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Norfolk Southern Corporation (NSC) CEO Jim Squires on Q3 2019 Results- Earnings Call Transcript

Oct. 23, 2019 2:57 PM ET | 2 Likes
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Q3: 10-23-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $2.58 misses by $-0.01 | Revenue of $2.84B (-3.60% Y/Y) misses by $-14.01M

Earning Call Audio

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Norfolk Southern Corporation (NYSE:NSC) Q3 2019 Earnings Conference Call October 23, 2019 8:45 AM ET

Company Participants

Pete Sharbel - Director, IR

Jim Squires - Chairman, President and CEO

Alan Shaw - Chief Marketing Officer

Mike Wheeler - COO

Cindy Earhart - CFO

Conference Call Participants

Justin Long - Stephens

Allison Landry - Credit Suisse

Brian Ossenbeck - JPMorgan

Scott Group - Wolfe Research

Jordan Alger - Goldman Sachs

Ravi Shanker - Morgan Stanley

Fadi Chamoun - BMO Capital Markets

Jason Seidl - Cowen and Company

Chris Wetherbee - Citi

Amit Mehrotra - Deutsche Bank

Tom Wadewitz - UBS

Bascome Majors - Susquehanna Financial Group

Ken Hoexter - Bank of America Merrill Lynch

Operator

Greetings, and welcome to the Norfolk Southern Corporation Third Quarter 2019 Earnings Conference Call. [Operator Instructions] As a reminder this conference is being recorded.

It is now my pleasure to introduce your host, Pete Sharbel, Director of Investor Relations. Thank you, Mr. Sharbel, you may begin.

Pete Sharbel

Thank you, Melissa, and good morning. Before we begin, please note that during today's call, we may make certain forward-looking statements, which are subject to risks and uncertainties and may differ materially from actual results. Please refer to our annual and quarterly reports filed with the SEC for a full discussion of those risks and uncertainties we view as most important. The slides of the presenters are available on our website at norfolksouthern.com in the Investors section, along with our non-GAAP reconciliation. Additionally, a transcript and downloads will be posted after the call.

Now, it's my pleasure to introduce Norfolk Southern's Chairman, President and CEO, Jim Squires.

Jim Squires

Good morning everyone, and welcome to Norfolk Southern's Third Quarter 2019 Earnings Call. Joining me today are Alan Shaw, Chief Marketing Officer; Mike Wheeler, Chief Operating Officer; and Cindy Earhart, Chief Financial Officer.

Turning to our financial results for the third quarter. Income from operations was approximately $1 billion , net income was $657 million, EPS was 249 and the operating ratio improved to 64.9%. These results include the unfavorable impact of a $32 million write-off of a receivable resulting from a legal dispute, which affected the OR by 110 basis points and EPS for $0.09.

As highlighted on Slide 4, these were record results including a record third quarter and year-to-date OR. Earlier this year, we outlined a dynamic flexible new operating plan, TOP21, capable of creating value in all market conditions. In the months since, particularly in the second half of this year, volumes across the transportation sector, including our volumes, turned sharply lower.

In response, leveraging TOP21, our team doubled down on productivity and achieved major resource reductions. For example, in the third quarter, we reduced crew starts and increased by 11% year-over-year. That was nearly double the rate of the volume decline, driving a 9% decrease in employment levels.

Following the first phase of TOP21, we swiftly moved to Phase II, which includes refinement of our guarding local trains, deployment of additional distributed power on long trains and blending of intermodal and unit trains into existing trains wherever feasible.

These efforts are producing further reductions in crew starts, circuity and road train miles. And we've begun Clean Sheeting our intermodal terminals and preparing for the third phase of TOP21 using the formula we used to successfully overhaul the carload network while sustaining a high level of network performance and service.

Earlier in the year, I spoke about the momentum building across our organization and our commitment to enhancing operational and financial outcomes. This commitment is evidenced by significant expense reduction so far this year, which Cindy will describe in more detail later in the call.

With revenue trending below our expectations in the second half and some unusual costs expected in the fourth quarter, we continue to expect operating ratio improvement for the full year, but that improvement now seems likely to be less than our earlier forecast of at least 100 basis points.

Nevertheless, we remain confident we can achieve our goal of a 60% OR by 2021 through additional cost structural changes and future revenue growth. For example, we are pursuing savings opportunities in fuel, mechanical and other aspects of operations about which Mike will speak shortly.

And we continue to drive bottom line improvement with pricing increases, commensurate with the value of our service with the results evident in the third quarter and year-to-date in revenue-per-unit and revenue-per-revenue ton-mile trends. Alan will speak further about those trends in a minute.

All of us at Norfolk Southern are committed to transforming our Company to drive shareholder value creation. As I've said before, we are embracing new ideas and positioning leaders throughout the organization who are Champions for Change.

We are all working hard to operate as safely and efficiently as possible and deliver what we promised to our customers and shareholders. The results so far this year. Improved service levels for our customers, a lower operating ratio and bottom line growth, and the return of nearly $2.3 billion to shareholders.

With that, I'll now turn the call over to Alan.

Alan Shaw

Thank you, Jim, and good morning everyone.

In the third quarter, we continued our focus on pricing to the value of our service product and delivering productivity gains, generating a record third quarter operating ratio despite difficult economic conditions. Trade uncertainly continue to influence the economic environment, which coupled with lower spot truck and commodity pricing negatively impacted volume during the quarter.

As we cycle through the headwinds associated with the market, we have and will maintain our focus on margin improvement driven by price, service and productivity, while collaborating with our customers to provide a platform for growth.

