NORFOLK SOUTHERN CORP
Form 10-K
February 22, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington , D.C. 20549

FORM 10-K

(X)	ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the fiscal year ended **DEC. 31, 2006**
( )	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
Registrant's telephone number, including area code	**(757) 629-2680**

No Change

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each Class	Name of each exchange on which registered
Norfolk Southern Corporation	

Common Stock (Par Value $1.00)	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: NONE

Indicate by checkmark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes (X) No ( )

Indicate by checkmark if the registrant is not required to file such reports pursuant to Section 13 or 15(d) of the Act. Yes ( ) No (X)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or Section 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ( )

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

Large accelerated filer (X) Accelerated filer ( ) Non-accelerated filer ( )

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

The aggregate market value of the voting common equity held by nonaffiliates as of June 30, 2006 was $22,023,555,376 (based on the closing price as quoted on the New York Stock Exchange on that date).

The number of shares outstanding of each of the registrant's classes of common stock, as of Jan. 31, 2007: 396,986,263(excluding 20,760,284 shares held by the registrant's consolidated subsidiaries).

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the Registrant's definitive proxy statement to be filed electronically pursuant to Regulation 14A not later than 120 days after the end of the fiscal year, are incorporated by reference in Part III.

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PART I

Norfolk Southern Corporation and Subsidiaries (NS)

Item 1. Business. and Item 2. Properties ..

GENERAL - Norfolk Southern Corporation (Norfolk Southern) is a Norfolk , Virginia based company that controls a major freight railroad, Norfolk Southern Railway Company. Norfolk Southern Railway Company is primarily engaged in the rail transportation of raw materials, intermediate products and finished goods primarily in the Southeast, East and Midwest and, via interchange with rail carriers, to and from the rest of the United States and parts of Canada .. Norfolk Southern also transports overseas freight through several Atlantic and Gulf Coast ports. Norfolk Southern provides comprehensive logistics services and offers the most extensive intermodal network in the eastern half of the United States .. The common stock of Norfolk Southern is listed on the New York Stock Exchange (NYSE) under the symbol "NSC."

Norfolk Southern was incorporated on July 23, 1980 , under the laws of the Commonwealth of Virginia .. On June l, 1982, Norfolk Southern acquired control of two major operating railroads, Norfolk and Western Railway Company (NW) and Southern Railway Company (Southern) in accordance with an Agreement of Merger and Reorganization dated as of July 31, 1980, and with the approval of the transaction by the Interstate Commerce Commission (now the Surface Transportation Board [STB]). Effective Dec. 31, 1990 , Norfolk Southern transferred all the common stock of NW to Southern, and Southern's name was changed to Norfolk Southern Railway Company (Norfolk Southern Railway or NSR). Effective Sept. 1, 1998 , NW was merged with and into Norfolk Southern Railway. As of Dec. 31, 2006, all the common stock of Norfolk Southern Railway was owned directly by Norfolk Southern.

Through a limited liability company, Norfolk Southern and CSX Corporation (CSX) jointly own Conrail Inc. (Conrail), whose primary subsidiary is Consolidated Rail Corporation (CRC). Norfolk Southern has a 58% economic and 50% voting interest in the jointly owned entity, and CSX has the remainder of the economic and voting interests. CRC owns and operates certain properties (the Shared Assets Areas) for the joint and exclusive benefit of NSR and CSX Transportation Inc. (CSXT). On June 1, 1999 , NSR and CSXT began operating separate portions of Conrail's rail routes and assets. On August 27, 2004, NS, CSX and Conrail completed a corporate reorganization of Conrail (Conrail Corporate Reorganization), which established direct ownership and control by NSR and CSXT of two former CRC subsidiaries, Pennsylvania Lines LLC and New York Central Lines LLC, respectively (see Note 4 to the Consolidated Financial Statements).

Norfolk Southern makes available free of charge through its website, www.nscorp.com, its annual report on Form 10 K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission (SEC). In addition, the following documents are available on the company's website and in print to any shareholder who requests them:

- Corporate Governance Guidelines
- Charters of the Committees of the Board of Directors
- Code of Ethics for employees
- Code of Ethical Conduct for Senior Financial Officers
- Categorical Independence Standards for Directors

Unless otherwise indicated, Norfolk Southern and its subsidiaries are referred to collectively as NS.

RAILROAD OPERATIONS – As of Dec. 31, 2006, NS' railroads operated approximately 21,000 miles of road in 22 eastern states, the District of Columbia and Ontario, Canada ..

The system's lines reach many individual industries, electric generating facilities, mines (in western Virginia , eastern Kentucky , southern and northern West Virginia and western Pennsylvania), distribution centers, transload facilities and other businesses located in smaller communities in its service area.

Corridors with heaviest freight volume:

New York City area to Chicago (via Allentown and Pittsburgh)

Chicago to Macon (via Cincinnati , Chattanooga and Atlanta)

Appalachian coal fields of Virginia , West Virginia and Kentucky to Norfolk and Sandusky , OH

Cleveland to Kansas City

Birmingham to Meridian

Memphis to Chattanooga

The miles operated, which includes leased lines between Cincinnati , Ohio , and Chattanooga , Tennessee , and trackage rights over property owned by North Carolina Railway Company, were as follows:

Mileage Operated as of Dec. 31, 2006

	Miles of Road	**Second and Other Main Track**	**Passing Track, Crossovers and Turnouts**	**Way and Yard Switching**	**Total**
Owned	16,194	2,808	2,084	8,569	29,655
Operated under lease, contract or trackage rights	4,947	1,978	417	969	8,311
Total	21,141	4,786	2,501	9,538	37,966

Triple Crown Operations – Triple Crown Services Company (TCSC), NS' subsidiary, offers door-to-door intermodal service using RoadRailer® equipment and domestic containers. RoadRailer® units are enclosed vans that can be pulled over highways in tractor-trailer configuration and over the rails by locomotives. TCSC provides intermodal service in major traffic corridors, including those between the Midwest and the Northeast, the Midwest and the Southeast, and the Midwest and Texas ..

The following table sets forth certain statistics relating to NS railroads' operations for the past 5 years:

Rail Operating Statistics

	Years Ended Dec. 31,				
	2006	**2005**	**2004**	**2003**	**2002**
Revenue ton miles (billions)	204	203	198	183	179

Freight train miles traveled (millions)	84.2	81.2	77.7	73.9	72.6
Revenue per ton mile	$0.0462	$0.0421	$0.0369	$0.0353	$0.0350
Revenue ton miles per					
man-hour worked	3,196	3,146	3,347	3,111	3,067
Percentage ratio of railway operating					
expenses to railway operating revenues	72.8%	75.2%	76.7%	83.5%[1]	81.5%

[1] Includes $107 million of costs for a voluntary separation program, which added 1.6 percentage points to the ratio.

RAILWAY OPERATING REVENUES -- NS' total railway operating revenues were $9.4 billion in 2006. See the financial information by traffic segment in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

COAL TRAFFIC -- Coal, coke and iron ore -- most of which is bituminous coal -- is NS' railroads' largest commodity group as measured by revenues. The railroads handled a total of 190.6 million tons in 2006, most of which originated on NS' lines in West Virginia , Virginia , Pennsylvania and Kentucky .. Revenues from coal, coke and iron ore accounted for about 25% of NS' total railway operating revenues in 2006.

Total coal handled through all system ports in 2006 was 33.8 million tons. Of this total, 10.8 million tons (including coastwise traffic) moved through Norfolk , Virginia , 2.4 million tons moved through the Baltimore Terminal, 13.0 million tons moved to various docks on the Ohio River, and 7.6 million tons moved to various Lake Erie ports. Other than coal for export, virtually all coal handled by NS' railroads was terminated in states east of the Mississippi River ..

See the discussion of coal traffic, by type of coal, in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

GENERAL MERCHANDISE TRAFFIC - General merchandise traffic is composed of five major commodity groupings: automotive; chemicals; metals and construction; agriculture, consumer products and government; and paper, clay and forest products. The automotive group includes finished vehicles for BMW, DaimlerChrysler, Ford Motor Company, General Motors, Honda, Isuzu, Jaguar, Land Rover, Mazda, Mercedes-Benz, Mitsubishi, Nissan, Saab, Subaru, Suzu ki , Toyota and Volkswagen, and auto parts for Ford Motor Company, General Motors, Mercedes-Benz and Toyota .. The chemicals group includes sulfur and related chemicals, petroleum products, chlorine and bleaching compounds, plastics, rubber, industrial chemicals, chemical wastes and municipal wastes. The metals and construction group includes steel, aluminum products, machinery, scrap metals, cement, aggregates, bricks and minerals. The agriculture, consumer products and government group includes soybeans, wheat, corn, fertilizer, animal and poultry feed, food oils, flour, beverages, canned goods, sweeteners, consumer products, ethanol and items for the military. The paper, clay and forest products group includes lumber and wood products, pulp board and paper products, wood fibers, wood pulp, scrap paper and clay.

In 2006, 147 million tons of general merchandise freight, or approximately 66% of total general merchandise tonnage handled by NS, originated online. The balance of general merchandise traffic was received from connecting carriers at interterritorial gateways. The principal interchange points for NS-received traffic included Chicago , Memphis , New Orleans , Cincinnati , Kansas City, Detroit , Hagerstown , St. Louis/East St. Louis and Louisville .. General merchandise carloads handled in 2006 were 2.9 million, the revenue from which accounted for 54% of NS’ total railway operating revenues in 2006.

See the discussion of general merchandise rail traffic by commodity group in Part II, Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations.”

INTERMODAL TRAFFIC - The intermodal market consists of shipments moving in trailers, domestic and international containers, and Roadrailer® equipment. These shipments are handled on behalf of intermodal marketing companies, international steamship lines, truckers and other shippers. Intermodal units handled in 2006 were 3.3 million, the revenues from which accounted for 21% of NS’ total railway operating revenues for the year.

See the discussion of intermodal traffic in Part II, Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations.”

FREIGHT RATES - In 2006, NS' railroads continued their reliance on private contracts and exempt price quotes as their predominant pricing mechanisms. Thus, a major portion of NS' railroads' freight business is not currently economically regulated by the government. In general, market forces have been substituted for government regulation and now are the primary determinant of rail service prices.

In 2006, NS' railroads were found by the STB to be “revenue adequate” based on results for the year 2005. A railroad is “revenue adequate” under the applicable law when its return on net investment exceeds the rail industry's composite cost of capital. This determination is made pursuant to a statutory requirement.

PASSENGER OPERATIONS

· Regularly scheduled passenger trains are operated by Amtrak on NS' lines between the following locations:

- Alexandria and New Orleans
- Greensboro and Selma , North Carolina
- Chicago , Illinois , and Detroit , Michigan
- Chicago and Harrisburg , Pennsylvania

· Commuter trains are operated on the NS line between Manassas and Alexandria in accordance with contracts with two transportation commissions of the Commonwealth of Virginia

· NS leases the Chicago to Manhattan , Illinois , line to the Commuter Rail Division of the Regional Transportation Authority of Northeast Illinois

· NS provides freight service over lines with significant ongoing Amtrak and commuter passenger operations, and is conducting freight operations over some trackage owned by:

- Amtrak
- New Jersey Transit
- Southeastern Pennsylvania Transportation Authority
- Metro-North Commuter Railroad Company
- Maryland DOT

· Passenger operations are conducted either by Amtrak or by the commuter agencies over trackage owned by Conrail in the Shared Assets Areas.

NONCARRIER OPERATIONS - NS' noncarrier subsidiaries engage principally in the acquisition, leasing and management of coal, oil, gas and minerals; the development of commercial real estate; telecommunications; and the leasing or sale of rail property and equipment. In 2006, no such noncarrier subsidiary or industry segment grouping of noncarrier subsidiaries met the requirements for a reportable business segment set forth in Statement of Financial Accounting Standards No. 131.

RAILWAY PROPERTY

The NS railroad system extends across 22 states, the District of Columbia and portions of Canada .. The railroad infrastructure makes the company capital intensive with total property of approximately $21 billion.

Capital Expenditures - Capital expenditures for road, equipment and other property for the past five years were as follows (including capitalized leases):

Capital Expenditures

	2006	2005	2004	2003	2002
	($ in millions)				
Road	$ 756	$ 741	$ 612	$ 502	$ 521
Equipment	422	284	429	218	174
Total	$ 1,178	$ 1,025	$ 1,041	$ 720	$ 695

Capital spending and maintenance programs are and have been designed to assure the ability to provide safe, efficient and reliable transportation services. For 2007, NS has budgeted $1.34 billion of capital spending. On May 1, 2006, NS and Kansas City Southern (KCS) formed a joint venture (MSLLC) pursuant to which NS intends to contribute $300 million in cash, substantially all of which will be used for capital improvements over a period of approximately three years, in exchange for a 30% interest in the joint venture. See the discussion following “Cash used for investing activities,” in Part II, Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations.”

