | <b>2007 vs. 2006</b>              |
|                        | <b><u>Increase (Decrease)</u></b> | <b><u>Increase (Decrease)</u></b> |
|                        | <i>(\$ in millions)</i>           |                                   |
| Traffic volume (units) | \$ (98)                           | \$ (296)                          |
| Revenue per unit/mix   | <u>58</u>                         | <u>186</u>                        |
| Total                  | <u>\$ (40)</u>                    | <u>\$ (110)</u>                   |

On January 26, 2007, the Surface Transportation Board (STB) issued a decision that the type of fuel surcharge imposed by NS and most other large railroads – a fuel surcharge based on a percentage of line haul revenue – would no longer be permitted for regulated traffic that moves under public (tariff) rates. The STB gave the railroads a 90 day transition period to adjust their fuel surcharge programs. During the second quarter, NS discontinued assessing fuel surcharges on its published (non-intermodal) public rates. Future adjustments to public prices will reflect ongoing market conditions. NS does not expect that compliance with the new STB regulations will have a material effect on its financial condition, results of operations or liquidity.

Revenues, units and average revenue per unit for the commodity groups were as follows:

**Third Quarter**

No Change

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|                              | <b>Revenues</b>         |                    | <b>Units</b>          |                    | <b>Revenue per Unit</b> |                    |
|------------------------------|-------------------------|--------------------|-----------------------|--------------------|-------------------------|--------------------|
|                              | <b><u>2007</u></b>      | <b><u>2006</u></b> | <b><u>2007</u></b>    | <b><u>2006</u></b> | <b><u>2007</u></b>      | <b><u>2006</u></b> |
|                              | <i>(\$ in millions)</i> |                    | <i>(in thousands)</i> |                    | <i>(\$ per unit)</i>    |                    |
| Coal                         | \$ 578                  | \$ 595             | 427.3                 | 436.7              | \$ 1,353                | \$ 1,362           |
| General merchandise:         |                         |                    |                       |                    |                         |                    |
| Chemicals                    | 297                     | 286                | 108.0                 | 109.1              | 2,748                   | 2,612              |
| Metals/construction          | 287                     | 316                | 200.3                 | 219.1              | 1,433                   | 1,441              |
| Agr./consumer<br>prod./govt. | 264                     | 239                | 151.4                 | 147.9              | 1,747                   | 1,617              |
| Automotive                   | 221                     | 211                | 123.5                 | 119.3              | 1,784                   | 1,774              |
| Paper/clay/forest            | 222                     | 231                | 108.5                 | 117.6              | 2,045                   | 1,964              |
| General merchandise          | 1,291                   | 1,283              | 691.7                 | 713.0              | 1,866                   | 1,799              |
| Intermodal                   | 484                     | 515                | 790.1                 | 841.2              | 612                     | 614                |
| Total                        | \$ 2,353                | \$ 2,393           | 1,909.1               | 1,990.9            | \$ 1,232                | \$ 1,202           |

**First Nine Months**

|                              | Revenues         |             | Units          |             | Revenue per Unit |             |
|------------------------------|------------------|-------------|----------------|-------------|------------------|-------------|
|                              | <u>2007</u>      | <u>2006</u> | <u>2007</u>    | <u>2006</u> | <u>2007</u>      | <u>2006</u> |
|                              | (\$ in millions) |             | (in thousands) |             | (\$ per unit)    |             |
| Coal                         | \$ 1,714         | \$ 1,738    | 1,282.1        | 1,321.0     | \$ 1,337         | \$ 1,316    |
| General merchandise:         |                  |             |                |             |                  |             |
| Chemicals                    | 868              | 813         | 323.4          | 324.0       | 2,683            | 2,508       |
| Metals/construction          | 860              | 899         | 595.7          | 650.3       | 1,444            | 1,382       |
| Agr./consumer<br>prod./govt. | 759              | 742         | 447.0          | 443.9       | 1,698            | 1,672       |
| Automotive                   | 703              | 749         | 402.9          | 433.3       | 1,744            | 1,729       |
| Paper/clay/forest            | 649              | 669         | 326.8          | 354.8       | 1,987            | 1,886       |
| General merchandise          | 3,839            | 3,872       | 2,095.8        | 2,206.3     | 1,832            | 1,755       |
| Intermodal                   | 1,425            | 1,478       | 2,345.0        | 2,445.5     | 607              | 605         |
| Total                        | \$ 6,978         | \$ 7,088    | 5,722.9        | 5,972.8     | \$ 1,219         | \$ 1,187    |

