NORFOLK SOUTHERN CORP
Form 10-Q
October 28, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the quarterly period ended **SEPTEMBER 30, 2011**

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF
1934 for the transition period from ___________ to___________

Commission file number 1-8339

NORFOLK SOUTHERN CORPORATION
(Exact name of registrant as specified in its charter)

Virginia	**52-1188014**
(State or other jurisdiction of incorporation)	(IRS Employer Identification No.)
Three Commercial Place	
Norfolk, Virginia	**23510-2191**
(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 [X] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes [X] 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 definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ] Smaller reporting company [ ]

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	**Outstanding at September 30, 2011**
Common Stock ($1.00 par value per share)	336,106,217 (excluding 20,320,777 shares held by the registrant's consolidated subsidiaries)

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	($ in millions, except per share amounts)			
Railway operating revenues	$ 2,889	$ 2,456	$ 8,375	$ 7,124
Railway operating expenses:				
Compensation and benefits	736	680	2,240	2,049
Purchased services and rents	403	377	1,191	1,086
Fuel	385	259	1,186	771
Depreciation	217	204	641	612
Materials and other	210	190	704	572
Total railway operating expenses	1,951	1,710	5,962	5,090
Income from railway operations	938	746	2,413	2,034
Other income - net	60	81	121	118
Interest expense on debt	114	113	339	347
Income before income taxes	884	714	2,195	1,805
Provision for income taxes	330	269	759	711
Net income	$ 554	$ 445	$ 1,436	$ 1,094
Per share amounts:				
Net income:				

Basic	$	1.61	$	1.21	$	4.09	$	2.95
Diluted	$	1.59	$	1.19	$	4.03	$	2.91
Dividends	$	0.43	$	0.36	$	1.23	$	1.04

See accompanying notes to consolidated financial statements.

Norfolk Southern Corporation and Subsidiaries
Consolidated Balance Sheets
(Unaudited)

	September 30, 2011	December 31, 2010
	($ in millions)	
Assets		
Current assets:		
Cash and cash equivalents	$ 242	$ 827
Short-term investments	152	283
Accounts receivable - net	1,029	807
Materials and supplies	212	169
Deferred income taxes	160	145
Other current assets	30	240
Total current assets	1,825	2,471
Investments	2,240	2,193
Properties less accumulated depreciation of $9,351 and $9,262, respectively	23,978	23,231
Other assets	268	304
Total assets	$ 28,311	$ 28,199
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 1,329	$ 1,181
Short-term debt	--	100
Income and other taxes	221	199
Other current liabilities	331	244
Current maturities of long-term debt	55	358
Total current liabilities	1,936	2,082
Long-term debt	6,782	6,567
Other liabilities	1,788	1,793
Deferred income taxes	7,550	7,088

Total liabilities		18,056		17,530
Stockholders' equity:				
Common stock $1.00 per share par value, 1,350,000,000 shares				
authorized; outstanding 336,106,217 and 357,362,604 shares,				
respectively, net of treasury shares		337		358
Additional paid-in capital		1,912		1,892
Accumulated other comprehensive loss		(753)		(805)
Retained income		8,759		9,224
Total stockholders' equity		10,255		10,669
Total liabilities and stockholders' equity	$	28,311	$	28,199

See accompanying notes to consolidated financial statements.

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

	Nine Months Ended September 30,	
	2011	**2010**
	($ in millions)	
Cash flows from operating activities		
Net income	$ 1,436	$ 1,094
Reconciliation of net income to net cash provided by operating activities:		
Depreciation	646	617
Deferred income taxes	414	172
Gains and losses on properties and investments	(30)	(38)
Changes in assets and liabilities affecting operations:		
Accounts receivable	(222)	(142)
Materials and supplies	(43)	(15)
Other current assets	60	50
Current liabilities other than debt	402	254
Other - net	101	136
Net cash provided by operating activities	2,764	2,128
Cash flows from investing activities		
Property additions	(1,433)	(907)
Property sales and other transactions	70	81
Investments, including short-term	(88)	(441)
Investment sales and other transactions	246	261
Net cash used in investing activities	(1,205)	(1,006)
Cash flows from financing activities		
Dividends	(432)	(384)
Common stock issued - net	95	59
Purchase and retirement of common stock	(1,611)	(437)
Proceeds from borrowings - net	396	250

