

CANADIAN PACIFIC RAILWAY LIMITED

# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS



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

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The following discussion and analysis 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 report. Except where otherwise indicated, all financial information reflected herein is expressed in Canadian dollars.

## EXECUTIVE SUMMARY

### 2016 Results

- *Financial performance* – In 2016, CP reported Diluted EPS of \$10.63 while Adjusted diluted EPS climbed to a record \$10.29, a 2% improvement compared to the Adjusted diluted EPS of \$10.10 in 2015. CP's commitment to operational efficiency produced a best-ever full-year operating ratio of 58.6%, beating the previous record set in 2015, despite a 7% decrease in revenue associated with challenging economic conditions. Adjusted diluted EPS is 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.
- *Free cash* – In 2016, CP generated Free cash of \$1.0 billion, a decrease of 27% over the prior year. The decrease was primarily driven by lower cash from operations and proceeds from the sale of D&H South in 2015, partially offset by lower capital expenditures. Free cash is defined and reconciled in Non-GAAP Measures and discussed further in Liquidity and Capital Resources of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.
- *Operating performance* – CP's continued focus on asset utilization and productivity gains resulted in significant improvements to CP's key operating metrics. In 2016, CP's network train speed increased by 10% to 23.5 miles per hour, terminal dwell improved by 7% to 6.7 hours, and fuel efficiency improved by 2% to 0.980 U.S. gallons of locomotive fuel consumed per 1,000 gross ton-miles ("GTMs"). These metrics are discussed further in Performance Indicators of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.
- *Safety* – The Company does not compromise safety for the sake of productivity gains. This relentless commitment to safety is demonstrated by CP's safety statistics filed with the FRA. For 2016, CP's FRA personal injuries frequency improved 11% and FRA train accidents per million train-miles frequency improved 27%, a new record for the Company.

### 2017 Outlook

For the full year 2017, CP expects Adjusted diluted EPS growth to be in the high single-digit percentages from full-year 2016 Adjusted diluted EPS of \$10.29, excluding the impacts of any share repurchases or CEO transition cost recoveries in 2017. CP assumes that, in 2017, the Canadian-to-U.S. dollar exchange rate will be in the range of \$1.30 to \$1.35 and the average price of West Texas Intermediate ("WTI") crude oil will be approximately U.S. \$45 to \$55 per barrel. The Company expects a normalized income tax rate of approximately 26.50% for 2017. To further enhance safety and fluidity of the network, CP also plans to invest approximately \$1.25 billion in capital programs in 2017, an increase of 6% over the \$1.18 billion spent in 2016. Capital programs is defined and discussed further in Liquidity and Capital Resources of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Adjusted diluted EPS is defined and discussed further in Non-GAAP Measures and in Forward-Looking Information of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations. Although CP has provided a forward-looking non-GAAP measure, it is not practicable to provide a reconciliation to a forward-looking reported diluted EPS, the most comparable GAAP measure, due to unknown variables and uncertainty related to future results. However, any such variability in reported diluted EPS may be excluded when determining Adjusted diluted EPS. Please see Forward-Looking Information of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations for further discussion.

## PERFORMANCE INDICATORS

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

| For the year ended December 31   | 2016    | 2015 <sup>(1)</sup> | 2014 <sup>(1)</sup> | % Change      |               |
|--|---------|---------------------|---------------------|---------------|---------------|
|  |         |                     |                     | 2016 vs. 2015 | 2015 vs. 2014 |
| <b>Operations Performance</b>  |         |                     |                     |               |               |
| Gross ton-miles ("GTMs") (millions)                                    | 242,694 | 263,344             | 272,862             | (8)           | (3)           |
| Train miles (thousands)  | 30,373  | 34,064              | 36,252              | (11)          | (6)           |
| Average train weight – excluding local traffic (tons)                  | 8,614   | 8,314               | 8,076               | 4             | 3             |
| Average train length – excluding local traffic (feet)                  | 7,217   | 6,935               | 6,682               | 4             | 4             |
| Average terminal dwell (hours)   | 6.7     | 7.2                 | 8.7                 | (7)           | (17)          |
| Average train speed (miles per hour, or "mph")                         | 23.5    | 21.4                | 18.0                | 10            | 19            |
| Fuel efficiency (U.S. gallons of locomotive fuel consumed /1,000 GTMs) | 0.980   | 0.999               | 1.035               | (2)           | (3)           |
| Total employees (average)  | 12,082  | 13,858              | 14,604              | (13)          | (5)           |
| Total employees (end of period)  | 11,653  | 12,817              | 14,255              | (9)           | (10)          |
| Workforce (end of period)  | 11,698  | 12,899              | 14,385              | (9)           | (10)          |
| <b>Safety Indicators</b>   |         |                     |                     |               |               |
| FRA personal injuries per 200,000 employee-hours                       | 1.64    | 1.84                | 1.67                | (11)          | 10            |
| FRA train accidents per million train-miles                            | 0.97    | 1.33                | 1.26                | (27)          | 6             |

<sup>(1)</sup> Certain figures have been updated to reflect new information or have been revised to conform with current presentation.

### Operations Performance

**A GTM** is 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 of the weight of the freight cars, their contents, and any inactive locomotives. An increase in GTMs indicates additional workload. GTMs for 2016 were 242,694 million, an 8% decrease compared with 263,344 million in 2015. This decrease was primarily driven by a drop in volume in the Crude, Potash, and Canadian Grain lines of business.

GTMs in 2015 decreased by 3% compared with 272,862 million in 2014. This decline was primarily due to a drop in volumes in the Intermodal, Crude and Metals, minerals and consumer products lines of business.

**Train-miles** are defined as the sum of the distance moved by all trains operated on the network. Train-miles for 2016 decreased by 11% compared with 2015 and in 2015 decreased by 6% compared with 2014, reflecting continuous improvements in operating efficiency from longer, heavier trains.

**Average train weight** is defined as the average gross weight of CP trains, both loaded and empty. This excludes trains in short-haul service, work trains used to move CP's track equipment and materials, and the haulage of other railways' trains on CP's network. Average train weight of 8,614 tons in 2016 increased by 300 tons, or 4%, from 2015.

The **average train length** is the sum of each car multiplied by the distance travelled, divided by train-miles. Local trains are excluded from this measure. Average train length of 7,217 feet in 2016, increased by 282 feet, or 4%, from 2015.

Average train weight increased in 2015 by 238 tons, or 3%, from 2014. Average train length increased in 2015 by 253 feet, or 4%, from 2014.

Both average train weight and length in 2016 and 2015 benefited from improvements in operating plan efficiency and increased bulk traffic being conveyed in longer, heavier trains.

The **average terminal dwell** is defined as the average time a freight car resides within terminal boundaries expressed in hours. The timing starts with a train arriving in the terminal, a customer releasing the car to the Company, or a car arriving at interchange from another railway. The timing ends when the train leaves, a customer receives the car from CP, or the freight car is transferred to another railway. Freight cars are excluded if they are being stored at the terminal or used in track repairs. Average terminal dwell decreased by 7% in 2016 from 7.2 hours in 2015 to 6.7 hours in 2016. Average terminal dwell also decreased by 17% in 2015 to 7.2 hours from 8.7 hours in 2014. These favourable decreases were primarily due to continued improvements in yard operating performance.

The **average train speed** is defined as a measure of the line-haul movement from origin to destination including terminal dwell hours. It is calculated by dividing the total train miles travelled by the total train hours operated. This calculation excludes delay time related to customer or foreign railways, and also excludes the time and distance travelled by: i) trains used in or around CP's yards; ii) passenger trains; and iii) trains used for repairing track. Average train speed was 23.5 mph in 2016, an increase of 10%, from 21.4 mph in 2015. Average train speed in 2015 increased by 19%, from 18.0 mph in 2014. These favourable increases were primarily due to improved train design and operating plan execution.

**Fuel efficiency** improved by 2% in 2016 compared to 2015 and by 3% in 2015 compared to 2014. Improvements in fuel efficiency were a result of increased locomotive productivity, operational fluidity, and execution of the Company's fuel conservation strategies.

### Total Employees and Workforce

An employee is defined by the Company as an individual currently engaged in full-time, part-time or seasonal employment with CP. The average number of total employees for 2016 decreased by 1,776, or 13%, compared with 2015. The total number of employees as at December 31, 2016 was 11,653, a decrease of 1,164, or 9%, compared with 12,817 in 2015. These decreases were primarily due to strong operational performance, natural attrition and efficient resource management planning.

The average number of total employees for 2015 decreased by 746, or 5%, compared with 2014. The total number of employees as at December 31, 2015 was 12,817, a decrease of 1,438, or 10%, compared with 14,255 in 2014. These improvements were primarily due to job reductions as a result of continuing strong operational performance and natural attrition.

The workforce is defined as total employees plus contractors and consultants. The workforce as at December 31, 2016 decreased by 1,201, or 9%, compared with December 31, 2015. The workforce as at December 31, 2015 also decreased by 1,486, or 10%, compared with December 31, 2014. These improvements were primarily due to strong operational performance, natural attrition and efficient resource management planning.

