

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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The following Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") is intended to enhance a reader's understanding of the Company's results of operations and financial condition. The MD&A is provided as a supplement to, and should be read in conjunction with the Company's Consolidated Financial Statements and the related notes in Item 8. Financial Statements and Supplementary Data, and other information in this annual report. Except where otherwise indicated, all financial information reflected herein is expressed in Canadian dollars. The following section generally discusses 2022 and 2021 items and year-to-year comparisons between 2022 and 2021. Discussions of 2020 items and year-to-year comparisons between 2021 and 2020 that are not included in this Form 10-K can be found in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part II, Item 7, of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2021.

For purposes of this report, all references herein to "CP", "the Company", "we", "our" and "us" refer to Canadian Pacific Railway Limited ("CPRL"), CPRL and its subsidiaries, CPRL and one or more of its subsidiaries, or one or more of CPRL's subsidiaries, as the context may require.

Executive Summary

2022 Results

- **Financial performance** – In 2022, the Company reported Diluted earnings per share ("EPS") of \$3.77, a 10% decrease from \$4.18 in 2021. Core adjusted diluted EPS has remained unchanged at \$3.77. The Company's commitment to service and operational efficiency produced an Operating ratio of 62.2% and an Adjusted operating ratio of 61.4%. Core adjusted diluted EPS and Adjusted operating ratio are defined and reconciled in Non-GAAP Measures and discussed further in Results of Operations of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.
- **Total revenues** – The Company's Total revenues increased by 10% to \$8,814 million in 2022 from \$7,995 million in 2021, driven primarily by higher fuel surcharge revenue as a result of higher fuel prices and higher freight rates.

Performance Indicators

The following table lists the key measures of the Company's operating performance:

| For the year ended December 31 | 2022 | 2021 | % Change |
|--|---------|---------|----------|
| Gross ton-miles ("GTMs") (millions) | 269,134 | 271,921 | (1) |
| Train miles (thousands) | 28,899 | 29,397 | (2) |
| Fuel efficiency (U.S. gallons of locomotive fuel consumed /1,000 GTMs) | 0.955 | 0.931 | 3 |
| Total employees (average) | 12,570 | 12,337 | 2 |

These key measures are used by management as comparisons to historical operating results and in the planning process to facilitate decisions that continue to drive further productivity improvements in the Company's operations. Results of these key measures reflect how effective the Company's management is at controlling costs and executing the Company's operating plan and strategy. Continued monitoring of these key measures ensures that the Company can take appropriate actions to ensure the delivery of superior service and be able to grow its business at low incremental cost.

A **GTM** is defined as the movement of one ton of train weight over one mile. GTMs are calculated by multiplying total train weight by the distance the train moved. Total train weight comprises the weight of the freight cars, their contents, and any inactive locomotives. An increase in GTMs indicates additional workload. GTMs for 2022 were 269,134 million, a slight decrease compared with 271,921 million in 2021. The decrease in GTMs was mainly attributable to lower volumes of Canadian grain, Coal, and Energy, chemicals and plastics. This decrease was partially offset by higher volumes of Intermodal, U.S. grain, Potash, and frac sand.

Train miles are defined as the sum of the distance moved by all trains operated on the network. Train miles provide a measure of the productive utilization of our network. A smaller increase in train miles relative to increases in volumes, as measured by RTMs, and/or workload, as measured by GTMs, indicates improved train productivity. Train miles for 2022 were 28,899 thousands, a decrease of 2% compared with 29,397 thousands in 2021. This decrease reflects the impact of a slight decrease in workload (GTM), as well as the impact of a 1% increase in average train weights.

Fuel efficiency is defined as U.S. gallons of locomotive fuel consumed per 1,000 GTMs. Fuel consumed includes gallons from freight, yard and commuter service but excludes fuel used in capital projects and other non-freight activities. An improvement in fuel efficiency indicates operational cost savings and the Company's commitment to corporate sustainability through a reduction of greenhouse gas emissions intensity. Fuel efficiency for 2022 was 0.955 U.S. gallons/1,000 GTMs, a decrease of 3% compared to 0.931 U.S. gallons/1,000 GTMs in 2021. This decrease was due to harsher winter

operating conditions in 2022, higher volumes of Intermodal, which has lower horsepower utilization, and lower locomotive productivity defined as the daily average GTMs divided by daily average operating horsepower.

An **employee** is defined as an individual currently engaged in full-time, part-time, or seasonal employment with the Company. The Company monitors employment levels in order to efficiently meet service and strategic requirements. The number of employees is a key driver to total compensation and benefits costs.

The average number of total employees for 2022 was 12,570, an increase of 233, or 2%, compared to 12,337 in 2021 to support anticipated future volume growth.

Results of Operations

Operating Revenues

| For the year ended December 31 | 2022 | 2021 | Total Change | % Change |
|---|----------|----------|--------------|----------|
| Freight revenues (in millions) ⁽¹⁾ | \$ 8,627 | \$ 7,816 | \$ 811 | 10 |
| Non-freight revenues (in millions) | 187 | 179 | 8 | 4 |
| Total revenues (in millions) | \$ 8,814 | \$ 7,995 | \$ 819 | 10 |
| Carloads (in thousands) | 2,782.1 | 2,735.5 | 46.6 | 2 |
| Revenue ton-miles (in millions) | 148,228 | 149,686 | (1,458) | (1) |
| Freight revenue per carload (in dollars) | \$ 3,101 | \$ 2,857 | \$ 244 | 9 |
| Freight revenue per revenue ton-mile (in cents) | 5.82 | 5.22 | 0.60 | 11 |

⁽¹⁾ Freight revenues include fuel surcharge revenues of \$1,303 million in 2022 and \$535 million in 2021. Fuel surcharge revenues include recoveries of carbon taxes, levies, and obligations under cap-and-trade program

The Company's revenues are primarily derived from transporting freight. Changes in freight volumes as measured by RTMs generally contribute to corresponding changes in freight revenues and certain variable expenses, such as fuel, crew costs, and equipment rents. Non-freight revenue is generated from leasing of certain assets; other arrangements, including contracts with passenger service operators and logistical services; switching fees; and other arrangements.

Total Revenues

The increase in Freight revenues was primarily due to increased freight revenue per RTM, partially offset by lower volumes as measured by RTMs. The increase in Non-freight revenues was primarily due to higher leasing revenue, higher passenger revenue from passenger service operators, and higher interline switching fees, partially offset by lower revenue from logistical services.

RTMs

RTMs are defined as the movement of one revenue-producing ton of freight over a distance of one mile. RTMs measure the relative weight and distance of rail freight moved by the Company. The decrease in RTMs was mainly attributable to lower volumes of Canadian grain, Coal, and Energy, chemicals and plastics. This decrease was partially offset by higher volumes of Intermodal, U.S. grain, Potash, and frac sand.

Freight revenue per RTM

Freight revenue per RTM is defined as freight revenue per revenue-producing ton of freight over a distance of one mile. This is an indicator of yield. The increase in Freight revenue per RTM was primarily due to higher fuel surcharge revenue as a result of higher fuel prices of \$709 million, higher freight rates, and the favourable impact of the change in foreign exchange ("FX") of \$142 million. This increase was partially offset by lower crude liquidated damages, including customer volume commitments, due to completion of customer contracts.

Lines of Business

Grain

| For the year ended December 31 | 2022 | 2021 | Total Change | % Change |
|---|----------|----------|--------------|----------|
| Freight revenues (in millions) | \$ 1,776 | \$ 1,684 | \$ 92 | 5 |
| Carloads (in thousands) | 382.1 | 426.2 | (44.1) | (10) |
| Revenue ton-miles (in millions) | 35,325 | 37,999 | (2,674) | (7) |
| Freight revenue per carload (in dollars) | \$ 4,648 | \$ 3,951 | \$ 697 | 18 |
| Freight revenue per revenue ton-mile (in cents) | 5.03 | 4.43 | 0.60 | 14 |

The increase in Grain revenue was primarily due to increased freight revenue per RTM and higher volumes of U.S. corn from the U.S. Midwest to western Canada, partially offset by lower volumes of Canadian grain to Vancouver, B.C. and eastern Canada due to drought conditions that impacted the 2021-2022 Canadian crop size. Freight revenue per RTM increased due to higher fuel surcharge revenue as a result of higher fuel prices, higher freight rates, and the favourable impact of the change in FX. RTMs decreased less than carloads due to moving higher volumes of U.S. corn from the U.S. Midwest to western Canada, which has a longer length of haul.

Coal

| For the year ended December 31 | 2022 | 2021 | Total Change | % Change |
|---|----------|----------|--------------|----------|
| Freight revenues (in millions) | \$ 577 | \$ 625 | \$ (48) | (8) |
| Carloads (in thousands) | 269.8 | 291.5 | (21.7) | (7) |
| Revenue ton-miles (in millions) | 14,970 | 18,345 | (3,375) | (18) |
| Freight revenue per carload (in dollars) | \$ 2,139 | \$ 2,144 | \$ (5) | — |
| Freight revenue per revenue ton-mile (in cents) | 3.85 | 3.41 | 0.44 | 13 |

The decrease in Coal revenue was primarily due to lower volumes of Canadian coal to Vancouver as a result of production challenges at the mines, partially offset by higher volumes of Canadian coal to Kamloops, B.C. and increased freight revenue per RTM. Freight revenue per RTM increased due to higher fuel surcharge revenue as a result of higher fuel prices and higher freight rates. RTMs decreased more than carloads due to moving lower volumes of Canadian coal to Vancouver, which has a longer length of haul, and moving higher volumes of Canadian coal to Kamloops, which has a shorter length of haul.

Potash

| For the year ended December 31 | 2022 | 2021 | Total Change | % Change |
|---|----------|----------|--------------|----------|
| Freight revenues (in millions) | \$ 581 | \$ 463 | \$ 118 | 25 |
| Carloads (in thousands) | 160.0 | 150.9 | 9.1 | 6 |
| Revenue ton-miles (in millions) | 18,176 | 16,671 | 1,505 | 9 |
| Freight revenue per carload (in dollars) | \$ 3,631 | \$ 3,068 | \$ 563 | 18 |
| Freight revenue per revenue ton-mile (in cents) | 3.20 | 2.78 | 0.42 | 15 |

The increase in Potash revenue was primarily due to increased freight revenue per RTM and higher volumes of export potash to Vancouver and Thunder Bay, Ontario. Freight revenue per RTM increased due to higher fuel surcharge revenue as a result of higher fuel prices, the favourable impact of the change in FX, and higher freight rates.

Fertilizers and Sulphur

| For the year ended December 31 | 2022 | 2021 | Total Change | % Change |
|---|----------|----------|--------------|----------|
| Freight revenues (in millions) | \$ 332 | \$ 305 | \$ 27 | 9 |
| Carloads (in thousands) | 61.8 | 64.4 | (2.6) | (4) |
| Revenue ton-miles (in millions) | 4,772 | 4,845 | (73) | (2) |
| Freight revenue per carload (in dollars) | \$ 5,372 | \$ 4,736 | \$ 636 | 13 |
| Freight revenue per revenue ton-mile (in cents) | 6.96 | 6.30 | 0.66 | 10 |

The increase in Fertilizers and sulphur revenue was primarily due to increased freight revenue per RTM and higher volumes of dry fertilizers, partially offset by lower volumes of wet fertilizers and sulphur. Freight revenue per RTM increased due to higher fuel surcharge revenue as a result of higher fuel prices, higher freight rates, and the favourable impact of the change in FX.

Forest Products

| For the year ended December 31 | 2022 | 2021 | Total Change | % Change |
|---|----------|----------|--------------|----------|
| Freight revenues (in millions) | \$ 403 | \$ 348 | \$ 55 | 16 |
| Carloads (in thousands) | 73.1 | 73.6 | (0.5) | (1) |
| Revenue ton-miles (in millions) | 5,741 | 5,718 | 23 | — |
| Freight revenue per carload (in dollars) | \$ 5,513 | \$ 4,728 | \$ 785 | 17 |
| Freight revenue per revenue ton-mile (in cents) | 7.02 | 6.09 | 0.93 | 15 |

The increase in Forest products revenue was primarily due to increased freight revenue per RTM and higher volumes of newsprint from Saint John, New Brunswick, partially offset by lower volumes of lumber. Freight revenue per RTM increased due to higher fuel surcharge revenue as a result of higher fuel prices, higher freight rates, and the favourable impact of the change in FX.

Energy, Chemicals and Plastics

| For the year ended December 31 | 2022 | 2021 | Total Change | % Change |
|---|----------|----------|--------------|----------|
| Freight revenues (in millions) | \$ 1,394 | \$ 1,563 | \$ (169) | (11) |
| Carloads (in thousands) | 297.4 | 320.1 | (22.7) | (7) |
| Revenue ton-miles (in millions) | 24,625 | 25,469 | (844) | (3) |
| Freight revenue per carload (in dollars) | \$ 4,687 | \$ 4,883 | \$ (196) | (4) |
| Freight revenue per revenue ton-mile (in cents) | 5.66 | 6.14 | (0.48) | (8) |

The decrease in Energy, chemicals and plastics revenue was primarily due to decreased freight revenue per RTM and lower volumes of conventional crude, LPG, and other energy products. This decrease was partially offset by higher fuel surcharge revenue as a result of higher fuel prices, higher volumes of DRUbit™ crude to Kansas City, Missouri and ethylene glycol to Vancouver, the favourable impact of the change in FX, and higher freight rates. Freight revenue per RTM decreased due to lower crude liquidated damages, including customer volume commitments, as a result of the completion of customer contracts. RTMs decreased less than carloads due to moving higher volumes of DRUbit™ crude to Kansas City, which has a longer length of haul.

Metals, Minerals and Consumer Products

| For the year ended December 31 | 2022 | 2021 | Total Change | % Change |
|---|----------|----------|-----------------|-------------|
| Freight revenues (in millions) | \$ 884 | \$ 728 | \$ 156 | 21 |
| Carloads (in thousands) | 248.3 | 236.7 | 11.6 | 5 |
| Revenue ton-miles (in millions) | 11,710 | 11,170 | 540 | 5 |
| Freight revenue per carload (in dollars) | \$ 3,560 | \$ 3,076 | \$ 484 | 16 |
| Freight revenue per revenue ton-mile (in cents) | 7.55 | 6.52 | 1.03 | 16 |

The increase in Metals, minerals and consumer products revenue was primarily due to increased freight revenue per RTM and higher volumes of frac sand to the Marcellus and Bakken shale formations, partially offset by lower volumes of steel and aggregates. Freight revenue per RTM increased due to higher fuel surcharge revenue as a result of higher fuel prices, higher freight rates, and the favourable impact of the change in FX.

