

NORFOLK SOUTHERN CORP  
Form 10-Q  
July 24, 2008

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

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13  
OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the quarterly period ended **JUNE 30, 2008****

**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**

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

Norfolk , Virginia

(Address of principal executive offices)

(Zip Code)

**(757) 629-2680**

(Registrant's telephone number, including area code)

**No Change**

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

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

Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if smaller reporting company)

Smaller reporting company

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes  No

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY**

**PROCEEDINGS DURING THE PRECEDING FIVE YEARS**

Indicate by checkmark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS**

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 June 30, 2008</u>                  |
|---------------------------------|--|
| Common Stock (par value \$1.00) | 375,199,214 (excluding 20,629,383 shares held by the |



**TABLE OF CONTENTS**

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

Page

Part I. Financial Information:

|         |   |    |
|---------|---|----|
| Item 1. | Financial Statements:   |    |
|         | Consolidated Statements of Income   |    |
|         | Three and Six Months Ended June 30, 2008 and 2007                                     | 3  |
|         | Consolidated Balance Sheets   |    |
|         | As of June 30, 2008, and Dec. 31, 2007  | 4  |
|         | Consolidated Statements of Cash Flows   |    |
|         | Six Months Ended June 30, 2008 and 2007   | 5  |
|         | Notes to Consolidated Financial Statements  | 6  |
|         | Report of Independent Registered Public Accounting Firm                               | 14 |
| Item 2. | Management's Discussion and Analysis of Financial Condition and Results of Operations | 15 |
| Item 3. | Quantitative and Qualitative Disclosures About Market Risk                            | 24 |
| Item 4. | Controls and Procedures   | 24 |

Part II. Other Information:

|         |                   |    |
|---------|-------------------|----|
| Item 1. | Legal Proceedings | 25 |
|---------|-------------------|----|

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

|               |   |    |
|---------------|---|----|
| Item 1A.      | Risk Factors  | 25 |
| Item 2.       | Unregistered Sales of Equity Securities and Use of Proceeds | 26 |
| Item 4.       | Submission of Matters to a Vote of Security Holders         | 26 |
| Item 6.       | Exhibits  | 26 |
| Signatures    |   | 27 |
| Exhibit Index |   | 28 |

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

## NORFOLK SOUTHERN CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Income

(Unaudited)

|  | Three Months Ended                         |        | Six Months Ended |          |
|--|--|--------|------------------|----------|
|  | June 30,                                   |        | June 30,         |          |
|  | 2008                                       | 2007   | 2008             | 2007     |
|  | (\$ in millions, except per share amounts) |        |                  |          |
| <b><i>Railway operating revenues</i></b> |  |        |                  |          |
| Coal                                     | \$ 775                                     | \$ 579 | \$ 1,437         | \$ 1,136 |
| General merchandise                      | 1,458                                      | 1,320  | 2,810            | 2,548    |
| Intermodal                               | 532  | 479    | 1,018            | 941      |
| Total railway operating revenues         | 2,765                                      | 2,378  | 5,265            | 4,625    |
| <b><i>Railway operating expenses</i></b> |  |        |                  |          |
| Compensation and benefits                | 662  | 629    | 1,367            | 1,310    |
| Purchased services and rents             | 400  | 380    | 775              | 764      |
| Fuel                                     | 491  | 279    | 895              | 527      |
| Depreciation                             | 199  | 192    | 397              | 384      |
| Materials and other                      | 214  | 208    | 454              | 422      |
| Total railway operating expenses         | 1,966                                      | 1,688  | 3,888            | 3,407    |

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

|                                       |                |                |                |             |
|---------------------------------------|----------------|----------------|----------------|-------------|
| <b>Income from railway operations</b> | 799            | 690            | 1,377          | 1,218       |
| Other income – net                    | 46             | 21             | 53             | 28          |
| Interest expense on debt              | 112            | 111            | 221            | 226         |
| Income before income taxes            | 733            | 600            | 1,209          | 1,020       |
| Provision for income taxes            | 280            | 206            | 465            | 341         |
| <b>Net income</b>                     | <b>\$ 453</b>  | <b>\$ 394</b>  | <b>\$ 744</b>  | <b>679</b>  |
| <i>Per share amounts</i>              |                |                |                |             |
| Net income                            |                |                |                |             |
| Basic                                 | <b>\$ 1.20</b> | <b>\$ 1.00</b> | <b>\$ 1.98</b> | <b>1.72</b> |
| Diluted                               | <b>\$ 1.18</b> | <b>\$ 0.98</b> | <b>\$ 1.94</b> | <b>1.69</b> |
| Dividends                             | <b>\$ 0.29</b> | <b>\$ 0.22</b> | <b>\$ 0.58</b> | <b>0.44</b> |

*See accompanying notes to consolidated financial statements.*



**NORFOLK SOUTHERN CORPORATION AND SUBSIDIARIES**

**Consolidated Balance Sheets**

**(Unaudited)**

-

**June 30,  
2008**

**Dec. 31,  
2007**

(\$ in millions)

**Assets**

Current assets:

|  |           |               |           |               |
|--|-----------|---------------|-----------|---------------|
| Cash and cash equivalents                | \$        | 454           | \$        | 206           |
| Accounts receivable, net                 |           | 1,084         |           | 942           |
| Materials and supplies                   |           | 203           |           | 176           |
| Deferred income taxes                    |           | 169           |           | 190           |
| Other current assets                     |           | 116           |           | 161           |
| <b>Total current assets</b>              |           | <b>2,026</b>  |           | <b>1,675</b>  |
| Investments                              |           | 1,804         |           | 1,974         |
| Properties less accumulated depreciation |           | 21,824        |           | 21,583        |
| Other assets                             |           | 760           |           | 912           |
| <b>Total assets</b>                      | <b>\$</b> | <b>26,414</b> | <b>\$</b> | <b>26,144</b> |

**Liabilities and stockholders' equity**

Current liabilities:

|                                      |    |              |    |              |
|--------------------------------------|----|--------------|----|--------------|
| Accounts payable                     | \$ | 1,114        | \$ | 1,139        |
| Income and other taxes               |    | 282          |    | 203          |
| Other current liabilities            |    | 246          |    | 237          |
| Current maturities of long-term debt |    | 486          |    | 369          |
| <b>Total current liabilities</b>     |    | <b>2,128</b> |    | <b>1,948</b> |