### Safety Indicators

Safety is a key priority and core strategy for CP's management, employees and Board of Directors. The Company's two main safety indicators—personal injuries and train accidents—follow strict U.S. FRA reporting guidelines.

The FRA personal injuries per 200,000 employee-hours frequency is the number of personal injuries, multiplied by 200,000 and divided by total employee hours. Personal injuries are defined as injuries that require employees to lose time away from work, modify their normal duties or obtain medical treatment beyond minor first aid. FRA employee-hours are the total hours worked, excluding vacation and sick time, by all employees, excluding contractors. The FRA personal injuries per 200,000 employee-hours frequency for CP was 1.64 in 2016, 1.84 in 2015 and 1.67 in 2014.

The FRA train accidents per million train-miles frequency is the number of train accidents, multiplied by 1,000,000 and divided by total train miles. Train accidents included in this metric meet or exceed the FRA reporting threshold of U.S. \$10,500 in damage. The FRA train accidents per million train-miles for CP in 2016 was 0.97, compared with 1.33 in 2015 and 1.26 in 2014.

## RESULTS OF OPERATIONS

### Income

Operating income was \$2,578 million in 2016, a decrease of \$110 million, or 4%, from \$2,688 million in 2015.

This decrease was primarily due to:

- lower traffic volumes;
- the unfavourable impacts of fluctuations in fuel price;
- a \$68 million gain on sale of D&H South in 2015;
- higher depreciation and amortization; and
- higher wage and benefit inflation.

This decrease was partially offset by:

- efficiencies generated from improved operating performance and asset utilization;
- a change of \$122 million in defined benefit pension plan from an expense of \$32 million in 2015 to \$90 million in income in 2016;

- the favourable impact of the change in foreign exchange (“FX”) of \$69 million; and
- higher land sales.

Operating income was \$2,688 million in 2015, an increase of \$349 million, or 15%, from \$2,339 million in 2014. This increase was primarily due to:

- the favourable impact of the change in FX of \$247 million;
- efficiencies generated from improved operating performance and asset utilization;
- the gain on sale of D&H South of \$68 million;
- lower share-based compensation primarily driven by the change in share price and lower incentive-based compensation;
- lower fuel price; and
- higher land sales.

This increase was partially offset by:

- lower traffic volume;
- a change of \$84 million in defined benefit pension plan from \$52 million in income in 2014 to an expense of \$32 million in 2015;
- higher wage and benefit inflation; and
- higher casualty expenses as a result of more costly incidents.

Adjusted operating income, defined and reconciled in Non-GAAP Measures of this Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations, was \$2,578 million in 2016, a decrease of \$42 million, or 2%, from \$2,620 million in 2015. This decrease was primarily due to the same factors discussed above for the decrease in Operating income, except that Adjusted operating income excluded the gain on sale of D&H South in 2015.

Adjusted operating income was \$2,620 million in 2015, an increase of \$285 million, or 12%, from \$2,335 million in 2014. This increase was due to the same factors discussed above for the increase in Operating income except that Adjusted operating income excludes the gain on sale of D&H South in 2015.

Net income was \$1,599 million in 2016, an increase of \$247 million, or 18%, from \$1,352 million in 2015. This increase was primarily due to the favourable impact of FX translation on U.S. dollar-denominated debt and a decrease in income tax expense due to the lower effective tax rate compared to 2015. This increase was partially offset by lower operating income and higher interest expense on new debt issued in 2015.

Net income was \$1,352 million in 2015, a decrease of \$124 million, or 8%, from \$1,476 million in 2014. This decrease was primarily due to the unfavourable impact of FX translation on U.S. dollar-denominated debt and higher interest expense on new debt issued in 2015, partially offset by higher operating income.

Adjusted income, defined and reconciled in Non-GAAP Measures of this Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations, was \$1,549 million in 2016, a decrease of \$76 million, or 5%, from \$1,625 million in 2015. This decrease was primarily due to a decrease in Adjusted operating income and higher interest expense on new debt issued in 2015, partially offset by a decrease in income tax expense due to the lower effective tax rate excluding significant items compared to 2015.

Adjusted income was \$1,625 million in 2015, an increase of \$143 million, or 10%, from \$1,482 million in 2014. This increase was primarily due to an increase in Adjusted operating income, partially offset by higher interest expense on new debt issued in 2015 and increased income tax expense.

### **Diluted Earnings per Share**

Diluted EPS was \$10.63 in 2016, an increase of \$2.23, or 27%, from \$8.40 in 2015. This increase was primarily due to higher Net income and the lower average number of outstanding shares due to the Company’s share repurchase program.

Diluted EPS was \$8.40 in 2015, a decrease of \$0.06, or 1%, from \$8.46 in 2014. This decrease was primarily due to lower Net income, partially offset by the lower average number of outstanding shares due to the Company’s share repurchase program.

Adjusted diluted EPS, defined and reconciled in Non-GAAP Measures of this Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations, was \$10.29 in 2016, an increase of \$0.19, or 2%, from \$10.10 in 2015. This increase was primarily due to the lower average number of outstanding shares due to the Company’s share repurchase program, partially offset by lower Adjusted income.

Adjusted diluted EPS was \$10.10 in 2015, an increase of \$1.60, or 19%, from \$8.50 in 2014. This increase was primarily due to higher Adjusted income and the lower average number of outstanding shares due to the Company's share repurchase program.

### **Operating Ratio**

The Operating ratio provides the percentage of revenues used to operate the railway. A lower percentage normally indicates higher efficiency in the operation of the railway. The Company's Operating ratio was 58.6% in 2016, a 140 basis point improvement from 60.0% in 2015. This improvement was primarily due to:

- efficiencies generated from improved operating performance and asset utilization;
- a change of \$122 million in defined benefit pension plan from an expense of \$32 million in 2015 to \$90 million in income in 2016;
- higher land sales of \$32 million; and
- the favourable impact of the change in FX of \$69 million.

This improvement was partially offset by:

- lower traffic volumes;
- a \$68 million gain on disposition of D&H South in 2015;
- higher depreciation and amortization; and
- higher wage and benefit inflation.

The Company's Operating ratio was 60.0% in 2015, a 470 basis point improvement from 64.7% in 2014.

This improvement was primarily due to:

- the favourable impact of the change in FX of \$247 million;
- efficiencies generated from improved operating performance and asset utilization;
- the gain on sale of D&H South;
- lower share-based compensation primarily driven by the change in share price and lower incentive-based compensation;
- lower fuel price; and
- higher land sales.

This improvement was partially offset by:

- lower traffic volume;
- a change of \$84 million in defined benefit pension plan from \$52 million in income in 2014 to an expense of \$32 million in 2015;
- higher wage and benefit inflation; and
- higher casualty expenses as a result of more costly incidents.

Adjusted operating ratio, defined and reconciled in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, was 58.6% in 2016, a 240 basis point improvement from 61.0% in 2015. The improvement in Adjusted operating ratio reflects the same factors discussed above for the improvement in Operating ratio except that Adjusted operating ratio excludes the gain on sale of D&H South in 2015.

Adjusted operating ratio was 61.0% in 2015, a 370 basis point improvement from 64.7% in 2014. This improvement in Adjusted operating ratio reflects the same factors discussed above except that Adjusted operating ratio excludes the gain on sale of D&H South in 2015.

### **Return on Invested Capital**

ROIC is a measure of 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. ROIC was 14.4% in 2016, a 150 basis point increase compared to 12.9% in 2015 due to higher income and the reduction in total Shareholders' equity, primarily due to the Company's share repurchase program, partially offset by the issuance of long-term debt in 2015. ROIC was 12.9% in 2015, a 150 basis point decrease compared to 14.4% in 2014 due to the issuance of long-term debt in 2015, partially offset by the reduction in total Shareholders' equity, primarily due to the Company's share repurchase program.

Adjusted ROIC was 14.0% at December 31, 2016, a 120 basis point decrease compared to 15.2% in 2015 due to lower Adjusted income and the issuance of long-term debt in 2015, partially offset by the reductions in total Shareholders' equity as discussed above. Adjusted ROIC was 15.2% in 2015, a 70 basis point increase compared to 14.5% in 2014 due to higher Adjusted income and the reductions in total Shareholders' equity as discussed above, partially offset by the issuance of long-term debt in 2015. ROIC and Adjusted ROIC are defined and reconciled in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

### Impact of Foreign Exchange on Earnings

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 2016, the impact of a stronger U.S. dollar resulted in an increase in total revenues of \$146 million, an increase in total operating expenses of \$77 million and an increase in interest expense of \$10 million.

| Average exchange rates (Canadian to U.S. dollar) | 2016    | 2015    | 2014    |
|--|---------|---------|---------|
| For the year ended – December 31                 | \$ 1.33 | \$ 1.28 | \$ 1.10 |
| For the three months ended – December 31         | \$ 1.33 | \$ 1.34 | \$ 1.13 |

| Exchange rates (Canadian to U.S. dollar) | 2016    | 2015    | 2014    |
|--|---------|---------|---------|
| Beginning of year – January 1            | \$ 1.38 | \$ 1.16 | \$ 1.06 |
| Beginning of quarter – April 1           | \$ 1.30 | \$ 1.27 | \$ 1.11 |
| Beginning of quarter – July 1            | \$ 1.29 | \$ 1.25 | \$ 1.07 |
| Beginning of quarter – October 1         | \$ 1.31 | \$ 1.33 | \$ 1.12 |
| End of quarter – December 31             | \$ 1.34 | \$ 1.38 | \$ 1.16 |

In 2017, CP expects that for every \$0.01 the U.S. dollar appreciates (depreciates) relative to the Canadian dollar, it will increase (decrease) revenues by \$25 million, operating expenses by \$13 million and interest expense by \$3 million on an annualized basis.

