

Opinion

Norfolk Southern Decides to Take a Different Track

The railroad's CEO, Alan Shaw, intends to keep employees on the payroll and continue to invest in operations instead of cutting back when the economy slumps.

by [Brooke Sutherland](#)
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After a derailed Norfolk Southern Corp. train spewed chemicals into the air, water and soil of East Palestine, Ohio, earlier this year, politicians accused the railroad of having prioritized profits over investments in railroad infrastructure and workers. The National Transportation Safety Board is still investigating the accident, but preliminary findings have focused on an overheated wheel bearing and temperature detectors that were operating as designed. There's little clear evidence so far to suggest the derailment was emblematic of corporate greed. Nevertheless, a harsh and perhaps overdue national spotlight has landed on the railroads.

The industry was vulnerable to public criticism after a bout of particularly bad service in the wake of the pandemic as companies struggled to hire back furloughed workers and after years of aggressive cost-cutting under the banner of "precision-scheduled railroading." The productivity strategy is premised on following preset timetables and eliminating waste and has resulted in shrunken workforces, closed rail yards and longer, more packed trains. Just about all of the top railroads have adopted some version of it in recent years to the chagrin of their customers and employees. But it was Norfolk Southern whose train went off the tracks on Feb. 3 and whose controlled release of vinyl chloride from damaged tank cars cast an ominous smoke plume over America's heartland. So most of the political accusations of cost-cutting villainy and share-buyback malfeasance have been directed at Chief Executive Officer Alan Shaw, who appeared twice before the US Senate in the wake of the accident.

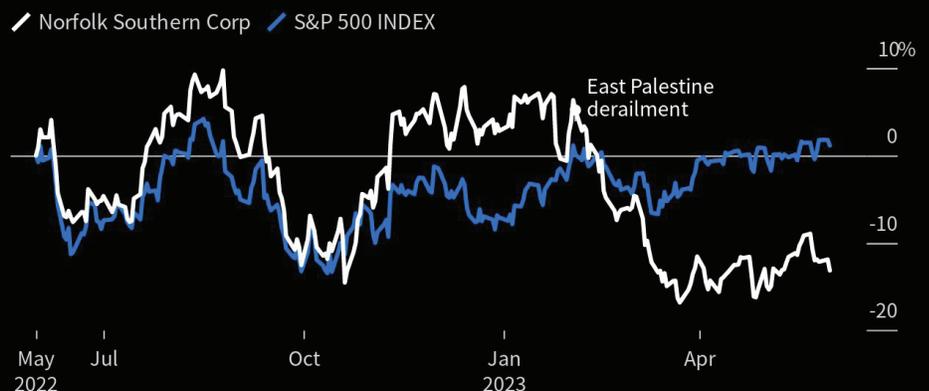
But Shaw, who was named CEO in December 2021 and officially took on the job in May 2022, has more in common



The long-term growth outlook for railroads is bright, but they need to invest in infrastructure to meet demand more reliably. *Photographer: Brooke Sutherland/Bloomberg*

Share Slump

Norfolk Southern took a preliminary \$387 million charge in the first quarter in connection with the accident. This doesn't reflect recoveries from insurance or other third parties who might bear responsibility.