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

|   |                  |                  |
|---|------------------|------------------|
| Long-term debt  | 6,003            | 5,999            |
| Other liabilities   | 1,812            | 2,039            |
| Deferred income taxes   | 6,479            | 6,431            |
| <b>Total liabilities</b>  | <b>16,422</b>    | <b>16,417</b>    |
| Stockholders' equity:   |                  |                  |
| Common stock \$1.00 per share par value,<br>1,350,000,000<br>shares authorized; outstanding 375,199,214<br>and<br>379,297,891 shares, respectively, net of<br>treasury shares | 376              | 380              |
| Additional paid-in capital  | 1,657            | 1,466            |
| Accumulated other comprehensive loss  | (392)            | (399)            |
| Retained income   | 8,351            | 8,280            |
| <b>Total stockholders' equity</b>   | <b>9,992</b>     | <b>9,727</b>     |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 26,414</b> | <b>\$ 26,144</b> |

*See accompanying notes to consolidated financial statements.*

**NORFOLK SOUTHERN CORPORATION AND SUBSIDIARIES**

**Consolidated Statements of Cash Flows**

**(Unaudited)**

Six Months Ended

**June 30,**

**2008**

**2007**

(\$ in millions)

***Cash flows from operating activities***

|   |    |       |    |       |
|---|----|-------|----|-------|
| Net income  | \$ | 744   | \$ | 679   |
| Reconciliation of net income to net cash<br>provided by operating activities: |    |       |    |       |
| Depreciation  |    | 402   |    | 390   |
| Deferred income taxes   |    | 63    |    | (22)  |
| Gains on properties and investments   |    | (22)  |    | (14)  |
| Changes in assets and liabilities affecting<br>operations:                    |    |       |    |       |
| Accounts receivable   |    | 55    |    | (9)   |
| Materials and supplies  |    | (27)  |    | (24)  |
| Other current assets  |    | 34    |    | 54    |
| Current liabilities other than debt   |    | (245) |    | 25    |
| Other – net   |    | 54    |    | 58    |
| Net cash provided by operating<br>activities                                  |    | 1,058 |    | 1,137 |

***Cash flows from investing activities***

|   |  |       |  |       |
|---|--|-------|--|-------|
| Property additions                      |  | (676) |  | (575) |
| Property sales and other transactions   |  | 66    |  | 69    |
| Investments, including short-term       |  | (34)  |  | (445) |
| Investment sales and other transactions |  | 251   |  | 566   |
| Net cash used in investing activities   |  | (393) |  | (385) |

***Cash flows from financing activities***

|  |  |         |       |
|--|--|---------|-------|
| Dividends  |  | (218)   | (174) |
| Common stock issued – net                            |  | 177     | 154   |
| Purchase and retirement of common stock              |  | (494)   | (427) |
| Proceeds from borrowings                             |  | 1,225   | --    |
| Debt repayments                                      |  | (1,107) | (433) |
| Net cash used in financing activities                |  | (417)   | (880) |
| Net increase (decrease) in cash and cash equivalents |  | 248     | (128) |

***Cash and cash equivalents***

|                      |    |     |        |
|----------------------|----|-----|--------|
| At beginning of year |    | 206 | 527    |
| At end of period     | \$ | 454 | \$ 399 |

***Supplemental disclosures of cash flow information***

Cash paid during the period for:

|                                       |    |     |        |
|---------------------------------------|----|-----|--------|
| Interest (net of amounts capitalized) | \$ | 208 | \$ 235 |
| Income taxes (net of refunds)         | \$ | 235 | \$ 240 |

*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 (Norfolk Southern) and subsidiaries' (collectively, NS) financial condition as of June 30, 2008, and its results of operations and cash flows for the three and six months ended June 30, 2008 and 2007, 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 2008, a committee of non-employee directors of Norfolk Southern's Board of Directors granted stock options, restricted stock units and performance share units (PSUs) pursuant to the Long-Term Incentive Plan (LTIP) and granted stock options pursuant to the Thoroughbred Stock Option Plan (TSOP) as discussed below. Stock-based compensation expense was \$30 million during the second quarter of 2008, and \$17 million during the same period of 2007. For the first six months of 2008 and 2007, stock-based compensation expense was \$95 million and \$68 million, respectively. The total tax effect recognized in income in relation to stock-based compensation were benefits of \$10 million and \$5 million for the quarters ended June 30, 2008 and 2007, respectively, and benefits of \$32 million and \$22 million for the first six months of 2008 and 2007, respectively.

**Stock Options**

In the first quarter of 2008, 1,162,600 options were granted under the LTIP and 250,000 options were granted under the TSOP. In each case, the grant price was \$50.74, which was the fair market value of Norfolk Southern Corporation common stock (Common Stock) on the date of grant. 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 who remain actively employed receive cash dividend equivalent payments for five years in an amount equal to the regular quarterly dividends paid on Common Stock.

The fair value of each option award in 2008 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 2008 LTIP grant are shown in the following table:

|                                 | <b><u>2008</u></b> |
|---------------------------------|--------------------|
| Expected volatility range       | 25% - 32%          |
| Average expected volatility     | 32%                |
| Average expected option life    | 5.9 years          |
| Average risk-free interest rate | 3.68%              |
| Per-share grant-date fair value | \$19.32            |

The grant-date fair value of the 2008 TSOP grant was \$16.29 using the same assumptions as the 2008 LTIP grant, except a dividend yield of 2.29% was used because no dividend equivalent payments are made on these options and the average expected option life was 8.0 years.

For the first six months of 2008, options relating to 4,391,618 shares were exercised, yielding \$105 million of cash proceeds and \$53 million of tax benefits recognized as additional paid-in capital. For the first six months of 2007, option exercises resulted in \$106 million of cash proceeds and \$48 million of tax benefits.

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

There were 299,950 restricted stock units granted in 2008, with an average grant-date fair value of \$50.47 and a five-year restriction period. The restricted stock units granted in 2008 will be settled through the issuance of shares of Common Stock. There were no restricted shares granted in 2008.

### **Performance Share Units**

No Change

PSUs provide for awards based on achievement of certain predetermined corporate performance goals at the end of a three-year cycle. There were 1,162,600 PSUs granted with a grant-date fair value of \$50.47 during the first quarter of 2008. 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 six months of 2008, 1,013,999 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 \$34.10 per unit and a fair value at pay out of \$50.47 per unit. The total related tax benefit was \$2 million for the first six months of 2008.