Automotive

| For the year ended December 31 | 2022 | 2021 | Total Change | % Change |
|---|----------|----------|-----------------|-------------|
| Freight revenues (in millions) | \$ 438 | \$ 376 | \$ 62 | 16 |
| Carloads (in thousands) | 104.4 | 109.2 | (4.8) | (4) |
| Revenue ton-miles (in millions) | 1,736 | 1,765 | (29) | (2) |
| Freight revenue per carload (in dollars) | \$ 4,195 | \$ 3,443 | \$ 752 | 22 |
| Freight revenue per revenue ton-mile (in cents) | 25.23 | 21.30 | 3.93 | 18 |

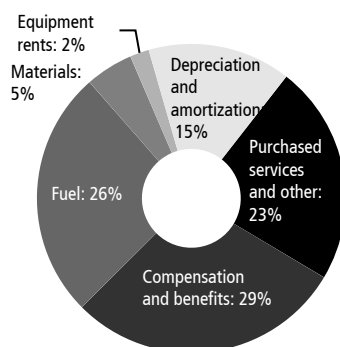
The increase in Automotive revenue was primarily due to increased freight revenue per RTM, partially offset by lower volumes as a result of global supply chain challenges. Freight revenue per RTM increased due to higher fuel surcharge revenue as a result of higher fuel prices, the favourable impact of the change in FX, and higher freight rates.

Intermodal

| For the year ended December 31 | 2022 | 2021 | Total Change | % Change |
|---|----------|----------|-----------------|-------------|
| Freight revenues (in millions) | \$ 2,242 | \$ 1,724 | \$ 518 | 30 |
| Carloads (in thousands) | 1,185.2 | 1,062.9 | 122.3 | 12 |
| Revenue ton-miles (in millions) | 31,173 | 27,704 | 3,469 | 13 |
| Freight revenue per carload (in dollars) | \$ 1,892 | \$ 1,622 | \$ 270 | 17 |
| Freight revenue per revenue ton-mile (in cents) | 7.19 | 6.22 | 0.97 | 16 |

The increase in Intermodal revenue was primarily due to increased freight revenue per RTM, higher volumes due to onboarding new international intermodal customers, higher international intermodal volumes to and from the Port of Saint John, the Port of Vancouver, and the Port of Montreal, and higher domestic intermodal retail and wholesale volumes. This increase was partially offset by lower domestic intermodal cross-border volumes. Freight revenue per RTM increased due to higher fuel surcharge revenue as a result of higher fuel prices, higher intermodal ancillary revenue, higher freight rates, and the favourable impact of the change in FX.

Operating Expenses



2022 Operating Expenses

| For the year ended December 31 (in millions of Canadian dollars) | 2022 | 2021 | Total Change | % Change |
|---|-----------------|-----------------|-----------------|-------------|
| Compensation and benefits | \$ 1,570 | \$ 1,570 | \$ — | — |
| Fuel | 1,400 | 854 | 546 | 64 |
| Materials | 260 | 215 | 45 | 21 |
| Equipment rents | 140 | 121 | 19 | 16 |
| Depreciation and amortization | 853 | 811 | 42 | 5 |
| Purchased services and other | 1,262 | 1,218 | 44 | 4 |
| Total operating expenses | \$ 5,485 | \$ 4,789 | \$ 696 | 15 |

Operating expenses were \$5,485 million in 2022, an increase of \$696 million, or 15%, from \$4,789 million in 2021. This increase was primarily due to:

- the unfavourable impact of higher fuel prices of \$483 million;
- the impact of cost inflation;
- the unfavourable impact of the change in FX of \$71 million;
- a gain on the exchange of property and construction easements in Chicago of \$50 million in 2021 and lower gains on land sales of \$15 million; and
- a decrease in efficiencies primarily due to harsh winter weather conditions in the first quarter of 2022.

This increase was partially offset by lower acquisition-related costs of \$109 million associated with the KCS acquisition recorded in Purchased services and other, and lower incentive and stock-based compensation primarily due to lower payout assumptions.

Compensation and Benefits

Compensation and benefits expense includes employee wages, salaries, fringe benefits, and stock-based compensation. Compensation and benefits expense was \$1,570 million in 2022, unchanged compared to \$1,570 million in 2021. This was primarily due to lower incentive and stock-based compensation primarily due to lower payout assumptions, and lower post-retirement benefits current service cost of \$24 million.

These decreases were offset by:

- the impact of wage and benefit inflation;
- the unfavourable impact of the change in FX of \$18 million; and
- increased new hire training cost.

Fuel

Fuel expense consists mainly of fuel used by locomotives and includes provincial, state, and federal fuel taxes. Fuel expense was \$1,400 million in 2022, an increase of \$546 million, or 64%, from \$854 million in 2021. This increase was primarily due to:

- the unfavourable impact of higher fuel prices of \$483 million;

- a decrease in fuel efficiency of 3% due to harsher winter operating conditions in 2022, higher volumes of Intermodal, which has lower horsepower utilization, and lower locomotive productivity defined as the daily average GTMs divided by daily average operating horsepower; and
- the unfavourable impact of the change in FX of \$27 million;

This increase was partially offset by a decrease in workload, as measured by GTMs.

Materials

Materials expense includes the cost of material used for maintenance of track, locomotives, freight cars, and buildings as well as software sustainment. Materials expense was \$260 million in 2022, an increase of \$45 million, or 21%, from \$215 million in 2021. This increase was primarily due to:

- the impact of cost inflation particularly in non-locomotive fuel prices;
- higher spending on track and locomotive maintenance and;
- an increase in non-locomotive fuel consumption.

Equipment Rents

Equipment rents expense includes the cost associated with using other companies' freight cars, intermodal equipment, and locomotives, net of rental income received from other railways for the use of the Company's equipment. Equipment rents expense was \$140 million in 2022, an increase of \$19 million, or 16%, from \$121 million in 2021. This increase was primarily due to:

- lower price incentives received on intermodal cars;
- slower cycle times; and
- greater usage of pooled freight cars.

This increase was partially offset by higher receipts for CP freight cars used by other railways.

Depreciation and Amortization

Depreciation and amortization expense represents the charge associated with the use of track and roadway, buildings, rolling stock, information systems, and other depreciable assets. Depreciation and amortization expense was \$853 million for 2022, an increase of \$42 million, or 5%, from \$811 million in 2021. This increase was primarily due to a higher asset base, as a result of the capital program spending in 2022 and recent years as well as the unfavourable impact of the change in FX of \$8 million.

Purchased Services and Other

| For the year ended December 31 (in millions of Canadian dollars) | 2022 | 2021 | Total Change | % Change |
|---|-----------------|-----------------|-----------------|-------------|
| Support and facilities | \$ 334 | \$ 293 | \$ 41 | 14 |
| Track and operations | 294 | 260 | 34 | 13 |
| Intermodal | 225 | 205 | 20 | 10 |
| Equipment | 112 | 105 | 7 | 7 |
| Casualty | 103 | 125 | (22) | (18) |
| Property taxes | 133 | 128 | 5 | 4 |
| Other | 85 | 191 | (106) | (55) |
| Land sales | (24) | (89) | 65 | (73) |
| Total Purchased services and other | \$ 1,262 | \$ 1,218 | \$ 44 | 4 |

Purchased services and other expense encompasses a wide range of third-party costs, including contractor and consulting fees, locomotive and freight car repairs performed by third parties, property and other taxes, intermodal pickup and delivery services, casualty expense, expenses for joint facilities, and gains on land sales. Purchased services and other expense was \$1,262 million in 2022, an increase of \$44 million, or 4%, from \$1,218 million in 2021. This increase was primarily due to:

- the impact of cost inflation, including higher pickup and delivery, which is reported in Intermodal;
- a gain on the exchange of property and construction easements in Chicago of \$50 million in 2021 and lower gains on land sales of \$15 million;
- higher expenses primarily due to higher events and sponsorship costs;
- the unfavourable impact of the change in FX of \$13 million;
- increased purchased services due to harsher weather conditions, reported in Track and operations; and
- a \$7 million arbitration settlement in 2021, reported in Track and operations.

This increase was partially offset by:

- lower acquisition-related costs of \$109 million associated with the KCS acquisition, reported in Other;
- lower expenses from lower volumes, reported in Intermodal, and Track and operations; and
- lower expenses primarily due to the reduced severity of casualty incidents.

Other Income Statement Items

Equity Earnings (Loss) of Kansas City Southern

On December 14, 2021, following the consummation of the KCS acquisition, the shares of KCS were placed into a voting trust while the United States Surface Transportation Board ("STB") considers the Company's application for control of KCS.

In 2022, the Company recognized \$1,074 million (U.S. \$820 million) of equity earnings of KCS in the Company's Consolidated Statements of Income. This amount is net of amortization of basis differences of \$163 million (U.S. \$125 million) associated with KCS purchase accounting, and includes acquisition-related costs incurred by KCS. These basis differences relate to depreciable property, plant and equipment, intangible assets with definite lives, and long-term debt, and are amortized over the related assets' remaining useful lives, and the remaining terms to maturity of the debt instruments. Equity earnings for 2022 represent a full year of income attributable to CP, whereas the \$141 million equity loss recognized in 2021 was limited to the 18 day period from the date of acquisition of KCS closing into the voting trust to December 31, 2021. The equity loss in 2021 was attributable to acquisition-related costs incurred by KCS during that period. Equity earnings of KCS recognized in 2022 also included KCS's gain on unwinding of interest rate hedges of \$212 million, which is net of CP's associated purchase accounting basis difference and tax. KCS's gain on unwinding of interest rate hedges and acquisition-related costs are discussed further and reconciled in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

On a historical basis, without any effect of purchase accounting, KCS recorded net income attributable to controlling interests of \$1,278 million (U.S. \$982 million) in 2022, a favourable change of \$620 million (U.S. \$457 million), or 94%, from \$658 million (U.S. \$525 million) net income in 2021. Included within the \$1,278 million (U.S. \$982 million) net income was a \$254 million (net of tax) (U.S. \$195 million) gain from the unwinding of interest rate hedges. The remainder of the change was primarily due to higher revenues of \$692 million (U.S. \$423 million) and lower acquisition related costs, partially offset by higher fuel cost of \$208 million (U.S. \$148 million). Acquisition-related costs (net of tax) incurred by KCS in 2022 were \$50 million (U.S. \$38 million), a decrease of \$221 million (U.S. \$178 million), or 82%, from \$271 million (U.S. \$216 million) in the same period of 2021. These values have been translated at the average FX rate of \$1.30 and \$1.25 CAD per USD for 2022 and 2021, respectively.

Other Expense (Income)

Other expense (income) consists of gains and losses from the change in FX on debt and lease liabilities and working capital, costs related to financing, shareholder costs, equity income, and other non-operating expenditures. Other expense was \$17 million in 2022, a decrease of \$220 million, or 93%, from expense of \$237 million in 2021. This decrease was primarily due to acquisition-related costs of \$247 million in 2021, which included losses on interest rate hedges of \$264 million and bridge facility and backstop revolver fees of \$52 million, partially offset by gains on cash held for the KCS acquisition of \$56 million, and gains on FX hedges of \$13 million. This decrease was partially offset by lower net FX gains on US-denominated cash, working capital, debt, and lease liabilities of \$11 million in 2022 and higher amortization of fees of \$11 million related to debt issued for the KCS acquisition in the last quarter of 2021.

FX translation gains and losses on debt and lease liabilities and acquisition-related costs are discussed further in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Merger Termination Fee

On May 21, 2021, KCS terminated the Agreement and Plan of Merger (the "Original Merger Agreement") with CP to enter into a definitive agreement with CN. At the same time and in accordance with the terms of the Original Merger Agreement, KCS paid CP a termination fee of \$845 million (U.S. \$700 million). This amount was reported as "Merger termination fee" in the Company's Consolidated Statements of Income in 2021. No similar items were received in 2022. Merger termination fee is discussed further and reconciled in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Other Components of Net Periodic Benefit Recovery

Other components of net periodic benefit recovery is related to the Company's pension and other post-retirement and post-employment benefit plans. It includes interest cost on benefit obligations, expected return on plan assets, recognized net actuarial losses, and amortization of prior service costs. Other components of net periodic benefit recovery were \$411 million in 2022, an increase of \$24 million, or 6%, from \$387 million in 2021. This increase was primarily due to a decrease in recognized net actuarial losses of \$57 million, partially offset by an increase in interest cost on the benefit obligation of \$32 million.

Net Interest Expense

Net interest expense includes interest on long-term debt and finance leases. Net interest expense was \$652 million in 2022, an increase of \$212 million, or 48%, from \$440 million in 2021. This increase was primarily due to interest of \$234 million on long-term debt issuances and term facility related to the KCS acquisition, a change in FX of \$15 million, and higher commercial paper interest of \$10 million. This increase was partially offset by the favourable impacts of maturing long-term debt repayments of \$32 million and \$14 million resulting from lower effective interest rates.

Income Tax Expense

Income tax expense was \$628 million in 2022, a decrease of \$140 million, or 18%, from \$768 million in 2021. This decrease was primarily due to:

- lower taxable earnings, mainly due to the \$845 million (U.S. \$700 million) merger termination payment received in 2021 in connection with KCS's termination of the Original Merger Agreement, partially offset by lower acquisition-related costs associated with the KCS acquisition;
- a reversal of an uncertain tax position related to a prior period of \$24 million; and
- income tax recoveries of \$12 million as a result of a decrease in the Iowa state tax rate.

This decrease was partially offset by lower deferred tax recoveries of \$14 million on changes in the outside basis difference of the equity investment in KCS.

The effective income tax rate for 2022 was 15.16% and 22.24% on an adjusted basis. The effective income tax rate for 2021 was 21.23% and 23.85% on an adjusted basis. The adjusted effective tax rate is a Non-GAAP measure, calculated as the effective tax rate adjusted for significant items as they are not considered indicative of future financial trends either by nature or amount or provide improved comparability to past performance, and, in 2022, the adjusted effective tax rate also excluded equity earnings of KCS. This Non-GAAP measure does not have a standardized meaning and is not defined by GAAP and, therefore, may not be comparable to similar measures presented by other companies. Significant items are discussed further in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The Company's 2023 effective tax rate is expected to be approximately 24%, which excludes discrete tax items, the impact of the change in the equity investment in KCS, and associated deferred tax on the outside basis difference during the year (discussed further in Critical Accounting Estimates of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation). The Company's 2023 outlook for its effective tax rate is based on certain assumptions about events and developments that may or may not materialize, or that may be offset entirely or partially by new events and developments. These assumptions are discussed further in Item 1A. Risk Factors.