Equipment - As of Dec. 31, 2006, NS owned or leased the following units of equipment:

	Number of Units			Capacity
	Owned*	**Leased****	**Total**	**of Equipment**
Locomotives:				(Horsepower)
Multiple purpose	3,505	132	3,637	12,563,600
Switching	207	--	207	303,700
Auxiliary units	74	--	74	--
Total locomotives	3,786	132	3,918	12,867,300
Freight cars:				(Tons)
Hopper	18,839	808	19,647	2,086,249
Box	17,555	2,346	19,901	1,590,557
Covered hopper	9,042	3,019	12,061	1,317,822
Gondola	29,806	8,283	38,089	4,093,356
Flat	2,708	1,336	4,044	316,712
Caboose	191	--	191	--
Other	4,028	20	4,048	303,650
Total freight cars	82,169	15,812	97,981	9,708,346
Other:				
Work equipment	5,337	3	5,340	
Vehicles	3,547	--	3,547	
Highway trailers and containers	184	11,496	11,680	
RoadRailer®	6,828	192	7,020	
Miscellaneous	1,356	18,686	20,042	
Total other	17,252	30,377	47,629	

* Includes equipment leased to outside parties and equipment subject to equipment trusts, conditional sale agreements and capitalized leases.

** Includes 6,437 freight cars leased from CRC.

The following table indicates the number and year built for locomotives and freight cars owned at Dec. 31, 2006.

	Year Built								
	2006	**2005**	**2004**	**2003**	**2002**	**1995-2001**	**1990-1994**	**1989 & Before**	**Total**
Locomotives:									
No. of units	143	89	207	100	-- *	1,073	395	1,779	3,786
% of fleet	4%	2%	5%	3%	--%	28%	11%	47%	100%
Freight cars:									
No. of units	404	89	--	--	--	6,536	5,065	70,075	82,169
% of fleet	1%	--%	--%	--%	--%	8%	6%	85%	100%

* Fifty of the locomotives built in 2001 were purchased in 2002.

The following table shows the average age of NS' locomotive and freight car fleets at Dec. 31, 2006 , and the number of retirements in 2006:

	Locomotives	Freight Cars
Average age – in service	17.7 years	30.0 years
Retirements	2 units	2,520 units
Average age – retired	35.0 years	38.7 years

Between 1988 and 2000, about 29,000 coal cars were rebodied. As a result, the remaining serviceability of the freight car fleet is greater than may be inferred from the high percentage of freight cars built in earlier years.

	Annual Average Bad Order Ratio				
	2006	2005	2004	2003	2002
Freight cars	6.4%	6.3%	7.4%	7.4%	8.1%
Locomotives	5.7%	6.2%	6.3%	6.2%	6.3%

Ongoing freight car and locomotive maintenance programs are intended to ensure the highest standards of safety, reliability, customer satisfaction and equipment marketability. The declines in 2006, 2005 and 2003 reflected an increase in maintenance activity as well as the retirement of unserviceable units. The locomotive bad order ratio includes units out of service for required inspections every 92 days and program work such as overhauls.

Encumbrances - Certain railroad equipment is subject to the prior lien of equipment financing obligations amounting to approximately $534 million as of Dec. 31, 2006, and $650 million as of Dec. 31, 2005 ..

Track Maintenance - Of the approximately 38,000 total miles of track operated, NS had responsibility for maintaining about 30,000 miles of track with the remainder being operated under trackage rights.

Over 75% of the main line trackage (including first, second, third and branch main tracks, all excluding trackage rights) has rail ranging from 131 to 155 pounds per yard with the standard installation currently at 136 pounds per yard. Approximately 45% of NS lines carried 20 million or more gross tons per track mile during 2006.

The following table summarizes several measurements regarding NS' track roadway additions and replacements during the past five years:

	2006	2005	2004	2003	2002
Track miles of rail installed	327	302	246	233	235
Miles of track surfaced	4,871	4,663	5,055	5,105	5,270
New crossties installed (millions)	2.7	2.5	2.5	2.8	2.8

Microwave System - The NS microwave system, consisting of approximately 7,400 radio route miles, 424 core stations, 14 secondary stations and 5 passive repeater stations, provides communications between most operating locations. The microwave system is used primarily for voice communications, VHF radio control circuits, data and facsimile transmissions, traffic control operations and AEI data transmissions.

Traffic Control - Of the approximately 16,200 route miles owned by NS, about 11,000 miles are signalized, including 8,000 miles of centralized traffic control (CTC) and 3,000 miles of automatic block signals. Of the 8,000 miles of CTC, approximately 3,000 miles are controlled by data radio originating at 244 base station radio sites.

Computers - A computer network consisting of a centralized data center in Atlanta , Georgia , and various distributed computers throughout the company connects the yards, terminals, transportation offices, rolling stock repair points, sales offices and other key system locations. Operating and traffic data are processed and stored to provide customers with information on their shipments throughout the system. Computer systems provide current information on the location of every train and each car on line, as well as related waybill and other train and car movement data. In addition, the computer systems are utilized to assist management in the performance of a variety of functions and services including payroll, car and revenue accounting, billing, material management activities and controls, and special studies.

ENVIRONMENTAL MATTERS - Compliance with federal, state and local laws and regulations relating to the protection of the environment is a principal NS goal. To date, such compliance has not affected materially NS' capital additions, earnings, liquidity or competitive position. See “Legal Proceedings,” Part I, Item 3; “Personal Injury, Environmental and Legal Liabilities” in Part II, Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations;” and Note 17 to the Consolidated Financial Statements.

EMPLOYEES – The following table shows the average number of employees and the average cost per employee for wages and benefits:

	2006	2005	2004	2003	2002
Average number of employees	30,541	30,294	28,475	28,753	28,970
Average wage cost per employee	$62,000	$61,000	$59,000	$58,000	$54,000
Average benefit cost per employee	$32,000	$29,000	$28,000	$28,000	$24,000

Approximately 85% of NS' railroad employees are covered by collective bargaining agreements with various labor unions. See the discussion of "Labor Agreements" in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

GOVERNMENT REGULATION - In addition to environmental, safety, securities and other regulations generally applicable to all businesses, NS' railroads are subject to regulation by the STB. The STB has jurisdiction over some rates, routes, conditions of service and the extension or abandonment of rail lines. The STB also has jurisdiction over the consolidation, merger or acquisition of control of and by rail common carriers. The Federal Railroad Administration regulates certain track and mechanical equipment standards.

The relaxation of economic regulation of railroads, begun over two decades ago under the Staggers Rail Act of 1980, has continued. Significant exemptions are TOFC/COFC (i.e., "piggyback") business, rail boxcar traffic, lumber, manufactured steel, automobiles and certain bulk commodities such as sand, gravel, pulpwood and wood chips for paper manufacturing. Transportation contracts on regulated shipments effectively remove those shipments from regulation as well for the duration of the contract. About 84% of NS' freight revenues come from either exempt traffic or traffic moving under transportation contracts.

Efforts may be made in 2007 to re-subject the rail industry to unwarranted federal economic regulation. The Staggers Rail Act of 1980, which substantially reduced such regulation, encouraged and enabled rail carriers to innovate and to compete for business, thereby contributing to the economic health of the nation and to the revitalization of the industry. Accordingly, NS will oppose efforts to reimpose unwarranted economic regulation.

COMPETITION - There is continuing strong competition among rail, water and highway carriers. Price is usually only one factor of importance as shippers and receivers choose a transport mode and specific hauling company. Inventory carrying costs, service reliability, ease of handling and the desire to avoid loss and damage during transit are also important considerations, especially for higher-valued finished goods, machinery and consumer products. Even for raw materials, semifinished goods and work-in-process, users are increasingly sensitive to transport arrangements that minimize problems at successive production stages.

NS' primary rail competitor is the CSX system; both operate throughout much of the same territory. Other railroads also operate in parts of the territory. NS also competes with motor carriers, water carriers and with shippers who have the additional option of handling their own goods in private carriage.

Certain marketing strategies among railroads and between railroads and motor carriers enable carriers to compete more effectively in specific markets.

Item 1A. Risk Factors.

NS is subject to significant governmental regulation and legislation over commercial, environmental and operating matters. Railroads are subject to commercial regulation by the Surface Transportation Board, which has jurisdiction over some rates, routes, fuel surcharges, conditions of service and the extension or abandonment of rail lines. The STB also has jurisdiction over the consolidation, merger or acquisition of control of and by rail common carriers. Occasional efforts are made to re-subject the rail industry to unwarranted federal economic regulation. In addition, Congress could enact re-regulation legislation. Economic re-regulation of the rail industry could have a significant negative impact on NS' ability to determine prices for rail services, reduce capital spending on its rail network, and result in a material adverse effect on NS' financial position, results of operations or liquidity in a particular year or quarter.

NS' operations are subject to extensive federal, state, and local environmental laws and regulations concerning, among other things, emissions to the air; discharges to water ways or ground water supplies; handling, storage, transportation, and disposal of waste and other materials; and the cleanup of hazardous material or petroleum releases. The risk of incurring environmental liability – for acts and omissions, past, present and future – is inherent in the railroad business. Several of NS' subsidiaries own, or have owned, land used as operating property or held for sale, or which is leased or may have been leased and operated by others. Environmental problems that are latent or undisclosed may exist on these properties, and NS could incur environmental liabilities or costs, the amount and materiality of which cannot be estimated reliably at this time, with respect to one or more of these properties. Moreover, lawsuits and claims involving other unidentified environmental sites and matters are likely to arise from time to time, and the resulting liabilities could have a significant effect on financial position, results of operations or liquidity in a particular year or quarter.

The Federal Railroad Administration regulates a host of operations matters including track and mechanical equipment standards; signaling systems; testing and inspection of grade crossing warning devices, hours of service of operating employees; drug and alcohol testing; locomotive engineer certification; and reporting of employee injuries, among other areas. NS' unintentional failure to comply with applicable laws and regulations could have a material adverse effect on NS, and changes in the legislative or regulatory frameworks within which NS operates could adversely affect its business.

NS, as a common carrier by rail, must offer to transport hazardous materials, regardless of risk. Transportation of certain hazardous materials could create catastrophic losses in terms of personal injury and property damage costs, and compromise critical parts of our rail network. Legislation introduced in Congress in early 2005 would give federal regulators increased authority to conduct investigations and levy substantial fines and penalties in connection with railroad accidents. Federal regulators also would be required to prescribe new regulations governing railroads' transportation of hazardous materials. Legislation proposed in 2006 would require the Department of Homeland Security (DHS) to develop rail security plans and the railroads to submit vulnerability assessments, security plans and employee training programs to DHS for approval. If enacted, such legislation and regulations could impose significant additional costs on railroads. Regulations proposed in late 2006 by DHS mandating chain of custody and security measures likely will cause service degradation and higher costs for the transportation of toxic inhalation hazard materials. Further, certain local governments have sought to enact ordinances banning hazardous materials moving by rail within their borders. Some legislators have contemplated pre-notification requirements for hazardous materials shipments. If promulgated such ordinances could require the re-routing of hazardous materials shipments, with the potential for significant additional costs and network inefficiencies.

NS may be affected by terrorism or war. Any terrorist attack, or other similar event, any government response thereto, and war or risk of war could cause significant business interruption and may adversely affect NS' results of operations, financial position, and liquidity. Because NS plays a critical role in the nation's transportation system, it could become the target of such an attack or have a significant role in the government's preemptive approach or response to an attack or war.

Although NS currently maintains insurance coverage for third-party liability arising out of war and acts of terrorism, it maintains only limited insurance coverage for first-party property damage and damage to property in NS' care, custody or control caused by certain acts of terrorism. In addition, premiums for some or all of NS' current insurance programs covering these losses could increase dramatically, or insurance coverage for certain losses may not be available to NS in the future.

NS may be affected by general economic conditions. Prolonged negative changes in domestic and global economic conditions affecting the producers and consumers of the commodities NS carries may have an adverse effect on its operating results, financial position, and liquidity. Economic conditions resulting in bankruptcies of one or more large customers could have a significant impact on NS' financial position, results of operations or liquidity in a particular year or quarter.

NS faces competition from other transportation providers. NS is subject to competition from motor carriers, railroads, and to a lesser extent, ships, barges, and pipelines, on the basis of transit time, pricing, and the quality and reliability of service. While NS has used primarily internal resources to build or acquire and maintain its rail system, trucks and barges have been able to use public rights-of-way maintained by public entities. Any future improvements or expenditures materially increasing the quality or reducing the cost of alternative modes of transportation in the regions in which NS operates, or legislation granting materially greater latitude for motor carriers with respect to size or weight limitations, could have a material adverse effect on its financial position, results of operations or liquidity in a particular year or quarter.