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**Coal**

Coal revenues decreased \$17 million, or 3%, in the third quarter and \$24 million, or 1%, in the first nine months, compared with the same periods last year. For the third quarter, the decrease reflected a 2% decline in carloads and a 1% decline in average revenue per unit. For year-to-date, the decrease reflected a 3% decline in carloads that offset a 2% increase in the average revenue per unit. For both periods, tonnage handled showed smaller decreases reflecting increases in tons per carload. Coal tonnage by market was as follows:

|            | <b><u>Third Quarter</u></b> |                      | <b><u>First Nine Months</u></b> |                      |
|------------|-----------------------------|----------------------|---------------------------------|----------------------|
|            | - <b><u>2007</u></b>        | - <b><u>2006</u></b> | - <b><u>2007</u></b>            | - <b><u>2006</u></b> |
|            | <i>(in thousands)</i>       |                      |                                 |                      |
| Utility    | 35,577                      | 36,576               | 107,758                         | 111,003              |
| Export     | 4,050                       | 2,810                | 11,372                          | 9,020                |
| Steel      | 4,856                       | 5,627                | 13,558                          | 15,963               |
| Industrial | 2,362                       | 2,308                | 7,412                           | 6,807                |
|            | 46,845                      | 47,321               | 140,100                         | 142,793              |

Utility coal tonnage declined 3% in the third quarter and in the first nine months as high stockpile levels led to reduced shipments, despite fairly strong electric generation that was up 4% in both periods in the NS service region. Export coal tonnage increased 44% for the third quarter and 26% for the first nine months, reflecting loading delays at Australian ports and increased demand due to a lower valued dollar. Domestic metallurgical coal, coke and iron ore tonnage declined 14% in the third quarter and 15% in the first nine months due to coke furnace outages, mine production outages and reduced spot iron ore traffic. Industrial coal tonnage increased 2% for the third quarter and 9% for the first nine months compared with 2006, principally due to new business and stronger demand.

NS is currently involved in litigation with Virginia Electric and Power Company/Old Dominion Electric Cooperative (Virginia Power) regarding rate adjustment provisions in a transportation contract between them. During the second quarter of 2007, the Virginia Supreme Court issued a decision that remanded the case to the trial court on the grounds that neither of its prior decisions constituted a final order. Future developments and the ultimate resolution of this matter could result in NS recognizing additional revenues related to this dispute, which could have a favorable impact on results of operations in a particular year or quarter.



Coal revenues in the fourth quarter are expected to be up slightly compared to prior year levels, as higher average revenue per unit and continued strength in the export markets are anticipated to offset weaker demand from utilities.

### **General Merchandise**

General merchandise revenues increased \$8 million, or 1%, in the third quarter, compared with the same period last year, reflecting a 4% increase in average revenue per unit, which was partially offset by a 3% decline in traffic volume. For the first nine months, general merchandise revenues decreased \$33 million, or 1%, as a 5% decline in traffic volume was partially offset by a 4% increase in average revenue per unit. The improvement in average revenue per unit for both periods reflected continued market-based pricing in all groups ..

Chemicals traffic volume decreased 1% for the third quarter and was down slightly for the first nine months, reflecting a weakening in plastics during the third quarter. Metals and construction volume was down 9% for the third quarter and 8% for the first nine months, principally due to lower iron, steel and coil shipments, in addition to reduced demand for construction materials. Agriculture, consumer products and government volume increased 2% for the third quarter and 1% for the first nine months. Increases in fertilizer, feed, soybeans, flour, sweeteners, and ethanol shipments more than offset lower government shipments. The decline in government shipments for the first nine months was largely attributable to the absence of last year's volume related to Hurricane Katrina recovery efforts. Automotive volumes increased 4% for the third quarter, but decreased 7% for the first nine months. The increase for the quarter reflected higher traffic volumes as Ford, Toyota and Chrysler increased production, and compared with a weak third quarter 2006. The decline for the year-to-date reflected lower traffic volumes resulting from softness in demand for vehicles as well as parts. Paper, clay and forest traffic volume was down 8% for the third quarter and first nine months, reflecting lower volumes related to the housing slowdown and continued decline in conventional paper markets.

General merchandise revenues are expected to trend modestly higher in the fourth quarter as improved year-over-year pricing should continue to offset modestly lower traffic volume.