Impact of Foreign Exchange on Earnings and Foreign Exchange Risk

Although the Company conducts business primarily in Canada, a significant portion of its revenues, expenses, assets and liabilities including debt are denominated in U.S. dollars. In addition, equity earnings or losses of KCS are denominated in U.S. dollars. The value of the Canadian dollar is affected by a number of domestic and international factors, including, without limitation, economic performance, commodity prices, and Canadian, U.S., and international monetary policies. Fluctuations in FX affect the Company's results because U.S. dollar-denominated revenues and expenses are translated into Canadian dollars. U.S. dollar-denominated revenues and expenses increase (decrease) when the Canadian dollar weakens (strengthens) in relation to the U.S. dollar.

In 2022, the U.S. dollar has strengthened to an average rate of \$1.30 Canadian/U.S. dollar, compared to \$1.25 Canadian/U.S. dollar in 2021. In 2022, the impact of a stronger U.S. dollar resulted in an increase in Total revenues of \$143 million, an increase in Total operating expenses of \$71 million, and an increase in Net interest expense of \$15 million.

In 2023, excluding impacts of KCS, the Company expects that every \$0.01 weakening (or strengthening) of the Canadian dollar relative to the U.S. dollar, positively (or negatively) impacts Total revenues by approximately \$37 million (2022 – approximately \$35 million), negatively (or positively) impacts Operating expenses by approximately \$18 million (2022 – approximately \$19 million), and negatively (or positively) impacts Net interest expense by approximately \$4 million (2022 – approximately \$4 million) on an annualized basis.

The Company uses U.S. dollar-denominated debt and operating lease liabilities to hedge its net investment in U.S. operations. As at December 31, 2022, the net investment in U.S. operations is greater than the total U.S. denominated debt. Consequently, FX translation on the Company's unhedged net investment in U.S. operations is recognized in Other comprehensive income. There is no additional impact on earnings in Other expense (income) related to the FX translation on the Company's debt and operating lease liabilities.

To manage its exposure to fluctuations in exchange rates between Canadian and U.S. dollars, the Company may sell or purchase U.S. dollar forwards at fixed rates in future periods. In addition, changes in the exchange rate between the Canadian dollar and other currencies (including the U.S. dollar) make the goods transported by the Company more or less competitive in the world marketplace and may in turn positively or negatively affect revenues.

Impact of Fuel Price on Earnings

Fluctuations in fuel prices affect the Company's results because fuel expense constitutes a significant portion of the Company's operating costs. As fuel prices fluctuate, there will be a timing impact on earnings, as discussed further in Item 1. Business, Operations, Fuel Cost Adjustment Program and Item 1A. Risk Factors, Fuel Cost Volatility.

The impact of fuel price on earnings includes the impacts of provincial and federal carbon taxes and levies recovered and paid on revenues and expenses, respectively.

In 2022, the favourable impact of fuel prices on Operating income was \$226 million. Higher fuel prices and increased carbon tax recoveries resulted in an increase in Total revenues of \$709 million from 2021. Higher fuel prices resulted in an increase in Total operating expenses of \$483 million.

Impact of Share Price on Earnings and Stock-Based Compensation

Fluctuations in the Common Share price affect the Company's operating expenses because share-based liabilities are measured at fair value. The Company's Common Shares are listed on the Toronto Stock Exchange ("TSX") and the New York Stock Exchange ("NYSE") with ticker symbol "CP".

In 2022, the impact of the change in Common Share prices resulted in stock-based compensation expense of \$16 million, an increase of \$5 million, from \$11 million in 2021.

Based on information available at December 31, 2022 and expectations for 2023 grants, excluding impacts of KCS, for every \$1.00 change in share price, stock-based compensation expense has a corresponding change of approximately \$1.2 million to \$1.8 million (2021 – approximately \$1.5 million to \$2.0 million). This excludes the impact of changes in share price relative to the S&P/TSX 60 Index, S&P 500 Industrials Index, and to Class I railways, which may trigger different performance share unit payouts. Stock-based compensation may also be impacted by non-market performance conditions.

Additional information concerning stock-based compensation is included in Item 8. Financial Statements and Supplementary Data, Note 22 Stock-based compensation.

Liquidity and Capital Resources

The Company's primary sources of liquidity include its Cash and cash equivalents, commercial paper program, bilateral letter of credit facilities, and revolving credit facility. The Company believes that these sources as well as cash flow generated through operations and existing debt capacity are adequate to meet its short-term and long-term cash requirements. The Company is not aware of any material trends, events, or uncertainties that would create any deficiencies in the Company's liquidity.

As at December 31, 2022, the Company had \$451 million of Cash and cash equivalents compared to \$69 million at December 31, 2021.

As at December 31, 2022, the Company's revolving credit facility was undrawn, unchanged from December 31, 2021, from a total available amount of U.S. \$1.3 billion. Effective April 9, 2021, the Company amended its revolving credit facility to modify certain provisions relating to the calculation of the financial covenant ratio in its revolving credit facility. Effective September 24, 2021, the Company entered into an amendment to extend the two-year tranche and the five-year tranche of its revolving credit facility to September 27, 2023 and September 27, 2026, respectively. Effective September 29, 2021, the Company entered into a further amendment to its revolving credit facility in order to provide financial covenant flexibility for acquisition financing pertaining to the KCS acquisition, which is in place for a two-year period until December 14, 2023. In 2021, the Company also entered into a U.S. \$500 million unsecured non-revolving term credit facility with a maturity date of March 15, 2022. Effective March 14, 2022, the Company extended the maturity date of the U.S. \$500 million term facility to September 15, 2022. During the year ended December 31, 2022, the Company repaid in full the borrowings of \$636 million (U.S. \$500 million) on this unsecured non-revolving term credit facility. The facility was automatically terminated on September 15, 2022, following the final principal repayment.

The Company has a commercial paper program that enables it to issue commercial paper up to a maximum aggregate principal amount of U.S. \$1.0 billion in the form of unsecured promissory notes. This commercial paper program is backed by the revolving credit facility. As at December 31, 2022, the Company did not have any borrowings on its commercial paper program (December 31, 2021 – U.S. \$265 million).

As at December 31, 2022, under its bilateral letter of credit facilities, the Company had letters of credit drawn of \$75 million from a total available amount of \$300 million (December 31, 2021 - \$58 million). Under the bilateral letter of credit facilities, the Company has the option to post collateral in the form of Cash or cash equivalents, equal at least to the face value of the letter of credit issued. As at December 31, 2022, the Company did not have any collateral posted on its bilateral letter of credit facilities (December 31, 2021 – Nil).

Contractual Commitments

The Company's material cash requirements from known contractual obligations and commitments to make future payments primarily consist of long-term debt and related interest, supplier purchases, leases, and other long term liabilities. Outstanding obligations related to debt and leases can be found in Item 8. Financial Statements and Supplementary Data, Note 15 Debt and Note 18 Leases. Interest obligations related to debt and finance leases amount to \$649 million within the next 12 months, with the remaining amount committed thereafter of \$13,710 million.

Supplier purchase agreements and other long-term liabilities amount to \$1,036 million and \$57 million within the next 12 months, respectively, with the remaining amount committed thereafter of \$364 million and \$443 million, respectively. Other long-term liabilities includes expected cash payments for environmental remediation, post-retirement benefits, worker's compensation benefits, long-term disability benefits, pension benefit payments for the Company's non-registered supplemental pension plan, and certain other long-term liabilities. Pension payments are discussed further in Critical Accounting Estimates of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Guarantees

Refer to Item 8. Financial Statements and Supplementary Data, Note 25 Guarantees for details.

Operating Activities

Cash provided by operating activities was \$4,142 million in 2022, an increase of \$454 million, or 12%, compared to \$3,688 million in 2021. This increase was primarily due to higher cash generating income in 2022 including dividends received from KCS of \$1,157 million, partially offset by the \$845 million merger termination fee received in 2021.

Investing Activities

Cash used in investing activities was \$1,496 million in 2022, a decrease of \$12,234 million, or 89%, from \$13,730 million in 2021. This decrease was primarily due to cash payments made to KCS and their stockholders for the acquisition of KCS in 2021.

Capital Programs

For the year ended December 31

(in millions of Canadian dollars, except for track miles and crossties)

| | 2022 | 2021 |
|---|-----------------|-----------------|
| Additions to capital | | |
| Track and roadway | \$ 1,048 | \$ 970 |
| Rolling stock | 243 | 297 |
| Buildings | 75 | 105 |
| Other ⁽¹⁾ | 199 | 179 |
| Total – accrued additions to capital | 1,565 | 1,551 |
| Less: | | |
| Non-cash transactions | 8 | 19 |
| Cash invested in additions to properties (per Consolidated Statements of Cash Flows) | \$ 1,557 | \$ 1,532 |
| Track installation capital programs | | |
| Track miles of rail laid (miles) | 271 | 284 |
| Track miles of rail capacity expansion (miles) | 17 | 9 |
| Crossties installed (thousands) | 1,215 | 1,222 |

⁽¹⁾ Comparative figures have been reclassified to conform with current period presentation.

Track and roadway expenditures include the replacement and enhancement of the Company's track infrastructure. Of the \$1,048 million additions in 2022 (2021 – \$970 million), approximately \$967 million (2021 – \$917 million) was invested in the renewal of depleted assets, namely rail, ties, ballast, signals, and bridges. Approximately \$81 million (2021 – \$53 million) was invested in network improvements and growth initiatives.

Rolling stock investments encompass locomotives and railcars. In 2022, expenditures on locomotives were approximately \$84 million (2021 – \$121 million) and were focused on the continued re-investment in the Company's existing locomotive fleet. Railcar investment of approximately \$159 million (2021 – \$176 million) was largely focused on renewal of depleted assets, including the acquisition of covered hoppers for grain transportation.

In 2022, investments in buildings were approximately \$75 million (2021 - \$105 million) and included items such as facility upgrades, renovations, and shop equipment. Other items were \$199 million (2021 – \$179 million) and included investments in work equipment, information system software, vehicles, containers, and other growth initiatives.

For 2023, the Company expects to invest approximately \$1.6 billion in its standalone capital programs, excluding any capital spend that the Company may require following acquisition of control of KCS. Capital programs will be financed with cash generated from operations. Approximately 60% to 70% of the planned capital programs is for track and roadway. Approximately 15% to 20% is expected to be allocated to rolling stock, including railcars and locomotive improvements. Approximately 5% is expected to be allocated to information services, and 5% is expected to be allocated to buildings. Other investments is expected to be 5% to 10%. Additional discussion of capital commitments can be found in Item 8. Financial Statements and Supplementary Data, Note 24 Commitments and Contingencies.

Financing Activities

Cash used in financing activities was \$2,297 million in 2022, a change of \$12,233 million, or 123%, from cash provided by financing activities of \$9,936 million in 2021. This change was primarily due to:

- issuance of U.S \$6.7 billion and \$2.2 billion notes (total proceeds of \$10,673 million) along with a U.S. \$500 million (\$633 million) term loan to fund the cash consideration component of the KCS acquisition in 2021;
- principal repayments of \$636 million (U.S. \$500 million) on a term loan in 2022;
- principal repayments of \$125 million of the Company's 5.100% 10-year Medium Term Notes, \$313 million (U.S. \$250 million) of the Company's 4.500% 10-year Notes at maturity in January 2022, and principal repayment of \$97 million (U.S. \$76 million) of the Company's 6.99% Finance lease at maturity in March 2022, compared to principal repayment of \$312 million (U.S \$250 million) of the Company's 9.450% notes in 2021; and
- increased dividend payments of \$200 million in 2022 due to a higher number of shares outstanding resulting from shares issued to fund the share consideration component of the KCS acquisition at the end of 2021.

Credit Measures

Credit ratings provide information relating to the Company's operations and liquidity, and affect the Company's ability to obtain short-term and long-term financing and/or the cost of such financing. The applicable margin that applies to outstanding loans under the Company's revolving credit facility is based on the credit rating assigned to CP's senior unsecured and unsubordinated debt.

If CP's credit ratings were to decline to below investment-grade levels, the Company could experience a significant increase in its interest cost for new debt along with a negative effect on its ability to readily issue new debt.

Credit ratings and outlooks are based on the rating agencies' methodologies and can change from time to time to reflect their views of the Company. Their views are affected by numerous factors including, but not limited to, the Company's financial position and liquidity along with external factors beyond the Company's control.

As at December 31, 2022, the Company's credit ratings from Standard & Poor's Rating Services ("Standard & Poor's") and Moody's Investor Service ("Moody's") remain unchanged from December 31, 2021. The following table shows the ratings issued for CP by the rating agencies noted herein as of December 31, 2022 and is being presented as it relates to the Company's cost of funds and liquidity.

Credit ratings as at December 31, 2022⁽¹⁾

| Long-term debt | | Outlook |
|---------------------------------|-------------|---------|
| <i>Standard & Poor's</i> | BBB+ | stable |
| <i>Moody's</i> | Baa2 | stable |
| Commercial paper program | | |
| <i>Standard & Poor's</i> | A-2 | N/A |
| <i>Moody's</i> | P-2 | N/A |

⁽¹⁾ Credit ratings are not recommendations to purchase, hold, or sell securities and do not address the market price or suitability of a specific security for a particular investor. Credit ratings are based on the rating agencies' methodologies and may be subject to revision or withdrawal at any time by the rating agencies.

Financial Ratios

The Long-term debt to Net income ratio was 5.6 in 2022, compared with 7.1 in 2021. This decrease was due to higher net income for the year ended December 31, 2022 and lower long-term debt.

The Pro-forma Adjusted Net Debt to Pro-forma Adjusted earnings before interest, tax, depreciation, and amortization ("EBITDA") ratio was 3.8 in 2022, compared with 4.0 in 2021. This decrease was primarily due to higher pro-forma adjusted EBITDA for the year ended December 31, 2022. Beginning in the first quarter of 2022, the Company added disclosure of Pro-forma Adjusted Net Debt to Pro-forma Adjusted EBITDA Ratio to better align with the Company's debt covenant calculation, which takes into account the trailing twelve month adjusted EBITDA of KCS as well as KCS's outstanding debt. Please see Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations for further discussion. Over the long term, the Company targets a Pro-forma Adjusted Net debt to Pro-forma Adjusted EBITDA ratio of 2.0 to 2.5.