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

NS relies on technology and technology improvements in its business operations. If NS experiences significant disruption or failure of one or more of its information technology systems, including computer hardware, software, and communications equipment, NS could experience a service interruption, security breach, or other operational difficulties, which could have a material adverse impact on its results of operations, financial condition, and liquidity. Additionally, if NS does not have sufficient capital to acquire new technology or if it is unable to implement new technology, NS may suffer a competitive disadvantage within the rail industry and with companies providing other modes of transportation service, which could have a material adverse effect on its financial position, results of operations or liquidity in a particular year or quarter.

The vast majority of NS employees belong to labor unions, and labor agreements, strikes, or work stoppages could adversely affect its operations. A pproximately 26,000, or about 85%, of NS railroad employees are covered by collective bargaining agreements with various labor unions. If unionized workers were to engage in a strike, work stoppage, or other slowdown, NS could experience a significant disruption of its operations. Additionally, future national labor agreements, or renegotiation of labor agreements or provisions of labor agreements, could significantly increase NS' costs for healthcare, wages, and other benefits. Any of these factors could have a material adverse impact on NS' financial position, results of operations or liquidity in a particular year or quarter.

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

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

Severe weather could result in significant business interruptions and expenditures. Severe weather conditions and other natural phenomena, including hurricanes and floods, may cause significant business interruptions and result in increased costs, increased liabilities, and decreased revenues, which could have an adverse effect on NS' financial position, results of operations or liquidity in a particular year or quarter.

Unpredictability of demand for rail services resulting in the unavailability of qualified personnel could adversely affect NS' operational efficiency and ability to meet demand. Workforce demographics, training requirements, and the availability of qualified personnel, particularly engineers and trainmen, could each have a negative impact on NS' ability to meet demand for rail service. Unpredictable increases in demand for rail services may exacerbate such risks, which could have a negative impact on NS' operational efficiency and otherwise have a material adverse effect on its financial position, results of operations or liquidity in a particular year or quarter.

NS may be affected by supply constraints resulting from disruptions in the fuel markets or the nature of some of its supplier markets. NS consumes over 500 million gallons of diesel fuel each year. Fuel availability could be affected by any limitation in the fuel supply or by any imposition of mandatory allocation or rationing regulations. If a severe fuel supply shortage arose from production curtailments, disruption of oil imports, disruption of domestic refinery production, damage to refinery or pipeline infrastructure, political unrest, war or otherwise, NS' financial position, results of operations or liquidity in a particular year or quarter could be affected. Also, such an event would impact NS as well as its customers and other transportation companies.

Due to the capital intensive nature and industry-specific requirements of the rail industry, there are high barriers of entry for potential new suppliers of core railroad items, such as locomotives and rolling stock equipment. Additionally, NS competes with other industries for available capacity and raw materials used in the production of certain track materials, such as rail and ties. Changes in the competitive landscapes of these limited-supplier markets could result in increased prices or material shortages that could materially affect NS' financial position, results of operations or liquidity in a particular year or quarter.

Item 1B. Unresolved Staff Comments.

NS has no unresolved SEC staff comments.

Item 3. Legal Proceedings ..

On Oct. 19, 2006, the Pennsylvania Department of Environmental Protection (PDEP) issued an assessment of civil penalties against NS and filed a complaint for civil penalties with the Pennsylvania Environmental Hearing Board (EHB) requesting that the EHB impose civil penalties upon NS for alleged violations of state environmental laws and regulations resulting from a discharge of sodium hydroxide which occurred as a result of the derailment of a NS train in Norwich Township, Pennsylvania, on June 30, 2006. The PDEP's actions seek to impose combined penalties of $8,890,000 for alleged past violations and $46,420 per day for alleged ongoing violations of state environmental laws and regulations. NS believes that the monetary penalties sought by the PDEP are excessive. Accordingly, NS intends to vigorously defend the action and has appealed the fines to the EHB. In addition, NS expects the Pennsylvania Fish and Boat Commission to impose a monetary penalty on NS for damages alleged to have been caused by this accident. NS does not believe that the outcome of these proceedings will have a material effect on its financial position, results of operations, or liquidity.

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

There were no matters submitted to a vote of security holders during the fourth quarter of 2006.

Executive Officers of the Registrant.

Norfolk Southern's executive officers generally are elected and designated annually by the Board of Directors at its first meeting held after the annual meeting of stockholders, and they hold office until their successors are elected. Executive officers also may be elected and designated throughout the year as the Board of Directors considers appropriate. There are no family relationships among the officers, nor any arrangement or understanding between any officer and any other person pursuant to which the officer was selected. The following table sets forth certain information, as of January 31, 2007 , relating to the executive officers.

Name, Age, Present Position	**Business Experience During Past Five Years**
Charles W. Moorman, 54, Chairman, President and Chief Executive Officer	Present position since February 1, 2006 .. Served as President and Chief Executive Officer from November 1, 2005 to February 1, 2006 ; as President from October 1, 2004 to November 1, 2005 ; as Senior Vice President – Corporate Planning and Services from December 1, 2003 to October 1, 2004 ; Senior Vice President – Corporate Services from February 1, 2003 to December 1, 2003 ; also served as President – Thoroughbred Technology and Telecommunications, Inc. since October 1999 and prior thereto was Vice President – Information Technology.
Stephen C. Tobias, 62, Vice Chairman and Chief Operating Officer	Present position since August 1998.
Henry C. Wolf, 64, Vice Chairman and Chief Financial Officer	Present position since August 1998.
James A. Hixon, 53, Executive Vice President –	Present position since October 1, 2005 .. Served as Executive Vice President – Finance and Public Affairs

Law and Corporate Relations	From October 1, 2004 , to October 1, 2005 ; Senior Vice President – Legal and Government Affairs from December 1, 2003 to October 1, 2004 ; Senior Vice President – Administration from February 1, 2001 to December 1, 2003 ; and prior thereto was Senior Vice President – Employee Relations.
Mark D. Manion, 54, Executive Vice President – Operations	Present position since October 1, 2004 .. Served as Senior Vice President – Transportation Operations from December 1, 2003 to October 1, 2004 ; Vice President – Transportation Services and Mechanical from February 1, 2001 to December 1, 2003 ; and prior thereto was Vice President – Mechanical.
Kathryn B. McQuade, 50, Executive Vice President – Planning and Chief Information Officer	Present position since October 1, 2004 .. Served as Senior Vice President – Finance from December 1, 2003 to October 1, 2004 ; and prior thereto was Senior Vice President – Financial Planning.

John P. Rathbone, 54, Executive Vice President – Administration	Present position since October 1, 2004 .. Served as Senior Vice President – Administration from December 1, 2003 to October 1, 2004 ; Senior Vice President and Controller from April 2000 to December 1, 2003 and prior thereto was Vice President and Controller.
Donald W. Seale, 54, Executive Vice President and Chief Marketing Officer	Present position since April 1, 2006 .. Served as Executive Vice President – Sales and Marketing from October 1, 2004 to April 1, 2006 ; as Senior Vice President - Marketing Services from December 1, 2003 to October 1, 2004; and prior thereto was Senior Vice President – Merchandise Marketing.
Dan iel D. Smith, 54, Senior Vice President – Energy and Properties	Present position since December 1, 2003 .. Served as President- NS Development from February 1, 2001 to December 1, 2003 ..
James A. Squires, 45, Senior Vice President – Financial Planning	Present position since April 1, 2006 .. Served as Senior Vice President – Law from October 1, 2004 to April 1, 2006 ; as Vice President – Law from December 1, 2003 to October 1, 2004 ; Senior General Counsel from February 1, 2002 to December 1, 2003 ; and prior thereto was General Counsel.
Marta R. Stewart , 49, Vice President and Controller	Present position since December 1, 2003 .. Prior thereto was Assistant Vice President Corporate Accounting.

PART II

NORFOLK SOUTHERN CORPORATION AND SUBSIDIARIES (NS)

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

NORFOLK SOUTHERN CORPORATION AND SUBSIDIARIES

STOCK PRICE AND DIVIDEND INFORMATION

The Common Stock of Norfolk Southern Corporation, owned by 38,900 stockholders of record as of Dec. 31, 2006, is traded on the New York Stock Exchange with the symbol NSC. The following table shows the high and low sales prices as reported by Bloomberg L.P. on its internet-based service and dividends per share, by quarter, for 2006 and 2005.

	Quarter							
2006		1st		2nd		3rd		4th
Market price								
High	$	54.93	$	57.71	$	54.00	$	55.07
Low		41.22		46.17		39.10		42.80
Dividends per share	$	0.16	$	0.16	$	0.18	$	0.18
2005		1st		2nd		3rd		4th
Market price								
High	$	38.99	$	37.78	$	40.93	$	45.81
Low		33.21		29.60		30.70		38.01
Dividends per share	$	0.11	$	0.11	$	0.13	$	0.13

ISSUER PURCHASES OF EQUITY SECURITIES

Period	**(a) Total Number of Shares (or Units) Purchased**	**(b) Average Price Paid per Share (or Unit)**	**(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs[2]**	**(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that may yet be Purchased Under the Plans or Programs[2]**
Oct. 1-31, 2006	985,889	$46.09	983,995	28,279,067
Nov. 1-30, 2006	1,889	$52.96	--	28,279,067
Dec. 1-31, 2006	53,239	$49.56	51,500	28,227,567
Total	1,041,017[1]	$46.28		

(1) Of this amount 5,522 represent s hares tendered by employees in connection with the exercise of stock options under the Long-Term Incentive Plan.

(2) On Nov. 22, 2005 , the Board of Directors authorized a share repurchase program, pursuant to which up to 50 million of the NS’ common stock may be purchased through Dec. 31, 2015 ..

Item 6. Selected Financial Data ..

NORFOLK SOUTHERN CORPORATION AND SUBSIDIARIES

FIVE-YEAR FINANCIAL REVIEW 2002-2006

	2006	2005 [1]	2004 [2]	2003 [3]	2002
	($ in millions, except per share amounts)				
RESULTS OF OPERATIONS					
Railway operating revenues	$ 9,407	$ 8,527	$ 7,312	$ 6,468	$ 6,270
Railway operating expenses	6,850	6,410	5,610	5,404	5,112
Income from railway operations	2,557	2,117	1,702	1,064	1,158
Other income – net	149	74	76	19	66
Interest expense on debt	476	494	489	497	518
Income from continuing operations before income taxes and accounting changes	2,230	1,697	1,289	586	706
Provision for income taxes	749	416	379	175	246
Income from continuing operations before accounting changes	1,481	1,281	910	411	460
Discontinued operations[4]	--	--	--	10	--

Cumulative effect of changes in										
accounting principles, net of										
taxes[5]		--		--		--		114		--
Net income	$	1,481	$	1,281	$	910	$	535	$	460
PER SHARE DATA										
Income from continuing										
operations before accounting										
changes – basic	$	3.63	$	3.17	$	2.31	$	1.05	$	1.18
– diluted	$	3.57	$	3.11	$	2.28	$	1.05	$	1.18
Net income – basic	$	3.63	$	3.17	$	2.31	$	1.37	$	1.18
– diluted	$	3.57	$	3.11	$	2.28	$	1.37	$	1.18
Dividends	$	0.68	$	0.48	$	0.36	$	0.30	$	0.26
Stockholders' equity at year end	$	24.19	$	22.63	$	19.92	$	17.83	$	16.71
FINANCIAL POSITION										
Total assets	$	26,028	$	25,859	$	24,748	$	20,596	$	19,956
Total long-term debt, including										
current maturities[6]	$	6,600	$	6,930	$	7,525	$	7,160	$	7,364
Stockholders' equity	$	9,615	$	9,276	$	7,977	$	6,976	$	6,500
OTHER										
Capital expenditures	$	1,178	$	1,025	$	1,041	$	720	$	695
Average number of shares										
outstanding (thousands)		405,988		404,170		394,201		389,788		388,213
Number of stockholders at year end		38,900		48,180		51,032		52,091		51,418

Average number of employees:					
Rail	30,079	29,851	28,057	28,363	28,587
Nonrail	462	443	418	390	383
Total	30,541	30,294	28,475	28,753	28,970

2005 provision for income taxes includes a $96 million benefit related to the reduction of NS' deferred income tax liabilities resulting from tax legislation enacted by Ohio ..   This benefit increased net income by $96 million, or 23 cents per diluted share.