### **Intermodal**

Intermodal revenues decreased \$31 million, or 6%, in the third quarter, and \$53 million, or 4%, for the first nine months, compared with the same periods last year, primarily due to lower traffic volumes (down 6% and 4%, respectively). Intermodal average revenue per unit was flat for the third quarter and first nine months.

Truckload volume decreased 14% in the third quarter and 8% in the first nine months. Domestic intermodal marketing companies (IMCs) volume declined 5% in the third quarter and first nine months. Triple Crown Services Company (Triple Crown) volume was down 1% in the third quarter and 3% in the first nine months.

The declines for Truckload, IMCs and Triple Crown were primarily due to lower national demand for dry van shipments primarily resulting from weakness in the housing and automotive sectors.

- International traffic volume declined 5% for the quarter and 4% for the first nine months, primarily driven by reduced shipment of empty international containers, and less inland rail movement of West Coast port traffic.
- The Premium business, which includes parcel and LTL (less-than-truckload) carriers, decreased 3% in the third quarter, but increased 2% in the first nine months as improved parcel business offset declines among LTL carriers.

Intermodal revenues in the fourth quarter are expected to be about even with the fourth quarter of last year.

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### **Railway Operating Expenses**

Third-quarter railway operating expenses were \$1.7 billion in 2007, down \$6 million, or less than 1%, compared with the same period last year. For the first nine months, expenses were \$5.1 billion, down \$66 million, or 1%.

Compensation and benefits expenses decreased \$5 million, or 1%, in the third quarter and \$53 million, or 3%, in the first nine months, compared with the same periods last year. The decrease for the quarter was primarily the result of lower expenses for incentive compensation (down \$10 million) and volume-related payroll (down \$10 million) that were largely offset by higher stock-based compensation costs (up \$15 million). For the first nine months, the decrease reflected lower incentive compensation (down \$35 million), the absence of the prior year retirement and waiver agreements with former executives as well as the cost of the regular stock-based grant to the former Chief Executive Officer (\$24 million), lower volume-related payroll (down \$22 million) and lower payroll taxes (down \$12 million), which included a favorable resolution of a claim in the second quarter, that were partially offset by increased wage rates (up \$20 million), and higher medical costs (up \$21 million).

Materials, services and rents increased \$3 million, or 1%, in the third quarter, but decreased \$9 million, or 1%, for the first nine months, compared with the same periods last year. Higher maintenance and repair expenses were partially offset for the quarter and completely offset for the year-to-date by lower volume-related equipment rents.

Diesel fuel expense increased \$1 million for the third quarter, but decreased \$22 million, or 3%, for the first nine months compared with the same periods last year. For the quarter, higher prices offset a 5% drop in consumption. The year-to-date decline resulted from lower consumption (down 5%) and a modest decrease in price offset in part by the absence of hedge benefits in 2007. Last year favorable hedge settlements reduced fuel expenses by \$20 million in the first half of the year.

No Change

Casualties and other claims expense decreased \$17 million, or 34%, in the third quarter and \$37 million, or 22%, for the first nine months, compared with the same periods last year. The decline for the quarter reflected favorable personal injury and lading claims development, as well as a \$5 million favorable settlement of a global insurance claim from Conrail's legacy policies. In addition, the year-to-date decrease reflected lower derailment costs.

Other railway operating expenses increased \$4 million, or 7%, in the third quarter and \$28 million, or 15%, for the first nine months, compared with the same periods last year. The increases were primarily due to higher property, sales and use, and franchise taxes.

### **Other Income – Net**

Other income – net decreased \$10 million in the third quarter and \$50 million in the first nine months. Interest income decreased \$11 million for the quarter and \$24 million for the first nine months, while gains on the sale of property and investments increased \$14 million for the quarter and \$4 million for the first nine months. In addition, the quarter reflected lower returns from corporate-owned life insurance (down \$8 million) and the first nine months included higher expenses associated with synthetic fuel-related tax credit investments (up \$19 million).

NS purchased a facility that produces synthetic fuel from coal in July 2007 and a second facility in August 2007. NS also has membership interests representing ownership in companies that own and operate facilities that produce synthetic fuel from coal. The production of synthetic fuel results in tax credits as well as expenses related to the investments. The expenses are recorded as a component of "Other income – net," and the tax credits, as well as tax benefits related to the expenses, are reflected in "Provision for income taxes" (see discussion below).

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### **Provision for Income Taxes**

The third-quarter effective income tax rate was 36.2% in 2007, compared with 34.6% last year. For the first nine months, the effective rate was 34.5% in 2007 compared with 35.2% in 2006. The increase for the quarter was the result of deferred tax accruals arising from the Illinois tax legislation enacted in August (see Note 2). For the first nine months, an increase in tax credits from synthetic fuel-related investments largely offset the expenses associated with the Illinois tax legislation.