Although the Company has provided a target Non-GAAP measure (Pro-forma Adjusted Net Debt to Pro-forma Adjusted EBITDA ratio), management is unable to reconcile, without unreasonable efforts, the target Pro-forma Adjusted Net debt to Pro-forma Adjusted EBITDA ratio to the most comparable GAAP measure (Long-term debt to Net income ratio), due to unknown variables and uncertainty related to future results. These unknown variables may include unpredictable transactions of significant value. In recent years, the Company has recognized acquisition-related costs, the merger termination payment received, KCS's gain on unwinding of interest rate hedges (net of CP's associated purchase accounting basis differences and tax), the FX impact of translating the Company's debt and lease liabilities (including borrowings under the credit facility), discrete tax items, changes in the outside basis tax difference between the carrying amount of the Company's equity investment in KCS and its tax basis of the investment, changes in income tax rates, and changes to an uncertain tax item. Acquisition-related costs include legal, consulting, financing fees, integration planning costs consisting of third-party services and system migration, fair value gain or loss on FX forward contracts and interest rate hedges, FX gain on U.S. dollar-denominated cash on hand from the issuances of long-term debt to fund the KCS acquisition, and transaction and integration costs incurred by KCS which were recognized within Equity earnings of Kansas City Southern in the Company's Consolidated Statements of Income. KCS has also recognized significant transaction costs and FX gains and losses. These or other similar, large unforeseen transactions affect Net income but may be excluded from the Company's Pro-forma Adjusted EBITDA. Additionally, the U.S.-to-Canada dollar exchange rate is unpredictable and can have a significant impact on the Company's reported results, but may, along with interest, taxes, and FX impact of translating the Company's debt and lease liabilities, be excluded from Pro-forma Adjusted EBITDA. Please see Forward-Looking Statements in this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations for further discussion.

Supplemental Guarantor Financial Information

Canadian Pacific Railway Company ("CPRC"), a 100%-owned subsidiary of Canadian Pacific Railway Limited ("CPRL"), is the issuer of certain securities which are fully and unconditionally guaranteed by CPRL on an unsecured basis. The other subsidiaries of CPRC do not guarantee the securities and are referred to below as the "Non-Guarantor Subsidiaries". The following is a description of the terms and conditions of the guarantees with respect to securities for which CPRC is the issuer and CPRL provides a full and unconditional guarantee.

As of the date of the filing of the Form 10-K, CPRC had U.S. \$12,050 million principal amount of debt securities outstanding due through 2115, and U.S. \$30 million and GBP £3 million in perpetual 4% consolidated debenture stock, for all of which CPRL is the guarantor subject to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act"), as amended. As of the same date, CPRC also had \$3,300 million principal amount of debt securities issued under Canadian Securities Law due through 2050 for which CPRL is the guarantor and not subject to the Exchange Act.

CPRL fully and unconditionally guarantees the payment of the principal (and premium, if any) and interest on the debt securities and consolidated debenture stock issued by CPRC, any sinking fund or analogous payments payable with respect to such securities, and any additional amounts payable when they become due, whether at maturity or otherwise. The guarantee is CPRL's unsubordinated and unsecured obligation and ranks equally with all of CPRL's other unsecured, unsubordinated obligations.

CPRL will be released and relieved of its obligations under the guarantees after obligations to the holders are satisfied in accordance with the terms of the respective instruments.

Pursuant to Rule 13-01 of the SEC's Regulation S-X, the Company provides summarized financial and non-financial information of CPRC in lieu of providing separate financial statements of CPRC.

More information on the securities under this guarantee structure can be found in Exhibit 22.1 List of Issuers and Guarantor Subsidiaries of this annual report.

Summarized Financial Information

The following tables present summarized financial information for CPRC (Subsidiary Issuer) and CPRL (Parent Guarantor) on a combined basis after elimination of (i) intercompany transactions and balances among CPRC and CPRL; (ii) equity in earnings from and investments in the Non-Guarantor Subsidiaries; and (iii) intercompany dividend income.

Statements of Income

| (in millions of Canadian dollars) | CPRC (Subsidiary Issuer) and CPRL (Parent Guarantor) | |
|-----------------------------------|--|---|
| | For the year ended December 31, 2022 | For the year ended December 31, 2021 |
| Total revenues | \$ 6,384 | \$ 5,924 |
| Total operating expenses | 4,110 | 3,712 |
| Operating income ⁽¹⁾ | 2,274 | 2,212 |
| Less: Other ⁽²⁾ | 234 | (522) |
| Income before income tax expense | 2,040 | 2,734 |
| Net income | \$ 1,533 | \$ 2,548 |

⁽¹⁾ Includes net lease costs incurred from non-guarantor subsidiaries for the year ended December 31, 2022, and 2021 of \$410 million and \$431 million, respectively.

⁽²⁾ Includes Other expense (income), Merger termination fee, Other components of net periodic benefit recovery, and Net interest expense.

Balance Sheets

| (in millions of Canadian dollars) | CPRC (Subsidiary Issuer) and CPRL (Parent Guarantor) | |
|-----------------------------------|--|-------------------------|
| | As at December 31, 2022 | As at December 31, 2021 |
| Assets | | |
| Current assets | \$ 1,395 | \$ 963 |
| Properties | 11,791 | 11,342 |
| Other non-current assets | 3,337 | 2,536 |
| Liabilities | | |
| Current liabilities | \$ 2,759 | \$ 2,789 |
| Long-term debt | 18,137 | 18,574 |
| Other non-current liabilities | 3,178 | 3,008 |

Excluded from the Income Statements and Balance Sheets above are the following significant intercompany transactions and balances that CPRC and CPRL have with the Non-Guarantor Subsidiaries:

Cash Transactions with Non-Guarantor Subsidiaries

| (in millions of Canadian dollars) | CPRC (Subsidiary Issuer) and CPRL (Parent Guarantor) | |
|---|--|---|
| | For the year ended December 31, 2022 | For the year ended December 31, 2021 |
| Dividend income from non-guarantor subsidiaries | \$ 133 | \$ 297 |
| Capital contributions to non-guarantor subsidiaries | — | (134) |
| Return of capital from non-guarantor subsidiaries | 115 | 1,370 |

Balances with Non-Guarantor Subsidiaries

| (in millions of Canadian dollars) | CPRC (Subsidiary Issuer) and CPRL (Parent Guarantor) | |
|-------------------------------------|---|-------------------------|
| | As at December 31, 2022 | As at December 31, 2021 |
| Assets | | |
| Accounts Receivable, intercompany | \$ 186 | \$ 344 |
| Short-term advances to affiliates | 2,209 | 2,859 |
| Long-term advances to affiliates | 7,502 | 7,616 |
| Liabilities | | |
| Accounts payable, intercompany | \$ 199 | \$ 212 |
| Short-term advances from affiliates | 2,649 | 2,777 |
| Long-term advances from affiliates | 88 | 82 |

Share Capital

At February 23, 2023, the latest practicable date prior to the date of this Annual Report on Form 10-K, there were 930,767,959 Common Shares and no preferred shares issued and outstanding, which consisted of 14,837 holders of record of the Common Shares. In addition, the Company has a Management Stock Option Incentive Plan ("MSOIP"), under which key officers and employees are granted options to purchase the Common Shares. Options issued prior to the share split further described in Item 1. Business, Business Developments now each provide rights over five shares. For consistency, all number of options presented herein are shown on the basis of the number of shares subject to the options. On April 27, 2022, at the Annual and Special Meeting, the Company's shareholders approved an amendment to the MSOIP to increase the maximum number of shares available for issuance under the MSOIP, effective at and after April 27, 2022, by 20,000,000 Common Shares. At February 23, 2023, 7,708,866 options were outstanding under the MSOIP and stand-alone option agreements entered into with Mr. Keith Creel. There are 21,883,561 options available to be issued by the Company's MSOIP in the future. The Company also has a Director's Stock Option Plan ("DSOP"), under which directors are granted options to purchase Common Shares. There are no outstanding options under the DSOP, which has 1,700,000 options available to be issued in the future.

Non-GAAP Measures

The Company presents Non-GAAP measures to provide a basis for evaluating underlying earnings and liquidity trends in the Company's business that can be compared with the results of operations in prior periods. In addition, these Non-GAAP measures facilitate a multi-period assessment of long-term profitability, allowing management and other external users of the Company's consolidated financial information to compare profitability on a long-term basis, including assessing future profitability, with that of the Company's peers.

These Non-GAAP measures have no standardized meaning and are not defined by GAAP and, therefore, may not be comparable to similar measures presented by other companies. The presentation of these Non-GAAP measures is not intended to be considered in isolation from, as a substitute for, or as superior to the financial information presented in accordance with GAAP.

Non-GAAP Performance Measures

The Company uses adjusted earnings results including Adjusted income, Adjusted diluted earnings per share, Adjusted operating income, and Adjusted operating ratio to evaluate the Company's operating performance and for planning and forecasting future business operations and future profitability. Core adjusted income and Core adjusted diluted earnings per share are presented to provide financial statement users with additional transparency by isolating for the impact of KCS purchase accounting. KCS purchase accounting represents the amortization of basis differences, being the difference in value between the consideration paid to acquire KCS and the underlying carrying value of the net assets of KCS immediately prior to its acquisition by the Company, net of tax, as recognized within Equity (earnings) loss of Kansas City Southern in the Company's Consolidated Statements of Income. All assets subject to KCS purchase accounting contribute to income generation and will continue to amortize over their estimated useful lives. These Non-GAAP measures are discussed further in other sections of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations. These Non-GAAP measures provide meaningful supplemental information regarding operating results because they exclude certain significant items that are not considered indicative of future financial trends either by nature or amount or provide improved comparability to past performance. As a result, these items are excluded for management's assessment of operational performance, allocation of resources, and preparation of annual budgets. These significant items may include, but are not limited to, restructuring and asset impairment charges, individually significant gains and losses from sales of assets, acquisition-related costs, the merger termination payment received, KCS's gain on unwinding of interest rate hedges (net of CP's associated purchase accounting basis differences and tax), as recognized within Equity (earnings) loss of Kansas City Southern in the Company's Consolidated Statements of Income, the FX impact of translating the Company's debt and lease liabilities (including borrowings under the credit facility), discrete tax

items, changes in the outside basis tax difference between the carrying amount of CP's equity investment in KCS and its tax basis of this investment, changes in income tax rates, changes to an uncertain tax item, and certain items outside the control of management. Acquisition-related costs include legal, consulting, financing fees, integration planning costs consisting of third-party services and system migration, fair value gain or loss on FX forward contracts and interest rate hedges, FX gain on U.S. dollar-denominated cash on hand from the issuances of long-term debt to fund the KCS acquisition, and transaction and integration costs incurred by KCS, net of tax, which were recognized within Equity (earnings) loss of Kansas City Southern in the Company's Consolidated Statements of Income. These items may not be non-recurring. However, excluding these significant items from GAAP results allows for a consistent understanding of the Company's consolidated financial performance when performing a multi-period assessment including assessing the likelihood of future results. Accordingly, these Non-GAAP financial measures may provide insight to investors and other external users of the Company's consolidated financial information.

In 2022, there were five significant items included in Net income as follows:

- in the fourth quarter, a gain of \$212 million due to KCS's gain on unwinding of interest rate hedges (net of CP's associated purchase accounting basis differences and tax) recognized in Equity earnings of KCS that favourably impacted Diluted EPS by 23 cents;
- in the fourth quarter, a deferred tax recovery of \$24 million as a result of a reversal of an uncertain tax item related to a prior period that favourably impacted Diluted EPS by 3 cents;
- in the third quarter, a deferred tax recovery of \$12 million due to a decrease in the Iowa state tax rate that favourably impacted Diluted EPS by 1 cent;
- during the course of the year, a net deferred tax recovery of \$19 million on changes in the outside basis difference of the equity investment in KCS that favourably impacted Diluted EPS by 2 cents as follows:
 - in the fourth quarter, a deferred tax recovery of \$27 million on changes in the outside basis difference of the equity investment in KCS that favourably impacted Diluted EPS by 3 cents;
 - in the third quarter, a deferred tax recovery of \$9 million on changes in the outside basis difference of the equity investment in KCS that favourably impacted Diluted EPS by 1 cent;
 - in the second quarter, a deferred tax expense of \$49 million on changes in the outside basis difference of the equity investment in KCS that unfavourably impacted Diluted EPS by 5 cents; and
 - in the first quarter, a deferred tax recovery of \$32 million on changes in the outside basis difference of the equity investment in KCS that favourably impacted Diluted EPS by 3 cents; and
- during the course of the year, acquisition-related costs of \$123 million in connection with the KCS acquisition (\$108 million after current tax recovery of \$15 million), including costs of \$74 million recognized in Purchased services and other, and \$49 million recognized in Equity earnings of KCS, that unfavourably impacted Diluted EPS by 12 cents as follows:
 - in the fourth quarter, acquisition-related costs of \$27 million (\$16 million after current tax recovery of \$11 million), including costs of \$17 million recognized in Purchased services and other and \$10 million recognized in Equity earnings of KCS, that unfavourably impacted Diluted EPS by 3 cents;
 - in the third quarter, acquisition-related costs of \$30 million (\$33 million after current tax expense of \$3 million), including costs of \$18 million recognized in Purchased services and other and \$12 million recognized in Equity earnings of KCS, that unfavourably impacted Diluted EPS by 3 cents;
 - in the second quarter, acquisition-related costs of \$33 million (\$29 million after current tax recovery of \$4 million), including costs of \$19 million recognized in Purchased services and other and \$14 million recognized in Equity earnings of KCS, that unfavourably impacted Diluted EPS by 3 cents; and
 - in the first quarter, acquisition-related costs of \$33 million (\$30 million after current tax recovery of \$3 million), including costs of \$20 million recognized in Purchased services and other and \$13 million recognized in Equity earnings of KCS, that unfavourably impacted Diluted EPS by 3 cents.