### Impact of Fuel Price on Earnings

Fluctuations in fuel prices affect the Company's results because fuel expense constitutes a significant portion of CP'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. In 2016, the impact of lower fuel prices resulted in a decrease in total revenues of \$178 million and a decrease in total operating expenses of \$100 million. The wildfires in northern Alberta negatively impacted fuel input costs by an estimated \$9 million without triggering a commensurate offsetting impact on benchmark fuel recovery prices during the second quarter of 2016.

| Average Fuel Price (U.S. dollars per U.S. gallon) | 2016    | 2015    | 2014    |
|---|---------|---------|---------|
| For the year ended – December 31                  | \$ 1.80 | \$ 2.13 | \$ 3.41 |
| For the three months ended – December 31          | \$ 2.01 | \$ 1.91 | \$ 3.11 |

### Impact of Share Price on Earnings

Fluctuations in the Common Share price affect the Company's operating expenses because share-based liabilities are measured at fair value. The following tables indicate the opening and closing CP Common Share Price on the TSX and the NYSE for the year ended December 31, 2016, 2015 and 2014.

| Toronto Stock Exchange (in Canadian dollars)                | 2016      | 2015       | 2014      |
|---|-----------|------------|-----------|
| Opening Common Share price, as at January 1                 | \$ 176.73 | \$ 223.75  | \$ 160.65 |
| Ending Common Share price, as at March 31                   | \$ 172.55 | \$ 231.90  | \$ 165.65 |
| Ending Common Share price, as at June 30                    | \$ 166.33 | \$ 200.02  | \$ 193.31 |
| Ending Common Share price, as at September 30               | \$ 200.19 | \$ 191.54  | \$ 232.43 |
| Ending Common Share price, as at December 31                | \$ 191.56 | \$ 176.73  | \$ 223.75 |
| Change in Common Share price for the year ended December 31 | \$ 14.83  | \$ (47.02) | \$ 63.10  |

| New York Stock Exchange (in U.S. dollars)                   | 2016      | 2015       | 2014      |
|---|-----------|------------|-----------|
| Opening Common Share price, as at January 1                 | \$ 127.60 | \$ 192.69  | \$ 151.32 |
| Ending Common Share price, as at March 31                   | \$ 132.69 | \$ 182.70  | \$ 150.43 |
| Ending Common Share price, as at June 30                    | \$ 128.79 | \$ 160.23  | \$ 181.14 |
| Ending Common Share price, as at September 30               | \$ 152.70 | \$ 143.57  | \$ 207.47 |
| Ending Common Share price, as at December 31                | \$ 142.77 | \$ 127.60  | \$ 192.69 |
| Change in Common Share price for the year ended December 31 | \$ 15.17  | \$ (65.09) | \$ 41.37  |

In 2016, the impact of the change in Common Share price resulted in an increase in stock-based compensation expense of \$9 million compared to a decrease of \$36 million in 2015, and an increase of \$46 million in 2014.

The impact of share price on stock-based compensation is discussed further in Item 7A. Quantitative and Qualitative Disclosures About Market Risk, Share Price Impact on Stock-Based Compensation.

## Operating Revenues

| For the year ended December 31                | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                                     | 2015 vs. 2014 |          |                                     |
|---|----------|----------|----------|---------------|----------|-------------------------------------|---------------|----------|-------------------------------------|
|   |          |          |          | Total Change  | % Change | FX Adjusted % Change <sup>(2)</sup> | Total Change  | % Change | FX Adjusted % Change <sup>(2)</sup> |
| Freight revenues (in millions) <sup>(1)</sup> | \$ 6,060 | \$ 6,552 | \$ 6,464 | \$ (492)      | (8)      | (10)                                | \$ 88         | 1        | (7)                                 |
| Non-freight revenues (in millions)            | 172      | 160      | 156      | 12            | 8        | 7                                   | 4             | 3        | —                                   |
| Total revenues (in millions)                  | \$ 6,232 | \$ 6,712 | \$ 6,620 | \$ (480)      | (7)      | (9)                                 | \$ 92         | 1        | (6)                                 |
| Carloads (in thousands)                       | 2,525    | 2,628    | 2,684    | (103)         | (4)      | N/A                                 | (56)          | (2)      | N/A                                 |
| Revenue ton-miles (in millions)               | 135,952  | 145,257  | 149,849  | (9,305)       | (6)      | N/A                                 | (4,592)       | (3)      | N/A                                 |
| Freight revenue per carload (dollars)         | \$ 2,400 | \$ 2,493 | \$ 2,408 | \$ (93)       | (4)      | N/A                                 | \$ 85         | 4        | N/A                                 |
| Freight revenue per revenue ton-miles (cents) | 4.46     | 4.51     | 4.31     | (0.05)        | (1)      | N/A                                 | 0.20          | 5        | N/A                                 |

<sup>(1)</sup> Freight revenues include fuel surcharge revenues of \$117 million in 2016, \$293 million in 2015 and \$637 million in 2014.

<sup>(2)</sup> FX Adjusted % Change does not have any standardized meaning prescribed by GAAP and, therefore is unlikely to be comparable to similar measures presented by other companies. FX adjusted variance is defined and reconciled in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

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

### Freight Revenues

Freight revenues were \$6,060 million in 2016, a decrease of \$492 million, or 8%, from \$6,552 million in 2015. This decrease was primarily due to lower volumes, as measured by RTMs, in Crude, Canadian grain, Potash, and Metals, minerals, and consumer products and the impact of lower fuel prices on fuel surcharge revenue.

This decrease was partially offset by higher volumes in International intermodal, Chemicals and plastics and Forest products, and the favourable impact of the change in FX of \$146 million.

Freight revenues were \$6,552 million in 2015, an increase of \$88 million, or 1%, from \$6,464 million in 2014. This increase was primarily due to the favourable impact of the change in FX of \$549 million and an increase in Canadian grain revenue due to increased exports. This increase was partially offset by the impact of lower fuel prices on fuel surcharge revenue of \$334 million, and lower volumes of Metals, mineral and consumer products and Crude.

### 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. RTMs for 2016 were 135,952 million, a decrease of 9,305 million, or 6%, compared with 145,257 million in 2015. This decrease was mainly attributable to decreased shipments of Crude, Canadian grain, Potash, and Metals, minerals and consumer products. This decrease was partially offset by increased shipments of International intermodal, Chemicals and Plastics, Forest products and U.S. grain.

RTMs for 2015 were 145,257 million, a decrease of 3% compared with 149,849 million in 2014. This decrease was primarily due to lower volumes of Crude, Metals, minerals and consumer products, and U.S. Grain. This decrease was partially offset by increased shipments of Potash, Canadian Grain, and Forest products.

#### Non-freight Revenues

Non-freight revenues were \$172 million in 2016, an increase of \$12 million, or 8%, from \$160 million in 2015. This increase was primarily due to higher transload, leasing, and logistics services revenues.

Non-freight revenues were \$160 million in 2015, an increase of \$4 million, or 3%, from \$156 million in 2014. This increase was primarily due to the favourable impact of the change in FX.

### Lines of Business

#### Canadian Grain

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 962   | \$ 1,068 | \$ 988   | \$ (106)      | (10)     | (11)                 | \$ 80         | 8        | 4                    |
| Carloads (in thousands)                      | 270      | 285      | 291      | (15)          | (5)      | N/A                  | (6)           | (2)      | N/A                  |
| Revenue ton-miles (in millions)              | 25,994   | 27,442   | 26,691   | (1,448)       | (5)      | N/A                  | 751           | 3        | N/A                  |
| Freight revenue per carload (dollars)        | \$ 3,559 | \$ 3,750 | \$ 3,391 | \$ (191)      | (5)      | N/A                  | \$ 359        | 11       | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 3.70     | 3.89     | 3.70     | (0.19)        | (5)      | N/A                  | 0.19          | 5        | N/A                  |

Canadian grain revenue was \$962 million in 2016, a decrease of \$106 million, or 10%, from \$1,068 million in 2015. This decrease was primarily due to a decline in volumes due to lower carryover from prior year and a weather delayed fall harvest, and lower freight rates that reflect the change in the MRE for Canadian regulated grain in the crop year 2015/2016. This decrease was partially offset by the favourable impact of the change in FX, and an increase in volumes due to a larger 2016/2017 crop.