1

2004 other income – net includes a $40 million net gain from the Conrail Corporate Reorganization. This gain increased net income by $40 million or 10 cents per diluted share.

2

3 2003 operating expenses include a $107 million charge for a voluntary separation program. Other income – net includes an $84 million charge to recognize the impaired value of certain telecommunications assets. These charges reduced net income by $119 million, or 30 cents per diluted share.

4 NS sold all the common stock of its motor carrier subsidiary, North American Van Lines, Inc. in 1998. Results in 2003 include an additional after-tax gain of $10 million, or 3 cents per diluted share, resulting from resolution of tax issues related to the transaction.

5 Net income in 2003 reflects two accounting changes, the cumulative effect of which increased net income by $114 million, or 29 cents per diluted share: a change in accounting for the cost to remove railroad crossties, which increased net income by $110 million, and a change in accounting related to a special-purpose entity that leases certain locomotives to NS, which increased net income by $4 million.

6 Excludes notes payable to Conrail of $716 million in 2003 and $513 million in 2002.

See accompanying Consolidated Financial Statements and notes thereto.

Item 7 .. 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 and the Selected Financial Data.

OVERVIEW

NS' 2006 results reflect substantial increases in revenues (up $880 million, or 10%) resulting primarily from higher pricing, including increased fuel surcharges. Traffic volume in 2006 rose modestly as increases in the first half of the year were largely offset by declines in the second half, particularly during the fourth quarter. Operating expenses rose 7%, resulting in a 21% improvement in income from railway operations and a lower operating ratio (a measure of the amount of operating revenues consumed by operation expenses) of 72.8% compared with 75.2% in 2005.

Higher operating income for the year translated into increased cash flows, which, combined with substantial proceeds from employee stock option exercises, were used to fund increased capital expenditures, purchase and retire common stock, increase dividends and pay maturing debt. At Dec. 31, 2006, the cash and short-term investment balance was $918 million. Loo ki ng ahead, NS expects revenue increases to continue but at a more moderate pace, reflecting lower volume growth and comparison with a strong 2006. NS plans to continue its focus on improving service levels and maintaining a market-based approach to pricing. Approximately one-half of NS' revenue base is subject to renegotiation or repricing in 2007.

During 2006, NS purchased and retired 21.8 million shares of common stock at a total cost of $964 million under the share repurchase program approved by the Board of Directors on Nov. 22, 2005. Under the program, the Board has authorized the repurchase of up to 50 million shares of NS common stock through Dec. 31, 2015.

SUMMARIZED RESULTS OF OPERATIONS

2006 Compared with 2005

Net income in 2006 was $1.5 billion, or $3.57 per diluted share, up $200 million, or 16%, compared with $1.3 billion, or $3.11 per diluted share, in 2005. The increase in net income was primarily due to higher income from railway operations, offset in part by the absence of the $96 million income tax benefit recorded in 2005 because of Ohio tax law changes (see Note 3). Railway operating revenues increased $880 million, reflecting higher rates, including fuel surcharges that accounted for about 40% of the increase and modestly higher traffic volume. Railway operating expenses rose $440 million, or 7%, principally due to higher diesel fuel prices and increased compensation and benefit costs.

2005 Compared with 2004

Net income in 2005 was $1.3 billion, or $3.11 per diluted share, up $371 million, or 41%, compared with $910 million, or $2.28 per diluted share, in 2004. Results in 2005 reflected a $96 million second quarter income tax benefit related to Ohio tax law changes (see Note 3), while results in 2004 included a $40 million net gain related to the Conrail Corporate Reorganization (see Note 4). The remaining $315 million increase in net income was primarily due to higher income from railway operations. Railway operating revenues increased $1.2 billion, reflecting higher rates (including the favorable effects of the coal rate cases settled in the second quarter – see below), fuel surcharges and increased traffic volume. Railway operating expenses rose $800 million, or 14%, principally due to higher diesel fuel prices, increased volume-related expenses and casualty claims costs.

DETAILED RESULTS OF OPERATIONS

Railway Operating Revenues

Railway operating revenues were $9.4 billion in 2006, $8.5 billion in 2005 and $7.3 billion in 2004. The following table presents a three-year comparison of revenues, volume and average revenue per unit by market group (prior period amounts for the chemicals, agriculture/consumer products/government and paper/clay/forest groups have been reclassified to conform to the current year presentation).

	Revenues			Units			Revenue per Unit		
	2006	2005	2004	2006	2005	2004	2006	2005	2004
	($ in millions)			(in thousands)			($ per unit)		
Coal	$ 2,330	$ 2,115	$ 1,728	1,760.0	1,735.4	1,690.8	$ 1,324	$ 1,219	$ 1,022
General merchandise:									
Metals/construction	1,168	978	818	835.3	794.2	781.1	1,398	1,231	1,048
Chemicals	1,079	978	868	426.4	442.1	444.7	2,530	2,212	1,953
Agr./cons. prod./govt.	994	832	716	594.1	571.8	559.8	1,673	1,454	1,279
Automotive	974	997	954	561.9	615.9	634.6	1,734	1,620	1,503
Paper/clay/forest	891	801	691	466.7	472.2	461.7	1,909	1,697	1,496
General merchandise	5,106	4,586	4,047	2,884.4	2,896.2	2,881.9	1,770	1,583	1,404
Intermodal	1,971	1,826	1,537	3,256.5	3,154.9	2,891.5	605	579	531
Total	$ 9,407	$ 8,527	$ 7,312	7,900.9	7,786.5	7,464.2	$ 1,191	$ 1,095	$ 980

Revenues increased $880 million, or 10%, in 2006 and $1.2 billion, or 17%, in 2005. As shown in the following table, both revenue improvements were the result of increased average revenues per unit, including fuel surcharges, and, to a lesser extent in 2006 than for 2005, higher traffic volumes.

Revenue Variance Analysis

	Increases	
	2006 vs. 2005	2005 vs. 2004
	($ in millions)	
Revenue per unit/mix	$ 755	$ 899
Traffic volume (units)	125	316
Total	$ 880	$ 1,215

Both comparisons reflect large increases in average revenue per unit, a result of higher rates and increased fuel surcharges. All market groups collected significant fuel surcharges, which accounted for approximately 40% of the 2006 increase in revenues and about one-third of the 2005 increase. At year-end 2006, fuel surcharge provisions covered approximately 91% of total revenues compared with about 85% at the end of 2005. Traffic volume increased 1% in 2006, principally due to higher intermodal and metals/construction shipments. In 2005, traffic volume rose 4%, reflecting a 9% increase in intermodal shipments. The favorable revenue per unit/mix variance in 2005 included an unfavorable mix component reflecting the 9% rise in intermodal traffic, which has a lower average revenue per unit.

On April 24, 2006 , NS announced that it was revising its fuel surcharge program for non-intermodal traffic originating and moving on NS-issued tariffs and public quotes issued on or after July 1, 2006 .. While the mechanics of the new fuel surcharge are generally the same as the previous fuel surcharge, the trigger price was raised from $23 to $64 per barrel of West Texas Intermediate (WTI) Crude Oil and the percentage by which the line haul rate is increased when oil exceeds the trigger price was decreased from 0.4% to 0.3% for each dollar or portion thereof in excess of the trigger price. Tariff prices and public quotes have been adjusted to reflect this change. The fuel surcharge is based on the monthly average price of WTI in the second calendar month prior to the month in which the fuel surcharge is applied. Application of the new fuel surcharge across tariff and public quotes as well as contracts now approximates 15% of NS' total revenue base.

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

COAL revenues increased $215 million, or 10%, compared with 2005, which reflected higher average revenue per unit and slightly higher traffic volume. Coal average revenue per unit was up 9% compared with 2005, reflecting increased fuel surcharges and higher rates, tempered by the absence of the $55 million benefit from the coal rate settlements in the second quarter of 2005 (see below). Coal represented 25% of NS' revenues in 2006, and 79% of shipments handled originated on NS' lines. Traffic volumes rose 1% primarily because of increased shipments of utility coal, domestic metallurgical coal and coke that offset lower export and iron ore shipments.

NS is currently involved in litigation with Virginia Electric and Power Company/Old Dominion Electric Cooperative (Virginia Power) regarding rate adjustment provisions in a transportation contract between them. During the third quarter of 2006, a court order was entered in favor of NS, and in the fourth quarter Virginia Power filed a petition with the Virginia Supreme Court appealing this order. Future developments and the ultimate resolution of this matter could result in NS recognizing additional revenues related to this dispute, which could have a favorable impact on results of operations in a particular year or quarter.

In 2005, coal revenues increased $387 million, or 22%, compared with 2004, reflecting higher average revenue per unit and increased traffic volume. Coal average revenue per unit was up 19% compared with 2004, reflecting higher rates, the favorable effects of fuel surcharges, longer-haul business and the rate cases settled in the second quarter (see below).   Coal represented 25% of NS’ revenues in 2005, and 83% of shipments handled originated on NS’ lines. Traffic volumes rose 3% primarily because of increased shipments of utility coal that offset lower export and domestic metallurgical coal, coke and iron ore shipments.

During the second quarter of 2005, NS entered into settlement agreements with two utility customers that resolved their rail transportation rate cases before the STB.   In 2002, these customers each filed rate reasonableness complaints with the STB.   In October 2004, the STB found NS’ rates to be reasonable in both cases.   As a result of the settlement of these cases, NS recognized $55 million of additional coal revenue in 2005 related to the period in dispute.

Total Coal, Coke and Iron Ore Tonnage

	2006	2005	2004
		(Tons in thousands)	
Utility	148,078	142,522	134,085
Domestic metallurgical	20,878	20,076	20,686
Export	12,409	14,531	16,583
Industrial	9,202	9,524	9,799
Total	190,567	186,653	181,153

Utility coal tonnage increased 4%, compared with 2005, reflecting the rebuilding of stockpiles by customers, more shipments from the Powder River Basin in the West and higher shipments of import coal through Charleston , SC.

In 2005, utility coal tonnage increased 6% compared to 2004, in response to increased coal-fired generation to meet the heavier electricity demand of a strong economy, limited nuclear power generation capacity, higher natural gas prices and utility coal stockpiles which were below target levels across NS' service area. Supply constraints dampened shipments while the increased demand for Eastern U.S. coal prompted some customers to shift to coal from non-traditional sources in Wyoming and Colorado and imported coal. Appalachian coal production increased modestly and Western coal production was up 2% in 2005.

While natural gas prices are expected to remain higher in 2007, demand for utility coal could be tempered by persistent mild winter weather in the East and above average stockpiles. Additionally, in November 2006, Virginia Power announced it intends to switch from domestic coal to imported coal for its Chesapeake , Virginia , Energy Center .. Since NS would not transport the imported coal, this change would result in the loss of approximately 1.6 million tons annually.

A number of evolving environmental issues could affect the utility coal market. These include potential regional programs aimed at capping and reducing power plant CO_2 emissions, and ongoing efforts at addressing climate change. In response to changes in environmental regulations, certain utilities have begun adding or are planning to add emissions control technologies to their electric generating units, allowing them to utilize their existing coal-fired power plants.

Domestic metallurgical coal, coke and iron ore tonnage increased 4% in 2006 compared with 2005. The increase was driven by higher domestic metallurgical coal and coke shipments in the first half of the year in response to steel-ma ki ng demand, which more than offset a decline in iron ore volume caused by the shutdown of a blast furnace at a major customer location.

For 2005, domestic metallurgical coal, coke and iron ore tonnage was down 3%, compared with 2004. Declines in domestic coke and iron ore volumes, principally due to the idling of a major steel blast furnace, were partially offset by an 8% increase in metallurgical coal.

Demand for domestic metallurgical coal and coke is expected to decline slightly with a softening in the steel industry in 2007, whereas new business is expected to modestly increase iron ore shipments.

Export coal tonnage decreased 15% in 2006 compared to 2005, reflecting weaker demand for U.S. coal as Europe and Asia continued to increase purchases from other countries. Baltimore volume was down approximately 13,500 cars, or 37%, and Norfolk volume declined by approximately 3,000 cars, or 3%.

In 2005, export coal tonnage decreased 12% compared to 2004, due to both coal supply constraints and a weak European steel market. Volume through Norfolk and Baltimore decreased. Norfolk was down approximately 16,000 carloads, or 14%, and Baltimore was down approximately 2,000 carloads, or 6%. U.S. exports in 2005 were constrained by several factors: (1) the tight coal supply from Eastern coal mines caused primarily by the sporadic closure of a major coal mine, (2) the idling of production by European steel manufacturers in order to manage finished goods inventory, and (3) the abundant supply of Chinese coke on the world market lowering the price and ma ki ng it more economical to buy coke rather than import metallurgical coal from the U.S. and convert it.