Debt repayments	(592)	(477)
Net cash used in financing activities	(2,144)	(989)
Net increase (decrease) in cash and cash equivalents	(585)	133
Cash and cash equivalents		
At beginning of year	827	996
At end of period	$ 242	$ 1,129
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest (net of amounts capitalized)	$ 296	$ 296
Income taxes (net of refunds)	$ 121	$ 498

See accompanying notes to consolidated financial statements.

Norfolk Southern Corporation and Subsidiaries
Notes to Consolidated Financial Statements
(Unaudited)

In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all adjustments (consisting of normal recurring accruals) necessary to present fairly Norfolk Southern Corporation (Norfolk Southern) and subsidiaries' (collectively, NS) financial condition as of September 30, 2011, and December 31, 2010, and its results of operations for the three and nine months ended September 30, 2011 and 2010, and its cash flows for the nine months ended September 30, 2011 and 2010, in conformity with U.S. generally accepted accounting principles.

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

1. Stock-Based Compensation

In the first quarter of 2011, 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 $3 million during the third quarter of 2011, and $9 million during the same period of 2010. For the first nine months of 2011 and 2010, stock-based compensation expense was $52 million and $60 million, respectively. The total tax effects recognized in income in relation to stock-based compensation were net benefits of $1 million and $3 million for the quarters ended September 30, 2011 and 2010, respectively, and net benefits of $17 million and $19 million for the first nine months of 2011 and 2010.

Stock Options

In the first quarter of 2011, 627,700 options were granted under the LTIP and 257,000 options were granted under the TSOP. In each case, the grant price was $62.75, which was the greater of the average fair market value of Norfolk Southern common stock (Common Stock) or the closing price of the Common Stock on the effective date of the grant, and the options have a term of ten years. The options granted under the LTIP and TSOP in 2011 may not be exercised prior to the fourth and third anniversaries of the date of grant, respectively. Holders of the 2011 options granted under the LTIP who remain actively employed receive cash dividend equivalent payments for four years in an amount equal to the regular quarterly dividends paid on Common Stock. Dividend equivalent payments are not made on TSOP options.

The fair value of each option award in 2011 was measured on the date of grant using a lattice-based option valuation model. Expected volatilities are based on implied volatilities from traded options on Common Stock and historical volatility of Common Stock. NS uses historical data to estimate option exercises and employee terminations within the valuation model. The average expected option life is derived from the output of the valuation model and represents the period of time that options granted are expected to be outstanding. The average risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. A dividend yield of zero was used for LTIP options during the four-year period in which dividend equivalent payments are made. A dividend yield of 2.55% was used for LTIP options for periods where no dividend equivalent payments are made as well as for TSOP options which do not receive dividend equivalents. The assumptions for the 2011 LTIP and TSOP grants are shown in the following table:

Expected volatility range	28% - 32%
Average expected volatility	28%
Average expected option life	8.5 years
Average risk-free interest rate	3.42%
LTIP per-share grant-date fair value	$22.26
TSOP per-share grant-date fair value	$18.10

During the third quarter of 2011, options relating to 555,659 shares were exercised, yielding $15 million in cash proceeds and $11 million of tax benefits recognized as additional paid-in capital. During the third quarter of 2010, options relating to 497,375 shares were exercised, yielding $11 million in cash proceeds and $6 million of tax benefits recognized as additional paid-in capital.

For the first nine months of 2011, options relating to 2,204,705 shares were exercised, yielding $60 million of cash proceeds and $33 million of tax benefits recognized as additional paid-in capital. For the first nine months of 2010, options relating to 1,655,271 shares were exercised yielding $37 million of cash proceeds and $20 million of tax benefits recognized as additional paid-in capital.

Restricted Stock Units and Restricted Shares

There were 177,400 restricted stock units granted in 2011, with an average grant-date fair value of $62.75 and a five-year restriction period. The restricted stock units granted in 2011 will be settled through the issuance of shares of Common Stock.