In 2021, there were four significant items included in Net income as follows:

- in the fourth quarter, a deferred tax recovery of \$33 million on changes in the outside basis difference of the equity investment in KCS that favourably impacted Diluted EPS by 5 cents;
- in the second quarter, the merger termination payment received of \$845 million (\$748 million after current taxes) in connection with KCS's termination of the Original Merger Agreement effective May 21, 2021, that favourably impacted Diluted EPS by \$1.11;
- during the course of the year, acquisition-related costs of \$599 million in connection with the KCS acquisition (\$500 million after current tax recovery of \$107 million net of deferred tax expense of \$8 million), including costs of \$183 million recognized in Purchased services and other, \$169 million recognized in Equity loss of KCS, and \$247 million recognized in Other expense (income), that unfavourably impacted Diluted EPS by 75 cents as follows:
 - in the fourth quarter, acquisition-related costs of \$157 million (\$157 million after current tax recovery of \$13 million net of deferred tax expense of \$13 million), including costs of \$36 million recognized in Purchased services and other, \$169 million in Equity loss of KCS, and a \$48 million recovery recognized in Other (income) expense, that unfavourably impacted Diluted EPS by 22 cents;
 - in the third quarter, acquisition-related costs of \$98 million (\$80 million after current tax recovery of \$61 million net of deferred tax expense of \$43 million), including costs of \$15 million recognized in Purchased services and other and \$83 million recognized in Other expense (income), that unfavourably impacted Diluted EPS by 12 cents;

- in the second quarter, acquisition-related costs of \$308 million (\$236 million after current taxes of \$25 million and deferred taxes of \$47 million), including costs of \$99 million recognized in Purchased services and other and \$209 million recognized in Other expense (income), that unfavourably impacted Diluted EPS by 35 cents; and
- in the first quarter, acquisition-related costs of \$36 million (\$27 million after current taxes of \$8 million and deferred taxes of \$1 million), including costs of \$33 million recognized in Purchased services and other and \$3 million recognized in Other expense (income), that unfavourably impacted Diluted EPS by 4 cents; and
- during the course of the year, a net non-cash gain of \$7 million (\$6 million after deferred tax) due to FX translation of debt and lease liabilities that favourably impacted Diluted EPS by 1 cent as follows:
 - in the fourth quarter, a \$32 million loss (\$28 million after deferred tax) that unfavourably impacted Diluted EPS by 4 cents;
 - in the third quarter, a \$46 million loss (\$40 million after deferred tax) that unfavourably impacted Diluted EPS by 6 cents;
 - in the second quarter, a \$52 million gain (\$45 million after deferred tax) that favourably impacted Diluted EPS by 7 cents; and
 - in the first quarter, a \$33 million gain (\$29 million after deferred tax) that favourably impacted Diluted EPS by 4 cents.

In 2020, there were two significant items included in Net income as follows:

- in the fourth quarter, a deferred tax recovery of \$29 million due to a change relating to a tax return filing election for the state of North Dakota that favourably impacted Diluted EPS by 5 cents; and
- during the course of the year, a net non-cash gain of \$14 million (\$12 million after deferred tax) due to FX translation of debt and lease liabilities that favourably impacted Diluted EPS by 2 cents as follows:
 - in the fourth quarter, a \$103 million gain (\$90 million after deferred tax) that favourably impacted Diluted EPS by 13 cents;
 - in the third quarter, a \$40 million gain (\$38 million after deferred tax) that favourably impacted Diluted EPS by 6 cents;
 - in the second quarter, an \$86 million gain (\$82 million after deferred tax) that favourably impacted Diluted EPS by 12 cents; and
 - in the first quarter, a \$215 million loss (\$198 million after deferred tax) that unfavourably impacted Diluted EPS by 28 cents.

In 2019, there were three significant items included in Net income as follows:

- in the fourth quarter, a deferred tax expense of \$24 million as a result of a provision for an uncertain tax item of a prior period that unfavourably impacted Diluted EPS by 3 cents;
- in the second quarter, a deferred tax recovery of \$88 million due to the change in the Alberta provincial corporate income tax rate that favourably impacted Diluted EPS by 13 cents; and
- during the course of the year, a net non-cash gain of \$94 million (\$86 million after deferred tax) due to FX translation of debt and lease liabilities that favourably impacted Diluted EPS by 12 cents as follows:
 - in the fourth quarter, a \$37 million gain (\$32 million after deferred tax) that favourably impacted Diluted EPS by 4 cents;
 - in the third quarter, a \$25 million loss (\$22 million after deferred tax) that unfavourably impacted Diluted EPS by 3 cents;
 - in the second quarter, a \$37 million gain (\$34 million after deferred tax) that favourably impacted Diluted EPS by 4 cents; and
 - in the first quarter, a \$45 million gain (\$42 million after deferred tax) that favourably impacted Diluted EPS by 6 cents.

In 2018, there were two significant items included in Net income as follows:

- in the second quarter, a deferred tax recovery of \$21 million due to reductions in the Missouri and Iowa state tax rates that favourably impacted Diluted EPS by 3 cents; and
- during the course of the year, a net non-cash loss of \$168 million (\$150 million after deferred tax) due to FX translation of debt that unfavourably impacted Diluted EPS by 21 cents as follows:
 - in the fourth quarter, a \$113 million loss (\$103 million after deferred tax) that unfavourably impacted Diluted EPS by 14 cents;
 - in the third quarter, a \$38 million gain (\$33 million after deferred tax) that favourably impacted Diluted EPS by 5 cents;
 - in the second quarter, a \$44 million loss (\$38 million after deferred tax) that unfavourably impacted Diluted EPS by 5 cents; and
 - in the first quarter, a \$49 million loss (\$42 million after deferred tax) that unfavourably impacted Diluted EPS by 6 cents.

Reconciliation of GAAP Performance Measures to Non-GAAP Performance Measures

The following tables reconcile the most directly comparable measures presented in accordance with GAAP to the Non-GAAP measures as discussed further in other sections of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations:

Adjusted income is calculated as Net income reported on a GAAP basis adjusted for significant items. Core adjusted income is calculated as Adjusted income less KCS purchase accounting.

| (in millions of Canadian dollars) | For the year ended December 31 | | | | |
|--|--------------------------------|-----------------|-----------------|-----------------|-----------------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Net income as reported | \$ 3,517 | \$ 2,852 | \$ 2,444 | \$ 2,440 | \$ 1,951 |
| Less significant items (pre-tax): | | | | | |
| KCS net gain on unwind of interest rate hedges | 212 | — | — | — | — |
| Acquisition-related costs | (123) | (599) | — | — | — |
| Merger termination fee | — | 845 | — | — | — |
| Impact of FX translation gain (loss) on debt and lease liabilities | — | 7 | 14 | 94 | (168) |
| Add: | | | | | |
| Tax effect of adjustments ⁽¹⁾ | (15) | (1) | 2 | 8 | (18) |
| Deferred tax recovery on the outside basis difference of the investment in KCS | (19) | (33) | — | — | — |
| Income tax rate changes | (12) | — | (29) | (88) | (21) |
| (Reversal of) provision for uncertain tax item | (24) | — | — | 24 | — |
| Adjusted income | \$ 3,358 | \$ 2,565 | \$ 2,403 | \$ 2,290 | \$ 2,080 |
| Less: KCS purchase accounting | (163) | (8) | — | — | — |
| Core adjusted income | \$ 3,521 | \$ 2,573 | \$ 2,403 | \$ 2,290 | \$ 2,080 |

⁽¹⁾ The tax effect of adjustments was calculated as the pre-tax effect of the adjustments multiplied by the applicable tax rate for the above items of 16.97%, 0.51%, 13.58%, 8.55% and 10.64% for the years presented, respectively. The applicable tax rates reflect the taxable jurisdictions and nature, being on account of capital or income, of the significant items.

Adjusted diluted earnings per share is calculated using Adjusted income, as defined above, divided by the weighted-average diluted number of Common Shares outstanding during the period as determined in accordance with GAAP. Core adjusted diluted earnings per share is calculated as Adjusted diluted earnings per share less KCS purchase accounting.

| | For the year ended December 31 | | | | |
|--|--------------------------------|---------|---------|---------|---------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Diluted earnings per share as reported | \$ 3.77 | \$ 4.18 | \$ 3.59 | \$ 3.50 | \$ 2.72 |
| Less significant items (pre-tax): | | | | | |
| KCS net gain on unwind of interest rate hedges | 0.23 | — | — | — | — |
| Acquisition-related costs | (0.14) | (0.88) | — | — | — |
| Merger termination fee | — | 1.24 | — | — | — |
| Impact of FX translation gain (loss) on debt and lease liabilities | — | 0.01 | 0.02 | 0.13 | (0.23) |
| Add: | | | | | |
| Tax effect of adjustments ⁽¹⁾ | (0.02) | — | — | 0.01 | (0.02) |
| Deferred tax recovery on the outside basis difference of the investment in KCS | (0.02) | (0.05) | — | — | — |
| Income tax rate changes | (0.01) | — | (0.04) | (0.13) | (0.03) |
| (Reversal of) provision for uncertain tax item | (0.03) | — | — | 0.04 | — |
| Adjusted diluted earnings per share | \$ 3.60 | \$ 3.76 | \$ 3.53 | \$ 3.29 | \$ 2.90 |
| Less: KCS purchase accounting | (0.17) | (0.01) | — | — | — |
| Core adjusted diluted earnings per share | \$ 3.77 | \$ 3.77 | \$ 3.53 | \$ 3.29 | \$ 2.90 |

⁽¹⁾ The tax effect of adjustments was calculated as the pre-tax effect of the adjustments multiplied by the applicable tax rate for the above items of 16.97%, 0.51%, 13.58%, 8.55% and 10.64% for the years presented, respectively. The applicable tax rates reflect the taxable jurisdictions and nature, being on account of capital or income, of the significant items.

Adjusted operating income is calculated as Operating income reported on a GAAP basis less significant items.

| (in millions of Canadian dollars) | For the year ended December 31 | | | | |
|-------------------------------------|--------------------------------|----------|----------|----------|----------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Operating income as reported | \$ 3,329 | \$ 3,206 | \$ 3,311 | \$ 3,124 | \$ 2,831 |
| Less significant item: | | | | | |
| Acquisition-related costs | (74) | (183) | — | — | — |
| Adjusted operating income | \$ 3,403 | \$ 3,389 | \$ 3,311 | \$ 3,124 | \$ 2,831 |

Operating ratio is calculated as operating expenses divided by revenues. Adjusted operating ratio excludes those significant items that are reported within Operating income.

| | For the year ended December 31 | | | | |
|------------------------------------|--------------------------------|--------|--------|--------|--------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Operating ratio as reported | 62.2 % | 59.9 % | 57.1 % | 59.9 % | 61.3 % |
| Less significant item: | | | | | |
| Acquisition-related costs | 0.8 | 2.3 | — | — | — |
| Adjusted operating ratio | 61.4 % | 57.6 % | 57.1 % | 59.9 % | 61.3 % |

Adjusted Return on Invested Capital ("Adjusted ROIC")

Return on average shareholders' equity is calculated as Net income divided by average shareholders' equity, averaged between the beginning and ending balance over a trailing twelve month period. Adjusted ROIC is calculated as Adjusted return divided by Adjusted average invested capital. Adjusted return is defined as Net income adjusted for interest expense, tax effected at the Company's adjusted annualized effective tax rate, and significant items in the Company's Consolidated Financial Statements, tax effected at the applicable tax rate. Adjusted average invested capital is defined as the sum of total

Shareholders' equity, Long-term debt, and Long-term debt maturing within one year, as presented in the Company's Consolidated Financial Statements, each averaged between the beginning and ending balance over a trailing twelve month period, adjusted for the impact of significant items, tax effected at the applicable tax rate, on closing balances as part of this average. Adjusted ROIC excludes significant items reported in the Company's Consolidated Financial Statements, as these significant items are not considered indicative of future financial trends either by nature or amount, and excludes interest expense, net of tax, to incorporate returns on the Company's overall capitalization. Adjusted ROIC is a performance measure that measures how productively the Company uses its long-term capital investments, representing critical indicators of good operating and investment decisions made by management, and is an important performance criteria in determining certain elements of the Company's long-term incentive plan. Adjusted ROIC is reconciled below from Return on average shareholders' equity, the most comparable measure calculated in accordance with GAAP.

Calculation of Return on average shareholders' equity

| (in millions of Canadian dollars, except for percentages) | For the year ended December 31 | | | | |
|---|--------------------------------|----------|----------|----------|----------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Net income as reported | \$ 3,517 | \$ 2,852 | \$ 2,444 | \$ 2,440 | \$ 1,951 |
| Average shareholders' equity | 36,358 | 20,574 | 7,194 | 6,853 | 6,537 |
| Return on average shareholders' equity | 9.7% | 13.9% | 34.0% | 35.6% | 29.8% |

Reconciliation of Net Income to Adjusted Return

| (in millions of Canadian dollars) | For the year ended December 31 | | | | |
|--|--------------------------------|----------|----------|----------|----------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Net income as reported | \$ 3,517 | \$ 2,852 | \$ 2,444 | \$ 2,440 | \$ 1,951 |
| Add: | | | | | |
| Net interest expense | 652 | 440 | 458 | 448 | 453 |
| Tax on interest ⁽¹⁾ | (145) | (106) | (113) | (112) | (112) |
| Significant items (pre-tax): | | | | | |
| KCS net gain on unwind of interest rate hedges | (212) | — | — | — | — |
| Acquisition-related costs | 123 | 599 | — | — | — |
| Merger termination fee | — | (845) | — | — | — |
| Impact of FX translation (gain) loss on debt and lease liabilities | — | (7) | (14) | (94) | 168 |
| Tax on significant items ⁽²⁾ | (15) | (1) | 2 | 8 | (18) |
| Deferred tax recovery on the outside basis difference of the investment in KCS | (19) | (33) | — | — | — |
| Income tax rate changes | (12) | — | (29) | (88) | (21) |
| (Reversal of) provision for uncertain tax item | (24) | — | — | 24 | — |
| Adjusted return | \$ 3,865 | \$ 2,899 | \$ 2,748 | \$ 2,626 | \$ 2,421 |

⁽¹⁾ Tax was calculated at the adjusted annualized effective tax rate of 22.24%, 23.85%, 24.61%, 24.96%, and 24.55% for each of the above items for the years presented, respectively.

⁽²⁾ Tax was calculated as the pre-tax effect of the adjustments multiplied by the applicable tax rate of 16.97%, 0.51%, 13.58%, 8.55%, and 10.64% for each of the above items for the years presented, respectively. The applicable tax rates reflect the taxable jurisdictions and nature, being on account of capital or income, of the significant items.