Export coal tonnage for 2007 is expected to weaken as higher mining costs offset potential gains from favorable ocean freight rates from the U.S. versus Australia ..

Other coal tonnage (principally steam coal shipped to industrial plants) decreased 3% versus 2005, primarily due to plant closures and mine production problems. In 2005, other coal tonnage decreased 3% versus 2004, primarily due to the diversion of coal to the utility market.

GENERAL MERCHANDISE revenues increased $520 million, or 11%, in 2006 compared with 2005, as all market groups posted higher average revenue per unit driven by increased rates and fuel surcharges. Traffic volume declined slightly as improved metals and construction and agriculture volumes were offset by declines in the other business groups. In 2005, general merchandise revenues increased 13% due to higher average rates and fuel surcharges. Traffic volume was up modestly in 2005 compared with 2004 as decreases in automotive and chemicals traffic partially offset increases in other business groups.

Metals and construction revenue increased 19% and traffic volume increased 5% in 2006 compared with 2005 as declines in the fourth quarter were offset by higher volumes through the rest of the year. Revenue per unit rose 14% because of increased rates and fuel surcharges. The increase in traffic volume was driven primarily by higher import slab business to NS-served steel mills, more scrap metal shipments and higher sand, gravel and cement traffic for commercial and highway construction projects.

In 2005, metals and construction revenue increased 20% and traffic volume increased 2% compared with 2004. Revenue per unit rose 17% because of higher rates and fuel surcharges. The volume improvements were due primarily to continued strength at NS-served integrated and electric arc mills and higher aluminum product shipments, which were partially offset by lower scrap metal carloads. Construction traffic volume benefited from increased residential, commercial and highway construction.

Metals and construction volume is expected to be tempered in the first quarter of 2007, reflecting a softening in domestic steel production affecting iron and steel shipments, with improving conditions expected in the second half of the year. Aggregate and cement shipments are expected to increase driven by highway projects and new stone terminals locating on NS' lines.

Chemicals revenue increased 10%, despite a 4% drop in traffic volume, reflecting increased rates and fuel surcharges. Petroleum, industrial and plastics traffic volumes were down as a result of lower inventories arising from post-Katrina conditions, the closure of several plants on NS lines and the weaker housing and automotive markets.

In 2005, chemicals revenues increased 13%, reflecting higher prices and fuel surcharges, while traffic volume was down slightly as a result of production curtailment in the Gulf Coast region and as compared with a strong 2004. Volume increases for plastic and petroleum products were offset by decreases in industrial and miscellaneous chemicals.

Chemical volume is expected to improve in 2007, supported by new and expanded business as the year progresses. However, volume could be adversely affected by the price of natural gas and crude oil, which accounts for more than 50% of the cost of many chemical products and presents a significant competitive challenge that could cause domestic chemical producers to move production overseas.

Agriculture, consumer products and government revenue increased 19% and traffic volume increased 4% in 2006 compared with 2005. Average revenue per unit rose 15%, a result of higher rates and fuel surcharges. Traffic volume growth resulted from increased ethanol, military and corn shipments. Military traffic growth was primarily due to the continued support of military operations in Iraq ..

In 2005, agriculture, consumer products and government revenue increased 16% and traffic volume increased 2% compared with 2004. Average revenue per unit rose 14%, a result of higher rates and fuel surcharges. Traffic growth resulted from sweeteners, government traffic and fertilizer. Government traffic growth was primarily due to the support of military operations in Iraq as well as shipments of temporary housing to hurricane-damaged areas. Ethanol traffic increased 38% due to higher shipments from current customers in addition to new business in Georgia and South Carolina ..

Agriculture volume is expected to continue to grow in 2007, benefiting from increasing demand for ethanol as a replacement for MTBE which was banned by the Federal Government as a fuel additive. However, declines in consumer products and government volumes are expected to offset this growth.

Automotive revenues declined 2% in 2006 compared with 2005 as lower volumes offset increased average revenues per unit, including fuel surcharges. Volume decreased 9% primarily due to substantial production cuts at Ford, General Motors and Daimler-Chrysler assembly plants, including two NS-served plant closures at Ford and one at General Motors during 2006. Ford and General Motors combined operate 15 of 29 assembly plants served by NS. Reduced production at Honda and BMW also contributed to the volume decrease.

In 2005, automotive revenues rose 5%, compared with 2004, the result of an 8% increase in average revenue per unit that reflected pricing improvements and higher fuel surcharges. In contrast, traffic volume decreased 3% primarily due to reduced production at Ford and General Motors, with General Motors closing NS-served assembly plants in Michigan , Maryland and New Jersey .. These reductions were partially offset by increased production at Honda, Mercedes-Benz and Toyota ..

For 2007, NS expects automotive revenues to continue to decline as a result of automotive production cutbacks. Decreases by U.S. automotive manufacturers are expected to be partially offset by higher domestic production by foreign manufacturers.

Paper, clay and forest products revenue increased 11% in 2006 compared with 2005 due to higher average revenues per unit, including fuel surcharges, despite a 1% decrease in traffic volume. Higher solid waste and debris traffic, and growth in traffic from the import of printing paper, partially offset reduced pulp and pulp board shipments.

In 2005, paper, clay and forest products revenue increased 16% and traffic volume increased 2% compared with 2004. Average revenue per unit rose 13% due to higher rates and fuel surcharges. Pulp board, printing paper, newsprint and woodchip produced volume gains despite consolidations within the industry and mill shutdowns.

In 2007, paper, clay and forest product revenues are expected to be up slightly and benefit from continued growth in waste and debris transportation.

INTERMODAL revenues increased $145 million, or 8%, compared with 2005, largely because of higher fuel surcharges, increased rates and improved traffic volume. Traffic volume for the year rose 3% notwithstanding a 3% decline in the fourth quarter. International traffic volume rose 9% reflecting growth in imported goods from Asia and exported goods through NS-served East Coast ports, as well as West Coast ports. Truckload volume increased 8% reflecting continued expansion of business with traditional truckload companies. Triple Crown Services Company, a service with rail-to-highway trailers, had flat volume compared with 2005 as higher consumer product shipments were offset by weaker automotive-related shipments. Domestic intermodal marketing companies (IMC) volume declined 9% reflecting declines in the housing, construction and automotive markets. Premium business, which includes parcel and LTL (less-than-truckload) carriers, was down 3% reflecting lower LTL shipper traffic that offset modest gains in parcel shipments. Intermodal revenue per unit increased 4%, principally a result of higher fuel surcharges as well as increased rates and longer-haul international traffic, which was offset in part by the ongoing shift of shipments from higher revenue per unit, rail-provided assets (trailers and containers) to lower revenue per unit shipments in shipper-provided equipment.

In 2005, intermodal revenues increased $289 million, or 19% compared with 2004, reflecting improved traffic volume, higher fuel surcharges, and increased rates. Despite moderated growth in domestic business, traffic volume increased 9% reflecting strength in the international, truckload and Triple Crown Services lines of business .. International traffic volume grew by 16% reflecting strength in U.S. consumer markets and growth in the movement of import and export goods through NS-served East Coast ports, as well as West Coast ports. Truckload volume increased 10% compared with 2004, reflecting additional business with traditional truckload companies. Premium business grew 6% due primarily to new business in the Northern region. Triple Crown Services volume grew 6% reflecting expanded geographic coverage and increased trailer fleet size to meet higher demand. Domestic volume decreased 3% compared with 2004, principally due to the continued reduction in transloading of West Coast international freight into domestic containers. Intermodal revenue per unit increased 9%, a result of fuel surcharges and rate increases.

In 2007, NS expects moderate growth in its intermodal markets, with continued strength in the international markets. Future growth may, however, be tempered by economic conditions in the U.S.

Railway Operating Expenses

Railway operating expenses in 2006 were $6.9 billion, up $440 million, or 7%, compared to 2005, which were up $800 million compared to 2004. The 2006 increase was principally due to higher diesel fuel prices and increased compensation and benefits. The increase in 2005 was principally due to a sharp rise in the price of diesel fuel, volume-related expense increases, more maintenance activities and higher casualty costs. Carloads rose 1% in 2006 compared to 2005 and 4% in 2005 compared to 2004.

The railway operating ratio, which measures the percentage of railway operating revenues consumed by railway operating expenses, improved to 72.8% in 2006, compared with 75.2% in 2005 and 76.7% in 2004.

The following table shows the changes in railway operating expenses summarized by major classifications.

Operating Expense Variances

Increases (Decreases)

	2006 vs. 2005	2005 vs. 2004
	($ in millions)	
Compensation and benefits	$ 144	$ 221
Materials, services and rents	86	208
Conrail rents and services	(3)	(190)
Depreciation	(36)	176
Diesel fuel	250	278
Casualties and other claims	(4)	73
Other	3	34
Total	$ 440	$ 800

Compensation and benefits , which represents nearly 40% of total railway operating expenses, increased $144 million, or 6%, compared with 2005, and increased $221 million in 2005, or 10%, compared with 2004. Expenses in 2006 included the effect of the implementation of Statement of Accounting Standards No. 123(R) “Share-Based Payment,” which increased stock-based compensation expense by $27 million. Most of the increase was reflected in the first quarter which included the effect of accelerated recognition of costs related to grants to retirement-eligible employees. This up front recognition of costs will occur in the first quarter of 2007 and is expected to be somewhat higher reflecting a higher proportion of retirement eligible grantees. The remaining increase was attributable to increased salaries and wages (up $44 million), higher health and welfare benefit costs (up $29 million), higher payroll taxes (up $17 million), retirement and waiver agreements entered into in the first quarter (up $13 million) and the cost of the regular stock-based grant to the former chief executive officer who retired in the first quarter ($11 million).

NS employment averaged 30,541 in 2006 compared with 30,294 in 2005 and 28,475 in 2004. The increased number of employees has come almost exclusively in operating department personnel to meet the increased volume and service needs, as well as expected retirements. NS continues to hire and train additional workers in order to meet the requirements of forecasted volumes in light of the demographics of its work force.

The increase in compensation and benefits for 2005 reflected increased hours for train operations, including trainees, and equipment maintenance (up $70 million); increased wage rates (up $46 million); increased pension, postretirement and health and welfare benefit costs (up $43 million); higher stock-based compensation (up $22 million); and higher payroll taxes (up $12 million).

The Railroad Retirement and Survivors' Improvement Act, which took effect Jan. 1, 2002, allows for investment of Tier II assets in a diversified portfolio through the National Railroad Retirement Investment Trust. The law also provides a mechanism for automatic adjustment of Tier II payroll taxes should the trust assets fall below a four-year reserve or exceed a six-year reserve. As a result, the employers' portion of Tier II retirement payroll taxes has been reduced from 13.1% in 2004 to 12.6% in 2005 and 2006, and to 12.1% for 2007. However, these savings are expected to continue to be substantially offset by higher payroll taxes on increased wages and a higher wage base.

Materials, services and rents includes costs related to items used for the maintenance of railroad lines, structures and equipment; the costs of services purchased from outside contractors, including the net costs of operating joint (or leased) facilities with other railroads; and the net cost of equipment rentals. This category of expenses increased $86 million, or 5%, in 2006 compared to 2005, and increased 13% in 2005 compared to 2004. For 2006, materials expense was up $39 million due to increased maintenance activities, purchased services was up $39 million reflecting increased intermodal traffic volume and equipment rents rose $8 million.

The increase in 2005 reflected higher volume-related purchased services (up $82 million) and higher maintenance expense (up $74 million). Equipment rents rose $28 million, reflecting higher traffic volume as well as leases from the Conrail Corporate Reorganization (see Note 4).

Locomotive and freight car repair costs increased in 2006 and in 2005, due to more maintenance activity related to higher usage from increased traffic volumes coupled with the age of the fleet. This level of expense is expected to continue and may increase depending on traffic volumes.

Equipment rents, which includes the cost to NS of using equipment (mostly freight cars) owned by other railroads or private owners less the rent paid to NS for the use of its equipment, rose 2% in 2006 and increased 11% in 2005. The increase in 2006 was principally due to a reduction in rents received on automotive equipment as a result of decreased shipments. The increase in 2005 was principally due to additional lease expense for a full year from the Conrail Corporate Reorganization and increased volume-related intermodal shipments.

Conrail rents and services decreased $3 million, or 2%, in 2006 compared to 2005, and decreased 60% in 2005 compared to 2004. For 2006 and 2005 this item includes amounts due to Conrail for operation of the Shared Assets Areas. Before the Conrail Corporate Reorganization in 2004 this item included amounts due to PRR for use of its operating properties and equipment, NS' equity in Conrail's net earnings and the additional amortization related to the difference between NS' investment in Conrail and its underlying equity (see Note 4). The decline in 2005 was primarily driven by the Conrail Corporate Reorganization, which resulted in the consolidated reporting of individual components of Conrail equity earnings, principally depreciation, equipment rents and interest expense (see Note 4). NS' share of equity earnings after the Conrail Corporate Reorganization is a component of "Other income-net" (see Note 2).