## 2. Income Taxes

There have been no material changes to the balance of unrecognized tax benefits reported at Dec. 31, 2007. During the second quarter, the IRS completed fieldwork on its examination of NS' 2004 and 2005 federal income tax returns; however, the audit remains subject to further administrative review. NS anticipates that this review will be completed during the third quarter. NS expects that the resolution of the 2004 and 2005 examination will not have a material effect on income tax expense. Also, NS' appeal of certain adjustments proposed by the IRS with respect to the 2002 and 2003 tax years was resolved in the second quarter without a material effect on income tax expense.

Interest expense related to the overpayment and underpayment of income taxes, which is included in "Other income – net," was reduced by \$13 million during the quarter primarily due to the resolution of certain refund claims submitted to the IRS and the resolution of NS' appeal of the 2002 and 2003 tax years. Depending upon the final outcome of the 2004 and 2005 examination, an adjustment to interest expense could be made during the third quarter.

## 3. Earnings Per Share

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

| <b>Three Months Ended</b>                                    |                    | <b>Six Months Ended</b> |                    |
|--|--------------------|-------------------------|--------------------|
| <b>June 30,</b>  |                    | <b>June 30,</b>         |                    |
| <b><u>2008</u></b>   | <b><u>2007</u></b> | <b><u>2008</u></b>      | <b><u>2007</u></b> |
| <i>(\$ in millions except per share, shares in millions)</i> |                    |                         |                    |

## Basic earnings per share:

|   |    |       |    |       |    |       |    |       |
|---|----|-------|----|-------|----|-------|----|-------|
| Income available to common stockholders | \$ | 452   | \$ | 393   | \$ | 742   | \$ | 677   |
| Weighted-average shares outstanding     |    | 375.4 |    | 393.7 |    | 375.6 |    | 394.0 |
| Basic earnings per share                | \$ | 1.20  | \$ | 1.00  | \$ | 1.98  | \$ | 1.72  |

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: \$1 million in the second quarter of 2008 and 2007, and \$2 million in the first six months of 2008 and 2007.

| Three Months Ended |             | Six Months Ended |             |
|--------------------|-------------|------------------|-------------|
| June 30,           |             | June 30,         |             |
| <u>2008</u>        | <u>2007</u> | <u>2008</u>      | <u>2007</u> |

*(\$ in millions except per share, shares in millions)*

## Diluted earnings per share:

|  |    |       |    |       |    |       |    |       |
|--|----|-------|----|-------|----|-------|----|-------|
| Income available to common stockholders  | \$ | 453   | \$ | 394   | \$ | 744   | \$ | 679   |
| Weighted-average shares outstanding per above  |    | 375.4 |    | 393.7 |    | 375.6 |    | 394.0 |
| Dilutive effect of outstanding options, PSUs and restricted shares (as determined by the application of the treasury stock method) |    | 8.1   |    | 8.0   |    | 8.1   |    | 8.0   |
| Adjusted weighted-average shares outstanding   |    | 383.5 |    | 401.7 |    | 383.7 |    | 402.0 |
| Diluted earnings per share   | \$ | 1.18  | \$ | 0.98  | \$ | 1.94  | \$ | 1.69  |

The diluted calculations exclude options having exercise prices exceeding the average market price of Common Stock as follows: none in the second and first quarters of 2008 and 2007.



#### **4. Stockholders' Equity**

Common stock is reported net of shares held by consolidated subsidiaries (treasury shares) of Norfolk Southern. Treasury shares at June 30, 2008, and Dec. 31, 2007, totaled 20,629,383 and 20,683,686, respectively, with a cost of \$20 million at both June 30, 2008, and Dec. 31, 2007.

#### **5. Share Repurchase Program**

In March 2007, Norfolk Southern's Board of Directors amended NS' share repurchase program, increasing the authorized amount of share repurchases from 50 million to 75 million shares and shortening the term of the program from 2015 to 2010. The timing and volume of purchases is 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 or proceeds from borrowings. NS repurchased and retired 9.0 million and 8.4 million shares of its Common Stock under this program in the first six months of both 2008 and 2007, respectively, at a cost of \$494 million and \$427 million for each of those periods, respectively.

#### **6. Investment in Conrail**

Through a limited liability company, Norfolk Southern and CSX Corporation (CSX) jointly own Conrail Inc. (Conrail), whose primary subsidiary is Consolidated Rail Corporation (CRC). NS has a 58% economic and 50% voting interest in the jointly owned entity, and CSX has the remainder of the economic and voting interests. NS' investment in Conrail was \$915 million at June 30, 2008, and \$899 million at Dec. 31, 2007.

CRC owns and operates certain properties (the Shared Assets Areas) for the joint and exclusive benefit of Norfolk Southern Railway Company (NSR) and CSX Transportation, Inc. (CSXT). The costs of operating the Shared Assets Areas are borne by NSR and CSXT based on usage. In addition, NSR and CSXT pay CRC a fee for access to the Shared Assets Areas. "Purchased services and rents" includes expenses for amounts due to CRC for operation of the Shared Assets Areas of \$31 million in the second quarter of 2008 and \$29 million in the second quarter of 2007, and \$62 million and \$61 million, respectively, for the first six months of 2008 and 2007. NS' equity in the earnings of Conrail, net of amortization, included in "Other income – net" was \$7 million and \$6 million in the second quarters of 2008 and 2007, respectively, and \$15 million and \$11 million for the first six months of 2008 and 2007, respectively.

"Accounts payable" includes \$60 million at June 30, 2008, and \$78 million at Dec. 31, 2007, due to Conrail for the operation of the Shared Assets Areas. In addition, "Other liabilities" includes \$133 million at both June 30, 2008, and Dec. 31, 2007, in long-term advances from Conrail, maturing 2035, entered into in 2005, that bear interest at an average rate of 4.4%.

## 7. Long-term Debt

In the second quarter of 2008, NS received \$100 million under its accounts receivable securitization facility, at an average variable interest rate of 2.8% with a 364-day term. At June 30, 2008, and Dec. 31, 2007, the amounts outstanding under the facility were \$100 million and \$250 million, respectively, and the amount of receivables included in "Accounts receivable – net" serving as collateral for these borrowings was \$884 million and \$778 million, respectively. During the second quarter of 2008, \$200 million of commercial paper matured, and was refinanced as part of a private offering, under which NS issued and sold \$600 million in debt securities at 5.75% due 2018. NS subsequently exchanged substantially all of these unregistered securities with essentially identical securities registered under the Securities Act of 1933.