Reconciliation of Average shareholders' equity to Adjusted average invested capital

| (in millions of Canadian dollars) | For the year ended December 31 | | | | |
|--|--------------------------------|-----------|-----------|-----------|-----------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Average shareholders' equity | \$ 36,358 | \$ 20,574 | \$ 7,194 | \$ 6,853 | \$ 6,537 |
| Average long-term debt, including long-term debt maturing within one year | 19,889 | 14,949 | 9,264 | 8,726 | 8,427 |
| | \$ 56,247 | \$ 35,523 | \$ 16,458 | \$ 15,579 | \$ 14,964 |
| Less: | | | | | |
| Significant items (pre-tax): | | | | | |
| KCS net gain on unwind of interest rate hedges | 106 | — | — | — | — |
| Acquisition-related costs | (62) | (300) | — | — | — |
| Merger termination fee | — | 423 | — | — | — |
| Tax on significant items ⁽¹⁾ | 8 | 1 | — | — | — |
| Deferred tax recovery on the outside basis difference of the investment in KCS | 10 | 16 | — | — | — |
| Income tax rate changes | 6 | — | 15 | 44 | 11 |
| (Reversal of) provision for uncertain tax item | 12 | — | — | (12) | — |
| Adjusted average invested capital | \$ 56,167 | \$ 35,383 | \$ 16,443 | \$ 15,547 | \$ 14,953 |

⁽¹⁾ Tax was calculated at the pre-tax effect of the adjustments multiplied by the applicable tax rate of 16.97% and 0.90% for 2022 and 2021, respectively. The applicable tax rate reflects the taxable jurisdictions and nature, being on account of capital or income, of the significant items.

Calculation of Adjusted ROIC

| (in millions of Canadian dollars, except for percentages) | For the year ended December 31 | | | | |
|---|--------------------------------|----------|----------|----------|----------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Adjusted return | \$ 3,865 | \$ 2,899 | \$ 2,748 | \$ 2,626 | \$ 2,421 |
| Adjusted average invested capital | 56,167 | 35,383 | 16,443 | 15,547 | 14,953 |
| Adjusted ROIC | 6.9% | 8.2% | 16.7% | 16.9% | 16.2% |

Free Cash

Free cash is calculated as Cash provided by operating activities, less Cash used in investing activities, adjusted for changes in Cash and cash equivalents balances resulting from FX fluctuations, cash settlement of hedges settled upon issuance of debt, the operating cash flow impacts of acquisition-related costs associated with the KCS transaction including settlement of cash flow hedges upon debt issuance and FX gain on U.S. dollar-denominated cash held to fund the KCS acquisition, the merger termination payment received related to KCS's termination of the Original Merger Agreement, and the acquisitions of KCS, Central Maine & Québec Railway ("CMQ"), and Detroit River Tunnel Partnership ("DRTP"). Free cash is a measure that management considers to be a valuable indicator of liquidity. Free cash is useful to investors and other external users of the Company's Consolidated Financial Statements as it assists with the evaluation of the Company's ability to generate cash to satisfy debt obligations and discretionary activities such as dividends, share repurchase programs, and other strategic opportunities, and is an important performance criteria in determining certain elements of the Company's long-term incentive plan. The cash settlement of forward starting swaps that occurred in conjunction with the issuance of long-term debt, the acquisition-related costs associated with the KCS acquisition, and the merger termination payment received related to KCS's termination of the Original Merger Agreement are not indicative of operating trends and have been excluded from Free cash. Similarly, the acquisitions of KCS, CMQ, and DRTP are not indicative of investment trends and have also been excluded from Free cash. Free cash should be considered in addition to, rather than as a substitute for, Cash provided by operating activities.

Reconciliation of Cash Provided by Operating Activities to Free Cash

| (in millions of Canadian dollars) | For the year ended December 31 | | | | |
|--|--------------------------------|----------|----------|----------|----------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Cash provided by operating activities | \$ 4,142 | \$ 3,688 | \$ 2,802 | \$ 2,990 | \$ 2,712 |
| Cash used in investing activities | (1,496) | (13,730) | (2,030) | (1,803) | (1,458) |
| Effect of foreign currency fluctuations on U.S. dollar-denominated cash and cash equivalents | 20 | 41 | 6 | (4) | 11 |
| Less: | | | | | |
| Settlement of forward starting swaps on debt issuance | — | — | — | — | (24) |
| Acquisition-related costs ⁽¹⁾ | (67) | (340) | — | — | — |
| Merger termination fee | — | 845 | — | — | — |
| Investment in Kansas City Southern | — | (12,299) | — | — | — |
| Investment in Central Maine & Québec Railway | — | — | 19 | (174) | — |
| Investment in Detroit River Tunnel Partnership | — | — | (398) | — | — |
| Free cash | \$ 2,733 | \$ 1,793 | \$ 1,157 | \$ 1,357 | \$ 1,289 |

⁽¹⁾ Including settlement of cash flow hedges upon debt issuance of \$226 million for the year ended December 31, 2021.

Foreign Exchange Adjusted % Change

FX adjusted % change allows certain financial results to be viewed without the impact of fluctuations in foreign currency exchange rates, thereby facilitating period-to-period comparisons in the analysis of trends in business performance. Financial result variances at constant currency are obtained by translating the comparable period of the prior year results denominated in U.S. dollars at the foreign exchange rates of the current period.

FX adjusted % changes in revenues are further used in calculating FX adjusted % change in freight revenue per carload and RTM.

| (in millions of Canadian dollars) | Reported 2022 | Reported 2021 | 2022 vs. 2021 | | |
|---|---------------|---------------|--------------------|------------------|----------------------|
| | | | Variance due to FX | FX Adjusted 2021 | FX Adjusted % Change |
| Freight revenues by line of business | | | | | |
| Grain | \$ 1,776 | \$ 1,684 | \$ 34 | \$ 1,718 | 3 |
| Coal | 577 | 625 | 3 | 628 | (8) |
| Potash | 581 | 463 | 9 | 472 | 23 |
| Fertilizers and sulphur | 332 | 305 | 9 | 314 | 6 |
| Forest products | 403 | 348 | 12 | 360 | 12 |
| Energy, chemicals and plastics | 1,394 | 1,563 | 31 | 1,594 | (13) |
| Metals, minerals, and consumer products | 884 | 728 | 22 | 750 | 18 |
| Automotive | 438 | 376 | 9 | 385 | 14 |
| Intermodal | 2,242 | 1,724 | 13 | 1,737 | 29 |
| Freight revenues | 8,627 | 7,816 | 142 | 7,958 | 8 |
| Non-freight revenues | 187 | 179 | 1 | 180 | 4 |
| Total revenues | \$ 8,814 | \$ 7,995 | \$ 143 | \$ 8,138 | 8 |

FX adjusted % changes in operating expenses are discussed in Operating Expenses of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

| (in millions of Canadian dollars) | Reported 2022 | Reported 2021 | 2022 vs. 2021 | | |
|-----------------------------------|-----------------|-----------------|--------------------|------------------|----------------------|
| | | | Variance due to FX | FX Adjusted 2021 | FX Adjusted % Change |
| Compensation and benefits | \$ 1,570 | \$ 1,570 | \$ 18 | \$ 1,588 | (1) |
| Fuel | 1,400 | 854 | 27 | 881 | 59 |
| Materials | 260 | 215 | 2 | 217 | 20 |
| Equipment rents | 140 | 121 | 3 | 124 | 13 |
| Depreciation and amortization | 853 | 811 | 8 | 819 | 4 |
| Purchased services and other | 1,262 | 1,218 | 13 | 1,231 | 3 |
| Total operating expenses | \$ 5,485 | \$ 4,789 | \$ 71 | \$ 4,860 | 13 |

Dividend Payout Ratio and Core Adjusted Dividend Payout Ratio

Dividend payout ratio is calculated as dividends declared per share divided by Diluted EPS. Core adjusted dividend payout ratio is calculated as dividends declared per share divided by Core adjusted diluted EPS, as defined above. This ratio is a measure of shareholder return and provides information on the Company's ability to declare dividends on an ongoing basis, excluding significant items and the impact of KCS purchase accounting.

Starting in 2022, Core adjusted dividend payout ratio is presented to provide users with additional transparency by isolating for the impact of KCS purchase accounting.

Calculation of Dividend Payout Ratio

| (in Canadian dollars, except for percentages) | For the year ended December 31 | | | | |
|---|--------------------------------|-----------|-----------|-----------|-----------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Dividends declared per share | \$ 0.7600 | \$ 0.7600 | \$ 0.7120 | \$ 0.6280 | \$ 0.5025 |
| Diluted EPS | 3.77 | 4.18 | 3.59 | 3.50 | 2.72 |
| Dividend payout ratio | 20.2% | 18.2% | 19.8% | 17.9% | 18.5% |

Calculation of Core Adjusted Dividend Payout Ratio

| (in Canadian dollars, except for percentages) | For the year ended December 31 | | | | |
|---|--------------------------------|-----------|-----------|-----------|-----------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| Dividends declared per share | \$ 0.7600 | \$ 0.7600 | \$ 0.7120 | \$ 0.6280 | \$ 0.5025 |
| Core adjusted diluted EPS | 3.77 | 3.77 | 3.53 | 3.29 | 2.90 |
| Core adjusted dividend payout ratio | 20.2% | 20.2% | 20.1% | 19.1% | 17.3% |

Adjusted Net Debt to Adjusted EBITDA Ratio and Pro-forma adjusted Net Debt to Pro-forma adjusted EBITDA Ratio

Adjusted net debt to Adjusted earnings before interest, tax, depreciation and amortization ("EBITDA") ratio is calculated as Adjusted net debt divided by Adjusted EBITDA. The Adjusted net debt to Adjusted EBITDA ratio is a key credit measure used to assess the Company's financial capacity. The ratio provides information on the Company's ability to service its debt and other long-term obligations from operations, excluding significant items, and is an important performance criteria in determining certain elements of the Company's long-term incentive plan. The Adjusted net debt to Adjusted EBITDA ratio is reconciled below from the Long-term debt to Net income ratio, the most comparable measure calculated in accordance with GAAP.

Beginning in the first quarter of 2022, CP added disclosure of Pro-forma adjusted net debt to Pro-forma adjusted EBITDA ratio to better align with CP's debt covenant calculation, which incorporates the trailing twelve month adjusted EBITDA of KCS as well as KCS's outstanding debt. CP is incorporating the trailing twelve month adjusted EBITDA of KCS on a pro-forma basis, as CP is not entitled to earnings prior to the acquisition date of December 14, 2021. CP does not control KCS while it is in the voting trust during review of our merger application by the STB, though CP is the beneficial owner of

KCS's outstanding shares and receives cash dividends from KCS. The adjustment to include the trailing twelve month EBITDA and KCS's outstanding debt provides users of the financial statements with better insight into CP's progress in achieving deleveraging commitments. KCS's disclosed U.S. dollar financial values for the years ended December 31, 2022, and December 31, 2021, were adjusted to Canadian dollars reflecting the FX rate for the appropriate period presented, respectively. The Pro-forma adjusted Net Debt to Pro-forma adjusted EBITDA ratio is discussed further in Liquidity and Capital Resources of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Calculation of Long-term Debt to Net Income Ratio

Long-term debt to Net income ratio is calculated as long-term debt, including long-term debt maturing within one year, divided by Net income.

| (in millions of Canadian dollars, except for ratios) | 2022 | 2021 | 2020 | 2019 | 2018 |
|--|------------|------------|------------|------------|------------|
| Long-term debt including long-term debt maturing within one year as at December 31 | \$ 19,651 | \$ 20,127 | \$ 9,771 | \$ 8,757 | \$ 8,696 |
| Net income for the year ended December 31 | 3,517 | 2,852 | 2,444 | 2,440 | 1,951 |
| Long-term debt to Net income ratio | 5.6 | 7.1 | 4.0 | 3.6 | 4.5 |

Reconciliation of Long-term Debt to Adjusted Net Debt and Pro-forma Adjusted Net Debt

Adjusted net debt is defined as Long-term debt, Long-term debt maturing within one year and Short-term borrowing as reported on the Company's Consolidated Balance Sheets adjusted for pension plans deficit, operating lease liabilities recognized on the Company's Consolidated Balance Sheets, and Cash and cash equivalents. Adjusted net debt is used as a measure of debt and long-term obligations as part of the calculation of Adjusted Net Debt to Adjusted EBITDA.

| (in millions of Canadian dollars) ⁽¹⁾ | 2022 | 2021 | 2020 | 2019 | 2018 |
|---|------------------|------------------|------------------|-----------------|-----------------|
| CP long-term debt including long-term debt maturing within one year as at December 31 | \$ 19,651 | \$ 20,127 | \$ 9,771 | \$ 8,757 | \$ 8,696 |
| Add: | | | | | |
| Pension plans deficit ⁽²⁾ | 175 | 263 | 328 | 294 | 266 |
| Operating lease liabilities | 270 | 283 | 311 | 354 | 387 |
| Less: | | | | | |
| Cash and cash equivalents | 451 | 69 | 147 | 133 | 61 |
| CP Adjusted net debt as at December 31 | \$ 19,645 | \$ 20,604 | \$ 10,263 | \$ 9,272 | \$ 9,288 |
| KCS's long-term debt including long-term debt maturing within one year as at December 31 | \$ 5,119 | \$ 4,789 | N/A | N/A | N/A |
| Add: | | | | | |
| KCS operating lease liabilities | 136 | 87 | N/A | N/A | N/A |
| Less: | | | | | |
| KCS cash and cash equivalents | 281 | 430 | N/A | N/A | N/A |
| KCS Adjusted net debt as at December 31 | 4,974 | 4,446 | N/A | N/A | N/A |
| CP Adjusted net debt as at December 31 | 19,645 | 20,604 | N/A | N/A | N/A |
| Pro-forma Adjusted net debt as at December 31 | \$ 24,619 | \$ 25,050 | N/A | N/A | N/A |

⁽¹⁾ KCS's amounts were translated at the period end FX rate of \$1.35 and \$1.27 for the years ended December 31, 2022 and 2021, respectively.

⁽²⁾ Pension plans deficit is the total funded status of the Pension plans in deficit only.