NS' interests in synthetic fuel credits are subject to reduction if the Reference Price of a barrel of oil for the year falls within an inflation-adjusted phase-out range specified by the Internal Revenue Code. The Reference Price for a year is the annual average wellhead price per barrel of unregulated domestic crude oil determined by the Secretary of the Treasury by April 1 of the following year. In 2006, the phase-out range was \$55.06 to \$69.12, and the phase-out

range is adjusted annually for inflation. While NS cannot predict with certainty the Reference Price of a barrel of oil for 2007, based on actual oil prices during the first nine months and forward curve prices for the remainder of 2007, in the third quarter NS estimated a 43% phase-out of synthetic fuel credits in 2007 compared with an estimated phase-out of 36% in the third quarter of 2006.

Net income for the third quarter and first nine months reflected a \$1 million and \$9 million increase, respectively, in net benefits from these credits, as compared with the same periods in 2006, as shown below:

|   | <u>Third Quarter</u>    |             | <u>First Nine Months</u> |             |
|---|-------------------------|-------------|--------------------------|-------------|
|   | <u>2007</u>             | <u>2006</u> | <u>2007</u>              | <u>2006</u> |
|   | <i>(\$ in millions)</i> |             |                          |             |
| Effect in "Other income – net:"                     |                         |             |                          |             |
| Expenses on synthetic fuel-related investments      | \$ 18                   | \$ 19       | \$ 61                    | \$ 42       |
| Effect in "Provision for income taxes:"             |                         |             |                          |             |
| Tax benefit of expenses on synthetic fuel-related   |                         |             |                          |             |
| Investments   | 7                       | 7           | 24                       | 16          |
| Tax credits   | 18                      | 18          | 57                       | 37          |
| Total reduction of income tax expense               | 25                      | 25          | 81                       | 53          |
| Effect in "Net income:"                             |                         |             |                          |             |
| Net benefit from synthetic fuel-related investments | \$ 7                    | \$ 6        | \$ 20                    | \$ 11       |

The net benefits from these investments were higher in both periods, notwithstanding the higher phase-out, because of increased production, particularly from the new facilities.

Volatility in crude oil prices and changes in production levels, both of which are largely beyond NS' control, could cause dramatic changes in the expenses and tax credits related to all of NS' synthetic fuel investments. The 43% phase-out equates to an average Nymex per-barrel oil price for the last three months of the year of about \$81. A one dollar change in that average price changes the net benefit by almost \$2 million.

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The effect of the new synthetic fuel facilities, along with NS' existing synthetic fuel investments in the fourth quarter of 2007, assuming the 43% phase-out, is projected to be as follows:

|   | <b>Last Three Months of 2007</b> |  |                           |                     |
|---|----------------------------------|--|---------------------------|---------------------|
|   | <b><u>Existing</u></b>           |  | <b><u>New</u></b>         |                     |
|   | <b><u>Investments</u></b>        |  | <b><u>Investments</u></b> | <b><u>Total</u></b> |
|   | <i>(\$ in millions)</i>          |  |                           |                     |
| Effect in "Other income – net:"                               |                                  |  |                           |                     |
| Expenses on synthetic fuel-related investments                | \$ 13                            |  | \$ 18                     | \$ 31               |
| Effect in "Provision for income taxes:"                       |                                  |  |                           |                     |
| Tax benefit of expenses on synthetic fuel-related investments | 5                                |  | 7                         | 12                  |
| Tax credits   | 12                               |  | 23                        | 35                  |
| Total reduction of income tax expense                         | 17                               |  | 30                        | 47                  |
| Effect in "Net income:"                                       |                                  |  |                           |                     |
| Net benefit from synthetic fuel-related investments           | \$ 4                             |  | \$ 12                     | \$ 16               |

Based on these projections it is expected that the effective tax rate will be approximately 34% for the full year 2007. The tax credits generated by NS' synthetic fuel-related investments expire at the end of 2007 and, accordingly, the effective tax rate is likely to increase thereafter.