## 8. Pensions and Other Postretirement Benefits

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

-

### Pension and Other Postretirement Benefit Cost Components

-

#### Three months ended June 30,

|  | <u>2008</u>             | <u>2007</u> | <u>2008</u>           | <u>2007</u> |
|--|-------------------------|-------------|-----------------------|-------------|
|  | <u>Pension Benefits</u> |             | <u>Other Benefits</u> |             |
|  | <i>(\$ in millions)</i> |             |                       |             |

|  |        |         |       |       |
|--|--------|---------|-------|-------|
| Service cost                                 | \$ 6   | \$ 6    | \$ 2  | \$ 6  |
| Interest cost                                | 25     | 23      | 13    | 11    |
| Expected return on plan assets               | (43)   | (42)    | (5)   | (3)   |
| Amortization of prior service cost (benefit) | 1      | --      | (3)   | (2)   |
| Amortization of net losses                   | 2      | 3       | 6     | 7     |
| Net (benefit) cost                           | \$ (9) | \$ (10) | \$ 13 | \$ 19 |

## Six months ended June 30,

|  | <u>2008</u>             | <u>2007</u> | <u>2008</u>           | <u>2007</u> |
|--|-------------------------|-------------|-----------------------|-------------|
|  | <u>Pension Benefits</u> |             | <u>Other Benefits</u> |             |

(\$ in millions)

|  |         |         |       |       |
|--|---------|---------|-------|-------|
| Service cost                                 | \$ 12   | \$ 12   | \$ 8  | \$ 11 |
| Interest cost                                | 50      | 46      | 25    | 23    |
| Expected return on plan assets               | (86)    | (84)    | (7)   | (6)   |
| Amortization of prior service cost (benefit) | 1       | 1       | (5)   | (4)   |
| Amortization of net losses                   | 4       | 5       | 13    | 14    |
| Net (benefit) cost                           | \$ (19) | \$ (20) | \$ 34 | \$ 38 |

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

|  | <b>Six Months</b>           | <b>Second</b>      | <b>Year</b>                 |
|--|-----------------------------|--------------------|-----------------------------|
|  | <b>Ended</b>                | <b>Half of</b>     | <b>Ending</b>               |
|  | <b><u>June 30, 2008</u></b> | <b><u>2008</u></b> | <b><u>Dec. 31, 2008</u></b> |

(\$ in millions)

## Defined benefit pension plans:

|                      |      |      |      |
|----------------------|------|------|------|
| Prior service cost   | \$ 1 | \$ 2 | \$ 3 |
| Estimated net losses | \$ 4 | \$ 3 | \$ 7 |

## Defined benefit post retirement plans:

|                       |        |        |        |
|-----------------------|--------|--------|--------|
| Prior service benefit | \$ (5) | \$ (3) | \$ (8) |
| Estimated net losses  | \$ 13  | \$ 12  | \$ 25  |

**9. Comprehensive Income**

NS' total comprehensive income was as follows:

No Change

|                            | <b>Three Months Ended</b> |                    | <b>Six Months Ended</b> |                    |
|----------------------------|---------------------------|--------------------|-------------------------|--------------------|
|                            | <b>June 30,</b>           |                    | <b>June 30,</b>         |                    |
|                            | <b><u>2008</u></b>        | <b><u>2007</u></b> | <b><u>2008</u></b>      | <b><u>2007</u></b> |
|                            | <i>(\$ in millions)</i>   |                    |                         |                    |
| Net income                 | \$ 453                    | \$ 394             | \$ 744                  | \$ 679             |
| Other comprehensive income | 3                         | 7                  | 7                       | 12                 |
| Total comprehensive income | \$ 456                    | \$ 401             | \$ 751                  | \$ 691             |

“Other comprehensive income” in 2008 and 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, for 2007, unrealized gains and losses on available-for-sale securities.

## 10. Commitments and Contingencies

### Lawsuits

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

### Casualty Claims

No Change

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

In April 2008, NS settled the lawsuit brought by Avondale Mills for claims associated with the Jan. 6, 2005, derailment in Graniteville, SC. The total liability related to the derailment 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 the unreimbursed portion and NS' self-insured retention, including NS' response costs and legal fees. The Consolidated Balance Sheets reflect current and long-term receivables for estimated recoveries from NS' insurance carriers. On July 1, 2008, NS filed a demand for arbitration against one of its insurance carriers that has failed to respond to an insurance claim submitted by NS. Accordingly, it is likely that all or part of the recorded recovery attributable to such carrier (\$100 million) will be contested. NS believes these expenses are covered by the insurance policy and that recovery of any contested amount is probable, in that if the carrier contests payment an arbitrator would determine the settlement amounts to be reasonable and that the insurer's refusal to consent to and to fund the settlement was a breach of contract.

**Employee personal injury claims** – The largest component of casualties and other claims expense is employee personal injury costs. The independent actuarial firm engaged by NS provides quarterly studies to aid in valuing its employee personal injury liability and estimating its employee personal injury expense. The actuarial firm studies NS' historical patterns of reserving for claims and subsequent settlements, taking into account relevant outside influences. The actuary uses the results of these analyses to estimate the ultimate amount of the liability, which includes amounts for incurred but unasserted claims. NS adjusts its liability quarterly based upon management's assessment and the results of the study. 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 differ from the estimated liability recorded.

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

liability may not be adequate to cover the future payment of claims. Adjustments to the recorded liability are reflected in operating expenses in the periods in which such adjustments become known.

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

## **Environmental Matters**

NS is subject to various jurisdictions' environmental laws and regulations. It is NS' policy to record a liability where such liability or loss is probable and its amount can be estimated reasonably. Claims, if any, against third parties for recovery of cleanup costs incurred by NS are reflected as receivables (when collection is probable) 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 include liabilities for environmental exposures in the amount of \$39 million at June 30, 2008, and \$46 million at Dec. 31, 2007 (of which \$12 million is classified as a current liability at the end of each period). At June 30, 2008, the liability represents NS' estimate of the probable cleanup and remediation costs based on available information at 152 known locations. As of that date, 11 sites accounted for \$19 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 30 locations, one or more Norfolk Southern subsidiaries, usually in conjunction with a number of other parties, have been identified as potentially responsible parties by the Environmental Protection Agency (EPA) or similar state authorities under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, or comparable state statutes, which often impose joint and several liability for cleanup costs.

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

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

On April 24, 2008, the United States Department of Justice (DOJ) brought an action against NS for alleged violations of federal environmental laws resulting from the discharge of chlorine and oil that occurred as a result of the Jan. 6, 2005 derailment in Graniteville, SC, including claims for civil penalties as well as injunctive relief. On June 24, 2008, NS filed a motion to dismiss DOJ's claims, contending that insufficient facts have been alleged to support such claims. NS does not believe that the resolution of these claims will have a material adverse effect on its financial position, results of operations or liquidity.