Canadian grain revenue was \$1,068 million in 2015, an increase of \$80 million, or 8%, from \$988 million in 2014. This increase was primarily due to higher freight rates, the favourable impact of the change in FX, and strong export volumes through the Port of Vancouver, partially offset by lower fuel surcharge revenue.

#### U.S. Grain

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 518   | \$ 522   | \$ 503   | \$ (4)        | (1)      | (5)                  | \$ 19         | 4        | (12)                 |
| Carloads (in thousands)                      | 162      | 157      | 173      | 5             | 3        | N/A                  | (16)          | (9)      | N/A                  |
| Revenue ton-miles (in millions)              | 10,898   | 10,625   | 11,724   | 273           | 3        | N/A                  | (1,099)       | (9)      | N/A                  |
| Freight revenue per carload (dollars)        | \$ 3,202 | \$ 3,326 | \$ 2,909 | \$ (124)      | (4)      | N/A                  | \$ 417        | 14       | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 4.75     | 4.91     | 4.29     | (0.16)        | (3)      | N/A                  | 0.62          | 14       | N/A                  |

U.S. grain revenue was \$518 million in 2016, a decrease of \$4 million, or 1%, from \$522 million in 2015. The decrease was primarily due to the decrease in average freight revenue per revenue ton-mile, and lower fuel surcharge revenue as a result of lower fuel prices. The decrease was partially offset by the favourable impact of the change in FX, and increased volumes. The decrease in average freight revenue per revenue ton-mile was primarily due to a change in the mix of commodities being shipped.

U.S. grain revenue was \$522 million in 2015, an increase of \$19 million, or 4%, from \$503 million in 2014. The increase was primarily due to the favourable impact of the change in FX, partially offset by a decrease in volumes of 9% primarily due to the reduction in export volumes, and lower fuel surcharge revenue.

## Coal

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 606   | \$ 639   | \$ 621   | \$ (33)       | (5)      | (6)                  | \$ 18         | 3        | 1                    |
| Carloads (in thousands)                      | 305      | 323      | 313      | (18)          | (6)      | N/A                  | 10            | 3        | N/A                  |
| Revenue ton-miles (in millions)              | 22,171   | 22,164   | 22,443   | 7             | —        | N/A                  | (279)         | (1)      | N/A                  |
| Freight revenue per carload (dollars)        | \$ 1,984 | \$ 1,978 | \$ 1,985 | \$ 6          | —        | N/A                  | \$ (7)        | —        | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 2.73     | 2.88     | 2.77     | (0.15)        | (5)      | N/A                  | 0.11          | 4        | N/A                  |

Coal revenue was \$606 million in 2016, a decrease of \$33 million, or 5%, from \$639 million in 2015. This decrease was primarily due to the decline in U.S. thermal coal shipments, and lower fuel surcharge revenue as a result of lower fuel prices, partially offset by increased shipments of metallurgical coal, and the favourable impact of the change in FX. The decrease in freight revenue per revenue ton-mile is primarily due to the decrease in U.S. thermal coal, which has a shorter length of haul versus export metallurgical coal.

Coal revenue was \$639 million in 2015, an increase of \$18 million, or 3%, from \$621 million in 2014. This increase was primarily due to the favourable impact of the change in FX and higher freight rates and volumes of U.S. originated thermal coal, partially offset by lower fuel surcharge revenue and a decline in volume in Canadian coal business.

## Potash

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 338   | \$ 359   | \$ 347   | \$ (21)       | (6)      | (8)                  | \$ 12         | 3        | (4)                  |
| Carloads (in thousands)                      | 116      | 124      | 118      | (8)           | (6)      | N/A                  | 6             | 5        | N/A                  |
| Revenue ton-miles (in millions)              | 14,175   | 15,117   | 14,099   | (942)         | (6)      | N/A                  | 1,018         | 7        | N/A                  |
| Freight revenue per carload (dollars)        | \$ 2,904 | \$ 2,887 | \$ 2,941 | \$ 17         | 1        | N/A                  | \$ (54)       | (2)      | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 2.38     | 2.37     | 2.46     | 0.01          | —        | N/A                  | (0.09)        | (4)      | N/A                  |

Potash revenue was \$338 million in 2016, a decrease of \$21 million, or 6%, from \$359 million in 2015. This decrease was primarily due to a decline in export potash volumes, and lower fuel surcharge revenue as a result of lower fuel prices. Favourable impact of the change in FX, and an adjustment to freight rates for one customer for prior periods partially offset this decrease. The freight revenue per revenue ton-mile is essentially flat due to the adjustment to freight rates for one customer for prior periods, offset by decreases in export traffic revenue ton-miles.

Potash revenue was \$359 million in 2015, an increase of \$12 million, or 3%, from \$347 million in 2014. This increase was primarily due to the favourable impact of the change in FX and an increase in volumes where growth in export Potash, which has a lower freight revenue per revenue ton-mile, outpaced domestic Potash growth.

## Fertilizers and Sulphur

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 284   | \$ 272   | \$ 234   | \$ 12         | 4        | 2                    | \$ 38         | 16       | 6                    |
| Carloads (in thousands)                      | 60       | 62       | 61       | (2)           | (3)      | N/A                  | 1             | 2        | N/A                  |
| Revenue ton-miles (in millions)              | 4,140    | 4,044    | 4,180    | 96            | 2        | N/A                  | (136)         | (3)      | N/A                  |
| Freight revenue per carload (dollars)        | \$ 4,769 | \$ 4,410 | \$ 3,801 | \$ 359        | 8        | N/A                  | \$ 609        | 16       | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 6.87     | 6.71     | 5.59     | 0.16          | 2        | N/A                  | 1.12          | 20       | N/A                  |

Fertilizers and sulphur revenue was \$284 million in 2016, an increase of \$12 million, or 4%, from \$272 million in 2015. This increase was primarily due to increased freight revenue per carload and the favourable impact of the change in FX, partially offset by lower fuel surcharge revenue as a result of lower fuel prices, and lower carloads. The increase in freight revenue per carload is primarily due to the increase in average length of haul for fertilizers.

Fertilizers and sulphur revenue was \$272 million in 2015, an increase of \$38 million, or 16%, from \$234 million in 2014.

This increase was primarily due to the favourable impact of the change in FX, higher freight rates and a shift in mix of traffic to fertilizers, which generally has higher freight rates than sulphur.

#### Forest Products

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 275   | \$ 249   | \$ 206   | \$ 26         | 10       | 7                    | \$ 43         | 21       | 8                    |
| Carloads (in thousands)                      | 66       | 62       | 59       | 4             | 6        | N/A                  | 3             | 5        | N/A                  |
| Revenue ton-miles (in millions)              | 4,691    | 4,201    | 3,956    | 490           | 12       | N/A                  | 245           | 6        | N/A                  |
| Freight revenue per carload (dollars)        | \$ 4,157 | \$ 4,026 | \$ 3,493 | \$ 131        | 3        | N/A                  | \$ 533        | 15       | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 5.86     | 5.92     | 5.20     | (0.06)        | (1)      | N/A                  | 0.72          | 14       | N/A                  |

Forest products revenue was \$275 million in 2016, an increase of \$26 million, or 10%, from \$249 million in 2015. This increase was primarily due to higher volumes, particularly of lumber and panel products, which have a longer length of haul than other forest products, and the favourable impact of the change in FX. Lower fuel surcharge revenue as a result of lower fuel prices partially offset this increase.

Forest products revenue was \$249 million in 2015, an increase of \$43 million, or 21%, from \$206 million in 2014. This increase was primarily due to the favourable impact of the change in FX, improved pricing and a change in traffic mix to lumber and panel products, which generally have higher freight rates than pulp and paper.

#### Chemicals and Plastics

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 714   | \$ 709   | \$ 637   | \$ 5          | 1        | (3)                  | \$ 72         | 11       | (2)                  |
| Carloads (in thousands)                      | 212      | 203      | 198      | 9             | 4        | N/A                  | 5             | 3        | N/A                  |
| Revenue ton-miles (in millions)              | 14,294   | 13,611   | 13,635   | 683           | 5        | N/A                  | (24)          | —        | N/A                  |
| Freight revenue per carload (dollars)        | \$ 3,368 | \$ 3,483 | \$ 3,214 | \$ (115)      | (3)      | N/A                  | \$ 269        | 8        | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 4.99     | 5.21     | 4.67     | (0.22)        | (4)      | N/A                  | 0.54          | 12       | N/A                  |

Chemicals and plastics revenue was \$714 million in 2016, an increase of \$5 million, or 1%, from \$709 million in 2015. This increase was primarily due to an increase in volumes, and the favourable impact of the change in FX. Lower fuel surcharge revenue as a result of lower fuel prices, and lower average freight revenue per revenue ton-mile due to fewer liquefied petroleum gas product shipments, partially offset this increase.