As shown on Slide 6, a 6% decline in volume led to a 4% revenue decline in the quarter. Increased revenue per unit, which has improved year-over-year for 11 consecutive quarters, partially offset the volume decrease. A consistent delivery of RPU growth highlights the effectiveness of our pricing strategy.

Third quarter revenue in our merchandise segment was flat year-over-year, as continued strength in pricing offset volume declines. Volume declined 4% resulting from reduced steel and natural gas shipments, while favorable fuel price differentials drove gains in crude oil, the East Coast refineries.

During the quarter, we experienced growth in automotive and aggregates as a result of increased production at [indiscernible] auto plants and improved service respectively. Intermodal revenue declined 5% due to reduced volume in our domestic franchise. Strong relationships with steamship lines and share shifts at the East Coast ports produced international volume growth year-over-year.

Domestic intermodal declined due to lower spot truck pricing and a weakened manufacturing environment. Intermodal arc of yield was flat in the quarter as pricing increases were offset by the negative mix impact of increased international volume and lower fuel surcharge revenue.

Turning to coal, revenue was down 13% in the third quarter. Our utility portfolio was impacted by additional natural gas capacity and prices that suppressed coal burn. Export thermal and metallurgical prices remain at low levels, making it difficult for U.S. coals to compete globally. Improved pricing drove our revenue-per-unit increase of 2%.

Moving to Slide 7. We expect the same factors affecting third quarter volumes to persist in the fourth quarter. Macroeconomic conditions, tariff uncertainty and global weakness continue to negatively influence business investment, manufacturing and exports. Lower commodity pricing will impact many of our markets, including coal and steel. Truck loadings are expected to be flat for the rest of 2019 with excess capacity keeping spot truck rates low.

While we expect a challenging economic environment for the remainder of the year, we remain focused on our strategic plan to drive margin improvement. We are collaborating with our customers daily to fine-tune our service product and identify long-term growth opportunities.

Our strategic plan is producing pricing and efficiency gains, and we are fully committed to the execution of the plan while meeting our customers' expectations and establishing a platform for future profitable growth.

I will now turn it over to Mike for an update on operations.

Mike Wheeler

Thank you, Alan.

Today, I will update you on the state of our operations and the efficiencies we are creating with our TOP21 plan. In the third quarter, we delivered strong service for our customers, made further progress on the next iteration of TOP21, and began implementing initiatives in TOP21 Phase II on a rolling basis.

Our operational momentum is driving significant cost savings and we are flexing our dynamic plan in accordance with market conditions. We continue realizing efficiencies while providing a superior service product to our customers.

Moving to Slide 9. We have continued our laser focus on the execution of our plan and principles of precision scheduled railroading. We substantially improved train speed and terminal dwell compared to last year and delivered record quarterly performance. These achievements support our strategy to meet our customers' expectations while eliminating costs and prudently managing our assets.

The operation continues to be resilient as evidenced by our ability to work through two recent major incidents in the fourth quarter, a bridge outage and a large derailment, with minimal disruption to our customer supply chains. This shows the strong resiliency of our operating model.

These overall results are due to relentless execution by our operations team and other employees supporting them. We want to thank our field employees for their unwavering focus on safety, service and efficiency.

Turning to our service and productivity metrics on Slide 10. These metrics align with our strategic plan as they measure key productivity and customer service levels. We have been aggressively reducing our resources to meet our productivity goals, account GTMs dropping by 9% in the quarter. Consistent with prior quarters, the blue bars represent our goals for 2019.

Starting with the Service Delivery Index, which is the on-time delivery performance of our scheduled shipments indexed to 2018. This is a customer-facing metric that combines intermodal availability and shipment consistency, which measures trip plan adherence for general merchandise as well as automotive traffic. Strong service performance continued in the third quarter and we expect to drive further improvement.

We are trending ahead of where we thought we would be with our T&E productivity goal for 2019. And we anticipate this trend will continue for the remainder of the year. We are at our lowest T&E headcount on record, having reduced by 14% versus third quarter 2018, while still providing exceptional service.

We are already realizing the benefits of our TOP21 plan. The results are driving the comp and benefit improvements, to which Cindy will speak.

As mentioned during the last call, we are continuing to work on improving our train weight. The majority of our goal was back-end loaded, as the first phase of the TOP21 operating plan was successfully implemented on July 1st.

We are seeing improvements in our general merchandise train weights, which were offset by headwinds associated with intermodal and coal volumes. Locomotive productivity continues to be an important metric for NS. We are tracking to meet our goal for this year. We have been rationalizing our locomotive fleet, which is 22% lower than the same period last year.

We also have an aggressive initiative to rationalize resources associated with the maintenance of these wealth of others, including a reduction of 525 positions already this year. We will continue to focus on the remaining resources required to maintain this lower fleet size.

And the Cars-On-Line, which is down 20% versus our 2018 baseline, continues to trend very positively. Thanks to our fast and consistent service product. This includes cars in storage, which can be deployed as market conditions warrant.

Turning to our progress on our TOP21 operating plan on Slide 11. As you may recall, our operating plan has four major objectives; operate as one network, execute a balanced train plan between terminals, serve our customers frequently, and reduce dependence on major terminals.

The first phase of TOP21 primarily focused on our general merchandise bulk and automotive business and was successfully implemented on July 1st. We have been aggressively implementing the next phase, which has an added emphasis on distributed power to drive further train consolidations. We have increased the number of DP trains per day by more than two-and-a-half times with the expansion of this initiative since our TOP21 rollout.