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 position, results of operations or liquidity.

## **Insurance**

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

## **Purchase Commitments**

At June 30, 2008, NSR had outstanding purchase commitments of approximately \$152 million primarily for coal hoppers, RoadRailer® trailers, and track material in connection with its capital programs through 2009. In July 2008, the Board of Directors authorized the addition of approximately \$80 million to the 2008 capital budget, three quarters of which is to acquire new locomotives and the remainder to accelerate program track work.

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 June 30, 2008, the related consolidated statements of income for the three month and six month periods ended June 30, 2008 and 2007 and the related consolidated statements of cash flows for the six month periods ended June 30, 2008 and 2007. These consolidated financial statements are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Norfolk Southern Corporation and subsidiaries as of December 31, 2007, and the related consolidated statements of income, changes in stockholders' equity and cash flows for the year then ended (not presented herein); and in our report dated February 15, 2008, we expressed an unqualified opinion on those consolidated financial statements. Our report refers to Norfolk Southern Corporation's adoption of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, effective January 1, 2007. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2007, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

No Change



Norfolk, Virginia  
July 22, 2008

**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' second-quarter 2008 net income was 15% higher than the prior year due to improved income from railway operations. Railway operating revenues increased 16% as higher average revenue per unit (which includes fuel surcharge) more than offset a 2% reduction in traffic volume. Railway operating expenses, driven by higher fuel costs, increased 16% as compared to the second quarter of 2007, and the railway operating ratio (a measure of the amount of operating revenues consumed by operating expenses) increased slightly to 71.1% compared with 71.0% for the second quarter of 2007.

At June 30, 2008, cash and short-term investment balances totaled \$454 million. Cash provided by operating activities for the first six months was \$1.1 billion and, along with proceeds from borrowings, provided funding for capital expenditures and dividends, as well as share repurchases. In the second quarter of 2008, 3.4 million shares of Norfolk Southern Corporation common stock (Common Stock) were repurchased at a total cost of \$218 million. Since inception of the stock repurchase program in 2006, NS has repurchased and retired 54.4 million shares of Common Stock at a total cost of \$2.7 billion.

**SUMMARIZED RESULTS OF OPERATIONS**

Second-quarter 2008 net income was \$453 million, up \$59 million, or 15%, compared with the same period last year. The improvement primarily resulted from a \$109 million increase in income from railway operations and a \$25 million increase in other income. Second-quarter net income was reduced by a \$74 million increase in income taxes, reflecting both higher pretax income and the absence of benefits associated with synthetic fuel tax credits that expired in 2007.

For the first six months of 2008, net income was \$744 million, up \$65 million, or 10%, compared with the same period last year. Increases of \$159 million in income from railway operations and \$25 million in other income were offset in part by a \$124 million increase in income taxes.

## DETAILED RESULTS OF OPERATIONS

### Railway Operating Revenues

Second-quarter 2008 railway operating revenues were \$2.8 billion, up \$387 million, or 16%, compared with the second quarter of 2007. As shown in the following table, the increases were the result of higher average revenue per unit, including increased fuel surcharges, that were offset in part by lower traffic volume. Fuel surcharges amounted to \$410 million in the second quarter (up \$231 million) and \$729 million for the first six months (up \$375 million).

|                        | <b>Second Quarter</b>             | <b>First Six Months</b>           |
|------------------------|-----------------------------------|-----------------------------------|
|                        | <b>2008 vs. 2007</b>              | <b>2008 vs. 2007</b>              |
|                        | <b><u>Increase (Decrease)</u></b> | <b><u>Increase (Decrease)</u></b> |
|                        | <i>(\$ in millions)</i>           |                                   |
| Revenue per unit/mix   | \$438                             | \$743                             |
| Traffic volume (units) | <u>(51)</u>                       | <u>(103)</u>                      |
| Total                  | <u>\$387</u>                      | <u>\$640</u>                      |

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

|                              | <b>Second Quarter</b>   |             |                       |             |                         |             |
|------------------------------|-------------------------|-------------|-----------------------|-------------|-------------------------|-------------|
|                              | <b>Revenues</b>         |             | <b>Units</b>          |             | <b>Revenue per Unit</b> |             |
|                              | <u>2008</u>             | <u>2007</u> | <u>2008</u>           | <u>2007</u> | <u>2008</u>             | <u>2007</u> |
|                              | <i>(\$ in millions)</i> |             | <i>(in thousands)</i> |             | <i>(\$ per unit)</i>    |             |
| Coal                         | \$ 775                  | \$ 579      | 448.3                 | 434.6       | \$ 1,729                | \$ 1,332    |
| General merchandise:         |                         |             |                       |             |                         |             |
| Chemicals                    | 322                     | 297         | 103.9                 | 109.7       | 3,095                   | 2,712       |
| Metals/construction          | 352                     | 298         | 210.4                 | 209.8       | 1,675                   | 1,423       |
| Agr./consumer<br>prod./govt. | 326                     | 254         | 156.6                 | 148.9       | 2,077                   | 1,701       |
| Automotive                   | 227                     | 255         | 116.3                 | 146.9       | 1,954                   | 1,733       |
| Paper/clay/forest            | 231                     | 216         | 102.4                 | 109.0       | 2,261                   | 1,981       |
| General merchandise          | 1,458                   | 1,320       | 689.6                 | 724.3       | 2,115                   | 1,822       |
| Intermodal                   | 532                     | 479         | 763.1                 | 783.4       | 698                     | 611         |
| Total                        | \$ 2,765                | \$ 2,378    | 1,901.0               | 1,942.3     | \$ 1,455                | \$ 1,224    |