Chemicals and plastics revenue was \$709 million in 2015, an increase of \$72 million, or 11%, from \$637 million in 2014. This increase was primarily due to the favourable impact of the change in FX, partially offset by lower fuel surcharge revenue.

#### Crude

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 138   | \$ 393   | \$ 484   | \$ (255)      | (65)     | (66)                 | \$ (91)       | (19)     | (29)                 |
| Carloads (in thousands)                      | 38       | 91       | 110      | (53)          | (58)     | N/A                  | (19)          | (17)     | N/A                  |
| Revenue ton-miles (in millions)              | 4,727    | 13,280   | 16,312   | (8,553)       | (64)     | N/A                  | (3,032)       | (19)     | N/A                  |
| Freight revenue per carload (dollars)        | \$ 3,646 | \$ 4,309 | \$ 4,419 | \$ (663)      | (15)     | N/A                  | \$ (110)      | (2)      | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 2.93     | 2.96     | 2.97     | (0.03)        | (1)      | N/A                  | (0.01)        | —        | N/A                  |

Crude revenue was \$138 million in 2016, a decrease of \$255 million, or 65%, from \$393 million in 2015. This decrease was primarily due to a decline in volumes as a result of the fall in crude oil prices and an increase in available pipeline capacity, as well as lower fuel surcharge revenue as a result of lower fuel prices. The favourable impact of the change in FX partially offset this decrease.

Crude revenue was \$393 million in 2015, a decrease of \$91 million, or 19%, from \$484 million in 2014. This decrease was primarily due to a decline in volume as a result of the fall in crude oil prices and lower fuel surcharge revenue, partially offset by the favourable impact of the change in FX.

### Metals, Minerals and Consumer Products

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 564   | \$ 643   | \$ 712   | \$ (79)       | (12)     | (15)                 | \$ (69)       | (10)     | (20)                 |
| Carloads (in thousands)                      | 196      | 217      | 253      | (21)          | (10)     | N/A                  | (36)          | (14)     | N/A                  |
| Revenue ton-miles (in millions)              | 8,338    | 9,020    | 11,266   | (682)         | (8)      | N/A                  | (2,246)       | (20)     | N/A                  |
| Freight revenue per carload (dollars)        | \$ 2,888 | \$ 2,963 | \$ 2,814 | \$ (75)       | (3)      | N/A                  | \$ 149        | 5        | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 6.77     | 7.13     | 6.32     | (0.36)        | (5)      | N/A                  | 0.81          | 13       | N/A                  |

Metals, minerals and consumer products revenue was \$564 million in 2016, a decrease of \$79 million, or 12%, from \$643 million in 2015. This decrease was primarily due to declines in the volume of aggregate products, steel, and waste products, and lower fuel surcharge revenue as a result of lower fuel prices, partially offset by the favourable impact of the change in FX. The decrease in average freight revenue per revenue ton-mile is primarily due to a change in mix of commodities.

Metals, minerals and consumer products revenue was \$643 million in 2015, a decrease of \$69 million, or 10%, from \$712 million in 2014. This decrease was primarily due to declines in the volume of frac sand, steel and other aggregates traffic, partially offset by the favourable impact of the change in FX.

### Automotive

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 350   | \$ 349   | \$ 357   | \$ 1          | —        | (3)                  | \$ (8)        | (2)      | (11)                 |
| Carloads (in thousands)                      | 124      | 131      | 134      | (7)           | (5)      | N/A                  | (3)           | (2)      | N/A                  |
| Revenue ton-miles (in millions)              | 1,667    | 1,750    | 1,953    | (83)          | (5)      | N/A                  | (203)         | (10)     | N/A                  |
| Freight revenue per carload (dollars)        | \$ 2,825 | \$ 2,659 | \$ 2,670 | \$ 166        | 6        | N/A                  | \$ (11)       | —        | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 21.02    | 19.97    | 18.26    | 1.05          | 5        | N/A                  | 1.71          | 9        | N/A                  |

Automotive revenue was \$350 million in 2016, a slight increase of \$1 million from \$349 million in 2015. The increase in average freight rates and the favourable impact of the change in FX were offset by declines in volume, and lower fuel surcharge revenue as a result of lower fuel prices.

Automotive revenue was \$349 million in 2015, a decrease of \$8 million, or 2%, from \$357 million in 2014. This decrease was primarily due to lower fuel surcharge revenue and lower volumes driven by weaker traffic to Western Canada, partially offset by the favourable impact of the change in FX.

### Domestic Intermodal

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 721   | \$ 757   | \$ 787   | \$ (36)       | (5)      | (5)                  | \$ (30)       | (4)      | (6)                  |
| Carloads (in thousands)                      | 427      | 414      | 428      | 13            | 3        | N/A                  | (14)          | (3)      | N/A                  |
| Revenue ton-miles (in millions)              | 11,992   | 12,072   | 11,867   | (80)          | (1)      | N/A                  | 205           | 2        | N/A                  |
| Freight revenue per carload (dollars)        | \$ 1,688 | \$ 1,831 | \$ 1,837 | \$ (143)      | (8)      | N/A                  | \$ (6)        | —        | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 6.01     | 6.27     | 6.63     | (0.26)        | (4)      | N/A                  | (0.36)        | (5)      | N/A                  |

Domestic intermodal revenue was \$721 million in 2016, a decrease of \$36 million, or 5%, from \$757 million in 2015. This decrease was primarily due to lower fuel surcharge revenue as a result of lower fuel prices, and lower average freight revenue per revenue ton-mile as a result of fewer shipments using temperature controlled equipment. The favourable impact of the change in FX partially offset this decrease.

Domestic intermodal revenue was \$757 million in 2015, a decrease of \$30 million, or 4%, from \$787 million in 2014. This decrease was primarily due to lower fuel surcharge revenue, partially offset by the favourable impact of the change in FX, and increased transcontinental traffic.

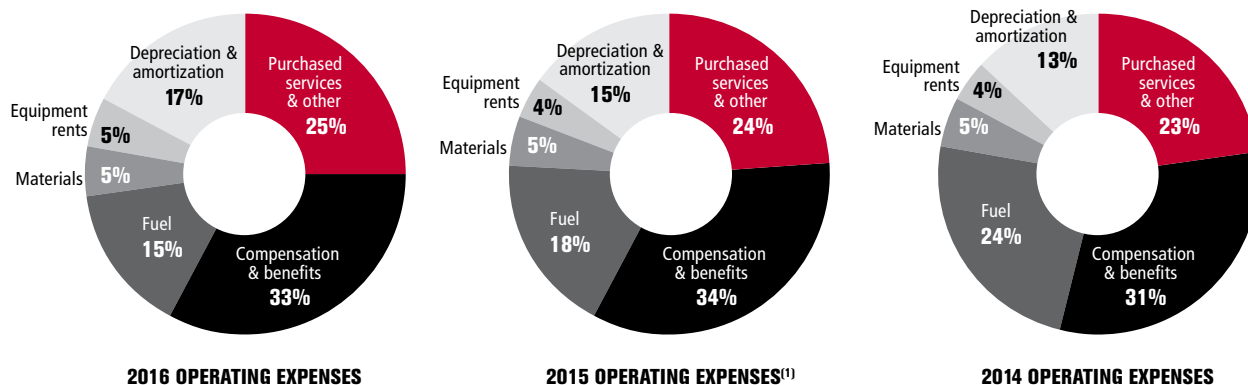
## International Intermodal

| For the year ended December 31               | 2016     | 2015     | 2014     | 2016 vs. 2015 |          |                      | 2015 vs. 2014 |          |                      |
|--|----------|----------|----------|---------------|----------|----------------------|---------------|----------|----------------------|
|  |          |          |          | Total Change  | % Change | FX Adjusted % Change | Total Change  | % Change | FX Adjusted % Change |
| Freight revenues (in millions)               | \$ 590   | \$ 592   | \$ 588   | \$ (2)        | —        | (2)                  | \$ 4          | 1        | (5)                  |
| Carloads (in thousands)                      | 549      | 559      | 546      | (10)          | (2)      | N/A                  | 13            | 2        | N/A                  |
| Revenue ton-miles (in millions)              | 12,865   | 11,931   | 11,723   | 934           | 8        | N/A                  | 208           | 2        | N/A                  |
| Freight revenue per carload (dollars)        | \$ 1,074 | \$ 1,061 | \$ 1,077 | \$ 13         | 1        | N/A                  | \$ (16)       | (1)      | N/A                  |
| Freight revenue per revenue ton-mile (cents) | 4.59     | 4.96     | 5.02     | (0.37)        | (7)      | N/A                  | (0.06)        | (1)      | N/A                  |

International intermodal revenue was \$590 million in 2016, a slight decrease of \$2 million from \$592 million in 2015. The decrease was primarily due to a decrease in freight revenue per revenue ton-mile due to fewer revenue generating moves of empty customer containers, and lower fuel surcharge revenue as a result of lower fuel prices. This decrease was offset by an increase in revenue ton-miles, as a result of longer haul shipments through the Port of Vancouver, and the favourable impact of the change in FX.