We will continue to add DP trains across the network, which will have the benefit of improving train length and fuel efficiency. Regarding fuel efficiency, we have several other initiatives for improvement. Specifically, one, ensuring a healthy energy management lead locomotive; two, compliance with horsepower-per-ton procedures; and three, compliance with usage of energy management technology.

We are also syncing up our local schedule and the new train plan. We are implementing these changes on a rolling basis and driving significant structural improvements. Specifically, total circuity for general merchandise and auto traffic is down 27% versus pre-TOP21 and road train miles are down 13%.

Additionally, we have been working to calibrate our local plan to maximize efficiency while continuing to provide good service to our customers. Together, these changes have helped to continue drive down crew starts while keeping velocity and customer service high.

We have also begun the process of Clean Sheeting our intermodal terminals and preparing for the third phase of TOP21, which remodels all traffic for additional opportunities. This will drive further cost and resource reductions and improve our fuel efficiency.

I will now turn it over to Cindy, who will cover our financials.

Cindy Earhart

Thank you, Mike. Good morning, everyone.

I'll begin with our operating results from Slide 13. The continued execution of our strategic plan is delivering tangible results that are flowing through to the bottom line. The structural changes we are making, including the implementation of our PSR-based operating plan, generated expense savings in compensation and benefits and equipment rents. These savings as well as lower fuel prices more than offset the decline in revenues.

However, in the third quarter, we wrote off a $32 million receivable as a result of a legal dispute, which added 110 basis points to the operating ratio and lowered earnings per share by $0.09. Income from railway operations for the quarter was nearly $1 billion and we reduced our third quarter operating ratio by 50 basis points, achieving a third quarter record of 64.9%.

Moving to Slide 14. We are delivering cost savings as evident in the $82 million decline in operating expenses. Our new operating plans have resulted in fewer trains on the network and reduced crew starts. Compensation and benefits expense declined as a result of a

$47 million in savings due to lower employee levels and reduced overtime and recruit.

We drove average headcount down by approximately 1,000 employees from last quarter and have reduced headcount by 2400 compared to last year. We also remain intensely focused on improving asset utilization. By increasing the velocity of our network and improving fluidity, we have significantly reduced the need for locomotives and freight cars, resulting in equipment rental savings of $35 million.

We also achieved savings of $10 million in material expense due to fewer locomotives and service and freight cars online. Partially offsetting the efficiency gains that we delivered in the quarter was the $32 million write-off that I previously mentioned.

We also experienced $17 million of additional expense due to increased pay rates. Finally, lower fuel price and a decrease in consumption drove the $48 million decline in fuel expense. Fuel efficiency continues to be an area of focus, and we know there are opportunities to generate savings through improved efficiency.

Slide 15 summarizes our third quarter results. Income from railway operations was slightly under last year's record, and non-operating items added an additional $16 million of expense. Third quarter net income was $657 million and diluted earnings per share was $2.49.

Recapping our year-to-date cash flows on Slide 16. Cash from operating activities was $3 billion, and free cash flow for the first nine months was $1.5 billion.

We continue to return capital to shareholders, as evidenced by the 9% increase in the quarterly dividend we announced in July. Dividends and share repurchases totaled almost $2.3 billion for the first nine months. As we head towards the conclusion of the year, I want to highlight a few specific items that will impact the fourth quarter.

First, starting with headcount, we expect a continuation of position reductions in the fourth quarter. By year-end, we expect headcount to approximate 23,300, which is a reduction of over 3200 positions compared to the same time last year.

Also, we expect incentive compensation to be favorable over prior year, but the magnitude will depend upon our full-year results. However, as Mike mentioned earlier, there have been some specific incidents in the fourth quarter that will result in incremental expenses.

We expect additional costs associated with future in trains due to a bridge outage and lighting damage resulting from a large derailment will approximate $25 million in additional expenses. Additionally, we expect that gains associated with the sales of operating property will be lower than last year.

You recall, the fourth quarter of 2018 included $145 million in gains on the sale of operating properties whereas, we expect the current quarter to be about one-third of that. The execution of our strategic plan is delivering results and even in the face of obstacles unforeseen at the outset of this year, we are confident we will improve our full-year operating ratio in 2019 and achieve our goal of 60% by 2021.

We are seeing the benefits associated with our new operating plan. We are actively identifying and implementing further measures that will produce improved financial results and drive shareholder value.

Thank you for your attention. And I'll turn the call back over to Jim.

Jim Squires

Thank you, Cindy.

As we've outlined, and as our third quarter results demonstrate, we continue to build momentum by executing planned initiatives and pushing well beyond many of the goals we set out earlier this year. We are hard at work preparing for the third phase of TOP21, rightsizing our local and yard operations, further consolidating road trains, and going after cost savings in fuel and mechanical operations.

While pursuing all of these efforts, the Norfolk Southern team continues to provide superior service to our customers, enabling us to price to our value in the marketplace while ensuring that we are positioned at the leading edge of growth when it returns.

These actions give us confidence, we will reach a 60% operating ratio by 2021. Before we open the call for Q&A, I do want to recognize Cindy for her 34 years of service to Norfolk Southern and her support to her final date here at the Company on November 1st. I highly value the role she has played in pioneering new technologies at our Company, developing our strategic plans, and delivering shareholder returns. On behalf of the entire Board and Management team, I thank Cindy for her many contributions and wish her well in retirement.

We'll now open the line for Q&A. Operator?

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from the line of Justin Long with Stephens. Please proceed with your question.