Depreciation expense decreased $36 million, or 5%, in 2006 compared with 2005, reflecting the results of an equipment depreciation study from an independent firm of engineers and an analysis of the assets received in the Conrail Corporation Reorganization completed in 2006. Depreciation expense increased 29% in 2005 compared to 2004 primarily a result of the Conrail Corporate Reorganization (see Note 4). In addition, substantial capital investments and improvements resulted in higher depreciation expense.

Diesel fuel expense increased $250 million, or 34%, in 2006 compared with 2005 and increased 62% in 2005 compared with 2004. Diesel fuel expense is recorded net of hedge benefits, although there have been no such benefits since May 2006 when the program wound down (see "Market Risks and Hedging Activities," below and Note 16). Expense in 2006 included hedge benefits of $20 million compared with benefits of $148 million in 2005, and $140 million in 2004, and reflected a 13% rise in the average price per gallon with a 1% increase in consumption. The increase in 2005 reflected a 43% rise in the average price per gallon and a 2% increase in consumption.

Legislation enacted in the first quarter of 2005 repealed the 4.3 cents per gallon excise tax on railroad diesel fuel for 2007, with the following phased reductions in 2005 and 2006: 1 cent per gallon from Jan. 1, 2005 through June 30, 2005; 2 cents per gallon from July 1, 2005 through Dec. 31, 2006; and by the full 4.3 cents thereafter. NS consumes about 520 million gallons of diesel fuel per year.

Casualties and other claims expenses (including the estimates of costs related to personal injury, property damage and environmental matters) decreased $4 million, or 2%, in 2006 compared to 2005 and increased 48% in 2005 compared to 2004. The decrease in 2006 reflected the absence of $38 million of costs associated with a derailment in Graniteville , South Carolina (see discussion below), and an unfavorable jury verdict in an employee injury case, partially offset by higher expenses arising from derailments and insurance costs. The increase in 2005 was attributable to the costs associated with the Graniteville derailment, $16 million for an unfavorable jury verdict rendered in an employee injury case, $9 million of higher insurance costs, and $4 million for the portion of the $12.5 million self-insured retention related to Hurricane Katrina expenses.

On Jan. 6, 2005 , a collision in Graniteville , South Carolina , between two NS trains caused the release of chlorine gas from a ruptured tank car. NS' liability related to this accident includes a current and long-term portion which represents NS' best estimate based on current facts and circumstances. The estimate includes amounts related to business property damage and other economic losses, personal injury and individual property damage claims as well as third-party response costs. NS' commercial insurance policies are expected to cover substantially all expenses related to this derailment above NS' self-insured retention, including NS' response costs and legal fees. Accordingly, the Consolidated Balance Sheets reflect a current and long-term receivable for estimated recoveries from NS' insurance carriers. The expense recorded in 2005 represents NS' retention under its insurance policies and other uninsured costs. While it is reasonable to expect that the liability for covered losses could differ from the amount recorded, such a change would be offset by a corresponding change in the insurance receivable. As a result, NS does not believe that it is reasonably likely that its net loss (the difference between the liability and future recoveries) will be materially different than the loss recorded in 2005. NS expects at this time that insurance coverage is adequate to cover potential claims and settlements above its self-insurance retention.

During the third quarter of 2005, NS' operations were adversely affected by Hurricane Katrina, and to a lesser extent, Hurricane Rita, both of which struck the Gulf Coast .. NS sustained damage to its facilities in the region as a result of Hurricane Katrina but restored rail freight service into and around New Orleans in a relatively short period of time. The damage sustained to NS facilities as a result of Hurricane Katrina did not materially impact NS' financial condition or results of operations and is covered by insurance above the self-insurance retention limit.

The largest component of casualties and other claims expense is personal injury costs. Cases involving occupational injuries comprised about two-thirds of total employee injury cases resolved and about one-third of total payments made. With its long-established commitment to safety, NS continues to work actively to eliminate all employee injuries and to reduce the associated costs. With respect to occupational injuries, which are not caused by a specific accident or event, but result from a claimed exposure over time, the benefits of any existing safety initiatives may not be realized immediately. These types of claims are being asserted by former or retired employees, some of whom have not been actively employed in the rail industry for decades.

The rail industry remains uniquely susceptible to litigation involving job-related accidental injury and occupational claims because of the Federal Employers' Liability Act (FELA), which is applicable only to railroads. FELA's fault-based system, which covers employee claims for job-related injuries, produces results that are unpredictable and inconsistent as compared with a no-fault workers' compensation system.

NS maintains substantial amounts of insurance for potential third-party liability and property damage claims. It also retains reasonable levels of risk through self-insurance (see Note 17). NS expects insurance costs to be slightly higher in 2007.

Other expenses increased $3 million, or 1%, in 2006 compared to 2005, and increased $34 million, or 15%, in 2005 compared to 2004. The increase in 2006 was primarily due to higher employee travel and relocation costs offset in part by lower property taxes. The increase in 2005 reflected higher property and sales and use taxes.

Other Income – Net

Other income – net was $149 million in 2006 and $74 million in 2005 (see Note 2). Results in 2006 reflected lower expense associated with tax credit investments primarily due to synthetic fuel related investments (see discussion under heading "Income Taxes"), greater interest income, and higher returns from corporate-owned life insurance, that were partially offset by lower equity in Conrail earnings.

In 2005, other income – net decreased by $2 million which reflected the absence of the $40 million gain recognized in 2004 for the Conrail Corporate Reorganization. The results in 2005 also reflected: (1) higher interest income, (2) equity in earnings of Conrail subsequent to the Conrail Corporate Reorganization, (3) additional coal royalties (up $12 million), and (4) lower interest accruals related to tax liabilities (down $9 million). These income improvements were partially offset by more expense associated with tax credit investments.

Income Taxes

Income tax expense in 2006 was $749 million for an effective rate of 34%, compared with effective rates of 25% in 2005 and 29% in 2004. The increase in the rate for 2006 was largely the result of the absence of an Ohio tax law change which lowered the effective rate in 2005 as well as fewer tax credits from synthetic fuel related investments (see below). The 2005 effective rate benefited from a $96 million reduction in deferred taxes resulting from the Ohio tax legislation, which lowered the rate by six percentage points (see Note 3).

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

NS' synthetic fuel tax credits are subject to reduction if the Reference Price of a barrel of oil for the year falls within an inflation-adjusted phase-out range specified by the tax code. The Reference Price for a year is the annual average wellhead price per barrel of unregulated domestic crude oil as determined by the Secretary of the Treasury by April 1 of the following year. In 2005, the phase-out range was $53.20 to $66.79, and the phase-out range is adjusted annually for inflation. While NS cannot predict with certainty the Reference Price for the year, NS estimated a 35 % phase-out of synthetic fuel credits in 2006 based on actual oil prices during the year.

Net income in 2006 reflects $18 million less in net benefits from these credits, as compared with the same period of 2005, as shown below:

	2006	2005	2004
		($ in millions)	
Effect in "Other income – net:"			
Expenses on synthetic fuel related investments	$ 62	$ 102	$ 58
Effect in "Provision for income taxes:"			
Tax credits	56	98	60
Tax benefit of expenses on synthetic fuel			
related investments	24	40	21
Total reduction of income tax expense	80	138	81
Effect in "Net income:"			
Net benefit from synthetic fuel related investments	$ 18	$ 36	$ 23

Subject to the uncertainty associated with these tax credits, the effective tax rate in 2007 is expected to be comparable to that of 2006. The tax credits generated by NS' synthetic fuel related investments expire at the end of 2007 and, accordingly, the effective tax rate may increase thereafter.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash provided by operating activities, NS' principal source of liquidity, was $2.2 billion in 2006, compared with $2.1 billion in 2005 and $1.7 billion in 2004. The improvement in 2006 reflected the $440 million increase in income from railway operations offset in part by higher income tax payments. The increase in 2005 reflected the $415 million increase in income from railway operations as well as the effects of the Conrail Corporate Reorganization (see below), offset in part by higher income tax payments, including a payment made upon settlement of a federal audit cycle.

Prior to the August 2004 Conrail Corporate Reorganization (see Note 4), a significant portion of the payments made to PRR under the operating and lease agreements (which were included in "Conrail rents and services" and, therefore, were a use of cash in "Net cash provided by operating activities"), was borrowed back from a subsidiary of PRR under a note due in 2032 and, therefore, was a source of cash in “Proceeds from borrowings.” NS’ net cash flow from these borrowings amounted to $118 million in 2004. This note was effectively extinguished by the reorganization in 2004. Subsequent to the Conrail Corporate Reorganization, 2005 payments under “Conrail rents and services” declined, depreciation charges increased and those net borrowings were terminated. Accordingly, NS’ cash provided by operating activities after the Conrail Corporate Reorganization has increased.

NS had wor ki ng capital of $307 million at Dec. 31, 2006, compared with wor ki ng capital of $729 million at Dec. 31, 2005. The reduction was largely due to share repurchases made in 2006 (see Note 13) and higher current maturities of long-term debt. NS’ cash, cash equivalents and short-term investment balances totaled $918 million and $1.3 billion at Dec. 31, 2006 and 2005, respectively.

Contractual obligations at Dec. 31, 2006, comprised of NS' long-term debt (including capital leases) (see Note 7), operating leases (see Note 8), agreements with CRC (see Note 4), unconditional purchase obligations (see Note 17) and long-term advances from Conrail (see Note 4) were as follows:

	Payments Due By Period				
	Total	**2007**	**2008-2009**	**2010-2011**	**2012 and Subsequent**
			($ in millions)		
Long-term debt and capital lease principal	$ 6,600	$ 491	$ 843	$ 676	$ 4,590
Operating leases	1,087	166	274	189	458
Agreements with CRC	448	26	52	52	318
Unconditional purchase obligations	276	238	33	5	--
Long-term advances from Conrail	133	--	--	--	133
Total	$ 8,544	$ 921	$ 1,202	$ 922	$ 5,499

Off balance sheet arrangements consist of obligations related to operating leases, which are included in the table of contractual obligations above and disclosed in Note 8. NS did not renew its accounts receivable securitization program which expired in May 2005.

Cash used for investing activities was $684 million in 2006, compared with $1.8 billion in 2005 and $1.2 billion in 2004. The decrease in 2006 reflected higher proceeds from short-term investment sales, principally to fund share repurchases reflected in financing activities, offset in part by the $100 million investment in Meridian Speedway LLC (MSLLC) (see discussion below) and increased property additions. The increase in 2005 was principally the result of larger purchases of short-term investments ..

Property additions account for most of the recurring spending in this category. The following tables show capital spending (including capital leases) and track and equipment statistics for the past five years.

Capital Expenditures

	2006	2005	2004	2003	2002
			($ in millions)		
Road and other property	$ 756	$ 741	$ 612	$ 502	$ 521
Equipment	422	284	429	218	174
Total	$ 1,178	$ 1,025	$ 1,041	$ 720	$ 695

Track Structure Statistics (Capital and Maintenance)

	2006	2005	2004	2003	2002
Track miles of rail installed	327	302	246	233	235
Miles of track surfaced	4,871	4,663	5,055	5,105	5,270
New crossties installed (millions)	2.7	2.5	2.5	2.8	2.8

Average Age of Owned Railway Equipment

	2006	2005	2004	2003	2002
			(years)		
Freight cars	30.0	29.4	28.6	27.8	27.0
Locomotives	17.7	17.4	16.9	15.3	16.1
Retired locomotives	35.0	27.4	22.9	28.7	28.2

The higher average age of locomotives in 2006 reflects the retirement of two locomotives compared with 52 retired in 2005.

For 2007, NS has budgeted $1.34 billion for capital expenditures. The anticipated spending includes $884 million for roadway projects, $401 million for equipment and $55 million for small projects and real estate. In roadway projects, $610 million is for track and bridge program work, including $73 million in infrastructure investments for increased main line and terminal capacity. Also included are projects for communications, signal and electrical systems, as well as projects for environmental and public improvements such as grade crossing separations and signal upgrades. Other roadway projects include marketing and industrial development initiatives, including increasing track capacity and access to coal receivers and vehicle production and distribution facilities, and continuing investments in intermodal infrastructure. Planned equipment spending of $401 million includes the purchase of 53 locomotives and upgrades to existing units, the purchase of 1,300 new higher capacity coal cars as part of a multi-year program to replace the existing coal car fleet, the purchase of 739 freight cars as their lease expires, improvements to multilevel automobile racks, and projects related to computers and information technology, including additional security and backup systems. NS expects to make all of its capital expenditures with internally generated funds.