#### First Six Months

|                              | Revenues         |             | Units          |             | Revenue per Unit |             |
|------------------------------|------------------|-------------|----------------|-------------|------------------|-------------|
|                              | <u>2008</u>      | <u>2007</u> | <u>2008</u>    | <u>2007</u> | <u>2008</u>      | <u>2007</u> |
|                              | (\$ in millions) |             | (in thousands) |             | (\$ per unit)    |             |
| Coal                         | \$ 1,437         | \$ 1,136    | 875.3          | 854.8       | \$ 1,642         | \$ 1,329    |
| General merchandise:         |                  |             |                |             |                  |             |
| Chemicals                    | 627              | 571         | 206.1          | 215.4       | 3,041            | 2,650       |
| Metals/construction          | 657              | 573         | 396.9          | 395.4       | 1,657            | 1,450       |
| Agr./consumer<br>prod./govt. | 625              | 495         | 308.7          | 295.6       | 2,023            | 1,673       |
| Automotive                   | 455              | 482         | 235.9          | 279.4       | 1,930            | 1,726       |
| Paper/clay/forest            | 446              | 427         | 202.6          | 218.3       | 2,201            | 1,958       |
| General merchandise          | 2,810            | 2,548       | 1,350.2        | 1,404.1     | 2,081            | 1,815       |
| Intermodal                   | 1,018            | 941         | 1,503.5        | 1,554.9     | 677              | 605         |
| Total                        | \$ 5,265         | \$ 4,625    | 3,729.0        | 3,813.8     | \$ 1,412         | \$ 1,213    |

-



Coal revenues for the remainder of the year are expected to be up compared to prior year levels, due to higher average revenue per unit and continued strength in the export market.

### **General Merchandise**

General merchandise revenues increased \$138 million, or 10%, in the second quarter and \$262 million, or 10%, in the first six months, compared with the same periods last year, a result of higher average revenue per unit. The improvement in average revenue per unit reflected continued market-based pricing in all groups and higher fuel surcharges. Traffic volume declined 5% for the quarter and 4% for the first six months, driven by lower automotive volumes. Chemicals traffic volume decreased 5% for the second quarter and 4% for the first six months, reflecting continued weakness in plastics and petroleum-based products linked to housing and roadway construction declines, respectively. Metals and construction volume was up slightly as increased carloads from metals offset declines in housing-related markets. Agriculture, consumer products and government volume increased 5% for the second quarter and 4% for the first six months, reflecting increases in ethanol, corn and feed shipments. Automotive volumes decreased 21% for the second quarter and 16% for the first six months, reflecting reduced North American sales and production. Automotive manufacturers, especially the domestic producers, continue to experience sales declines as consumers are opting for more fuel efficient vehicles. Ford, General Motors and Chrysler combined operate 17 of 27 assembly plants served by NS. Two of these assembly plants implemented shift reductions during the first half of 2008, and two other plants have announced plans to reduce shifts in the third quarter. In addition, one manufacturer has announced plans to close an assembly plant later in the year. Paper, clay and forest traffic volume was down 6% for the second quarter and 7% for the first six months, reflecting lower volumes related to the housing slowdown and continued decline in conventional paper markets.

General merchandise revenues are expected to be higher for the remainder of the year as improved year-over-year pricing should continue to offset lower traffic volume.

### **Intermodal**

Intermodal revenues increased \$53 million, or 11%, in the second quarter and \$77 million, or 8%, for the first six months, compared with the same periods last year, primarily due to higher average revenue per unit including fuel surcharges. Intermodal volume declined 3% in the second quarter and first six months. Domestic volume (which includes truckload and intermodal marketing companies' [IMC] volumes) increased 7% for the second quarter, and was up slightly for the first six months, reflecting the relative efficiency of intermodal versus over-the-road transportation in a high fuel cost environment. International traffic volume declined 8% for the second quarter and 7% for the first six months, primarily driven by a soft economy and less inland rail movement of West Coast port traffic that offset East Coast port volume growth. The Premium business, which includes parcel and less-than-truckload (LTL) carriers, decreased 6% for the second quarter and 4% for the first six months, as reduced private empty movements and soft parcel business offset LTL conversions. Triple Crown Services Company volume was down 1% for the second quarter, but improved slightly for the first six months.

Intermodal revenues for the remainder of the year are expected to reflect growth due to modestly higher traffic volume and increased revenue per unit.

-

### **Railway Operating Expenses**

Second-quarter railway operating expenses were \$2.0 billion in 2008, up \$278 million, or 16%, compared with the same period last year. For the first six months, railway operating expenses were \$3.9 billion, up \$481 million, or 14%, compared with the same period last year.

Compensation and benefits expenses increased \$33 million, or 5%, in the second quarter and \$57 million, or 4%, in the first six months, compared with the same periods last year. The changes reflected increased incentive compensation due to a higher projected payout (up \$19 million for the quarter and \$22 million for the first six months), increased stock-based compensation primarily due to a stock price increase (up \$13 million for the quarter and \$27 million for the first six months), increased pay rates (up \$10 million for the quarter and \$20 million for the first six months) and the absence of a second-quarter 2007 settlement of a \$9 million payroll tax refund claim that were offset in part by lower health and welfare benefits expenses (down \$10 million for the quarter and \$14 million for the first six months).

Purchased services and rents increased \$20 million, or 5%, in the second quarter and \$11 million, or 1%, in the first six months, compared with the same periods last year. The increases were driven by higher intermodal operational costs, higher roadway repair expenses and increased professional and legal services that were offset in part by lower equipment rents.

Fuel expense, which includes the cost of locomotive fuel as well as other fuel used in railway operations, increased \$212 million, or 76%, for the second quarter and \$368 million, or 70%, for the first six months, compared with the same periods last year, reflecting sharply higher fuel prices.

Materials and other expenses (including the estimates of costs related to personal injury, property damage and environmental matters) increased \$6 million, or 3%, in the second quarter and \$32 million, or 8%, for the first six months, compared with the same periods last year. The quarterly increase reflected higher expenses associated with derailments and increased materials costs for locomotive and freight car repairs that were offset in part by \$12 million of favorable personal injury claims and \$4 million of environmental costs development. The year-to-date increase also reflected the above as well as costs associated with the Avondale Mills settlement related to the Graniteville accident (see additional discussion below). The following table shows the components of materials and other expenses.



|                             | <u>Second Quarter</u> |             | <u>First Six Months</u> |             |
|-----------------------------|-----------------------|-------------|-------------------------|-------------|
|                             | <u>2008</u>           | <u>2007</u> | <u>2008</u>             | <u>2007</u> |
|                             | <i>(in millions)</i>  |             |                         |             |
| Materials                   | \$ 96                 | \$ 91       | \$ 197                  | \$ 180      |
| Casualties and other claims | 42                    | 46          | 107                     | 98          |
| Other                       | 76                    | 71          | 150                     | 144         |
|                             | \$ 214                | \$ 208      | \$ 454                  | \$ 422      |

In April 2008, NS settled the lawsuit brought by Avondale Mills for claims associated with the Jan. 6, 2005, derailment in Graniteville, SC. A portion of the settlement will not be reimbursed by insurance and was included in first-quarter 2008 expenses. The total liability related to the derailment 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 the unreimbursed portion and NS' self-insured retention, including NS' response costs and legal fees. The Consolidated Balance Sheets reflect current and long-term receivables for estimated recoveries from NS' insurance carriers. On July 1, 2008, NS filed a demand for arbitration against one of its insurance carriers that has failed to respond to an insurance claim submitted by NS. Accordingly, it is likely that all or part of the recorded recovery attributable to such carrier (\$100 million) will be contested. NS believes these expenses are covered by the insurance policy and that recovery of any contested amount is probable, in that if the carrier contests payment an arbitrator would determine the settlement amounts to be reasonable and that the insurer's refusal to consent to and to fund the settlement was a breach of contract.