Justin Long

Thanks, good morning and congrats, Cindy, on the retirement. Maybe to start with the OR guidance for 2019, I just wanted to clarify something. Are you excluding the impact of the $32 million write-off in 3Q in that guidance? And then Cindy, you mentioned the $25 million of unusual cost in the fourth quarter. So I'm just curious that if you exclude that $32 million write-off and the $25 million of unusual items in the fourth quarter, if that OR guidance of at least 100 basis points that you previously put out there would have been achievable.

Jim Squires

Justin, it's Jim. Let me see if I can clarify for you what we have said this morning. Our guidance is that we expect to achieve a full-year operating ratio improvement year-over-year, even with the additional expenses and the trend in revenue and even with the receivables write-off that we discussed earlier. But, also including those things, we do not expect to be able to hit our goal of at least 100 basis points improvement in the operating ratio.

Now with that said, that does not diminish our confidence in any way that we can get to a 60% operating ratio by 2021. And to back that up, I just want to take a minute to recap what we have achieved to date. Because those achievements are the foundation of further improvements that we will make to get to the 60% operating ratio.

And I'll just touch it again, on our operating plan. Because that, in many ways, is the bedrock of the improvements we have made and will continue to make. All right, Phase I. As of July 1, we cut over it seamless. We see an immediate reduction in train starts and active trains on the network as we have shown you previously. We see a sharp decline in crew starts as we showed you today. There is no disruption to service as a result of it, however.

In Phase II, we pursue additional train consolidations. We blend more intermodal bulk and carload traffic. We accelerate distributed power. By now, we have more than doubled the number of DP trains per day operating on the network. We pursue further rationalization of equipment. We work to sync up the local operating plan, would give you network plan and that results in additional crew start reductions.

As you can see on Slide 11, crew start reductions actually accelerate coming out of the initial cut-over as we move through Phase II. And then, if we pursue intermodal Clean Sheeting, the analog, if you will, to the Clean Sheeting we did in the merchandise network and we are hard at work on fuel efficiency initiatives, where we know we have some grounds to make up.

So, these are the things we are operative today. In Phase III of TOP21, we will remodel all traffic to unlock additional efficiencies. Now, what has been the results in terms of resources of these various phases of TOP21. So, let's start with T&E productivity. As Mike mentioned, T&E down 13% versus third quarter of 2018, giving us the lowest T&E headcount on record for our company.

In terms of locomotive productivity, we have reduced the number of locomotives out there by 22% versus last year. And that reduction in locomotives operating on the network, along with the reduction in Cars-On-Line, yielded an additional reduction of 525 mechanical positions already in this year, which together with the G&A reductions, which together with other employment reductions we have made, gave us 9% lower overall again in the third quarter with more decline in the fourth quarter. Cars-On-Line down 20% versus the 2018 benchmark, yielding significant equipment rent savings along with the locomotive reductions.

Cindy went through the different expense categories; the compensation and benefit savings, the material savings, the equipment rent savings that were the result of these resource reductions. In TOP21 Phase III, there will be more of the same.

We will see through additional train consolidations additional reductions in crew starts and we would expect to see T&E reductions follow. With continued rationalization of locomotive fleet, we will see lower maintenance spending and so on and so forth.

And lastly, we will stay very focused on our pricing plan, our yield-up strategy which showed excellent results in the third quarter and for the full year-to-date. We are determined to price to the value of our service in the marketplace.

Justin Long

That's great and comprehensive answer. I think, secondly, I just wanted to ask a bigger picture question. Obviously, we're dealing with a more challenging demand backdrop right now. As we think about that guidance to get to a 60% OR in 2021, do you think that's still achievable if the demand environment stays around current levels and the coal environment stays around current levels, or do we need to see a positive inflection and demand in order to hit that 60% OR?

Jim Squires

We are determined to achieve the 60% OR goal by 2021 in any foreseeable revenue environment, including the one that we are in now. But yeah, ours is a balanced plan and we've said that all along; we are pursuing growth, we believe we will see the fruits of our efforts in the form of a resumption of growth during the remaining years of our current strategic plan. But if we don't, we will push even harder on efficiency measures, on productivity measures, to get to the 60% OR.

Operator

Our next question comes from the line of Allison Landry with Credit Suisse. Please proceed with your question.

Allison Landry

So now that you're in Phase II of TOP21, and as you move into Phase III, should we start to expect at a meaningful acceleration in the year-over-year OR improvement. I guess, just as you're talking about all the trains you're eliminating and increasing train weights and adding the DPU, why wouldn't you be able to move below a 60% OR more quickly, as we've seen with many of your peers.

Jim Squires

If we can get to 60% OR sooner, Allison, we will continue to push. We are determined to do all we can to generate shareholder value through growth and through a lower operating ratio. And 60% is our goal by 2021, if we can do better than that, we certainly will.

Allison Landry

And then I was hoping maybe you could offer some thoughts on the recent addition to the Board by Claude Mongeau. What role would you expect him to play, and how is that materializing so far? Thank you.

Jim Squires

Claude, as you know, brings a great deal of experience in our industry, having served as CEO of Canadian Natural. He brings in-depth knowledge of operations of railway finances. He served as CN CFO for a number of years and so, he is a most-welcome addition to our Board. We are looking forward to having him advice and counsel us as we pursue all of the initiatives that we intend to pursue for the next few years and beyond.

Operator

Our next question comes from the line of Brian Ossenbeck with JPMorgan. Please proceed with your question.

Brian Ossenbeck

Appreciate taking the question. So, Alan, maybe one for you on coal, I was little surprised to see that RPU was up sequentially ex-fuel, so maybe if you can give some color behind that and where do you think this goes in 4Q, '19 and 2020. And obviously the export markets are telling us, things are going to get worse before they get better again. So I just wanted to see if there's any other offsets that you might have from a pricing or yield perspective, considering it was a bit stronger this quarter than we expected.