Source: Bloomberg

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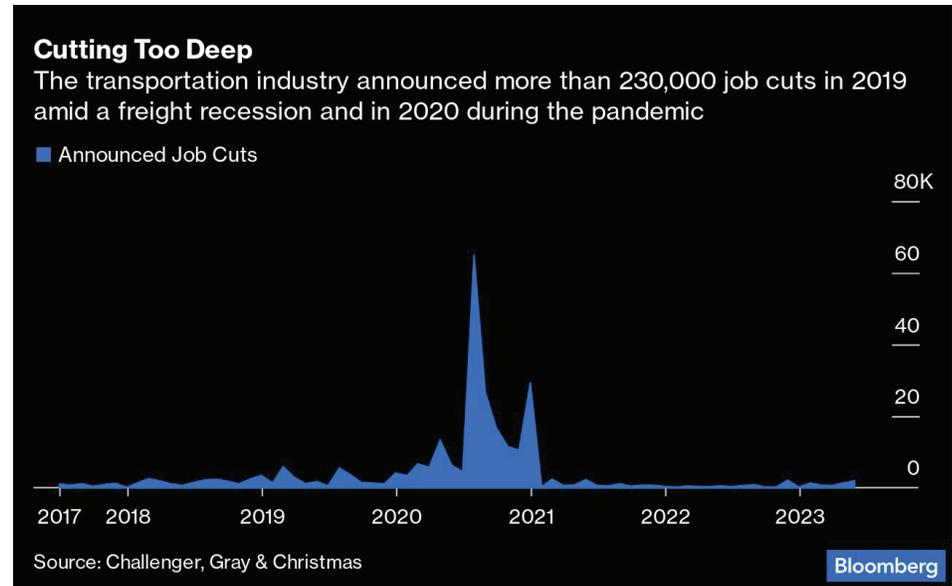
philosophically with his critics than might have been apparent in the tense grilling by senators. He also believes railroads have been too narrow-minded in their pursuit of higher margins and was already reordering Norfolk Southern's priorities around a broader set of stakeholders when the train derailed in East Palestine. "We were the first to pivot out of it," Shaw said in response to a call from Senator Bernie Sanders to disavow PSR at the March 9 hearing. The senator, an independent from Vermont, cut him off and pivoted to pressuring the CEO about the railroad's paid sick leave policies.

In December, three months before the accident, Shaw hosted his first investor day as CEO and laid out a plan to keep employees on the payroll and continue to invest in locomotives, track improvements, rail yards and technology even when the economy takes a turn. This might mean that there are periods when the company has more workers and capacity than it needs, but this temporary drag on profitability is dwarfed by the cost of network disruptions and lost market share when that dynamic flips and the company doesn't have the resources to handle rebounding volumes.

"When I became CEO, I thought to myself, 'There's got to be a better way to do this,'" Shaw said in an interview at Norfolk Southern's intermodal rail terminal in Austell, Georgia, just outside of Atlanta. "I want to take a longer-term view of things. The traditional rail model has been really focused on near-term operating margins. That drives your behavior. If you see a downturn in demand, you start cutting wherever you can. Crews would be the first place you would cut. And then you get behind when the economy recovers because it always does."

Norfolk Southern employed an average of 26,662 workers in 2018, but that metric dropped to 18,500 over the course of 2021. Its operating ratio – a measure of how well a company can control costs relative to sales and for which a lower number is better – improved from 65.4% in 2018 to 60.1% in 2021. But the railroad was caught flat-footed by the snapback in volumes after the initial Covid slowdown. It didn't have enough people or equipment. Shippers complained of widespread rail service disruptions, including delivery delays and caps on pickups.

This isn't just a Norfolk Southern issue; Union Pacific Corp. was the worst offender for temporary shipping limits. But the reli-