## FINANCIAL CONDITION AND LIQUIDITY

Cash provided by operating activities, NS' principal source of liquidity, was \$1.8 billion in the first nine months of 2007, compared with \$1.7 billion in the first nine months of 2006. NS had a working capital deficit of \$171 million at Sept. 30, 2007, compared with working capital of \$307 million at Dec. 31, 2006; the change was largely the result of reduced cash and short-term investment balances. NS' cash, cash equivalents and short-term investment balances totaled \$418 million at Sept. 30, 2007. NS expects that cash on hand combined with cash flow from operations will be sufficient to meet its ongoing obligations. There have been no material changes to the contractual obligation amounts contained in NS' Dec. 31, 2006, Form 10-K, except for the commitment to purchase 50 locomotives, discussed below. In addition, information relating to NS' future obligations related to certain tax positions, the timing of which is uncertain, is disclosed in Note 2.

Cash used for investing activities for the first nine months of 2007 was \$600 million, compared with \$541 million for the same period of 2006, reflecting lower investment sales net of purchases and higher property additions. NS committed in the third quarter of 2007 to purchase 50 locomotives, taking delivery of 20 locomotives in the fourth quarter with the remainder in the first quarter of 2008. As a result, 2007 capital expenditures are expected to be approximately \$1.4 billion.

Cash used for financing activities was \$1.3 billion in the first nine months of 2007, compared with \$1.2 billion in the first nine months of 2006. The change reflected higher debt repayments, increased dividend payments and fewer exercises of employee stock options that were partially offset by fewer share repurchases as part of NS' ongoing share repurchase program (see Note 4). NS expects to continue to increase its dividend, subject to business conditions, toward a goal of paying out about one-third of net income. The timing and volume of future share purchases will be guided by management's assessment of market conditions and other factors. Near-term purchases under the program are expected to be made with internally generated cash; however, future funding sources are likely to include proceeds from financings. NS' debt-to-total capitalization ratio was 38.4% at Sept. 30, 2007, compared with 40.7% at Dec. 31, 2006.

In the second quarter, NS amended its \$1 billion credit facility to, among other things, extend the facility until 2012. The credit facility provides for borrowing at prevailing rates and includes typical financial covenants. There were no amounts outstanding under this facility at Sept. 30, 2007, and NS is in compliance with all of the financial covenants. NS also has in place a shelf registration statement on Form S-3 filed with the SEC in September 2004 under which up to \$700 million of additional securities could be issued.

## 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 change them. 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 Dec. 31, 2006, with the exception of the adoption of Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," which is discussed below in "New Accounting Pronouncement" and in Note 2.

## **OTHER MATTERS**

### Labor Agreements

Approximately 26,000, or about 85%, 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 in concert with other major railroads. Moratorium provisions in the labor agreements govern when the railroads and the unions may propose changes.

The most recent bargaining round began in late 2004. Since that time, the railroads have reached agreements that extend through 2009 with all of the major rail unions except the United Transportation Union (UTU) and the International Association of Machinists (IAM). The unions with which the railroads have reached agreement represent about two-thirds of NS' unionized employees. A tentative agreement with IAM failed ratification.

Because NS previously reached separate agreements with the Brotherhood of Locomotive Engineers and Trainmen (BLET) and the American Train Dispatchers Association (ATDA), only the health and welfare provisions from the national agreements will apply to NS' locomotive engineers and ATDA-represented dispatchers. NS has also reached a further tentative agreement (subject to ratification by employees) that would extend its contract with BLET through 2014.

Negotiations with the unions that have not settled are being mediated by the National Mediation Board (NMB), a federal agency. The status quo is preserved during mediation (that is, the unions may not strike and management may not change the labor agreements) while the NMB assists the parties in their efforts to reach agreement. If the NMB

were to terminate mediation, it would, at that time, propose that the parties arbitrate their differences. A strike could occur 30 days thereafter if the parties did not accept arbitration. However, the President of the United States of America could then appoint an Emergency Board which would delay any strike for a further 60 days while the Board made recommendations and the parties engaged in further negotiations. The outcome of the negotiations cannot be determined at this time.

### Market Risks and Hedging Activities

NS has used derivative financial instruments in the past to reduce the risk of volatility in its diesel fuel costs and currently to manage its overall exposure to fluctuations in interest rates.

In 2001, NS began a program to hedge a portion of its diesel fuel consumption. The intent of the program was to assist in the management of NS' aggregate risk exposure to fuel price fluctuations, which can significantly affect NS' operating margins and profitability, through the use of one or more types of derivative instruments. No new hedges have been entered into since May of 2004, and the last remaining contracts were settled in the second quarter of 2006, bringing an end to the benefits from the program.