During the third quarters of 2011 and 2010, no restricted stock units were earned or paid out. There were no restricted stock units earned or paid out during the first nine months of 2011. The total related tax benefit recognized as additional paid-in capital was less than $1 million for both the third quarter of 2011 and the first nine months of 2011.

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

Performance Share Units

PSUs provide for awards based on achievement of certain predetermined corporate performance goals at the end of a three-year cycle. During the first quarter of 2011, there were 580,900 PSUs granted with a grant-date fair value of $62.75. The PSUs granted in 2011 and 2010 will be paid in the form of shares of Common Stock.

During the first nine months of 2011, 850,595 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 $50.47 per unit and a fair value at payout of $62.75 per unit. The total related tax benefit recognized as additional paid-in capital was $2 million for the first nine months of 2011.

During the first nine months of 2010, 851,893 PSUs were earned and paid out, one-half in shares of Common Stock and one-half in cash. These PSUs had a grant-date fair value of $49.56 per unit and a fair value at payout of $47.76 per unit. The total related tax expense recognized as a reduction to additional paid-in capital was less than $1 million for the first nine months of 2010.

2. Income Taxes

During the second quarter of 2011, the Internal Revenue Service (IRS) completed its examination of NS' 2008 tax return and review of certain claims for refund for prior years that resulted in a decrease in income tax expense of $40 million. Also during the second quarter, three states enacted tax law changes that, as required by the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 740, *"Income Taxes,"* decreased deferred income tax expense by $19 million.

NS' balance of unrecognized tax benefits reported at December 31, 2010 has decreased by $74 million, primarily because of the timing of deductibility of a tax position that became certain during the first quarter; the completion of the IRS examination and review of certain claims for refund during the second quarter; and the resolution of certain state tax matters during the third quarter. These decreases during the first nine months were offset by additions to prior year unrecognized tax benefits for new information during the third quarter. NS' consolidated income tax returns for 2009 and 2010 are undergoing routine audit by the IRS.

During the first quarter of 2010, the Patient Protection and Affordable Care Act, and the Health Care and Education Reconciliation Act of 2010 were signed into law. Provisions of the Acts eliminated, after 2012, the tax deduction available for reimbursed prescription drug expenses under the Medicare Part D retiree drug subsidy program. As required by ASC 740, NS recorded a $27 million charge to deferred tax expense in the first quarter of 2010.

3. Earnings Per Share

	Three Months Ended September 30,			
	2011	2010	2011	2010
	Basic		Diluted	
	($ in millions except per share, shares in millions)			
Net income	$ 554	$ 445	$ 554	$ 445
Dividend equivalent payments	(2)	(2)	--	(2)
Income available to common stockholders	$ 552	$ 443	$ 554	$ 443
Weighted-average shares outstanding	343.2	366.3	343.2	366.3
Dilutive effect of outstanding options and share-settled awards			5.8	5.3
Adjusted weighted-average shares outstanding			349.0	371.6
Earnings per share	$ 1.61	$ 1.21	$ 1.59	$ 1.19

	Nine Months Ended September 30,			
	2011	2010	2011	2010
	Basic		Diluted	
	($ in millions except per share, shares in millions)			
Net income	$ 1,436	$ 1,094	$ 1,436	$ 1,094
Dividend equivalent payments	(6)	(6)	(2)	(6)
Income available to common stockholders	$ 1,430	$ 1,088	$ 1,434	$ 1,088
Weighted-average shares outstanding	349.8	368.5	349.8	368.5
Dilutive effect of outstanding options and share-settled awards			5.8	5.3
Adjusted weighted-average shares outstanding			355.6	373.8
Earnings per share	$ 4.09	$ 2.95	$ 4.03	$ 2.91

During the third quarters and first nine months of 2011 and 2010, dividend equivalent payments were made to holders of stock options and restricted stock units. For purposes of computing basic earnings per share, the total amount of dividend equivalent payments made to holders of stock options and restricted stock units were deducted from net income to determine income available to common stockholders. For purposes of computing diluted earnings per share, NS evaluates on a grant-by-grant basis those stock options and restricted stock units receiving dividend equivalent payments under the two-class and treasury stock methods to determine which method is the more dilutive for each grant. For those grants for which the two-class method was more dilutive, net income was reduced by the amount of dividend equivalent payments on these grants to determine income available to common stockholders. The diluted calculations exclude options having exercise prices exceeding the average market price of Common Stock as follows: zero in 2011 and 2010.