International intermodal revenue was \$592 million in 2015, an increase of \$4 million, or 1%, from \$588 million in 2014. This increase was primarily due to the favourable impact of the change in FX, partially offset by lower fuel surcharge revenue.

## Operating Expenses



<sup>(1)</sup> Purchased services and other includes a \$68 million gain on sale of D&H South in 2015.

| For the year ended December 31 (in millions) | 2016            | 2015            | 2014            | 2016 vs. 2015   |            |                                     | 2015 vs. 2014   |            |                                     |
|--|-----------------|-----------------|-----------------|-----------------|------------|-------------------------------------|-----------------|------------|-------------------------------------|
|  |                 |                 |                 | Total Change    | % Change   | FX Adjusted % Change <sup>(1)</sup> | Total Change    | % Change   | FX Adjusted % Change <sup>(1)</sup> |
| Compensation and benefits                    | \$ 1,189        | \$ 1,371        | \$ 1,348        | \$ (182)        | (13)       | (14)                                | \$ 23           | 2          | (3)                                 |
| Fuel   | 567             | 708             | 1,048           | (141)           | (20)       | (23)                                | (340)           | (32)       | (41)                                |
| Materials                                    | 180             | 184             | 193             | (4)             | (2)        | (3)                                 | (9)             | (5)        | (7)                                 |
| Equipment rents                              | 173             | 174             | 155             | (1)             | (1)        | (3)                                 | 19              | 12         | 1                                   |
| Depreciation and amortization                | 640             | 595             | 552             | 45              | 8          | 7                                   | 43              | 8          | 4                                   |
| Purchased services and other                 | 905             | 1,060           | 985             | (155)           | (15)       | (16)                                | 75              | 8          | 1                                   |
| Gain on sale of D&H South                    | —               | (68)            | —               | 68              | (100)      | (100)                               | (68)            | 100        | 100                                 |
| <b>Total operating expenses</b>              | <b>\$ 3,654</b> | <b>\$ 4,024</b> | <b>\$ 4,281</b> | <b>\$ (370)</b> | <b>(9)</b> | <b>(11)</b>                         | <b>\$ (257)</b> | <b>(6)</b> | <b>(12)</b>                         |

<sup>(1)</sup> FX Adjusted % Change does not have any standardized meaning prescribed by GAAP and, therefore is unlikely to be comparable to similar measures presented by other companies. FX adjusted variance is defined and reconciled in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Operating expenses were \$3,654 million in 2016, a decrease of \$370 million, or 9%, from \$4,024 million in 2015. This decrease was primarily due to:

- efficiencies generated from improved operating performance and asset utilization;
- lower volume variable expenses;
- change of \$122 million in defined benefit pension plan from an expense of \$32 million in 2015 to \$90 million in income in 2016;

- the favourable impact of \$100 million from lower fuel prices; and
- a \$32 million increase in land sales.

This decrease was partially offset by:

- the unfavourable impact of the change in FX of \$77 million;
- the gain on sale of D&H South of \$68 million in 2015;
- higher depreciation and amortization due to a higher asset base; and
- the impact of wage and benefit inflation of approximately 3%.

Operating expenses were \$4,024 million in 2015, a decrease of \$257 million, or 6%, from \$4,281 million in 2014.

This decrease was primarily due to:

- the favourable impact of \$403 million from lower fuel prices;
- efficiencies generated from improved operating performance and asset utilization;
- the favourable impact of \$87 million from lower stock-based compensation primarily driven by the change in stock price and lower incentive-based compensation;
- the \$68 million favourable gain on sale of D&H South;
- lower volume variable expenses; and
- a \$42 million increase in land sales.

This decrease was partially offset by:

- the unfavourable impact of the change in FX of \$306 million;
- a change of \$84 million in defined benefit pension plan from \$52 million in income in 2014 to an expense of \$32 million in 2015;
- the impact of wage and benefit inflation of approximately 3%; and
- higher casualty expenses as a result of more costly incidents of \$37 million.

#### *Compensation and Benefits*

Compensation and benefits expense includes employee wages, salaries, fringe benefits and stock-based compensation. Compensation and benefits expense was \$1,189 million in 2016, a decrease of \$182 million, or 13%, from \$1,371 million in 2015. This decrease was primarily due to:

- change of \$122 million in defined benefit pension plan from an expense of \$32 million in 2015 to \$90 million in income in 2016;
- lower costs achieved through job reductions;
- lower volume variable expenses as a result of a decrease in workload as measured by GTMs;
- road and yard efficiencies as a result of continuing strong operational performance; and
- the favourable impact of \$20 million from lower stock-based compensation and incentive-based compensation.

This decrease was partially offset by the impact of wage and benefit inflation of approximately 3% and the unfavourable impact of the change in FX of \$18 million.

Compensation and benefits expense was \$1,371 million in 2015, an increase of \$23 million, or 2%, from \$1,348 million in 2014. This increase was primarily due to:

- a change of \$84 million in defined benefit pension plan from \$52 million in income in 2014 to an expense of \$32 million in 2015;
- the unfavourable impact of the change in FX of \$62 million; and
- the impact of wage and benefit inflation of approximately 3%.

This increase was partially offset by:

- the favourable impact of \$87 million from lower stock-based compensation primarily driven by the change in stock price and lower incentive-based compensation;
- lower costs achieved through job reductions;

- road and yard efficiencies as a result of continuing strong operational performance; and
- lower volume variable expenses as a result of a decrease in workload as measured by GTMs.

#### *Fuel*

Fuel expense consists mainly of fuel used by locomotives and includes provincial, state and federal fuel taxes. Fuel expense was \$567 million in 2016, a decrease of \$141 million, or 20%, from \$708 million in 2015. This decrease was primarily due to:

- lower fuel prices with a favourable impact of \$100 million;
- a reduction in workload, as measured by GTMs; and
- improvements in fuel efficiency of approximately 2% as a result of increased locomotive productivity, operational fluidity and the advancement of the Company's fuel conservation strategies.

This decrease was partially offset by the unfavourable impact of the change in FX of \$25 million.

Fuel expense was \$708 million in 2015, a decrease of \$340 million, or 32%, from \$1,048 million in 2014. This decrease was primarily due to:

- lower fuel prices with a favourable impact of \$403 million;
- a reduction in workload, as measured by GTMs; and
- improvements in fuel efficiency of approximately 3% as a result of increased locomotive productivity, operational fluidity and the advancement of the Company's fuel conservation strategies.

This decrease was partially offset by the unfavourable impact of the change in FX of \$143 million.

#### *Materials*

Materials expense includes the cost of material used for track, locomotive, freight car, building maintenance and software sustainment. Materials expense was \$180 million in 2016, a decrease of \$4 million, or 2%, from \$184 million in 2015. This decrease was primarily due to lower car repair and locomotive maintenance costs.

Materials expense was \$184 million in 2015, a decrease of \$9 million, or 5%, from \$193 million in 2014. This decrease was primarily due to lower locomotive units maintained.

#### *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 CP's equipment. Equipment rents expense was \$173 million in 2016, a decrease of \$1 million, or 1%, from \$174 million in 2015. This decrease was primarily due to the purchase or return of leased freight cars reducing rental expenses by \$12 million. This decrease was partially offset by the return of subleased locomotives and freight cars reducing rental income by \$6 million and the unfavourable impact of the change in FX of \$5 million.

Equipment rents expense was \$174 million in 2015, an increase of \$19 million, or 12%, from \$155 million in 2014. This increase was primarily due to the unfavourable impact of the change in FX of \$18 million, a return of subleased locomotives reducing rental income by \$15 million, and a decrease in car hire expense resulting from the lower use of CP's equipment by other railroads. This increase was largely offset by the purchase of previously leased freight cars reducing rental expenses by \$21 million and lower use of foreign equipment.

#### *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 \$640 million for 2016, an increase of \$45 million, or 8%, from \$595 million in 2015. This increase was primarily due to a higher depreciable asset base and the unfavourable impact of the change in FX of \$5 million.

Depreciation and amortization expense was \$595 million for 2015, an increase of \$43 million, or 8%, from \$552 million in 2014. This increase was primarily due to a higher depreciable asset base and the unfavourable impact of the change in FX of \$18 million.