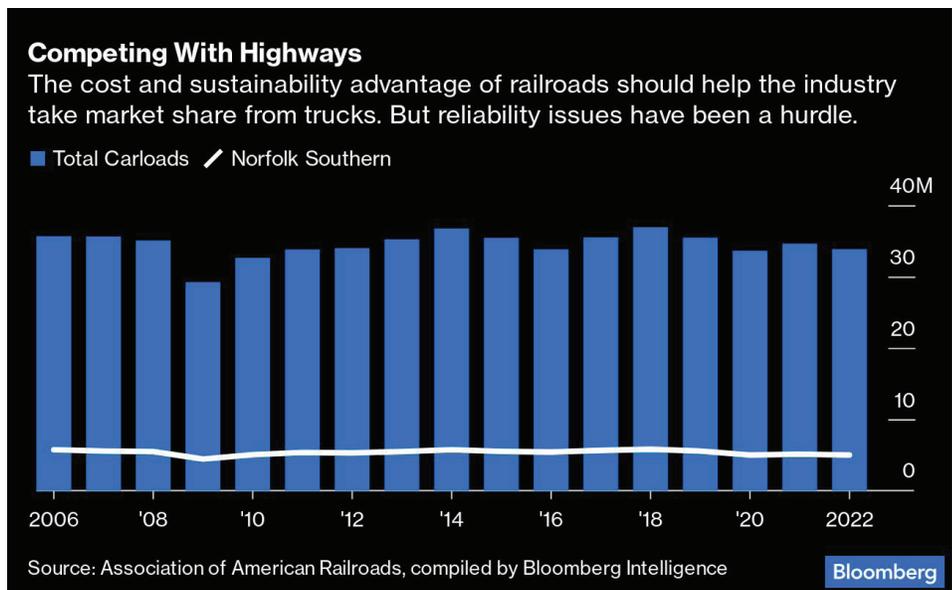


ability issues meant the industry collectively couldn't seize as much market share as it otherwise could and should have during this period of robust demand. Norfolk Southern carried 5.1 million originated carloads in 2021 and just under 5 million in 2022, down from 5.8 million in 2018 and 5.5 million in 2013, according to data from the Association of American Railroads compiled by Bloomberg Intelligence.

The model of cutting costs in a downturn and building operations back up again in an upturn makes sense in theory, but the timing has to be close to perfect for a railroad, and Norfolk Southern is "really bad at forecasting," Shaw said. "I'm not going to get it right as to exactly when the economy is going to take a downturn

or when it's going to recover and certainly not without enough lead time to get the assets in place to be ready to handle that recovery," he said. "There are strategic assets we know we're going to need over time. Just acknowledge we're never going to get the timing perfectly right and let's invest in those."

This is more than just talk: Empty shipping containers were piled up against the outer fence of Norfolk Southern's Austell intermodal yard, and Shaw conceded there are more of them than he would like as volumes come in weaker than expected. Consumers have shifted more of their spending back to services and inflation is eating into their purchasing power, leaving retailers with a glut of inventory and



dragging down demand for rail services. Even so, Norfolk Southern is hiring. The company's headcount moved up to 19,300 at the end of 2022, and it averaged 1,400 more railroad workers in the first quarter than it did in the period a year earlier. It's also investing in new technology and infrastructure, including the installation of six diesel-electric hybrid cranes in the Austell yard that will be used to stack shipping containers vertically to free up space and increase capacity during periods of heavy demand. ¹

Before ascending to the CEO post, Shaw served as Norfolk Southern's chief marketing officer and as head of the company's intermodal operations (this category of freight involves goods that can be transferred from ships to either rails or trucks, meaning the two industries compete aggressively for this business). Those jobs gave him a front-row view to the toll that cost cuts and underinvestment take on both the railroad's network and its customer service. With the freight economy in a recession in 2019, Norfolk Southern cut spending on chassis – trailers used to move shipping containers – from its capital budget, a decision that Shaw was involved in making. When e-commerce demand boomed during the pandemic, that was a problem. "We didn't have enough chassis," Shaw said. "And so then we have to go out and buy chassis, and we're at the back of the line for production. The cost had gone up 2X and we weren't supplying our customers with the service that they needed."

That's just one example of how railroads' pursuit of efficiency can wind up costing them money. Shaw laid out some compelling math at the December investor day, and he said the numbers were resonating with investors, particularly those with a longer-term bias. Norfolk Southern might get \$35 million in annual savings from the kind of furloughs it's typically done in normal downturns. But service disruptions from a slower-than-needed network can cost the railroad \$40 million a quarter. It costs about \$50,000 to recruit, hire and train a new conductor; multiplied by 200, that's \$10 million. This is to say nothing of missed revenue opportunities because the company can't meet customer demand and a longer-term loss of confidence that factors into shippers' willingness to choose rail transport over trucks.

Railroads have an inherent advantage over trucks because trains can carry more cargo in one go, they have lower carbon emissions and usually it costs less to ship



Stacking containers with the new cranes will more than double Norfolk Southern's international intermodal capacity at the Austell terminal, the company said. *Photographer: Brooke Sutherland*

products this way. But that's all a bit moot if the trains don't show up on time or at all. "A customer will generally never get fired for spending more money on truck than rail," Shaw said. "A customer will get fired if her plant shuts down."