#### **Other income – net**

Other income – net increased \$25 million in both the second quarter and the first six months of 2008, compared with the same periods in 2007. The increases reflect the absence of expenses related to synthetic fuel investments (down \$26 million for the quarter and \$46 million for the first six months), reduced interest expense (down \$9 million for the quarter and \$10 million for the first six months) due to a second-quarter adjustment to reflect the expected outcome of certain tax examinations, and more gains on the sale of property (up \$5 million for the quarter and \$8 million for the first six months). These benefits were offset in part by lower returns and higher borrowing costs on corporate-owned life insurance (down \$11 million for the quarter and \$32 million for the first six months) and lower interest income (down \$7 million for the quarter and \$17 million for the first six months).

#### **Provision for Income Taxes**

No Change

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

The second-quarter and year-to-date effective income tax rates were 38.2% and 38.5% in 2008, compared with 34.3% and 33.4% for the same periods last year. The increases were largely due to the absence of synthetic fuel-related credits which expired at the end of 2007.

NS' consolidated federal income tax returns for 2004 and 2005 are being audited by the Internal Revenue Service and the audit is expected to be completed during the third quarter (see Note 2).

## FINANCIAL CONDITION AND LIQUIDITY

Cash provided by operating activities, NS' principal source of liquidity, was \$1.1 billion for the first six months of 2008 and 2007. NS had a working capital deficit of \$102 million at June 30, 2008, compared with a working capital deficit of \$273 million at Dec. 31, 2007; the change was largely the result of increased proceeds from borrowings that were partially used to repurchase shares of Common Stock. The payment of the Avondale Mills settlement affected working capital because the amount subject to arbitration is classified as a long-term receivable. NS' cash, cash equivalents and short-term investment balances totaled \$454 million at June 30, 2008. NS expects that cash on hand combined with cash flows from operations will be sufficient to meet its ongoing obligations. In addition to the contractual obligation amounts and information relating to NS' future obligations related to certain tax positions contained in NS' Form 10-K as of Dec. 31, 2007, NS made additional purchase commitments for capital assets, discussed below, and through a private offering issued and sold \$600 million in debt securities during the second quarter of 2008.

Cash used for investing activities was \$393 million for the first six months of 2008, compared with \$385 million in the same period last year, reflecting higher property additions offset in part by increased investment sales net of purchases. In the first quarter of 2008, Norfolk Southern's Board of Directors approved the addition of \$64 million to its 2008 capital budget to accelerate the purchase of approximately 750 new coal cars. In July 2008, the Board of Directors authorized the addition of approximately \$80 million to the 2008 capital budget, three quarters of which is to acquire new locomotives and the remainder to accelerate program track work.

Cash used for financing activities was \$417 million for the first six months of 2008, compared with \$880 million for the same period of 2007. The change reflected net debt issuances of \$118 million in 2008 compared with debt repayments of \$433 million in 2007. Additionally, NS share repurchases for the first six months of 2008 were \$67 million higher than for the first six months of 2007. The timing and volume of future share repurchases will be guided by management's assessment of market conditions and other factors. Near-term purchases under the share repurchase program are expected to be made with internally generated cash and proceeds from financings. NS' debt-to-total capitalization ratio was 39.4% at June 30, 2008, compared with 39.6% at Dec. 31, 2007.

NS has in place and available a \$1 billion, five-year credit agreement expiring in 2012, which provides for borrowings at prevailing rates and includes financial covenants. There were no amounts outstanding under this facility at June 30, 2008, and NS is in compliance with all of the financial covenants. Through February 2009, NS is ineligible to utilize its March 2001 and September 2004 Form S-3 registration statements due to a late filing of a Form 8-K which was unrelated to its financial condition or results of operations. However, this is not expected to have an impact on financial liquidity. Through a private offering, NS issued and sold \$600 million in debt securities in April 2008 (see Note 7), and subsequently exchanged substantially all of these unregistered securities with essentially identical securities registered under the Securities Act of 1933.

## **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, 2007.

## **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 International Association of Machinists (IAM). The unions with which the railroads have reached agreement represent about 95% of NS' unionized employees. A tentative agreement with IAM failed ratification and the parties remain in mediation.

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 also had reached a further tentative agreement that would have extended its contract with BLET through 2014; however, the tentative agreement failed ratification by the employees.

Negotiations with the IAM are being mediated by the National Mediation Board (NMB), a federal agency. The status quo is preserved during mediation (that is, the union may not strike and management may not change the labor agreement) 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 uses derivative financial instruments to manage its overall exposure to fluctuations in interest rates. 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 June 30, 2008, NS' debt subject to interest rate fluctuations totaled \$124 million. A 1% increase in interest rates would increase NS' total annual interest expense related to all its variable debt by approximately \$1 million. Management considers it unlikely that interest rate fluctuations applicable to these instruments will result in a material adverse effect on NS' financial 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 June 30, 2008, the average pay rate under these agreements was 4%, and the average receive rate was 7%. The effect of the swaps was to reduce interest expense by less than \$1 million in the second quarters of 2008 and 2007. 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

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

NS' Consolidated Balance Sheets include liabilities for environmental exposures in the amount of \$39 million at June 30, 2008, and \$46 million at Dec. 31, 2007 (of which \$12 million is classified as a current liability at the end of each period). At June 30, 2008, the liability represents NS' estimate of the probable cleanup and remediation costs based on available information at 152 known locations. As of that date, 11 sites account for \$19 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 30 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.

### New Accounting Pronouncement

In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements." This statement, effective for interim or annual reporting periods beginning after Nov. 15, 2007, establishes a framework for measuring fair value in U.S. generally accepted accounting principles and expands disclosures about fair value measurements. NS adopted the statement Jan. 1, 2008, related to financial instrument assets and liabilities with no material effect on NS' consolidated financial statements.