Reconciliation of Net Income to EBIT, Adjusted EBIT and Adjusted EBITDA and Pro-forma Adjusted EBITDA

Earnings before interest and tax ("EBIT") is calculated as Net income before Net interest expense and Income tax expense. Adjusted EBIT excludes significant items reported in both Operating income and Other expense (income). Adjusted EBITDA is calculated as Adjusted EBIT plus operating lease expense and Depreciation and amortization, less Other components of net periodic benefit recovery. Adjusted EBITDA is used as a measure of liquidity derived from operations, excluding significant items, as part of the calculation of Adjusted Net Debt to Adjusted EBITDA.

| (in millions of Canadian dollars) ⁽¹⁾ | For the year ended December 31 | | | | |
|--|--------------------------------|----------|----------|----------|----------|
| | 2022 | 2021 | 2020 | 2019 | 2018 |
| CP Net income as reported | \$ 3,517 | \$ 2,852 | \$ 2,444 | \$ 2,440 | \$ 1,951 |
| Add: | | | | | |
| Net interest expense | 652 | 440 | 458 | 448 | 453 |
| Income tax expense | 628 | 768 | 758 | 706 | 637 |
| EBIT | 4,797 | 4,060 | 3,660 | 3,594 | 3,041 |
| Less significant items (pre-tax): | | | | | |
| KCS net gain on unwind of interest rate hedges | 212 | — | — | — | — |
| Acquisition-related costs | (123) | (599) | — | — | — |
| Merger termination fee | — | 845 | — | — | — |
| Impact of FX translation gain (loss) on debt and lease liabilities | — | 7 | 14 | 94 | (168) |
| Adjusted EBIT | 4,708 | 3,807 | 3,646 | 3,500 | 3,209 |
| Add: | | | | | |
| Operating lease expense | 75 | 72 | 78 | 83 | 97 |
| Depreciation and amortization | 853 | 811 | 779 | 706 | 696 |
| Less: | | | | | |
| Other components of net periodic benefit recovery | 411 | 387 | 342 | 381 | 384 |
| CP Adjusted EBITDA | \$ 5,225 | \$ 4,303 | \$ 4,161 | \$ 3,908 | \$ 3,618 |
| Net income attributable to KCS and subsidiaries | \$ 1,290 | \$ 675 | N/A | N/A | N/A |
| Add: | | | | | |
| KCS interest expense | 204 | 196 | N/A | N/A | N/A |
| KCS income tax expense | 426 | 269 | N/A | N/A | N/A |
| KCS EBIT | 1,920 | 1,140 | N/A | N/A | N/A |
| Less significant items (pre-tax): | | | | | |
| KCS merger costs | (60) | (310) | N/A | N/A | N/A |
| KCS gain on settlement of treasury lock agreements | 352 | — | N/A | N/A | N/A |
| KCS Adjusted EBIT | 1,628 | 1,450 | N/A | N/A | N/A |
| Add: | | | | | |
| KCS total lease cost | 43 | 40 | N/A | N/A | N/A |
| KCS depreciation and amortization | 509 | 459 | N/A | N/A | N/A |
| KCS Adjusted EBITDA | \$ 2,180 | \$ 1,949 | N/A | N/A | N/A |
| CP Adjusted EBITDA | \$ 5,225 | \$ 4,303 | N/A | N/A | N/A |
| Less: | | | | | |
| Equity earnings (loss) of KCS ⁽²⁾ | 1,074 | (141) | N/A | N/A | N/A |
| Acquisition-related costs of KCS ⁽³⁾ | 49 | 169 | N/A | N/A | N/A |
| KCS net gain on unwind of interest rate hedges ⁽⁴⁾ | (212) | — | N/A | N/A | N/A |
| Pro-forma Adjusted EBITDA | \$ 6,494 | \$ 6,224 | N/A | N/A | N/A |

⁽¹⁾ KCS's amounts were translated at the quarterly average FX rate of \$1.36, \$1.30, \$1.28, and \$1.27 for Q4 2022, Q3 2022, Q2 2022 and Q1 2022 and \$1.26, \$1.26, \$1.23, and \$1.27 for Q4 2021, Q3 2021, Q2 2021, and Q1 2021, respectively.

⁽²⁾ Equity earnings (loss) of KCS were part of CP's reported net income and therefore have been deducted in arriving to the Pro-forma Adjusted EBITDA.

⁽³⁾ Acquisition-related costs of KCS have been adjusted in CP's Adjusted EBITDA calculation above, therefore have been deducted in arriving to the Pro-forma Adjusted EBITDA.

⁽⁴⁾ KCS net gain on unwind of interest rate hedges has been adjusted in CP's Adjusted EBITDA calculation above and therefore has been added back in arriving to the Pro-forma Adjusted EBITDA.

Calculation of Adjusted Net Debt to Adjusted EBITDA Ratio and Pro-forma Adjusted Net Debt to Pro-forma Adjusted EBITDA Ratio

| (in millions of Canadian dollars, except for ratios) | 2022 | 2021 | 2020 | 2019 | 2018 |
|--|------------|-----------|-----------|----------|----------|
| Adjusted net debt as at December 31 | \$ 19,645 | \$ 20,604 | \$ 10,263 | \$ 9,272 | \$ 9,288 |
| Adjusted EBITDA for the year ended December 31 | 5,225 | 4,303 | 4,161 | 3,908 | 3,618 |
| Adjusted net debt to Adjusted EBITDA ratio | 3.8 | 4.8 | 2.5 | 2.4 | 2.6 |

| (in millions of Canadian dollars, except for ratios) | 2022 | 2021 | 2020 | 2019 | 2018 |
|---|------------|-----------|------|------|------|
| Pro-forma adjusted net debt as at December 31 | \$ 24,619 | \$ 25,050 | N/A | N/A | N/A |
| Pro-forma adjusted EBITDA for the year ended December 31 | 6,494 | 6,224 | N/A | N/A | N/A |
| Pro-forma adjusted net debt to Pro-forma adjusted EBITDA ratio | 3.8 | 4.0 | N/A | N/A | N/A |

Critical Accounting Estimates

To prepare the Consolidated Financial Statements that conform with GAAP, the Company is required 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 Consolidated Financial Statements and the reported amounts of revenues and expenses during the reported periods. Using the most current information available, the Company reviews estimates on an ongoing basis.

The development, selection and disclosure of these estimates, and this Management's Discussion and Analysis of Financial Condition and Results of Operations, have been reviewed by the Board of Directors' Audit and Finance Committee, which is composed entirely of independent directors.

Environmental Liabilities

Environmental remediation accruals cover site-specific remediation programs. The Company's estimates of the probable costs to be incurred in the remediation of properties contaminated by past activities reflect the nature of contamination at individual sites according to typical activities and scale of operations conducted. The Company screens and classifies sites according to typical activities and scale of operations conducted. The Company has developed remediation strategies for each property based on the nature and extent of the contamination, as well as the location of the property and surrounding areas that may be adversely affected by the presence of contaminants. The Company also considers available technologies, treatment and disposal facilities and the acceptability of site-specific plans based on the local regulatory environment. Site-specific plans range from containment and risk management of the contaminants through to the removal and treatment of the contaminants and affected soils and groundwater. The details of the estimates reflect the environmental liability at each property. The Company is committed to fully meeting regulatory and legal obligations with respect to environmental matters.

Some sites include remediation activities that are projected beyond the 10-year period, which the Company is unable to reasonably estimate and determine. Therefore, the Company's accruals of the environmental liabilities are based on an estimate of costs for a rolling 10-year period covered by the environmental program. Payments are expected to be made over 10 years to 2032.

As of December 31, 2022 and 2021 the Company's provision for specific environmental sites including discounting was \$83 million and \$79 million respectively.

Provisions for environmental remediation costs are recorded in "Other long-term liabilities" (refer to Item 8. Financial Statements and Supplementary Data, Note 17 Other long-term liabilities), except for the current portion which is recorded in "Accounts payable and accrued liabilities" (refer to Item 8. Financial Statements and Supplementary Data, Note 14 Accounts payable and accrued liabilities). The accruals for environmental remediation represent the Company's best estimate of its probable future obligations and include both asserted and unasserted claims, without reduction for anticipated recoveries from third parties. Although the recorded accruals include the Company's best estimate of all probable costs, the Company's total environmental remediation costs cannot be predicted with certainty. Accruals for environmental remediation may change from time to time as new information about previously untested sites becomes known, environmental laws and regulations evolve and advances are made in environmental remediation technology. The accruals may also vary as the courts decide legal proceedings against outside parties responsible for contamination. These potential charges, which cannot be quantified at this time, are not expected to be material to the Company's financial position, but may materially affect income in the period in which a charge is recognized.

The environmental liabilities are also sensitive to the increase in cost of materials which would be reflected as increases to "Other long-term liabilities" and "Accounts payable and accrued liabilities" on the Company's Consolidated Balance Sheets and to "Purchased services and other" within Operating expenses on the Company's Consolidated Statements of Income. The Company's cash payments for environmental initiatives were \$10 million in 2021, \$8 million in 2022 and are estimated to be approximately \$12 million in 2023, \$11 million in 2024, \$10 million in 2025 and a total of approximately \$53 million over the remaining years through 2032. All payments will be funded from general operations.

Pensions and Other Benefits

The Company has defined benefit and defined contribution pension plans. Other benefits include post-retirement medical and life insurance for pensioners, and some post-employment workers' compensation and long-term disability benefits in Canada. Workers' compensation and long-term disability benefits are discussed in the Personal Injury and Other Claims Liabilities section below.

The obligations and costs for pensions and other benefits are based on the discounted present value of future benefits. The underlying benefits are paid over many years and are estimated based on uncertain demographic and economic assumptions. As a result, the obligations and costs themselves involve a significant amount of estimation uncertainty.

Information concerning the measurement of obligations and costs for pensions and other benefits is discussed in Item 8. Financial Statements and Supplementary Data, Note 1 Summary of significant accounting policies, and Note 21 Pensions and other benefits.

Net Periodic Benefit Costs

The Company estimates net periodic benefit recoveries for defined benefit pensions to be approximately \$293 million in 2023 (\$70 million in current service cost and \$363 million in other components of net periodic benefit recovery), and net periodic benefit costs for defined contribution pensions to be approximately \$13 million in 2023. Net periodic benefit costs for post-retirement benefits in 2023 are not expected to differ materially from the 2022 costs. Total net periodic benefit recoveries for all plans are estimated to be approximately \$250 million in 2023 (2022 – \$240 million), comprising \$92 million (2022 – \$171 million) in current service cost and \$342 million (2022 – \$411 million) in other components of net periodic benefit recovery.

Pension Plan Contributions

The Company estimates its aggregate pension contributions, including its defined benefit and defined contribution plans, to be in the range of \$25 million to \$35 million in 2023, and in the range of \$25 million to \$50 million per year from 2024 to 2026.

The Company's main Canadian defined benefit pension plan accounts for nearly all of the Company's pension obligation and can produce significant volatility in pension funding requirements, given the pension fund's size, the many factors that drive the pension plan's funded status, and Canadian statutory pension funding requirements. The Company made voluntary prepayments totaling \$1,750 million between 2009 and 2011 to the Company's main Canadian defined benefit pension plan. The Company has applied \$1,324 million of these voluntary prepayments to reduce its pension funding requirements in 2012–2022, leaving \$426 million of the voluntary prepayments still available at December 31, 2022, to reduce the Company's pension funding requirements in 2023 and future years. The Company continues to have significant flexibility with respect to the rate at which the remaining voluntary prepayments are applied to reduce future years' pension contribution requirements, which allows the Company to manage the volatility of future pension funding requirements. At this time, the Company estimates it will not apply any of the remaining voluntary prepayments against its 2023 pension funding requirements.

Future pension contributions will be highly dependent on the Company's actual experience with respect to variables such as investment returns, interest rate fluctuations, and demographic changes, on the rate at which previous years' voluntary prepayments are applied against pension contribution requirements, and on any changes in the regulatory environment. The Company will continue to make contributions to the pension plans that, at a minimum, meet pension legislative requirements.

Pension Plan Risks

Fluctuations in the obligations and net periodic benefit costs for pensions result from favourable or unfavourable investment returns, changes to the outlook for future investment returns, and changes in long-term interest rates. The impact of favourable or unfavourable investment returns is moderated by the use of a market-related asset value for the main Canadian defined benefit pension plan's public equity securities and absolute return strategies. The impact of changes in long-term interest rates on pension obligations is partially offset by their impact on the pension plans' investments in fixed income assets.

The plans' investment policy provides a target allocation of approximately 45% of the plans' assets to be invested in public equity securities. As a result, stock market performance is a key driver in determining the pension plans' asset performance. If the rate of investment return on the plans' public equity securities in 2022 had been 10% higher (or lower) than the actual 2022 rate of investment return on such securities, 2023 net periodic benefit costs for pensions would be lower (or higher) by approximately \$21 million.

For computing the net periodic benefit recovery in 2023, the Company is continuing to use an expected rate of return on the market-related asset value of 6.90% to reflect the Company's current view of future long-term investment returns. Changes to the outlook for future long-term investment returns can result in changes to the expected rate of return on the market-related asset value. If the expected rate of return as at December 31, 2022 had been higher (or lower) by 0.1%, 2023 net periodic benefit recoveries for pensions would be higher (or lower) by approximately \$13 million.

Changes in bond yields can result in changes to discount rates and to the value of fixed income assets. If the discount rate as at December 31, 2022 had been higher (or lower) by 0.1% with no related changes in the value of the pension plans' investments in fixed income assets, 2023 net periodic benefit recoveries for pensions would be higher (or lower) by approximately \$8 million and 2023 current service costs for pensions would be lower (or higher) by approximately \$3 million. However, a change in bond yields would also lead to a change in the value of the pension funds' investments in fixed income assets, and this change would partially offset the impact on net periodic benefit costs noted above.

The Company estimates that an increase in the discount rate of 0.1% would decrease the defined benefit pension plans' projected benefit obligations by approximately \$112 million, and that a decrease in the discount rate of 0.1% would increase the defined benefit pension plans' projected benefit obligations by approximately \$115 million. Similarly, for every 0.1% that the actual return on assets varies above (or below) the estimated return for the year, the value of the defined benefit pension plans' assets would increase (or decrease) by approximately \$13 million.

Adverse experience with respect to these factors could eventually increase funding and pension expense significantly, while favourable experience with respect to these factors could eventually decrease funding and pension expense significantly.

Fluctuations in the post-retirement benefit obligation also can result from changes in the discount rate used. A 0.1% increase (decrease) in the discount rate would decrease (increase) the obligation by approximately \$3 million.

The Company reviews its pensioner mortality experience to ensure that the mortality assumption continues to be appropriate, or to determine what changes to the assumption are needed.