On May 1, 2006, NS and Kansas City Southern (KCS) formed a joint venture (MSLLC) pursuant to which NS intends to contribute $300 million in cash, substantially all of which will be used for capital improvements over a period of approximately three years, in exchange for a 30% interest in the joint venture. At the formation of MSLLC , NS contributed $100 million and KCS contributed its 320 mile rail line between Meridian , Mississippi and Shreveport , Louisiana (the Meridian Speedway). NS is recognizing its pro rata share of the joint venture’s earnings or loss as required under the equity method of accounting. NS’ total investment in MSLLC is supported by the fair value of the rail line as well as intangible assets obtained through the transaction. The transaction is expected to be modestly dilutive in the early years of the venture due to lost interest income on the cash contributed to the joint venture. However, NS expects that the dilution from the lost interest income will be offset from additional traffic as the investment is made and improvements are completed. The joint venture is expected to increase capacity and improve service over the Meridian Speedway into the Southeast.

During the third quarter of 2006, NS and the states of Ohio , West Virginia and Virginia each entered into a Memorandum of Agreement with the Federal Highway Administration that governs the release of up to $95 million in federal funding and up to $11 million in state funding for the Heartland Corridor rail double-stack clearance project. NS expects to spend about $60 million over a five-year period in connection with this project. The Heartland Corridor is a package of proposed clearance improvements and other facilities that will create a seamless high-capacity intermodal route across Virginia and West Virginia to Midwest markets.

NS and other railroads have agreed to participate in the Chicago Region Environmental and Transportation Efficiency (CREATE) project in Chicago .. The intent of the proposed public-private partnership is to reduce rail and highway congestion and add freight and passenger capacity in the metropolitan Chicago area. A portion of the public funding has been approved and the parties are wor ki ng to develop a list of projects to be included in Phase I of the project. Funding requirements will be determined by the selection of Phase I projects. The railroads expect to complete Phase I over the next four years.

Cash used for financing activities was $1.3 billion in 2006, compared with $456 million in 2005 and $233 million in 2004. Financing activity in 2006 included $964 million for the purchase and retirement of common stock as part of NS’ ongoing share repurchase program (see discussion below). Financing activities for 2006 also included $212 million of proceeds and $85 million of tax benefits from employee exercises of stock options (see Note 11).

In 2005, financing activity included: (1) the issuance of $300 million aggregate principal amount of 6% unsecured notes due March 2105, and (2) the issuance of $717 million of unsecured notes ($350 million at 5.64% due 2029 and $367 million at 5.59% due 2025) and payment of $218 million of premium in exchange for $717 million of previously issued unsecured notes ($350 million at 7.8% due 2027, $200 million at 7.25% due 2031, and $167 million at 9.0% due 2021) (see Note 7). The $218 million cash premium payment is reflected as a reduction of debt in the Consolidated Balance Sheets and Statement of Cash Flows and will be amortized as additional interest expense over the terms of the new debt. Financing activities in 2005 included $194 million in proceeds relating to employee exercises of stock options. NS’ debt-to-total capitalization ratio was 40.7% at Dec. 31, 2006, and 42.8% at Dec. 31, 2005.

In November 2005, NS’ Board of Directors authorized the repurchase of up to 50 million shares of NS common stock through Dec. 31, 2015. The timing and volume of any purchases will be guided by management’s assessment of market conditions and other factors. Near-term purchases under the program are expected to be made with internally generated cash; however, future funding sources could include proceeds from the sale of commercial paper notes or the issuance of long-term debt.

NS currently has in place and available a $1 billion, five-year credit agreement that expires in 2009, which provides for borrowings at prevailing rates and includes financial covenants. There were no amounts outstanding under this facility at Dec. 31, 2006 , and NS is in compliance with all of the financial covenants. NS also has in place a shelf registration statement on Form S-3 filed with the SEC in September 2004 with $700 million of available capacity (see Note 7). On July 18, 2005 , Standard & Poor’s (S&P) upgraded its ratings on NS’ unsecured debt from BBB to BBB+. Moody’s rating remains at Baa1, comparable to S&P’s.

APPLICATION OF CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in accordance with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates and assumptions may require significant judgment about matters that are inherently uncertain, and future events are likely to occur that may require management to change them. Accordingly, management regularly reviews these estimates and assumptions based on historical experience, changes in the business environment and other factors that management believes to be reasonable under the circumstances. Management discusses the development, selection and disclosures concerning critical accounting estimates with the Audit Committee of its Board of Directors.

Pensions and Other Postretirement Benefits

Accounting for pensions and other postretirement benefit plans requires management to make several estimates and assumptions (see Note 10). These include the expected rate of return from investment of the plans' assets, projected increases in medical costs and the expected retirement age of employees as well as their projected earnings and mortality. In addition, the amounts recorded are affected by changes in the interest rate environment because the associated liabilities are discounted to their present value. Management makes these estimates based on the company's historical experience and other information that it deems pertinent under the circumstances (for example, expectations of future stock market performance). Management engages an independent consulting actuarial firm to assist it in selecting appropriate assumptions and valuing its related liabilities.

NS' net pension benefit, which is included in “Compensation and benefits” on its Consolidated Statements of Income, was $29 million for the year ended Dec. 31, 2006. In recording this amount, NS assumed a long-term investment rate of return of 9%. Investment experience of the pension fund over the past 10-, 15- and 20-year periods has been a rate of return in excess of 10% and supports the current rate of return assumption. A one percentage point change to this rate of return assumption would result in a $19 million change to the pension credit and, as a result, an equal change in “Compensation and benefits” expense. Changes that are reasonably likely to occur in assumptions concerning retirement age, projected earnings and mortality would not be expected to have a material effect on NS' net pension benefit or net pension asset in the future. The net pension asset is recorded at its net present value using a discount rate that is based on the current interest rate environment in light of the timing of expected benefit payments. Specifically, NS refers to Moody’s seasoned Aa corporate bond yields and the changes in such yields; therefore, management has little discretion in this assumption.

NS' net cost for other postretirement benefits, which is also included in “Compensation and benefits,” was $70 million for the year ended Dec. 31, 2006. In recording this expense and valuing the net liability for other postretirement benefits, which is included in “Other postretirement benefits” as disclosed in Note 10, management estimated future increases in health-care costs. These assumptions, along with the effect of a one percentage point change in them, are described in Note 10.

Properties and Depreciation

Most of NS' total assets are comprised of long-lived railway properties (see Note 5). As disclosed in Note 1, NS' properties are depreciated using group depreciation. Rail is depreciated primarily on the basis of use measured by gross-ton miles. Other properties are depreciated generally using the straight-line method over the lesser of estimated service or lease lives. NS reviews the carrying amount of properties whenever events or changes in circumstances indicate that such carrying amount may not be recoverable based on future undiscounted cash flows. Assets that are deemed impaired as a result of such review are recorded at the lesser of carrying amount or fair value.

NS' depreciation expense is based on management's assumptions concerning service lives of its properties as well as the expected net salvage that will be received upon their retirement. These assumptions are the product of periodic depreciation studies that are performed by an outside firm of consulting engineers. These studies analyze NS' historical patterns of asset use and retirement and take into account any expected change in operation or maintenance practices. NS' recent experience with these studies has been that while they do result in changes in the rates used to depreciate its properties, these changes have not caused a significant effect to its annual depreciation expense. The studies may also indicate that the recorded amount of accumulated depreciation is deficient (or in excess) of the amount indicated by the study. Any such deficiency (or excess) is amortized as a component of depreciation expense over the remaining service lives of the affected class of property. NS' depreciation expense for the year ended Dec. 31, 2006, amounted to $738 million. NS' weighted-average depreciation rates for 2006 are disclosed in Note 5; a one-tenth percentage point increase (or decrease) in these rates would have resulted in a $26 million increase (or decrease) to NS' depreciation expense.

Personal Injury, Environmental and Legal Liabilities

NS' expense for “Casualties and other claims” amounted to $220 million for the year ended Dec. 31, 2006. Most of this expense was composed of NS' accrual related to personal injury liabilities. Job-related personal injury and occupational claims are subject to FELA, which is applicable only to railroads. FELA’s fault-based tort system produces results that are unpredictable and inconsistent as compared with a no-fault worker’s compensation system. The variability inherent in this system could result in actual costs being very different from the liability recorded. In all cases, NS records a liability when the expected loss for the claim is both probable and estimable.

NS engages an independent consulting actuarial firm to aid in valuing its personal injury liability and determining the amount to accrue during the year. For employee personal injury cases, the actuarial firm studies NS' historical patterns of reserving for claims and subsequent settlements, ta ki ng into account relevant outside influences. An estimate of the ultimate amount of the liability, which includes amounts for incurred but unasserted claims, is based on the results of this analysis. For occupational injury claims, the actuarial firm studies NS’ history of claim filings, severity, payments and other relevant facts. Additionally, the estimate of the ultimate loss for occupational injuries includes a provision for those claims that have been incurred but not reported by projecting NS’ experience into the future as far as can be reasonably determined. NS has recorded this actuarially determined liability. The liability is dependent upon many individual judgments made as to the specific case reserves as well as the judgments of the consulting actuary and management in the periodic studies. Accordingly, there could be significant changes in the liability, which NS would recognize when such a change became known. The most recent actuarial study, completed in the fourth quarter of 2006, resulted in a slight increase to NS' personal injury liability during the fourth quarter. While the liability recorded is support ed by the most recent study, it is reasonably possible that the liability could be higher or lower.

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 (see Note 17). 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 established an Environmental Policy Council, composed of senior managers, to oversee and interpret its environmental policy.

Operating expenses for environmental matters totaled approximately $19 million in 2006, $16 million in 2005 and $11 million in 2004, and capital expenditures totaled approximately $6 million in 2006, and $9 million in each of 2005 and 2004. Capital expenditures in 2007 are expected to be comparable to those in 2006.

NS' Consolidated Balance Sheets included liabilities for environmental exposures in the amount of $54 million at Dec. 31, 2006, and $58 million at Dec. 31, 2005 (of which $12 million was accounted for as a current liability at Dec. 31, 2006 , and 2005). At Dec. 31, 2006, the liability represented NS' estimate of the probable cleanup and remediation costs based on available information at 172 identified locations. On that date, 15 sites accounted for $29 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 some of the 172 locations, certain 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 or by the EPA or comparable state authorities), estimates of NS' ultimate potential financial exposure for a given site or in the aggregate for all such sites are necessarily imprecise because of the widely varying costs of currently available cleanup techniques, the likely development of new cleanup technologies, the difficulty of determining in advance the nature and full extent of contamination and each potential participant's share of any estimated loss (and that participant's ability to bear it), and evolving statutory and regulatory standards governing liability. 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.

Based on its assessment of the facts and circumstances now known, management believes that it has recorded the probable costs for dealing with those environmental matters of which NS is aware. Further, management believes that it is unlikely that any known matters, either individually or in the aggregate, will have a material adverse effect on NS' financial position, results of operations or liquidity.

Norfolk Southern and certain subsidiaries are defendants in numerous lawsuits and other claims relating principally to railroad operations. When management concludes that it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated, it is accrued through a charge to expenses. 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, if any, 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 recorded liabilities will be reflected in expenses in the periods in which such adjustments are known.

On Oct. 19, 2006, the Pennsylvania Department of Environmental Protection (PDEP) issued an assessment of civil penalties against NS and filed a complaint for civil penalties with the Pennsylvania Environmental Hearing Board (EHB) requesting that the EHB impose civil penalties upon NS for alleged violations of state environmental laws and regulations resulting from a discharge of sodium hydroxide which occurred as a result of the derailment of a NS train in Norwich Township, Pennsylvania, on June 30, 2006. The PDEP’s actions seek to impose combined penalties of $8,890,000 for alleged past violations and $46,420 per day for alleged ongoing violations of state environmental laws and regulations. NS believes that the monetary penalties sought by the PDEP are excessive. Accordingly, NS intends to vigorously defend the action and has appealed the fines to the EHB. In addition, NS expects the Pennsylvania Fish and Boat Commission to impose a monetary penalty on NS for damages alleged to have been caused by this accident. NS does not believe that the outcome of these proceedings will have a material effect on its financial position, results of operations, or liquidity.