### 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 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, Item 1A "Risk Factors" in NS' Form 10-K as of Dec. 31, 2007, 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 June 30, 2008. Based on such evaluation, such officers have concluded that, as of June 30, 2008, 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 second quarter of 2008, 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.**

With respect to the antitrust class actions consolidated on November 6, 2007, in the U.S. District Court for the District of Columbia by the Judicial Panel on Multidistrict Litigation, consolidated amended class action complaints were filed against NS and three other railroads on April 15, 2008. The complaints allege violations of Federal antitrust laws and other laws with regard to the railroads' fuel surcharge programs. Motions to dismiss the consolidated complaints were filed by the railroads on May 30, 2008, and discovery has been stayed pending resolution of such motions. On March 25, 2008, a lawsuit containing similar allegations against NS and four other major railroads was filed in the U.S. District Court for the District of Minnesota by a customer on behalf of itself, although NS has not yet received service of process. NS believes the allegations in the complaints are without merit and intends to vigorously defend these actions. NS does not believe that the outcome of these proceedings will have a material effect on its financial position, results of operations, or liquidity.

With respect to the state investigation into the setting of fuel surcharges and the related grand jury subpoena received by NS in July 2007, NS was notified by the state that the state has decided not to move forward with its investigation at this time, while reserving its right to re-open the matter in the future if it decides that circumstances so dictate.

On April 24, 2008, the United States Department of Justice (DOJ) brought an action against NS for alleged violations of federal environmental laws resulting from the discharge of chlorine and oil that occurred as a result of the Jan. 6, 2005 derailment in Graniteville, SC, including claims for civil penalties as well as injunctive relief. On June 24, 2008, NS filed a motion to dismiss DOJ's claims, contending that insufficient facts have been alleged to support such claims. NS does not believe that the resolution of these claims will have a material adverse effect on its financial position, results of operations or liquidity.

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

The following risk factor, which was included in NS' 2007 Form 10-K, is amended in its entirety to read as follows. The remaining risk factors included in NS' 2007 Form 10-K remain unchanged and are incorporated herein by reference.

**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. In April 2008, federal regulators prescribed 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.

**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> |
|----------------------|---|--|---|---|
| April 1-30, 2008     | 67,053  | \$59.91  | 50,000  | 23,985,455  |
| May 1-31, 2008       | 1,195,286   | \$63.96  | 1,184,115   | 22,801,340  |
| June 1-30, 2008      | <u>2,178,000</u>  | \$63.93  | <u>2,178,000</u>  | 20,623,340  |
| Total                | <u>3,440,339<sup>(1)</sup></u>                                |  | <u>3,412,115</u>  |   |

(1) Of this amount, 28,224 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 repurchased through Dec. 31, 2015. On March 27, 2007, the Board of Directors amended the program so as to increase the number of shares that may be repurchased to 75 million, and shortened the repurchase term by five years to Dec. 31, 2010.

**Item 4. Submission of Matters to a Vote of Security Holders.**

Edgar Filing: NORFOLK SOUTHERN CORP - Form 10-Q

Registrant's Annual Meeting of Stockholders was held on May 8, 2008, at which meeting four directors were elected to serve for a term of three years and the appointment of NS' independent registered public accounting firm was ratified.

The four directors, each of whom received a greater number of "for" votes than "withheld" votes, were elected by the following vote:

|                   | <b><u>FOR</u></b> | <b><u>AUTHORITY WITHHELD</u></b> |
|-------------------|-------------------|----------------------------------|
| Gerald L. Baliles | 304,425,947 votes | 18,704,281 votes                 |
| Gene R. Carter    | 315,060,296 votes | 8,069,932 votes                  |
| Karen N. Horn     | 314,428,772 votes | 8,701,456 votes                  |
| J. Paul Reason    | 316,670,773 votes | 6,459,455 votes                  |

The appointment of KPMG LLP, independent registered public accounting firm, as auditors of NS' books and records was ratified by the following vote:

FOR: 315,465,922 shares

AGAINST: 4,557,991 shares

ABSTAINED: 3,106,315 shares

**Item 6. Exhibits.**

See Exhibit Index beginning on page 28 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: July 24, 2008

/s/ Howard D. McFadden

Howard D. McFadden

Corporate Secretary (Signature)

Date: July 24, 2008

/s/ Marta R. Stewart

Marta R. Stewart

Vice President and Controller

(Principal Accounting Officer) (Signature)

**EXHIBIT INDEX**

- 10.1\* Transaction Agreement, dated May 15, 2008, by and among Norfolk Southern Railway Company, Pan Am Railways, Inc., Boston and Maine Corporation, and Springfield Terminal Railway Company (Exhibits, annexes and schedules omitted. The Registrant will furnish supplementary copies of such materials to the SEC upon request).
- 10.2 Directors' Deferred Fee Plan of Norfolk Southern Corporation, as amended effective Jan. 1, 2009, is incorporated herein by reference to Exhibit 10.01 to Norfolk Southern Corporation's Form 8-K filed on July 24, 2008.
- 10.3 Norfolk Southern Corporation Executives' Deferred Compensation Plan, as amended effective January 1, 2009, is incorporated herein by reference to Exhibit 10.02 to Norfolk Southern Corporation's Form 8-K filed on July 24, 2008.
- 10.4 Amendment to Norfolk Southern Corporation Officers' Deferred Compensation Plan, effective Jan. 1, 2008, is incorporated herein by reference to Exhibit 10.03 to Norfolk Southern Corporation's Form 8-K filed on July 24, 2008.
- 10.5 Norfolk Southern Corporation Long-Term Incentive Plan, as amended effective Jan. 1, 2009, is incorporated herein by reference to Exhibit 10.04 to Norfolk Southern Corporation's Form 8-K filed on July 24, 2008.
- 10.6 Norfolk Southern Corporation Restricted Stock Unit Plan, as amended effective Jan. 1, 2009, is incorporated herein by reference to Exhibit 10.05 to Norfolk Southern Corporation's Form 8-K filed on July 24, 2008.
- 10.7 Supplemental Benefit Plan of Norfolk Southern Corporation and Participating Subsidiary Companies, as amended effective Jan. 1, 2009, is incorporated herein by reference to Exhibit 10.06 to Norfolk Southern Corporation's Form 8-K filed on July 24, 2008.
- 15\* Letter regarding unaudited interim financial information.

31\* Rule 13a-14(a)/15d-14(a) Certifications.

32\* Section 1350 Certifications.

\* Filed herewith.