4. Stockholders' Equity

Common stock is reported net of shares held by consolidated subsidiaries of Norfolk Southern, which at September 30, 2011 and December 31, 2010, amounted to 20,320,777 and 20,336,843 shares, respectively, with a cost of $19 million as of both dates.

5. Stock Repurchase Program

NS repurchased and retired 23.8 million shares of Common Stock in the first nine months of 2011, at a cost of $1.6 billion, and 7.8 million shares at a cost of $437 million for the same period of 2010. The timing and volume of purchases is guided by management's assessment of market conditions and other pertinent factors. Any near-term share repurchases are expected to be made with internally generated cash, cash and short-term investments on hand, or proceeds from borrowings. Since 2005, NS has repurchased and retired 103.2 million shares at a total cost of $5.7 billion.

6. Investments

	September 30, 2011	December 31, 2010
	($ in millions)	
Short-term investments with average remaining maturities:		
Available-for-sale:		
Corporate bonds, 8 and 4 months, respectively	$ 43	$ 64
Federal government bond, 6 months	15	--
Certificates of deposit, 2 and 5 months, respectively	10	76
Commercial paper, 4 months	--	35
Total available-for-sale	68	175
Held-to-maturity:		
Federal government bonds, 2 and 9 months, respectively	43	49
Corporate bonds, 2 and 10 months, respectively	41	59
Total held-to-maturity	84	108
Total short-term investments	$ 152	$ 283

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 $980 million at September 30, 2011, and $959 million at December 31, 2010.

CRC owns and operates certain properties (the Shared Assets Areas) for the joint and exclusive benefit of Norfolk Southern Railway Company (NSR) and CSX Transportation, Inc. (CSXT). The costs of operating the Shared Assets Areas are borne by NSR and CSXT based on usage. In addition, NSR and CSXT pay CRC a fee for access to the Shared Assets Areas. "Purchased services and rents" and "Fuel" include expenses for the use of the Shared Assets Areas totaling $32 million and $30 million for the third quarters of 2011 and 2010, respectively, and $97 million and $88 million for the first nine months of 2011 and 2010, respectively. NS' equity in the earnings of Conrail, net of amortization, included in "Other income – net" was $8 million and $3 million for the third quarters of 2011 and 2010, respectively, and $21 million and $16 million for the first nine months of 2011 and 2010, respectively.

"Accounts payable" includes $166 million at September 30, 2011, and $128 million at December 31, 2010, due to Conrail for the operation of the Shared Assets Areas. In addition, "Other liabilities" includes $133 million at both September 30, 2011 and December 31, 2010, for long-term advances from Conrail, maturing 2035, that bear interest at an average rate of 4.4%.

7. Debt

In the first quarter of 2011, NS repaid $100 million under its accounts receivable securitization facility. At September 30, 2011, and December 31, 2010, the amounts outstanding under the facility were $100 million (at an average variable interest rate of 1.49%) and $200 million (at an average variable interest rate of 1.54%), respectively. In October 2011, NS renewed its account receivable securitization facility with a 364-day term to run until October 2012.

During the third quarter of 2011, NS issued $600 million of unsecured notes ($596 million at 4.837% due 2041 and $4 million at 6.00% due 2111) and paid $146 million of premium in exchange for $526 million of its previously issued unsecured notes ($422 million at 7.05% due 2037, $77 million at 7.90% due 2097, and $27 million at 7.25% due 2031). The premium is reflected as a reduction of debt in the Consolidated Balance Sheet and Statement of Cash Flows and will be amortized as additional interest expense over the terms of the new debt. No gain or loss was recognized as a result of the debt exchange.

During the second quarter of 2011, NS issued $400 million of 6.00% senior notes due 2111.