Alan Shaw

Yes, absolutely, Brian. As I've noted in my prepared remarks, we continue to deliver strong pricing across all of our business units. Coal is no exception. Coal will be pressured in the fourth quarter with the reduction and the seaborne coking coal price.

So, you should see a sequential decline in export coal pricing as we move into the fourth quarter and that's going to be running up against some difficult comps, because at the same this time last year we were seeing a sequential improvement in export coal pricing.

So that will be a headwind for us. Throughout all of this, we are continuing to focus on pricing to the value of our product and we are delivering a very good product to our customers.

Brian Ossenbeck

And then one on fuel and train weights for you, Mike. We've seen some pretty good progress on fuel in particular from the rest of the class ones we're looking at Norfolk. It looks like fuel efficiency, gallons-per-thousand GTMs are actually getting a bit worse sequentially and year-over-year. So, clearly we're seeing train weighs aren't moving up as fast as you think throughout the course of the plan, but what can you offer on, I know you’ve got some initiatives there, but it seems to be a pretty big factor for efficiency gains that others have realized, but you haven't been able to take that sort of stride.

Mike Wheeler

Yes, so on the fuel efficiency side, we are seeing an increase in general merchandise train weights. So that was part of the TOP21 plan. We're getting those benefits, but they are offset by the headwinds of the lower train weights on the intermodal and bulk trains and we're making - we're taking actions to address that. You'll see more of that in Phase II as we go forward and then some of that in Phase III as well. But we also have a very aggressive initiative on utilizing the energy management technology that we've been rolling out.

And so, this is an all-hands-on-deck thing and we've got folks down in our new consolidated network operation center really staying on top of this, making sure we got the right locomotive on the head-end that's got working energy management and then making sure that we're using the right horsepower-per-tonnage for our trains, being very aggressive with that, and then making sure that, that we're compliant with the energy management technology. So, big initiative and we expect that to be paying off as we go forward.

Jim Squires

Brian, I'd like to weigh in on this as well. We benchmark our peers' performance all the time and do so extensively, and we are aware of the ground that we have to make up in fuel efficiency. We have - because we have not made progress despite our best efforts in the last couple of quarters [indiscernible]. That's going to change. We are focused on all the things that Mike has outlined. Running longer, heavier trains is certainly a part of it. On-board energy management, real-time fuel monitoring, horsepower-per-trailing-ton compliance and so forth. A host of initiatives in place, which we believe will bear fruit as I am holding our operations team shortly accountable to that goal.

Operator

Our next question comes from the line of Scott Group with Wolfe Research. Please proceed with your question.

Scott Group

So I want to go back to Justin's first question because I'm not sure if I understood the answer. So, you guys said there's $32 million of legal costs in the third and you talked about $25 million of bridge costs in the fourth. So, that's 50 basis points to OR. If we were to exclude those, would you have been hitting the OR targets or not? I guess we're all trying to understand, is this a small margin missed that's arguably understandable or is this a bigger margin miss?

Jim Squires

Cindy, why don't you give that.

Cindy Earhart

So, Scott. As Jim said previously, the $32 million and the additional cost of $25 million were not only bridge costs, but also lading costs associated with derailment. Well, our guidance to a miss on the 100 basis point OR improvement, we don't exclude either one of those and we're going to continue to push as hard as we can to improve the OR. But those have not been excluded in that guidance today.

Scott Group

No, no. I understand they're not excluded; I'm just saying as we play with our models, if we were to exclude them, would you be hitting that OR target or not. I think that's what we're all trying to understand.

Cindy Earhart

I think that I would say that we will miss our target. The extent of it is probably not material. It's not a big miss, but it will be a miss.

Jim Squires

Again, that does not diminish our confidence in any way that we will get to a 60% operating ratio by 2021.

Scott Group

And then, Jim. So I think - I mean, all the rails are dealing with the same volume issues. I look so far - I think every rail has had better margin improvement than you so far in the third quarter, even though you're at a lower starting point. So, do you feel like you're going fast enough? Do you feel like you've got the right people to get us here? And then another difference is sort of on the capital front. Is there - With volumes weaker, are there opportunities to sort of change the capital spend?

Jim Squires

We are controlling the things that we can control and doing so aggressively. So we've been through all of the expense savings initiatives, which bore fruit in the third quarter and for the year-to-date, and we will continue to push on all of those things as far as we must to get to that 60% operating ratio by 2021. We've got a great team in place and everybody is aligned around our bottom line shareholder value goals.

Let's see. The second part of your question, Scott, was the capital. Yeah. So we have previously talked about a range of 16% to 18% of revenue for capital spending. What really matters here, obviously, is shareholder returns and return on capital. That's what we're managing to, that's why we are targeting that level of capital spend because we believe that it is the optimal range of capital spending relative to revenue, to generate the return on capital and the shareholder returns we're seeking to generate. It's a range and in the mean times we may take it down somewhat within that range. But again, it really gets back to return on capital and our goal of generating superior shareholder value.

Operator

Our next question comes from the line of Jordan Alger with Goldman Sachs. Please proceed with your question.

Jordan Alger

So I know you've reiterated the 60 operating ratio in 2021. I'm just sort of curious if volumes stay kind of soft for at least the first part of next year. I mean can you give some sort of sense for how much you think OR and PSR benefits can push things in 2020 even with let's say, first half continuing softness environment? Thanks.