## Purchased Services and Other

| For the year ended December 31 (in millions) | 2016 <sup>(1)</sup> | 2015            | 2014          | 2016 vs. 2015 |                 | 2015 vs. 2014 |              |
|--|---------------------|-----------------|---------------|---------------|-----------------|---------------|--------------|
|  |                     |                 |               | % Change      | Total Change    | % Change      | Total Change |
| Support and facilities                       | \$ 271              | \$ 298          | \$ 297        | (9)           | \$ (27)         | —             | \$ 1         |
| Track and operations                         | 238                 | 266             | 243           | (11)          | (28)            | 9             | 23           |
| Intermodal                                   | 180                 | 184             | 176           | (2)           | (4)             | 5             | 8            |
| Equipment                                    | 165                 | 196             | 166           | (16)          | (31)            | 18            | 30           |
| Casualty                                     | 68                  | 74              | 35            | (8)           | (6)             | 111           | 39           |
| Property taxes                               | 116                 | 103             | 94            | 13            | 13              | 10            | 9            |
| Other  | (27)                | 13              | 6             | (308)         | (40)            | 117           | 7            |
| Land sales                                   | (106)               | (74)            | (32)          | 43            | (32)            | 131           | (42)         |
| <b>Total Purchased services and other</b>    | <b>\$ 905</b>       | <b>\$ 1,060</b> | <b>\$ 985</b> | <b>(15)</b>   | <b>\$ (155)</b> | <b>8</b>      | <b>\$ 75</b> |

<sup>(1)</sup> Certain prior quarters' figures have been revised to conform with current presentation.

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 \$905 million in 2016, a decrease of \$155 million, or 15%, from \$1,060 million in 2015. This decrease was primarily due to:

- lower third party service costs, reported in Track and operations and Support and facilities;
- a \$17 million gain on sale of surplus freight cars, and a reduction in accrued discontinuance costs for certain branch lines, reported in Other;
- higher land sales of \$32 million resulting from optimization of the Company's assets, as discussed further below;
- lower crew travel and accommodations costs, reported in Track and operations;
- lower third-party freight car and locomotive maintenance costs, reported in Equipment; and
- lower casualty expenses of \$8 million (excluding FX) as a result of lower third party claims and incident related environmental costs due to effective incident response and case management. This is partially offset by higher personal injury costs.

This decrease was partially offset by the unfavourable impact of the change in FX of \$21 million and higher property taxes of \$12 million (excluding FX).

Purchased services and other expense was \$1,060 million in 2015, an increase of \$75 million, or 8%, from \$985 million in 2014. This increase was primarily due to:

- the unfavourable impact of the change in FX of \$60 million;
- higher casualty expenses as a result of more costly incidents, reported in Casualty;
- higher intermodal expenses related to pickup and delivery service, reported in Intermodal;
- increased locomotive overhauls, reported in Equipment; and
- higher legal fees and support costs, reported in Support and facilities.

This increase was partially offset by higher land sales of \$42 million and efficiencies generated from the insourcing of certain IT activities, included in Support and facilities.

As part of optimizing its assets, the Company may identify and dispose of property used or formerly used in operating activities. The Company includes as part of operating expenses the gains and losses that arise on disposal of such long-lived assets. The following disposals have impacted Purchased services and other during the current and comparative periods:

- in the fourth quarter of 2016, the Company completed the sale of CP's Obico rail yard for gross proceeds of \$38 million and a gain on sale of \$37 million;
- in the second quarter of 2016, the Company disposed of 1,000 surplus freight cars that had reached or were nearing the end of their useful life, in a non-monetary exchange for new freight cars. The Company recognized a gain on sale of \$17 million from the transaction and the sale did not impact cash from investing activities;

- in the first quarter of 2016, the Company completed the sale of CP's Arbutus Corridor to the City of Vancouver for gross proceeds of \$55 million and a gain on sale of \$50 million. The agreement allows the Company to share in future proceeds on the eventual development and/or sale of certain parcels of the Arbutus Corridor; and
- in the first quarter of 2015, the Company recorded gains on land sales totalling \$60 million, including a gain of \$31 million following the sale of a building after resolution of legal proceedings, and various sections of land in eastern Canada for transit purposes.

#### *Gain on Sale of D&H South*

On November 17, 2014, the Company announced a proposed agreement with NS for the sale of approximately 283 miles of the Delaware and Hudson Railway Company, Inc.'s line between Sunbury, Pennsylvania, and Schenectady, New York, ("D&H South").

During the first quarter of 2015, the Company finalized the sales agreement with NS for D&H South. The sale, which received approval by the STB on May 15, 2015, was completed on September 18, 2015 for proceeds of \$281 million (U.S. \$214 million). The Company recorded a gain on sale of \$68 million (\$42 million after tax) from the transaction during the third quarter of 2015.

### **Other Income Statement Items**

#### *Other Income and Charges*

Other income and charges consists of gains and losses from the change in FX on long-term debt, working capital, various costs related to financing, shareholder costs, equity income and other non-operating expenditures. Other income and charges was a gain of \$45 million in 2016, compared to an expense of \$335 million in 2015, a change of \$380 million, or 113%. This was primarily due to the favourable impact of FX translation of \$79 million on U.S. dollar-denominated debt in 2016 compared to the unfavourable impact of FX translation of \$297 million on U.S. dollar-denominated debt in 2015 and a \$47 million premium charged upon early redemption of notes in the third quarter of 2015. This was partially offset by a legal settlement charge of \$25 million in the third quarter of 2016. This is discussed further in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Other income and charges was an expense of \$335 million in 2015, compared with an expense of \$19 million in 2014, a change of \$316 million, or 1,663%. This increase was primarily due to the unfavourable impact of FX translation of \$297 million on U.S. dollar-denominated debt and the loss of \$47 million on early redemption of notes. The increase was partially offset by \$24 million of other FX gains and losses.

#### *Net Interest Expense*

Net interest expense includes interest on long-term debt and capital leases. Net interest expense was \$471 million in 2016, an increase of \$77 million, or 20%, from \$394 million in 2015. This increase was primarily due to interest on new debt issued during the third quarter in 2015 and the unfavourable impact of the change in FX of \$11 million, partially offset by higher capitalized interest.

Net interest expense was \$394 million in 2015, an increase of \$112 million, or 40%, from \$282 million in 2014. This increase was primarily due to the unfavourable impact of the change in FX of \$37 million and interest on new debt issued during the third quarter in 2015.

#### *Income Tax Expense*

Income tax expense was \$553 million in 2016. This represents a decrease of \$54 million, or 9%, from \$607 million in 2015. The decrease is due primarily to a lower effective income tax rate in 2016, partially offset by higher taxable earnings in 2016.

Income tax expense was \$607 million in 2015. This represents an increase of \$45 million, or 8%, from \$562 million in 2014. The increase was due to a higher effective income tax rate, partially offset by lower taxable earnings in 2015.

The effective income tax rate for 2016 was 25.68% on reported income and 26.15% on Adjusted income. Adjusted income is a Non-GAAP measure, which is discussed further in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The effective income tax rate for 2015 was 30.95% on reported income and 27.25% on Adjusted income, compared with 27.59% on reported income and 27.58% on Adjusted income for 2014.

The Company expects a normalized 2017 income tax rate of approximately 26.50%. The Company's 2017 outlook for its normalized income 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. This is discussed further in Item 1A. Risk Factors.

## **LIQUIDITY AND CAPITAL RESOURCES**

The Company believes adequate amounts of Cash and cash equivalents are available in the normal course of business to provide for ongoing operations, including the obligations identified in the tables in Contractual Commitments of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations. The Company is not aware of any trends or expected fluctuations in the Company's liquidity that would create any deficiencies. The Company's primary sources of liquidity include its Cash and cash equivalents, its bilateral letter of credit facilities, and its revolving credit facility.

As at December 31, 2016, the Company had \$164 million of Cash and cash equivalents, U.S. \$2.0 billion available under its revolving credit facilities and up to \$280 million available under its letters of credit (December 31, 2015 – \$650 million of Cash and cash equivalents, U.S. \$2.0 billion available under revolving credit facilities and up to \$225 million available under its letters of credit).

As at December 31, 2016, the Company's U.S. \$2.0 billion revolving credit facility, which includes a U.S. \$1.0 billion five-year portion and U.S. \$1.0 billion one-year plus one-year term-out portion, was undrawn (December 31, 2015 – undrawn). On June 28, 2016, the maturity date on the U.S. \$1.0 billion one-year plus one-year term-out portion was extended to June 28, 2018, and the maturity date on the U.S. \$1.0 billion five year portion was extended to June 28, 2021. The Company did not draw significant amounts from its revolving credit facility during the year ended December 31, 2016 (December 31, 2015 – \$nil). The revolving credit facility agreement requires the Company not to exceed a maximum debt to earnings before interest, tax, depreciation, and amortization ratio. As at December 31, 2016, the Company was in compliance with the threshold stipulated in this financial covenant.

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. The commercial paper is backed by the U.S. \$1.0 billion one-year plus one-year term-out portion of the revolving credit facility. During the year ended December 31, 2016, the maximum amount borrowed under the commercial paper program was \$308 million. These borrowings were issued on a short-term basis to finance the Company's share repurchase program. The Company used cash from operations to repay the amounts borrowed during the year, such that there were no commercial paper borrowings outstanding as at December 31, 2016 (December 31, 2015 – \$nil).