NS has authority from its Board of Directors to issue an additional $600 million of debt or equity securities through public or private sale.

8. Pensions and Other Postretirement Benefits

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

	Three Months Ended September 30,			
	2011	**2010**	**2011**	**2010**
	Pension Benefits		**Other Benefits**	
	($ in millions)			
Service cost	$ 7	$ 7	$ 3	$ 3
Interest cost	23	24	14	16
Expected return on plan assets	(35)	(36)	(4)	(4)
Amortization of net losses	16	12	11	15
Amortization of prior service cost	1	1	--	--
Net cost	$ 12	$ 8	$ 24	$ 30

	Nine Months Ended September 30,			
	2011	**2010**	**2011**	**2010**
	Pension Benefits		**Other Benefits**	
	($ in millions)			

Service cost	$ 21	$ 20	$ 11	$ 11
Interest cost	69	72	43	46
Expected return on plan assets	(105)	(107)	(11)	(11)
Amortization of net losses	50	36	33	39
Amortization of prior service cost	2	2	--	--
Net cost	$ 37	$ 23	$ 76	$ 85

9. Comprehensive Income

	Three Months Ended September 30, 2011	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2010
	($ in millions)			
Net income	$ 554	$ 445	$ 1,436	$ 1,094
Other comprehensive income	17	16	52	49
Total comprehensive income	$ 571	$ 461	$ 1,488	$ 1,143

Other comprehensive income in 2011 and 2010 reflects primarily, net of tax, the amortization of the net losses and prior service costs for the pension and other postretirement benefit plans.

10. Fair Value

Fair Value Measurements

ASC 820-10, *"Fair Value Measurements,"* established a framework for measuring fair value and a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels, as follows:

Level 1 Inputs to the valuation methodology are unadjusted quoted prices for identical assets or liabilities in active markets that NS has the ability to access.

Level 2 Inputs to the valuation methodology include:

· Quoted prices for similar assets or liabilities in active markets;
· Quoted prices for identical or similar assets or liabilities in inactive markets;
· Inputs other than quoted prices that are observable for the asset or liability;
· Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

If the asset or liability has a specified (contractual) term, the Level 2 input must be observable for substantially the full term of the asset or liability.

Level 3 Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The asset's or liability's fair value measurement level within the hierarchy is based on the lowest level of any input that is significant to the fair value measurement. At September 30, 2011, and December 31, 2010, for assets measured at fair value on a recurring basis, there were $68 million and $175 million, respectively, of available-for-sale securities valued under level 2 of the fair value hierarchy. There were no available-for-sale securities valued under level 1 or level 3 valuation techniques.

Fair Values of Financial Instruments

NS has evaluated the fair values of financial instruments and methods used to determine those fair values. The fair values of “Cash and cash equivalents,” “Short-term investments,” “Accounts receivable,” “Accounts payable,” and “Short-term debt” approximate carrying values because of the short maturity of these financial instruments. The carrying value of corporate-owned life insurance is recorded at cash surrender value and, accordingly, approximates fair value.

The carrying amounts and estimated fair values for the remaining financial instruments, excluding derivatives and investments accounted for under the equity method, consisted of the following:

	September 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	($ in millions)			
Long-term investments	$ 152	$ 183	$ 192	$ 222
Long-term debt, including current maturities	$ (6,837)	$ (8,757)	$ (6,925)	$ (7,971)

Underlying net assets were used to estimate the fair value of investments with the exception of notes receivable, which are based on future discounted cash flows. The fair values of long-term debt were estimated based on quoted market prices or discounted cash flows using current interest rates for debt with similar terms, company rating, and remaining maturity.

Carrying amounts of available-for-sale securities reflect immaterial unrealized holding gains as of both September 30, 2011 and December 31, 2010. Sales of available-for-sale securities were $173 million and $160 million for the nine months ended September 30, 2011 and 2010, respectively.