Jim Squires

We've spent a good deal of time already this morning talking about the efficiency initiatives, those that are well underway in Phase II of TOP21. Those will come to fruition in 2020 so we will see the full year benefit of expense savings from all of those initiatives, which we're pushing so hard on in 2019. And then we get into Phase III of TOP21, which will result in additional cost structural savings in 2021. And those will be again the drivers of further expense savings on the royalty 60 operating ratio.

Jordan Alger

And then just a quick follow-up on intermodal, comps obviously get pretty easy by middle of next year. If we get some truck capacity tightening and maybe spot pricing turns the other way a little bit. Would you expect or can you potentially anticipate some sort of inflection, especially given where your network is on rail intermodal volumes. I mean is that something that's conceivable as we move through next year, again assuming the economy is reasonably okay?

Jim Squires

Alan?

Alan Shaw

Yes, so Jordan we are aligned with the best channel partners in the business. And we are aligned with the steamship lines that are adding capacity to the East Coast as you see a shift from the West Coast to the East Coast. So we've got some strategic advantages to our intermodal franchise, which make it the best in the East. And so absolutely - as the economy turns and we deliver a very strong service product to our customers. We anticipate that intermodal is going to remain a growth engine for Norfolk Southern.

Intermodal revenues, as you know grew by 11% in 2017 and then follow that with an 18% growth last year. We've got a great franchise, great customers it’s going to continue to pay dividends for our shareholders.

Operator

Our next question comes from the line of Ravi Shanker with Morgan Stanley. Please proceed with your question.

Ravi Shanker

Can you just clarify your current go-to-market strategy on price are you at a point where you guys can command the price you need to make the yield-up targets without losing volume. Or do you think that's more of a 2020 or 2021 thing, when there are more changes made in the network?

Jim Squires

Alan?

Alan Shaw

Ravi, we are very confident in our ability to price through a - vastly improved service product and we're providing our customers with a platform for growth. Take a look at our merchandise network in which the year-over-year rate of increase in price has improved for nine consecutive quarters. And you also see it reflected in RPU trends and revenue per ton mile trend. So we are intently focused on price even in this weak economic backdrop because we've got a great franchise and a great service product.

Ravi Shanker

And as follow-up you guys recently appointed Mr. Claude Mongeau to your Board at this point in your PSR strategy kind of what do you looking for from him and kind of what role is he likely to play?

Jim Squires

As I mentioned earlier Claude is an outstanding addition to our Board with his extensive experience in the industry. He got operations knowledge and experience, same on the finance side. So he will be a welcome addition, he is a welcome addition to our Board. And we'll bring all of that and more as we proceed through our PSR journey for the next couple of years and beyond.

Operator

Our next question comes from the line of Fadi Chamoun with BMO Capital Markets. Please proceed with your question.

Fadi Chamoun

Maybe, Alan if the pricing in the intermodal business doesn't really improve like truck pricing competition remains intense. Can intermodal margin improve to the level needed to achieve a 60% OR over the next couple of years and - if you're looking on the operating side. Are there steps meaningful steps that can be taken in the intermodal network to improve the OR if you can maybe outline those?

Jim Squires

Alan?

Alan Shaw

You take a look at the cyclical nature of the trucking industry we saw weakness in the spot truck market in 2011 and 2015 and 2019. And through all of that, we continue to deliver year-over-year rate increases in intermodal every single quarter. So we are very confident in the strength, the unique strength of our intermodal franchise.

Our alignment with the best channel partners in the business and we're going to cycle through this as - we noted before we grow revenue by 11% in 2017 and 18% and 2018. We've got a very strong franchise. The spot market will recover, and we're going to be positioned for growth because of the very strong service product that we're delivering.

Fadi Chamoun

And maybe just follow-up on the operational side, you mentioned clean sheeting in intermodal what is that exactly in tailwind. And if you can describe to us what is going on the operating side that would - going to improve the margin performance of that business?

Jim Squires

Mike, why don’t you take that one?

Mike Wheeler

So, on the intermodal terminals just like we did the clean sheeting of our merchandise terminals. We're looking at each terminal and making sure that we have the best practices across all the terminals in our intermodal network. We've got all the right processes and procedures. And then once we do that we'll sink that up with the train plan for more efficiencies going forward and then continue to deliver good service product at the same time.

So it's kind of that deep dive into each one of the - each one of the intermodal terminals using good industrial engineering practices to make them as efficient as possible and more importantly consistent best practices across all the intermodal terminals.

Jim Squires

Mike, I'm very encouraged by this process because we and our customer saw the benefits in the merchandise network as we clean sheeted the merchandise network. You saw it reflected in a reduction and dwell, you saw it reflected in an increase in train speed and you saw it reflected in an improvement and our SDI our customer facing service metrics. And so I'm confident that we're going to continue to deliver the same as we apply these same principles to our intermodal franchise.

Operator

Our next question comes from the line of Jason Seidl with Cowen and Company. Please proceed with your question.

Jason Seidl

I wanted to talk a little bit about your T&E productivity. You've shown a slight improvement in 2019 and you put a check there saying you're sort of on track but if we look out to your 2021 goal that's a much larger step-up. Could you walk us through how you guys plan on getting there?

Jim Squires

Mike?

Mike Wheeler

Yes it's going to be the continuation of the things that we've done where we continue to look at increasing the size of the trains and that drives crew starts down. Continuing the distributed power strategy, we're going to do more and more of that and that will drive train consolidations. And then continue to look at our local and yard network and making sure we're as efficient as possible there. So as we go through all this we uncover more opportunities.