Income Taxes

NS' net long-term deferred tax liability totaled $6.4 billion at Dec. 31, 2006 (see Note 3). This liability is estimated based on the expected future tax consequences of items recognized in the financial statements. After application of the federal statutory tax rate to book income, judgment is required with respect to the timing and deductibility of expenses in the corporate income tax returns .. For state income and other taxes, judgment is also required with respect to the apportionment among the various jurisdictions. A valuation allowance is recorded if management expects that it is more likely than not that its deferred tax assets will not be realized. NS had a $9 million valuation allowance on $637 million of deferred tax assets as of Dec. 31, 2006, reflecting the expectation that most of these assets will be realized. In addition, NS has a recorded liability for its estimate of potential income tax exposures. Management believes this liability for potential exposure to be adequate. Income tax expense is adjusted to the extent the final outcome of these matters differs from the amounts recorded. For every one half percent change in the 2006 effective rate net income would have changed by $11 million.

OTHER MATTERS

Labor Agreements

Approximately 26,000, or about 85%, of NS' railroad employees are covered by collective bargaining agreements with various labor unions. These agreements remain in effect until changed pursuant to the Railway Labor Act (RLA). NS largely bargains in concert with other major railroads. Moratorium provisions in the labor agreements govern when the railroads and the unions may propose labor agreement changes. The current bargaining round began in late 2004. Industry issues include contracting out of certain work and employee contributions for medical and other benefits.

After a period of direct negotiations, either party may file for mediation if it believes insufficient progress is being made. The status quo is preserved during mediation while a federal mediator assists the parties in their efforts to reach agreement. The railroads are currently in mediation with all of the involved labor unions. If the National Mediation Board, a federal agency, were to terminate mediation, it would, at that time, propose that the parties arbitrate their differences. A strike could occur 30 days thereafter if the parties did not accept arbitration. However, if arbitration is rejected by either party the President of the United States of America could then appoint an Emergency Board which would delay any strike for a further 60 days while the Board made recommendations and the parties engaged in further negotiations. The outcome of the negotiations cannot be determined at this point.

Market Risks and Hedging Activities

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

In 2001, NS began a program to hedge a portion of its diesel fuel consumption. The intent of the program was to assist in the management of NS' aggregate risk exposure to fuel price fluctuations, which can significantly affect NS' operating margins and profitability, through the use of one or more types of derivative instruments. No new hedges have been entered into since May of 2004, and the last remaining contracts were settled in the second quarter of 2006, bringing an end to the benefits from the program. Diesel fuel costs represented 14% of NS' operating expenses for 2006, 11% for 2005 and 8% for 2004.

NS manages its overall exposure to fluctuations in interest rates by issuing both fixed- and floating-rate debt instruments and by entering into interest-rate hedging transactions to achieve an appropriate mix within its debt portfolio.

At Dec. 31, 2006, NS' debt subject to interest rate fluctuations totaled $237 million. A 1% point increase in interest rates would increase NS' total annual interest expense related to all its variable debt by approximately $2 million. Management considers it unlikely that interest rate fluctuations applicable to these instruments will result in a material adverse effect on NS' financial position, results of operations or liquidity.

Some of NS' capital leases, which carry an average fixed rate of 7%, were effectively converted to variable rate obligations using interest rate swap agreements. On Dec. 31, 2006, the average pay rate under these agreements was 6%, and the average receive rate was 7%. During 2006 and 2005, the effect of the swaps was to reduce interest expense by $1 million and $2 million, respectively .. A portion of the lease obligations is payable in Japanese yen. NS eliminated the associated exchange rate risk at the inception of each lease with a yen deposit sufficient to fund the yen-denominated obligation. Most of these deposits are held by foreign banks, primarily Japanese. As a result, NS is exposed to financial market risk relative to Japan .. Counterparties to the interest rate swaps and Japanese banks holding yen deposits are major financial institutions believed by management to be creditworthy.

New Accounting Pronouncements

In June 2006, the FASB issued Interpretation No. (FIN) 48, “Accounting for Uncertainty in Income Taxes.” This Interpretation clarifies accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with SFAS No. 109, “Accounting for Income Taxes.” FIN 48 prescribes a recognition threshold and measurement attribute for a tax position taken or expected to be taken in a tax return. Under the guidelines of FIN 48, an entity should recognize the financial statement benefit of a tax position if it determines that it is more likely than not that the position will be sustained on examination. NS will adopt this Interpretation in the first quarter of 2007 and expects it will not have a material effect on NS’ consolidated financial statements.

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans.” This statement requires an employer to recognize in its statement of financial position the overfunded or underfunded status of defined benefit pension and postretirement plans measured as the difference between the fair value of plan assets and the benefit obligation. Employers must also recognize as a component of other comprehensive income, net of tax, the actuarial gains and losses and the prior service costs, credits and transition costs that arise during the period. NS adopted this statement in the fourth quarter of 2006 (see Note 10).

In December 2004, the FASB issued SFAS No. 123(R), “Share-Based Payment.” This statement establishes standards for accounting for transactions in which an entity exchanges its equity instruments for goods or services, such as stock-based compensation plans. NS adopted this standard in the first quarter of 2006 (see Note 1).

Inflation

In preparing financial statements, U.S. generally accepted accounting principles require the use of historical cost that disregards the effects of inflation on the replacement cost of property. NS, a capital-intensive company, has most of its capital invested in such assets. The replacement cost of these assets, as well as the related depreciation expense, would be substantially greater than the amounts reported on the basis of historical cost.

Proposed Legislation and Regulations on Safety and Transportation of Hazardous Materials

Regulations proposed by the Department of Homeland Security in late 2006 would mandate that railroads adopt chain of custody and security measures. If enacted, such regulations could cause service degradation and higher costs for the transportation of toxic inhalation hazard materials. In addition, certain local governments have sought to enact ordinances banning hazardous materials moving by rail within their borders. Some legislators have contemplated pre-notification requirements for hazardous material shipments. If promulgated, such ordinances could require the re-routing of hazardous materials shipments, with the potential for significant additional costs and network inefficiencies. Accordingly, NS will oppose efforts to impose unwarranted regulation in this area.

FORWARD-LOOKING STATEMENTS

This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-loo ki ng statements that may be identified by the use of words like "believe," "expect," "anticipate" and "project." Forward-loo ki ng statements reflect management's good-faith evaluation of information currently available. However, such statements are dependent on and, therefore, can be influenced by, a number of external variables over which management has little or no control, including: domestic and international economic conditions; interest rates; the business environment in industries that produce and consume rail freight; competition and consolidation within the transportation industry; the operations of carriers with which NS interchanges; acts of terrorism or war; fluctuation in prices of key materials, in particular diesel fuel; labor difficulties, including strikes and work stoppages; legislative and regulatory developments; changes in securities and capital markets; disruptions to NS' technology infrastructure including computer systems; and natural events such as severe weather, hurricanes and floods. For more discussion about each risk factor, see Part I, Item 1A "Risk Factors." Forward-loo ki ng statements are not, and should not be relied upon as a guarantee of future performance or results, nor will they necessarily prove to be accurate indications of the times at or by which any such performance or results will be achieved. As a result, actual outcomes and results may differ materially from those expressed in forward-loo ki ng statements. NS undertakes no obligation to update or revise forward-loo ki ng statements.

Item 7A .. Quantitative and Qualitative Disclosures about Market Risk.

The information required by this item is included in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" under the heading "Market Risks and Hedging Activities."

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Item 8 .. Financial Statements and Supplementary Data.

INDEX TO FINANCIAL STATEMENTS

Report of Management

February 20, 2007

To the Stockholders

Norfolk Southern Corporation

Management is responsible for establishing and maintaining adequate internal control over financial reporting. In order to ensure that the Corporation's internal control over financial reporting is effective, management regularly assesses such controls and did so most recently for its financial reporting as of December 31, 2006. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management has concluded that the Corporation maintained effective internal control over financial reporting as of December 31, 2006 ..

KPMG LLP, independent registered public accounting firm, has audited the Corporation's financial statements and has reported on management's assessment of the effectiveness of the Corporation's internal control over financial reporting as of December 31, 2006 ..

/s/ Charles W. Moorman	/s/ Henry C. Wolf	/s/ Marta R. Stewart
Charles W. Moorman	Henry C. Wolf	Marta R. Stewart
Chairman, President and	Vice Chairman and	Vice President and
Chief Executive Officer	Chief Financial Officer	Controller

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Norfolk Southern Corporation:

We have audited management's assessment, included in the accompanying Report of Management, that Norfolk Southern Corporation maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control – Integrated Framework,* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Norfolk Southern Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of Norfolk Southern Corporation's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Norfolk Southern Corporation maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control – Integrated Framework,* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, Norfolk Southern Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control – Integrated Framework,* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Report of Independent Registered Public Accounting Firm

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We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Norfolk Southern Corporation and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2006. In connection with our audits of the consolidated financial statements, we have also audited the financial statement schedule as listed in Item 15(A)2. Our report dated February 20, 2007, expressed an unqualified opinion on the consolidated financial statements and financial statement schedule.

/s/ KPMG LLP

Norfolk , Virginia

February 20, 2007

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Norfolk Southern Corporation:

We have audited the accompanying consolidated balance sheets of Norfolk Southern Corporation and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2006. In connection with our audits of the consolidated financial statements, we have also audited the financial statement schedule as listed in Item 15(A)2. These consolidated financial statements and financial statement schedule are the responsibility of Norfolk Southern Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Norfolk Southern Corporation and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in note 1 to the consolidated financial statements, Norfolk Southern Corporation adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment,* effective January 1, 2006, and Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans,* effective December 31, 2006.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Norfolk Southern Corporation's internal control over financial reporting as of December

31, 2006, based on criteria established in *Internal Control – Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 20, 2007, expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

Norfolk , Virginia

February 20, 2007

Norfolk Southern Corporation and Subsidiaries

Consolidated Statements of Income

	Years ended Dec. 31,		
	2006	**2005**	**2004**
	($ in millions, except earnings per share)		
Railway operating revenues	$ 9,407	$ 8,527	$ 7,312
Railway operating expenses:			
Compensation and benefits	2,637	2,493	2,272
Materials, services and rents	1,895	1,809	1,601
Conrail rents and services	126	129	319
Depreciation	738	774	598
Diesel fuel	977	727	449
Casualties and other claims	220	224	151
Other	257	254	220
Total railway operating expenses	6,850	6,410	5,610
Income from railway operations	2,557	2,117	1,702
Other income – net	149	74	76
Interest expense on debt	476	494	489
Income before income taxes	2,230	1,697	1,289
Provision for income taxes	749	416	379
Net income	$ 1,481	$ 1,281	$ 910

Per share amounts:			
Net income			
Basic	$ 3.63	$ 3.17	$ 2.31
Diluted	$ 3.57	$ 3.11	$ 2.28

See accompanying notes to consolidated financial statements.

Norfolk Southern Corporation and Subsidiaries

Consolidated Balance Sheets

	As of Dec. 31,	
	2006	**2005**
	($ in millions)	
Assets		
Current assets:		
Cash and cash equivalents	$ 527	$ 289
Short-term investments	391	968
Accounts receivable – net	992	931
Materials and supplies	151	132
Deferred income taxes	186	167
Other current assets	153	163
Total current assets	2,400	2,650
Investments	1,755	1,558
Properties less accumulated depreciation	21,098	20,735
Other assets	775	916
Total assets	$ 26,028	$ 25,859
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 1,181	$ 1,163
Income and other taxes	205	231
Other current liabilities	216	213
Current maturities of long-term debt	491	314
Total current liabilities	2,093	1,921
Long-term debt	6,109	6,616
Other liabilities	1,767	1,415

Deferred income taxes		6,444		6,631
Total liabilities		16,413		16,583
Stockholders' equity:				
Common stock $1.00 per share par value, 1,350,000,000 shares				
authorized; issued 418,200,239 and 430,718,913 shares,				
Respectively		418		431
Additional paid-in capital		1,303		992
Unearned restricted stock		--		(17)
Accumulated other comprehensive loss		(369)		(77)
Retained income		8,283		7,967
Less treasury stock at cost, 20,780,638 and 20,833,125 shares,				
Respectively		(20)		(20)
Total stockholders' equity		9,615		9,276
Total liabilities and stockholders' equity	$	26,028	$	25,859

See accompanying notes to consolidated financial statements.

Norfolk Southern Corporation and Subsidiaries

Consolidated Statements of Cash Flows

	Years Ended Dec. 31,		
	2006	**2005**	**2004**
	($ in millions)		
Cash flows from operating activities			
Net income	$ 1,481	$ 1,281	$ 910
Reconciliation of net income to net cash			
provided by operating activities:			
Depreciation	750	787	609
Deferred income taxes	(8)	80	200
Equity in earnings of Conrail	(25)	(37)	(54)
Gain on Conrail Corporate Reorganization	--		