11. Commitments and Contingencies

Lawsuits

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

Two of NS' customers, DuPont and South Mississippi Electric Power Association (SMEPA), have filed rate reasonableness complaints at the Surface Transportation Board (STB) alleging that the NS tariff rates for transportation of regulated movements is unreasonable. NS disputes these allegations and in August 2011, NS agreed to settle the rate reasonableness complaint with SMEPA. Settlement of this claim did not have a material effect on NS' financial position, results of operations, or liquidity. Since June 1, 2009, in the case of DuPont, NS has been billing and collecting amounts based on the challenged tariff rates. Management presently expects resolution of the DuPont case to occur in late 2012 or 2013 and believes the estimate of reasonably possible loss will not have a material effect on NS' financial position, results of operations, or liquidity. With regard to rate cases, management records adjustments to revenues in the periods, if and when, such adjustments are probable and estimable.

Casualty Claims

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

The Consolidated Balance Sheets reflect long-term receivables for estimated recoveries from NS' insurance carriers for claims associated with the January 6, 2005, derailment in Graniteville, S.C. During the first quarter of 2010, NS settled an arbitration claim ($100 million) with one of its insurance carriers with no adverse effect on NS' financial position, results of operations, or liquidity. In the first quarter of 2011, NS received an unfavorable ruling for an arbitration claim with another insurance carrier, and was denied recovery of the contested portion ($43 million) of the claim. As a result, NS recorded a $43 million expense during the first quarter of 2011 for the receivables associated with the contested portion of the claim and a $15 million expense for other receivables affected by the ruling for which recovery is no longer probable.

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 independent 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 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 vary from the estimated liability recorded.

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

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

Environmental Matters

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

NS' Consolidated Balance Sheets include liabilities for environmental exposures in the amount of $32 million at September 30, 2011, and $33 million at December 31, 2010 (of which $12 million is classified as a current liability at the end of each period). At September 30, 2011, the liability represents NS' estimate of the probable cleanup and remediation costs based on available information at approximately 154 known locations and projects. As of that date, seven sites accounted for $11 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 31 locations, one or more NS 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, 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. NS estimates its environmental remediation liability on a site-by-site basis, using assumptions and judgments that management deems appropriate for each site. As a result, it is not practical to quantitatively describe the effects of changes in these many assumptions and judgments. NS has consistently applied its methodology of estimating its environmental liabilities.

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.

Based on its assessment of known facts and circumstances, 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 $50 million and above $1 billion per occurrence for bodily injury and property damage to third parties and up to $25 million and above $175 million per occurrence for property owned by NS or in NS' care, custody, or control.

Purchase Commitments

At September 30, 2011, NS had outstanding purchase commitments totaling approximately $813 million for long-term service contracts through 2019, as well as locomotives, freight cars, track material, and RoadRailer® trailers, in connection with its capital programs through 2014.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
Norfolk Southern Corporation:

We have reviewed the accompanying consolidated balance sheet of Norfolk Southern Corporation and subsidiaries as of September 30, 2011, the related consolidated statements of income for the three-month and nine-month periods ended September 30, 2011 and 2010 and the related consolidated statements of cash flows for the nine-month periods ended September 30, 2011 and 2010. 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, 2010, 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 16, 2011, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2010, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP
KPMG LLP
Norfolk, Virginia
October 28, 2011

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

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

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

OVERVIEW

NS' third quarter net income grew from $445 million in 2010 to $554 million in 2011 as the global and domestic economies have continued their slow growth recovery. The increase was primarily the result of higher income from railway operations, partially offset by higher income taxes. Earnings per share improved to $1.59 from $1.19 in the prior year. Revenues grew 18% as a result of higher average revenue per unit (including fuel surcharges) and increased traffic volume. Railway operating expenses increased 14%, reflecting higher fuel prices and increased traffic volume. The railway operating ratio (a measure of the amount of operating revenues consumed by operating expenses) improved to 67.5%, compared with 69.6% for the third quarter of 2010.

Cash provided by operating activities for the first nine months of 2011 was $2.8 billion, which along with cash on hand and proceeds from borrowings allowed for share repurchases, property additions, and debt repayments. In the third quarter of 2011, 12.2 million shares of Norfolk Southern Corporation common stock (Common Stock) were repurchased at a total cost of $819 million. Since inception of the stock repurchase program in 2005, NS has repurchased and retired 103.2 million shares of Common Stock at a total cost of $5.7 billion. At September 30, 2011, cash, cash equivalents, and short-term investments totaled $394 million.