And when we uncover those more opportunities we get into that we take the benefits of it and then we go the next step. So this has been a very good process for us to continue down that path. And we will continue to do that, we've got more in the gas tank with all these phases that we're talking about. So yeah, we're going to get there

Q – Jason Seidl

And I want to jump a little bit back on Scotts CapEx question going forward. Jim, I think you mentioned a range of 16% to 18%. Given what we've seen in the overall demand environment and the competitive truck market, should we look at 2020 as probably being towards the lower end of that range?

Jim Squires

Jason, we'll give you some more guidance on CapEx, expected CapEx, when we meet again in January. But let me say this, majority of our capital budget, as you well know, the great majority is replenishment capital spending, including our DC to AC conversion program, which is meant to and will rejuvenate our locomotive fleet.

So for us, that's a pretty significant line item in and of itself in the capital budget under the category of sustaining capital spending. And then of course there's everything else that goes into sustaining franchise rail cost balance and so on and so forth.

The growth piece of it, we will protect, we will project. It's relatively small compared to the sustaining CapEx. But it needs to be part of the plan, because we do aspire to grow and we believe we have growth prospects that will generate excellent shareholder returns down the road.

Operator

Our next question comes from the line of Chris Wetherbee with Citi. Please proceed with your question.

Q – Chris Wetherbee

Wanted to ask about head count. Obviously, you've made some progress here and target further progress in the fourth quarter. I wanted to get a sense of maybe how you feel like the workforce is calibrated to the volume environment? Assuming some degree of stabilization, how much more is there to go as you kind of run through Phase 2 and Phase 3 of Top 21? How should we be thinking about sort of headcount as we move through the beginning to first half of 2020?

Jim Squires

Cindy, why don't you go back over to what we are expecting in the fourth quarter, reflecting end of year versus our average headcount in the fourth quarter versus fourth quarter of last year and then talk a little bit about where we're going?

Cindy Earhart

Yes. Well, Chris, as I said, we expect the year-end headcount to be at 20 - around 23,300; which is 3,200 less than the end of last year of 2018. So we've made obviously significant progress. I think our original estimates for headcount reductions this year were 500. So that has really been accelerating.

And obviously, big part of that structural, there has been - there's been reductions associated with volume and then you could moderate that as volume goes up or down, but we certainly expect going into next year, you've heard all the initiatives that Mike has talked about, both in terms of T&E as well as mechanical that we expect headcount to continue to come down.

Jim Squires

We also want to be sure we are prepared for when - so that's a balancing act, and we want to be sure that we operate as optimally as we can in a declining volume environment, like we're in now, but we also want to be confident that we can handle the business when it comes back.

We believe that we have a great formula for that, we're just that. And that is responding appropriately in the current volume environment, but we are also protecting our ability to handle the business when it returns down the road.

Q – Chris Wetherbee

And then if I could turn to Purchase Services, it was up sequentially, although volumes were down. I wanted to get a sense, it's a big, obviously, line item on the cost side for you guys. When we think about sort of plan, as it continues to roll out over the next few phases, how big an opportunity is that? Was there anything specific in the third quarter and just kind of how can you go from here?

Jim Squires

Cindy?

Cindy Earhart

Well, Chris, as we talked before about Purchase Services. And I will say, if you look at Purchase Services and rents, we have seen big improvements, as I mentioned before on equipment rent side, a $35 million improvement year-over-year. And that's really been associated with just the improved velocity of the network, as well as getting a lot of these cars offline. So that has been favorable. We expect that to continue to be favorable going forward.

On Purchase Services and rents, there's a lot of different things that are in that category. Some is volume dependent, although not as much as you would think. We have pointed out in the prior quarters that we've had additional spending on the IT side. We're going to continue to invest in IT and we've seen that on capital spending, as well as in this particular item.

We think that that's really prudent investment to be making, because it's focused on things that are going to improve the productivity of the workforce, the reliability of our equipment and so forth.

We did have - we've had a little bit additional expenditure in Purchase Services and rents associated with freight cars, as we've taken freight cars offline and we've had to turn them back leases, we've had some additional repair costs associated with that.

So there's some puts and takes there. But overall, I think you'll see Purchase Services continue similarly as we move forward sequentially.

Operator

Our next question comes from the line of Amit Mehrotra with Deutsche Bank. Please proceed with your question.

Amit Mehrotra

Just a quick one. The first one at least will be quick. Was there any impact in the quarter from the strike at General Motors? I know auto volumes were actually up in the quarter and yield was kind of flat. I didn't know if there was anything to call out there with respect to stranded or unabsorbed costs related to that or even in the fourth quarter?

Jim Squires

Alan, why don't you take that.

Alan Shaw

Yes, the timing of that work stoppage will more impact our volumes in the fourth quarter.

Amit Mehrotra

Any stranded costs associated with that, that we should think about for the fourth quarter or not enough to call out?

Alan Shaw

No.

Amit Mehrotra

And then, Jim, I wanted to just, if I could just follow-up, I think on the - one of the very first questions. And I think it's really the most important one with respect to your OR targets for 2021 at least. And obviously it's in the context, if you guys walking back this year's OR improvement.

So when we look back in February or February 11th, when you did the Investor Day in Atlanta, you guys were very explicit about your revenue targets; 5% compounded annual growth rate for the entire business, 10% revenue growth in intermodal. I was hoping that you could be as specific now, 10-months later or so or a little bit less than that. Given what's happened in the revenue framework, how the revenue side of the business rolls up to your OR target.

And I understand you're not going to use revenue as excuse and there's a lot of productivity, but given how specific you were in February, we'd appreciate it I think if you can give us some sense of what that revenue roll up looks like now, relative to the 5% and 10% growth you did in February to get to that 60, 60 by 2021 target?