His strategy of investing in resources and emphasizing resiliency is a bet on the long-term growth opportunity for railroads in general and for Norfolk Southern in particular from the acceleration of e-commerce, a push to bring more manufacturing back to North America and a reordering of supply chains. "I think most people didn't realize that operating ratio is a ratio," Shaw said. "There are rev-

enues involved in it, too. They genuinely thought, 'Well, the only thing I can control is cost.' And I don't think that's true." It used to be that more than 50% of the intermodal cargo that Norfolk Southern carried touched the West Coast ports at one point; now it's closer to 20% as customers steer more shipments to East Coast outposts that line up well with the railroad's network. The shift reflects concerns about labor tensions at the West Coast ports but also the relocation of manufacturing work from China to Southeast Asian countries that can ship goods in a reasonably timely and cost-effective fashion through the Suez Canal and across the Atlantic. That

business is Norfolk Southern's to capture as long as it doesn't squander the opportunity on reliability issues.

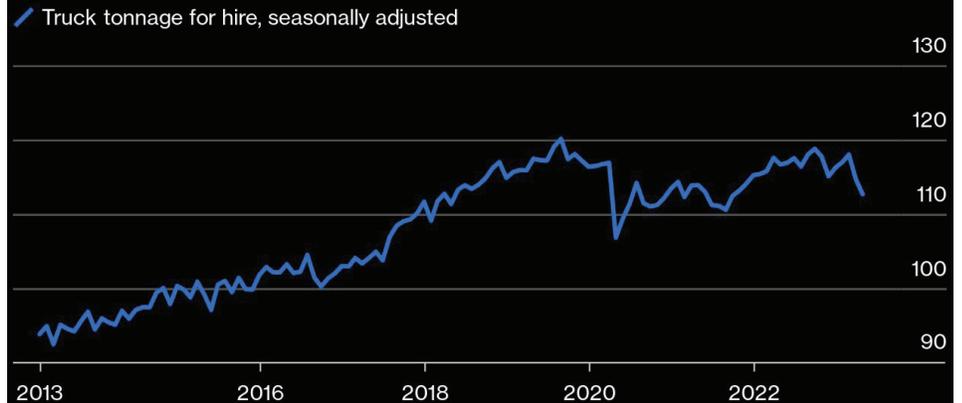
But Shaw's rethinking of Norfolk Southern's operating ethos also reflects a realization that even industrial companies that get their revenues exclusively from other businesses need to adopt a more consumer-oriented mindset. "It's a different railroad than it was 20 years ago when we were just handling a bunch of heavy bulk stuff" like coal and steel, he said. Much of the cargo Norfolk Southern carries today "can go via truck really, really easily. So you've got to figure out where can you add value." That means investing in digital enhancements so customers can track a container full of BMWs just as easily as they can an Amazon.com Inc. delivery to their homes. It also means rejiggering the company's communications strategy.

When the train derailed in East Palestine, Norfolk Southern's initial response was hyperlocal and deferential to regulators and first responders. This was the right strategy 20 years ago when the people who cared about a nonfatal train accident were primarily those living in the affected community. It didn't work in the era of 24/7 news cycles, social media, disinformation campaigns and the politicization of everything, and Norfolk Southern lost control over the narrative.

"We've got to recognize we're not just communicating with our customers," Shaw said. "That's just the way the world is moving." He's worked at the company for 29 years, and up until a few years ago, "we did not invest in corporate communications. It was just kind of like a job that got put somewhere." The company hired

Fierce Competition

Demand for trucking has grown significantly over the past decade



Source: American Trucking Association, compiled by Bloomberg

Bloomberg

a vice president of corporate communications who started in January 2021 and a director of strategic communications that same year. It's expanding that team, including adding staff with social media expertise. Norfolk Southern now has a website called nsmakingitright.com that regularly updates with its progress in East Palestine. So far, the company has committed more than \$36 million to the community, including reimbursements to residents, a donation to the local schools and support for the fire department. It has removed almost 20 million gallons of impacted water and nearly 55,000 tons of waste soil, including dirt underneath East Palestine tracks that the railroad agreed to rip up after complaints from the community. Government officials have said tests

show the air and water are safe.

This consumerization of the Norfolk Southern's communications strategy is a work in progress. Under questioning before the Senate, Shaw often said Norfolk Southern was committed to doing "what's right" in the wake of the derailment and would "do more than less" without really specifying what that meant and without fully committing to backing some of the legislation that has been introduced to bolster railroad safety. "You sound like a politician," Senator Sanders quipped. Lost in this master class on how to avoid answering the question was the possibility that Shaw might actually be trying to do "what's right" – for East Palestine, for customers, for employees and ultimately for shareholders, too.