Property, Plant and Equipment

The Company follows the group depreciation method under which a single depreciation rate is applied to the total cost in a particular class of property, despite differences in the service life or salvage value of individual properties within the same class. The Company performs depreciation studies of each property asset class approximately every three years to update depreciation rates. The studies are conducted with assistance from third-party specialists and analyzed and reviewed by the Company's management. Depreciation studies for U.S. assets are reviewed and approved by the STB. Depreciation studies for Canadian assets are provided to the Canadian Transportation Agency (the "Agency"), but the Agency does not approve depreciation rates. In determining appropriate depreciation rates, management is required to make judgments and assumptions about a variety of key factors that are subject to future variability due to inherent uncertainties. These include the following:

| Key Assumptions | Assessments |
|---|---|
| <ul style="list-style-type: none"> Whole and remaining asset lives | <ul style="list-style-type: none"> Statistical analysis of historical retirement patterns; Evaluation of management strategy and its impact on operations and the future use of specific property assets; Assessment of technological advances; Engineering estimates of changes in current operations and analysis of historic, current, and projected future usage; Additional factors considered for track assets: density of traffic and whether rail is new or has been re-laid in a subsequent position; Assessment of policies and practices for the management of assets including maintenance; and Comparison with industry data. |
| <ul style="list-style-type: none"> Salvage values | <ul style="list-style-type: none"> Analysis of historical, current, and estimated future salvage values. |

The estimates of economic lives are uncertain and can vary due to changes in any of the assessed factors noted in the table above for whole and remaining asset lives. Additionally, the depreciation rates are updated to reflect the change in residual values of the assets in the class.

It is anticipated that there will be changes in the estimates of weighted-average useful lives and net salvage for each property asset class as assets are acquired, used, and retired. Substantial changes in either the useful lives of properties or the salvage assumptions could result in significant changes to depreciation expense. For example, if the estimated average life of track assets, including rail, ties, ballast, and other track material, increased (or decreased) by one year, annual depreciation expense would decrease (or increase) by approximately \$19 million.

Due to the capital intensive nature of the railway industry, depreciation represents a significant part of operating expenses. The estimated useful lives of properties have a direct impact on the amount of depreciation recorded as a component of "Properties" on the Company's Consolidated Balance Sheets.

Deferred Income Taxes

The Company accounts for deferred income taxes based on the liability method. This method focuses on the Company's balance sheet and the temporary differences otherwise calculated from the comparison of book versus tax values. The provision for deferred income taxes arises from temporary differences in the carrying values of assets and liabilities for financial statement and income tax purposes and the effect of loss carryforwards. The provision amount is sensitive to any changes in book and tax values and changes to statutory tax rates. For example, a change in temporary differences of \$10 million would result in an approximate deferred income tax change of \$3 million. It is assumed that such temporary differences will be settled in the deferred income tax assets and liabilities at the balance sheet date.

In determining deferred income taxes, the Company makes estimates and assumptions regarding deferred tax matters, including estimating the timing of the realization and settlement of deferred income tax assets (including the benefit of tax losses) and liabilities, and estimating unrecognized tax benefits for uncertain tax positions. Deferred income taxes are calculated using enacted federal, provincial, and state future income tax rates, which may differ in future periods.

Deferred income tax expense is included in "Income tax expense" on the Company's Consolidated Statements of Income. At December 31, 2022 and 2021, deferred income tax expense was \$136 million and \$242 million, respectively. Management does anticipate the total net deferred tax liabilities will change significantly within the next 12 months as a result of the pending business combination with KCS, subject to STB approval. A future fair value remeasurement of the carrying value of the Company's investment in KCS would result in a change in the deferred tax liability recognized in the Company's income statement. Upon the Company obtaining control, the entire deferred tax liability of \$7.5 billion at December 31, 2022, reflecting the outside basis of the investment in KCS, would be reversed through deferred tax expense in the Company's income statement. Under a business combination, the Company would allocate the purchase price to the individual assets and liabilities assumed, and goodwill would be recognized. A deferred tax liability would be recognized on an inside basis based on the liability method described above with a resultant offsetting increase in goodwill. Additional disclosures are provided in Item 8. Financial Statements and Supplementary Data, Note 5 Income taxes.

Personal Injury and Other Claims Liabilities

The Company estimates the potential liability arising from incidents, claims and pending litigations relating to personal injury claims by employees, third-party claims, certain occupation-related claims, and property damage claims.

Personal Injury

In Canada, employee occupational injuries are governed by provincial workers' compensation legislation. Occupational injury claims in the provinces of Québec, Ontario, Manitoba, and B.C. are self-insured and administered through each Worker's Compensation Board ("WCB"). The future costs related to occupation-related injuries are actuarially determined based on past experience and assumptions associated with the injury, compensation, income replacement, health care, and administrative costs. In the four provinces where the Company is self-insured, a discount rate is applied to the future estimated costs based on market rates for investment-grade corporate bonds to determine the liability. An actuarial study is performed on an annual basis. In the provinces of Saskatchewan and Alberta, the Company is assessed an annual WCB contribution on a premium basis and this amount is not subject to estimation by management. Changes to these assumptions could have a material adverse impact to the Company's results of operations, financial position and liquidity. At December 31, 2022 and 2021, respectively, the WCB liability was \$74 million and \$77 million in "Pension and other benefit liabilities"; \$11 million and \$11 million in "Accounts payable and accrued liabilities", offset by deposits paid to WCB of \$1 million and \$1 million in "Other assets" on the Company's Consolidated Balance Sheets.

Fluctuations in WCB can result from changes in the discount rate used. A 0.1% increase (decrease) in the discount rate would decrease (increase) the obligation by approximately \$1 million.

U.S. railway employees are covered by federal law under the Federal Employers' Liability Act ("FELA") rather than workers' compensation programs. Accruals are set for individual cases based on facts, legal opinion and statistical analysis. U.S. accruals are also set and include alleged occupational exposure or injury.

Other Claims

A provision for litigation matters, equipment damages or other claims will be accrued according to applicable accounting standards and any such accrual will be based on an ongoing assessment of the strengths and weaknesses of the litigation or claim and its likelihood of success, together with an evaluation of the damages or other monetary relief sought. The Company accrues for probable claims when the facts of an incident become known and investigation results provide a reasonable basis for estimating the liability. The lower end of the range is accrued if the facts and circumstances permit only a range of reasonable estimates and no single amount in that range is a better estimate than any other. Facts and circumstances related to asserted claims can change, and a process is in place to monitor accruals for changes in accounting estimates. The final outcome with respect to actions

outstanding or pending at December 31, 2022, or with respect to future claims cannot be predicted with certainty. Material changes to litigation trends, equipment damages, or other claims could have a material adverse impact to the Company's results of operations, financial position, and liquidity.

Forward-Looking Statements

This Management's Discussion and Analysis of Financial Condition and Results of Operations and Annual Report on Form 10-K contains certain forward-looking statements within the meaning of the *United States Private Securities Litigation Reform Act of 1995* and forward-looking information within the meaning of other relevant securities legislation, including applicable securities laws in Canada (collectively referred to herein as "forward-looking statements"). Forward-looking statements typically include words such as "financial expectations", "key assumptions", "anticipate", "believe", "expect", "plan", "will", "outlook", "should" or similar words suggesting future outcomes. To the extent that the Company has provided forecasts or targets using Non-GAAP financial measures, the Company may not be able to provide a reconciliation to a GAAP measure without unreasonable efforts, due to unknown variables and uncertainty related to future results.

This Management's Discussion and Analysis of Financial Condition and Results of Operations and Annual Report on Form 10-K includes forward-looking statements relating, but not limited to statements concerning the Company's defined benefit pension expectations for 2023 and through 2026, expected impacts resulting from changes in the U.S.-to-Canadian dollar exchange rate, and the effective tax rate, as well as statements concerning the Company's operations, anticipated financial performance, business prospects and strategies, including statements concerning the anticipation that cash flow from operations and various sources of financing will be sufficient to meet debt repayments and obligations in the foreseeable future and concerning anticipated capital programs, statements regarding future payments including income taxes, statements regarding the Company's greenhouse gas ("GHG") emissions targets, and statements concerning the pending KCS business combination.

The forward-looking statements contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations and Annual Report on Form 10-K are based on current expectations, estimates, projections and assumptions, having regard to the Company's experience and its perception of historical trends, and includes, but is not limited to, expectations, estimates, projections and assumptions relating to: North American and global economic growth; commodity demand growth; sustainable industrial and agricultural production; commodity prices and interest rates; foreign exchange rates (as specified herein); effective tax rates (as specified herein); performance of our assets and equipment; sufficiency of our budgeted capital expenditures in carrying out our business plan; geopolitical conditions; applicable laws, regulations and government policies; the availability and cost of labour, services and infrastructure; the satisfaction by third parties of their obligations to the Company; and the anticipated impacts of the COVID-19 pandemic on the Company's business, operating results, cash flows and/or financial condition. Although the Company believes the expectations, estimates, projections and assumptions reflected in the forward-looking statements presented herein are reasonable as of the date hereof, there can be no assurance that they will prove to be correct. Current conditions, economic and otherwise, render assumptions, although reasonable when made, subject to greater uncertainty.

With respect to the pending KCS business combination, we can provide no assurance when or if the combination will be completed. Completion of the combination is subject to the receipt of final approval from the STB of the CP-KCS control application by December 31, 2023. There can be no assurance of receipt of this final approval by December 31, 2023. Additionally, even if such final approval is received, there can be no guarantee of the successful integration of KCS or that the combined company will realize the anticipated benefits of the business combination, whether financial, strategic or otherwise, and this may be exacerbated by changes to the economic, political and global environment in which the merged company will operate.

Our GHG emissions targets are subject to a number of inherent risks, assumptions and uncertainties that include, but are not limited to, changes in carbon markets, evolving sustainability strategies and scientific or technological developments. Additionally, although our data underlying GHG emissions estimates have been internally vetted using accepted and relevant scientific and technical methodologies, historical performance data may become outdated due to a variety of factors, including improvement in our data collection and measuring systems, activities such as joint ventures, mergers and acquisitions or divestitures, and industry-driven changes to methodologies. As a result of these and other factors, we may not achieve our stated targets.

Undue reliance should not be placed on forward-looking statements as actual results may differ materially from those expressed or implied by forward-looking statements. By their nature, forward-looking statements involve numerous inherent risks and uncertainties that could cause actual results to differ materially from the forward-looking statements, including but not limited to the following factors: changes in business strategies; general North American and global economic, credit and business conditions; risks associated with agricultural production such as weather conditions and insect populations; the availability and price of energy commodities; the effects of competition and pricing pressures; industry capacity; shifts in market demand; changes in commodity prices; uncertainty surrounding timing and volumes of commodities being shipped via the Company; inflation; geopolitical instability; changes in laws, regulations and government policies, including regulation of rates; changes in taxes and tax rates; potential increases in maintenance and operating costs; changes in fuel prices; uncertainties of investigations, proceedings or other types of claims and litigation; labour disputes; risks and liabilities arising from derailments; transportation of dangerous goods; timing of completion of capital and maintenance projects; currency and interest rate fluctuations; effects of changes in market conditions and discount rates on the financial position of pension plans and investments; trade restrictions or other changes to international trade arrangements; climate change; various events that could disrupt operations, including severe weather, such as droughts, floods, avalanches and earthquakes, and cybersecurity attacks, as well as security threats and governmental response to them, and technological changes; and the pandemic created by the outbreak of COVID-19 and its variants and resulting effects on economic conditions, the demand

environment for logistics requirements and energy prices, restrictions imposed by public health authorities or governments, fiscal and monetary policy responses by governments and financial institutions, and disruptions to global supply chains. The foregoing list of factors is not exhaustive.

There are more specific factors that could cause actual results to differ materially from those described in the forward-looking statements contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations and Annual Report on Form 10-K. These more specific factors are identified and discussed in Item 1A. Risk Factors. Other risks are detailed from time to time in reports filed by the Company with securities regulators in Canada and the United States.

The forward-looking statements contained in this Management's Discussion and Analysis of Financial Condition and Results of Operations and Annual Report on Form 10-K are made as of the date hereof. Except as required by law, the Company undertakes no obligation to update publicly or otherwise revise any forward-looking statements, or the foregoing assumptions and risks affecting such forward-looking statements, whether as a result of new information, future events or otherwise.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Information concerning market risk sensitive instruments is set forth under Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Impact of Foreign Exchange on Earnings and Foreign Exchange Risk and Impact of Changes in Share Price on Earnings and Stock-Based Compensation.

Interest Rate Risk

Debt financing forms part of the Company's capital structure. The debt agreements entered into expose the Company to increased interest costs on future fixed debt instruments and existing variable rate debt instruments, should market rates increase. As at December 31, 2022, a hypothetical one percentage point change in interest rates on the Company's floating rate debt obligations outstanding is not material. In addition, the present value of the Company's assets and liabilities will also vary with interest rate changes. To manage interest rate exposure, the Company may enter into forward rate agreements such as treasury rate locks or bond forwards that lock in rates for a future date, thereby protecting against interest rate increases. The Company may also enter into swap agreements whereby one party agrees to pay a fixed rate of interest while the other party pays a floating rate. Contingent on the direction of interest rates, the Company may incur higher costs depending on the contracted rate.

The fair value of the Company's fixed rate debt may fluctuate with changes in market interest rates. A hypothetical one percentage point decrease in interest rates as of December 31, 2022, would result in an increase of approximately \$1.5 billion to the fair value of the Company's debt as at December 31, 2022 (December 31, 2021 - approximately \$2.3 billion). Fair values of the Company's fixed rate debt are estimated by considering the impact of the hypothetical interest rates on quoted market prices and current borrowing rates, but do not consider other factors that could impact actual results.

Information concerning market risks is supplemented in Item 8. Financial Statements and Supplementary Data, Note 16 Financial Instruments.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

As of December 31, 2022, an evaluation was carried out under the supervision of and with the participation of the Company's management, including CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) of the *Exchange Act*. Based on that evaluation, the CEO and CFO concluded that these disclosure controls and procedures were effective as of December 31, 2022, to ensure that information required to be disclosed by the Company in reports that they file or submit under the *Exchange Act* is (i) recorded, processed, summarized and reported within the time periods specified by the SEC rules and forms and (ii) accumulated and communicated to the Company's management, including the CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

Management's Report on Internal Control over Financial Reporting

Management is responsible for the financial statements and for establishing and maintaining adequate internal control over financial reporting for the Company as defined in Rules 13a-15(f) and 15d-15(f) of the *Exchange Act*. The Corporation's internal control system was designed to provide reasonable assurance to the Corporation's management and Board of Directors regarding the preparation and fair presentation of published financial statements. Due to 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.

Management has assessed the effectiveness of the Company's internal control over financial reporting in accordance with the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework (2013)*. Based on this assessment, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2022. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to the reliability of financial reporting and preparation of financial statements in accordance with generally accepted accounting principles.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2022 has been audited by EY LLP, the Company's independent registered public accounting firm who audited the Company's Consolidated Financial Statements included in this Form 10-K, as stated in their report, which is included herein.

Changes in Internal Control over Financial Reporting

During the three months ended December 31, 2022, the Company has not identified any changes in internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.