Jim Squires

Fair enough. Let me say, first of all, about the strategic plan. As with any such plan, the assumptions they are in, are good for about as long as it takes the inkjet to write on the strategic plan.

So conditions change. Business conditions change, the revenue picture, the volume picture has changed rather dramatically since we issued the three-year plan in February. We've always said that one of our hallmarks is flexibility and adjustability. That's what we did in 2016, when we saw a significant volume decline. And we responded with additional productivity initiatives in order to hit our goals. That's what we will do again this time around.

Now, we will review with you our revised macro assumptions in January when we report out on the fourth quarter results, and we'll give you our productivity goals, our Tier-1 methods going forward for the next couple of years. We'll give you some high-level assumptions with regard to revenue, and it's part of that plan as well.

Operator

Our next question comes from the line of Tom Wadewitz with UBS. Please proceed with your question.

Tom Wadewitz

So, Alan, I wanted to get your thoughts on the export coal framework for 2020. Just maybe if you could give us a sense about, at current prices, did you expect tonnage to be down pretty meaningfully? Or if you look at seaborne prices, do you think it's more of a hit to your, the revenue per ton that you're achieving? Just maybe some broader thoughts about that and I don't know if you want to tie it to met coal levels and where you really have the sensitivity to a tonnage decline?

Alan Shaw

Tom, as I've talked about, at current prices it makes it really difficult for U.S. coals to compete in the market, both on the - with respect to thermal and metallurgical. We've talked before about some of those thermal contracts are effectively hedged, but contracts between the producers and the receivers are effectively hedged through 2019.

And so you'll see pressure in the thermal market as we roll into 2020. And the met market is going to follow demand overseas in the global economy, and seaborne coking coal pricing. And I'll provide a lot more color on that on our fourth quarter earnings call, as we start talking about 2020.

Tom Wadewitz

I guess if you look back just to kind of look at levels of export coal on Norfolk, in the 2015-2016 area, you were kind of 15 million tons, 16 million tons. I think 2019, you're running at a rate of like something like 24 million tons. So do you think this feels like 2015, 2016 or would you say; hey, we haven't fallen to that level, it of feels better than that. So just trying to get a sense of the right framework to consider given that there's obviously pressure on the export market.

Alan Shaw

There is pressure and we've been pretty clear about that. Let's just talk about coal broadly. Right now coal is about 12% of our volume. And export coal is about 25% of our coal volumes. So there you're talking about a little bit less than 3% of our overall volume.

It's important to us, it's important to our franchise. We've got a very diverse franchise, as we've built out our intermodal network. So it's - I'll provide more color and more historical context on the outlook for export coal in the fourth quarter call.

The important thing to consider is that we've got a great merchandise network, a great intermodal franchise and we are securing price, reflecting the value of our product.

Operator

Our next question comes from the line of Bascome Majors with Susquehanna Financial Group. Please proceed with your question.

Bascome Majors

On the receivables write-off you took for the September jury ruling on the [indiscernible] contract. Is there any accruing revenue for liquidated damages in this year, and is there any go forward impact associated with that ruling?

Jim Squires

Cindy?

Cindy Earhart

Bascome, we've recognized what we think is the probable financial impact of that legal dispute.

Bascome Majors

Was that all backward looking or is there some ongoing impact included in that charge?

Cindy Earhart

No, that was backwards.

Operator

Our next question comes from the line of Ken Hoexter with Bank of America Merrill Lynch. Please proceed with your question.

Ken Hoexter

And I know OR has been hit a lot, but in an environment where you're supposed to be significantly cutting costs and walking away from the 100-basis point improvement, and your peer is doing 400 basis points better excluding the real estate sales, and you've got employees down 9%, cars and trains are down. Jim, maybe talk about why is this not getting better or Michael, why are we not seeing a stair-step improvement at this point?

Given the changes you've made, is it just the coal margins are impacting so much overwhelming the gains or is there something else that's constraining the ability to get that stair-step improvement?

Jim Squires

Ken, certainly, we're dealing with a different sort of revenue and volume context and reward in the first half. So that's been a major change. We have responded aggressively to that change with the resource reductions we've been through this morning, positions locomotives, freight cars, materials, all favorable in expenses. So you're seeing the momentum in expense reductions from our acceleration of the various initiatives with more to come.

Now, we still don't expect to see operating ratio improvement for the full year. But because of the additional expenses that we've been through this morning in the fourth quarter, we don't expect to meet the - at least a 100-basis points goal. But that does not diminish our confidence. We can get to a 60-operating ratio by 2021.

Ken Hoexter

And then I guess maybe, Alan, given that volumes have gotten worse now year sequentially and seemingly at an accelerating pace, I don't know if that was - is related to the derailment Cindy talked about, but you're now down 8% quarter-to-date. And I know it's only a couple of weeks in the 4th quarter, but down from 5% to 6%. Coal seems to be staying down mid-teens, but, Alan, you mentioned things are still ugly. But are things getting worse than an accelerating pace, just looking at intermodal and ag and some of the other commodities outside of kind of autos from the strike? It just seems like we're accelerating on the downside, maybe your view on economic side.

Alan Shaw

Again, we're not really seeing this much of a peak within the intermodal franchise. And so that is certainly having an impact on volumes and year-over-year comps.

Operator

Thank you. Ladies and gentlemen, this does conclude our question-and-answer session. I'll now turn the floor back to Mr. Squires, for any closing comments.

Jim Squires

I want to thank you all for your questions and for participating in today's call, and we look forward to speaking with you again in January. Thank you.

Operator

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.