SUMMARIZED RESULTS OF OPERATIONS

Third quarter 2011 net income was $554 million, up $109 million, or 24%, compared with the same period last year. The increase primarily resulted from a $192 million increase in income from railway operations partially offset by a $61 million increase in income taxes. The increase in income from railway operations reflected a $433 million, or 18%, improvement in railway operating revenues, partially offset by a $241 million, or 14%, increase in railway operating expenses.

For the first nine months of 2011, net income was $1.4 billion, up $342 million, or 31%, compared with the same period last year. Income from railway operations increased 19%, reflecting an 18% improvement in railway operating revenues that was partially offset by a 17% increase in railway operating expenses. Improved results for the first nine months of 2011 also reflect a lower effective income tax rate due to the favorable resolution of an IRS examination of NS' 2008 return and review of certain claims for refund as well as state tax law changes.

Oil prices affect NS' results of operations in a variety of ways and can have an overall favorable or unfavorable impact in any particular period. In addition to the impact of oil prices on general economic conditions, traffic volume, and supplier costs, oil prices directly affect NS' revenues through market-based fuel surcharges and contract escalators (see "Railway Operating Revenues") and also affect fuel costs (see "Railway Operating Expenses"). For the third quarter and first nine months of 2011, excluding the impact of increased consumption, the increase in fuel surcharge revenue was greater than the increase in fuel expense. Future changes in oil prices may cause volatility in operating results that could be material to a particular year or quarter.

DETAILED RESULTS OF OPERATIONS

Railway Operating Revenues

Third quarter railway operating revenues were $2.9 billion in 2011, up $433 million, or 18%, compared with the third quarter of 2010. For the first nine months of 2011, railway operating revenues were $8.4 billion, up $1.3 billion, or 18%, compared with the same period last year.

The revenue increases were the result of higher average revenue per unit (which includes the effects of fuel surcharges), and higher traffic volume. Fuel surcharges amounted to $358 million in the third quarter (up $179 million) and $968 million for the first nine months (up $431 million):

	Third Quarter 2011 vs. 2010 Increase	First Nine Months 2011 vs. 2010 Increase
	($ in millions)	
Revenue per unit	$ 353	$ 895
Traffic volume (units)	80	356
Total	$ 433	$ 1,251

Many of Norfolk Southern's negotiated fuel surcharges for coal and general merchandise traffic are based on the monthly average price of West Texas Intermediate Crude Oil (WTI Average Price). These surcharges are reset the first day of each calendar month based on the WTI Average Price for the second preceding calendar month. This two-month lag in applying WTI Average Price coupled with the change in fuel prices increased fuel surcharge revenue by approximately $52 million for the third quarter and had an insignificant impact for the first nine months.

Two of NS' customers, DuPont and South Mississippi Electric Power Association (SMEPA), filed rate reasonableness complaints at the Surface Transportation Board (STB) alleging that the NS tariff rates for transportation of regulated movements is unreasonable. NS disputes these allegations, however, in August 2011, NS agreed to settle the rate reasonableness complaint with SMEPA. Settlement of this claim did not have a material effect on NS' financial position, results of operations, or liquidity. Since June 1, 2009, in the case of DuPont, NS has been billing and collecting amounts based on the challenged tariff rates. Management presently expects resolution of the DuPont case to occur in late 2012 or 2013 and believes the estimate of reasonably possible loss will not have a material effect on NS' financial position, results of operations, or liquidity. With regard to rate cases, management records adjustments to revenues in the periods, if and when, such adjustments are probable and estimable.

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

	Third Quarter					
	Revenue		Units		Revenue per Unit	
	2011	2010	2011	2010	2011	2010
	($ in millions)		*(in thousands)*		*($ per unit)*	
Coal	$ 899	$ 709	405.1	402.7	$ 2,219	$ 1,762
General merchandise:						
Agriculture/consumer/gov't	357	331	143.2	154.5	2,487	