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 Sept. 30, 2007, NS' debt subject to interest rate fluctuations totaled \$169 million. A 1% increase in interest rates would increase NS' total annual interest expense related to all its variable debt by approximately \$2 million. Management considers it unlikely that interest rate fluctuations applicable to these instruments will result in a material adverse effect on NS' financial condition, results of operations or liquidity.

Some of NS' capital leases, which carry an average fixed rate of 7%, were effectively converted to variable rate obligations using interest rate swap agreements. On Sept. 30, 2007, the average pay rate under these agreements was 6%, and the average receive rate was 7%. The effect of the swaps was to reduce interest expense by less than \$1 million in the third quarter and first nine months of 2007, compared with reductions of less than \$1 million and \$1 million for the same periods in 2006, respectively. A portion of the lease obligations is payable in Japanese yen. NS eliminated the associated exchange rate risk at the inception of each lease with a yen deposit sufficient to fund the yen-denominated obligation. Most of these deposits are held by foreign banks, primarily Japanese. As a result, NS is exposed to financial market risk relative to Japan .. Counterparties to the interest rate swaps and Japanese banks holding yen deposits are major financial institutions believed by management to be creditworthy.

### Environmental Matters

OTHER 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 Sheet 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 included liabilities for environmental exposures in the amount of \$47 million at Sept. 30, 2007, and \$54 million at Dec. 31, 2006, (of which \$12 million was accounted for as a current liability at the end of both periods). At Sept. 30, 2007, the liability represented NS' estimate of the probable cleanup and remediation costs based on available information at 155 known locations. On that date, 13 sites accounted for \$25 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 32 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 matters, either individually or in the aggregate, will have a material adverse effect on NS' financial condition, results of operations or liquidity.

On Oct. 19, 2006, the Pennsylvania Department of Environmental Protection (PDEP) issued an assessment of civil penalties against NS and filed a complaint for civil penalties with the Pennsylvania Environmental Hearing Board (EHB) requesting that the EHB impose civil penalties upon NS for alleged violations of state environmental laws and regulations resulting from a discharge of sodium hydroxide that occurred as a result of the derailment of a NS train in Norwich Township, Pennsylvania, on June 30, 2006. PDEP's actions sought to impose combined penalties of \$8,890,000 for alleged past violations and \$46,420 per day for alleged continuing violations of state environmental laws and regulations. NS appealed the fines to the EHB. The Pennsylvania Fish and Boat Commission sought financial restitution for damages alleged to have been caused by this accident. In addition, the Pennsylvania Attorney

General and the McKean County District Attorney filed three misdemeanor charges for alleged violations of state environmental and aquatic resource protection laws and regulations. NS has reached a settlement agreement with all Commonwealth of Pennsylvania parties, subject to execution of a written agreement and the passage of statutory comment and appeal periods. Pursuant to that agreement, which will resolve all claims by the Commonwealth for civil liability resulting from the derailment and spill, NS will pay approximately \$7.35 million in restitution to compensate for all natural resource damages and the agencies' response costs caused by the derailment and spill. NS has also reached a verbal agreement with the Pennsylvania Attorney General and the McKean County District Attorney, under which NS will plead no contest and pay a fine of approximately \$250,000 to the Attorney General's office to resolve the misdemeanor charges brought against it as a result of the derailment.

#### New Accounting Pronouncement

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes." This Interpretation clarifies accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." NS adopted this Interpretation in the first quarter of 2007 (see Note 2).

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#### 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 assets. 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: domestic and international economic conditions; interest rates; the business environment in industries that produce and consume rail freight; competition and consolidation within the transportation industry; fluctuation in prices or availability of key materials, in particular diesel fuel; labor difficulties, including strikes and work stoppages; legislative and regulatory developments; results of synthetic fuel-related investments, as affected by production levels and the price of crude oil; results of litigation; changes in securities and capital markets; disruptions to our technology infrastructure, including our computer systems; and natural events such as severe weather, hurricanes and floods. For a discussion of significant risk factors applicable to NS, see Part I,

### **OTHER MATTERS**

Item 1A "Risk Factors" in NS' Dec. 31, 2006 Form 10-K and any updates contained herein. 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 Sept. 30, 2007. Based on such evaluation, such officers have concluded that, as of Sept. 30, 2007, 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 2007, 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 Oct. 19, 2006, the Pennsylvania Department of Environmental Protection (PDEP) issued an assessment of civil penalties against NS and filed a complaint for civil penalties with the Pennsylvania Environmental Hearing Board (EHB) requesting that the EHB impose civil penalties upon NS for alleged violations of state environmental laws and regulations resulting from a discharge of sodium hydroxide that occurred as a result of the derailment of a NS train in Norwich Township, Pennsylvania, on June 30, 2006. The PDEP's actions sought to impose combined penalties of \$8,890,000 for alleged past violations and \$46,420 per day for alleged continuing violations of state environmental laws and regulations. NS appealed the fines to the EHB. The Pennsylvania Fish and Boat Commission sought financial restitution for damages alleged to have been caused by this accident. In addition, the Pennsylvania Attorney General and the McKean County District Attorney filed three misdemeanor charges for alleged violations of state environmental and aquatic resource protection laws and regulations. NS has reached a settlement agreement with all

Commonwealth of Pennsylvania parties, subject to execution of a written agreement and the passage of statutory comment and appeal periods. Pursuant to that agreement, which will resolve all claims by the Commonwealth for civil liability resulting from the derailment and spill, NS will pay approximately \$7.35 million in restitution to compensate for all natural resource damages and the agencies' response costs caused by the derailment and spill. NS has also reached a verbal agreement with the Pennsylvania Attorney General and the McKean County District Attorney, under which NS will plead no contest and pay a fine of approximately \$250,000 to the Attorney General's office to resolve the misdemeanor charges brought against it as a result of the derailment.

In three separate incidents occurring on or about Jan. 5, 2004, Jan. 31, 2005, and Oct. 20, 2006, freight trains operated by NS derailed in the Pennsylvania municipalities of Bell Township, East Deer Township (Creighton) and New Brighton, respectively, resulting in discharges of diesel fuel, lube oil and corn at Bell Township, hydrogen fluoride at Creighton and ethanol at New Brighton in alleged violation of state environmental laws and regulations. NS reached a settlement with PDEP resolving all penalty claims arising out of these incidents, the terms of which included payment of a civil penalty of \$575,000 during the third quarter.

As of Oct. 24, 2007, 26 antitrust class actions have been filed against NS and the other Class 1 railroads in various Federal district courts regarding fuel surcharges. These actions are expected to be consolidated in one court by the Judicial Panel on Multidistrict Litigation. NS believes the allegations in the complaints are without merit and intends to vigorously defend the cases. In addition, NS received a subpoena from a state grand jury on July 13, 2007, requesting documents and materials relating to the setting of fuel surcharges. NS is cooperating with the state in its investigation. NS does not believe that the outcome of these proceedings will have a material effect on its financial condition, results of operations, or liquidity.

#### **Item 1A. Risk Factors.**

The following risk factors, which were included in NS' 2006 Form 10-K, are amended in their entirety to read as follows. The remaining risk factors included in NS' 2006 Form 10-K remain unchanged and are incorporated herein by reference.

**NS is subject to significant governmental regulation and legislation over commercial, environmental and operating matters.** NS' unintentional failure to comply with applicable laws and regulations could have a material adverse effect on NS, and changes in the legislative or regulatory frameworks within which NS operates could adversely affect its business.

Railroads are subject to commercial regulation by the Surface Transportation Board, which has jurisdiction over some rates, routes, fuel surcharges, conditions of service and the extension or abandonment of rail lines. The STB also has jurisdiction over the consolidation, merger or acquisition of control of and by rail common carriers.

In addition, Congress could enact re-regulation legislation. Economic re-regulation of the rail industry could have a significant negative impact on NS' ability to determine prices for rail services, reduce capital spending on its rail network, reduce levels of service, and result in a material adverse effect on NS' financial condition, results of operations or liquidity in a particular year or quarter, and in the future, would likely have a lasting material adverse effect on the value of an investment in NS.

Railroads are subject to safety regulation by the Federal Railroad Administration, which regulates most aspects of NS' operations. Proposed amendments to federal rail safety statutes, if enacted, could add significantly to operating costs and could have a material adverse effect on NS' financial condition, results of operations or liquidity if NS is unable to recover those higher costs.

**NS, as a common carrier by rail, must offer to transport hazardous materials, regardless of risk.**

Transportation of certain hazardous materials could create catastrophic losses in terms of personal injury and property damage costs, and compromise critical parts of our rail network. Legislation introduced in Congress would give federal regulators increased authority to conduct investigations and levy substantial fines and penalties in connection with railroad accidents. Under provisions enacted in August 2007, federal regulators are required to prescribe new regulations governing railroads' transportation of hazardous materials, including annual routing analyses, security risk assessments and employee security training. Regulations proposed in late 2006 by DHS mandating chain of custody and security measures likely will cause service degradation and higher costs for the transportation of toxic inhalation hazard materials. Further, certain local governments have sought to enact ordinances banning hazardous materials moving by rail within their borders. Some legislators have contemplated pre-notification requirements for hazardous materials shipments. If promulgated such ordinances could require the re-routing of hazardous materials shipments, with the potential for significant additional costs and network inefficiencies.

**The operations of carriers with which NS interchanges may adversely affect its operations.** NS' ability to provide rail service to customers in the U.S. and Canada depends in large part upon its ability to maintain cooperative relationships with connecting carriers with respect to, among other matters, freight rates, revenue divisions, car supply and locomotive availability, data exchange and communications, reciprocal switching, interchange, and trackage rights. Deterioration in the operations of, or service provided by connecting carriers, or in our relationship with those connecting carriers, could result in NS' inability to meet its customers' demands or require NS to use alternate train routes, which could result in significant additional costs and network inefficiencies.

**NS may be subject to various claims and lawsuits that could result in significant expenditures.** The nature of NS' business exposes it to the potential for various claims and litigation related to labor and employment, personal injury, commercial disputes, freight loss and other property damage, and other matters. Job-related personal injury and occupational claims are subject to the Federal Employers' Liability Act (FELA), which is applicable only to railroads. FELA's fault-based tort system produces results that are unpredictable and inconsistent as compared with a no-fault worker's compensation system. The variability inherent in this system could result in actual costs being very different from the liability recorded.

Any material changes to current litigation trends or a catastrophic rail accident involving any or all of freight loss or property damage, personal injury, and environmental liability could have a material adverse effect on NS' operating results, financial condition, and liquidity to the extent not covered by insurance. NS has obtained insurance for potential losses for third-party liability and first-party property damages. Specified levels of risk are retained on a self-insurance basis (currently up to \$25 million per occurrence for bodily injury and property damage to third parties and \$25 million per occurrence for property owned by NS or in its care, custody or control). Insurance is available from a limited number of insurers and may not continue to be available or, if available, may not be obtainable on terms acceptable to NS.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.****ISSUER REPURCHASES OF EQUITY SECURITIES**

| <b><u>Period</u></b> | <b><u>(a) Total Number of Shares (or Units) Purchased</u></b> | <b><u>(b) Average Price Paid per Share (or Unit)</u></b> | <b><u>(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs<sup>(2)</sup></u></b> | <b><u>(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that may yet be Purchased Under the Plans or Programs<sup>(2)</sup></u></b> |
|----------------------|---|--|---|---|
| July 1-31, 2007      | 639,747   | \$53.98  | 639,600   | 44,168,367  |
| Aug. 1-31, 2007      | 4,252,212   | \$50.48  | 4,252,212   | 39,916,155  |
| Sept. 1-30, 2007     | <u>1,816,800</u>  | \$50.49  | <u>1,816,800</u>  | 38,099,355  |
| Total                | <u>6,708,759</u> <sup>(1)</sup>                               |  | <u>6,708,612</u>  |   |

(1) Of this amount, 147 represent shares tendered by employees in connection with the exercise of stock options under the Long-Term Incentive Plan.

(2) On Nov. 22, 2005, the Board of Directors authorized a share repurchase program, pursuant to which up to 50 million shares of Common Stock could be purchased through Dec. 31, 2015. On March 27, 2007, the Board of Directors amended the program and increased the number of shares that may be repurchased to 75 million, and shortened the repurchase term by five years to Dec. 31, 2010.

**Item 6. Exhibits.**



See Exhibit Index beginning on page 31 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: Oct. 25, 2007

/s/ Dezora M. Martin

Dezora M. Martin

Corporate Secretary (Signature)

Date: Oct. 25, 2007

/s/ Marta R. Stewart

Marta R. Stewart

Vice President and Controller

(Principal Accounting Officer) (Signature)

**EXHIBIT INDEX**

- 3\*        The Bylaws of Norfolk Southern Corporation, as amended effective Jan. 1, 2008.
  
- 10        The Norfolk Southern Directors' Charitable Award Program, as amended effective July 2007, is incorporated herein by reference to Exhibit 10.6 to Norfolk Southern Corporation's Form 10-Q for the quarter ended June 30, 2007.
  
- 15\*       Letter regarding unaudited interim financial information.
  
- 31\*       Rule 13a-14(a)/15d-14(a) Certifications.
  
- 32\*       Section 1350 Certifications.

\* Filed herewith.