As at December 31, 2016, under its bilateral letter of credit facilities, the Company had letters of credit drawn of \$320 million from a total available amount of \$600 million. This compares to letters of credit drawn of \$375 million from a total available amount of \$600 million as at December 31, 2015. 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 letters of credit issued. Collateral provided may include highly liquid investments purchased three months or less from maturity and is stated at cost, which approximates market value. As at December 31, 2016, the Company had posted \$nil in collateral on the bilateral letter of credit facilities (December 31, 2015 – \$nil).

The following discussion of operating, investing and financing activities describes the Company's indicators of liquidity and capital resources.

### **Operating Activities**

Cash provided by operating activities was \$2,089 million in 2016 compared to \$2,459 million in 2015, a decrease of \$370 million. The decrease in cash provided by operating activities is primarily due to lower cash generating income and an unfavourable change in working capital primarily as a result of higher income taxes paid in 2016 and an increase in interest payments resulting from debt issued in the third quarter of 2015.

Cash provided by operating activities was \$2,459 million in 2015, an increase of \$336 million from \$2,123 million in 2014. This increase was primarily due to higher cash generating earnings, and improvements in working capital as a result of a decrease in Accounts receivable attributable to higher collection rates and lower income taxes paid, partially offset by an increase in interest payments resulting from debt issued in the third quarter of 2015.

## Investing Activities

Cash used in investing activities was \$1,069 million in 2016, a decrease of \$54 million from \$1,123 million in 2015. This decrease was largely due to lower additions to properties ("capital programs") during 2016 partially offset by the proceeds from the sale of D&H South that occurred in 2015.

Cash used in investing activities was \$1,123 million in 2015, a decrease of \$38 million from \$1,161 million in 2014. This decrease was primarily due to higher proceeds from line sales, including \$281 million for D&H South in 2015 compared to \$236 million for DM&E West in 2014, and the sale of other assets for higher proceeds of \$114 million in 2015 compared to \$52 million in 2014. This increase was partially offset by higher additions to properties in 2015.

Additions to properties were \$1,182 million in 2016, a decrease of \$340 million from \$1,522 million in 2015. The decrease, primarily in track and roadway investments, is reflective of the track upgrade programs completed in 2015.

Additions to properties were \$1,522 million in 2015, an increase of \$73 million from \$1,449 million in 2014. The increase, primarily in track and roadway investments, reflects CP's strategy of reinvesting in the plant, enhancing throughput and capacity, and optimizing existing assets.

### Capital Programs

For the year ended December 31

(in millions, except for track miles and crossties)

|   | 2016            | 2015            | 2014            |
|---|-----------------|-----------------|-----------------|
| Additions to capital  |                 |                 |                 |
| Track and roadway   | \$ 904          | \$ 1,119        | \$ 1,011        |
| Rolling stock   | 105             | 158             | 219             |
| Information systems <sup>(1)</sup>  | 88              | 79              | 96              |
| Buildings and other   | 108             | 180             | 150             |
| <b>Total – accrued additions to capital</b>   | <b>1,205</b>    | <b>1,536</b>    | <b>1,476</b>    |
| Less:   |                 |                 |                 |
| Non-cash transactions   | 23              | 14              | 27              |
| <b>Cash invested in additions to properties (per Consolidated Statements of Cash Flows)</b> | <b>\$ 1,182</b> | <b>\$ 1,522</b> | <b>\$ 1,449</b> |
| <b>Track installation capital programs</b>  |                 |                 |                 |
| Track miles of rail laid (miles)  | 252             | 468             | 492             |
| Track miles of rail capacity expansion (miles)  | 2               | 22              | 21              |
| Crossties installed (thousands)   | 1,008           | 1,009           | 1,040           |

<sup>(1)</sup> Information systems include hardware and software.

Track and roadway expenditures include the replacement and enhancement of the Company's track infrastructure. Of the \$904 million additions in 2016, approximately \$721 million was invested in the renewal of depleted assets, namely rail, ties, ballast, signals, and bridges. Approximately \$33 million was spent on PTC compliance requirements and \$150 million was invested in network improvements, which increased productivity and capacity.

Rolling stock investments encompass locomotives and freight cars. In 2016, expenditures on locomotives were approximately \$51 million and were focused on the remanufacture of older six-axle units. Freight car investments of approximately \$54 million were largely focused on the acquisition of existing units previously held under operating leases.

In 2016, CP invested approximately \$88 million in information systems primarily focused on rationalizing and enhancing business systems, providing real-time data, and modernizing core hardware and applications. Investments in buildings and other items were \$108 million, and include items such as facility upgrades and renovations, vehicles, containers, and shop equipment.

For 2017, CP expects to invest approximately \$1.25 billion in its capital programs, which will be financed with cash generated from operations and leverages the considerable network upgrade and improvement investments that have been made over the last several years. Approximately 70% of planned capital programs are for track and roadway, including approximately \$48 million for PTC. Approximately 10% to 15% is expected to be allocated to rolling stock assets, including locomotive improvements and the continued acquisition of freight cars previously held under operating leases. Between 5% and 10% is expected to be allocated to information services, and 10% is expected to be allocated to buildings and other.

## Financing Activities

Cash used in financing activities was \$1,493 million in 2016, an increase of \$536 million from \$957 million in 2015. This increase in cash used in financing activities was primarily due to issuance of long-term debt in 2015. This increase was partially offset by higher payments to buy back shares under the Company's share repurchase program and the net repayment of commercial paper and long-term debt in 2015.

Cash used in financing activities was \$957 million in 2015, as compared to \$1,630 million in 2014. This decrease was largely due to the issuance of long-term debt in 2015 and was partially offset by higher payments to buy back shares under the Company's share repurchase program and the net repayment of commercial paper compared to net issuances in 2014, and the early redemption of notes.

### *Interest Coverage Ratio*

At December 31, 2016, the Company's interest coverage ratio was 5.6, compared with 6.0 at December 31, 2015. This decrease was primarily due to an increase in Net interest expense of \$77 million compared to the prior year, partially offset by a year over year improvement in Earnings before interest and taxes ("EBIT"). In 2016, EBIT was negatively impacted by a legal settlement charge and positively impacted by FX translation on U.S. dollar-denominated debt, while in 2015 EBIT was negatively impacted by FX translation on U.S. dollar-denominated debt and the early redemption premium on notes, and positively impacted by the gain on sale of D&H South.

Excluding these significant items from EBIT, Adjusted interest coverage ratio was 5.5 at December 31, 2016, compared with 6.7 at December 31, 2015. This decrease was primarily due to an increase in Net interest expense, as well as a year over year decrease in Adjusted EBIT. Interest coverage ratio, Adjusted interest coverage ratio, EBIT, Adjusted EBIT, and significant items are defined and reconciled in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

### *Credit Measures*

Credit ratings provide information relating to the Company's financing costs, liquidity and operations and affect the Company's ability to obtain short-term and long-term financing and/or the cost of such financing.

A mid-investment grade credit rating is an important measure in assessing the Company's ability to maintain access to public financing and to minimize the cost of capital. It also affects the ability of the Company to engage in certain collateralized business activities on a cost-effective basis.

Credit ratings and outlooks are based on the rating agencies' methodologies and can change from time to time to reflect their views of CP. 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, 2016, CP's credit rating from Standard & Poor's Rating Services ("Standard & Poor's") and Moody's Investor Service ("Moody's") remains unchanged from December 31, 2015. During the second quarter of 2016, Moody's changed the outlook on CP's Senior unsecured debt to negative from stable, and Dominion Bond Rating Service Limited ("DBRS") changed the outlook on CP's Unsecured debentures and Medium-term notes from BBB (high) stable outlook to BBB (high) negative outlook. Subsequently, on August 2, 2016, DBRS downgraded the Company's credit rating from BBB (high) negative outlook to BBB with a stable outlook for unsecured debentures and medium-term notes and from R-2 (high) to R-2 (middle) for the \$1 billion Commercial paper program. Standard & Poor's affirmed a stable rating on CP's Long-term corporate credit, Senior secured debt and Senior unsecured debt.

Credit ratings as at December 31, 2016<sup>(1)</sup>

| <b>Long-term debt</b>                       |                     |  | Outlook  |
|---|---------------------|--|----------|
| <b>Standard &amp; Poor's</b>                |                     |  |          |
| Long-term corporate credit                  | <b>BBB+</b>         |  | stable   |
| Senior secured debt                         | <b>A</b>            |  | stable   |
| Senior unsecured debt                       | <b>BBB+</b>         |  | stable   |
| <b>Moody's</b>                              |                     |  |          |
| Senior unsecured debt                       | <b>Baa1</b>         |  | negative |
| <b>DBRS</b>                                 |                     |  |          |
| Unsecured debentures                        | <b>BBB</b>          |  | stable   |
| Medium-term notes                           | <b>BBB</b>          |  | stable   |
| <b>\$1 billion Commercial paper program</b> |                     |  |          |
| <b>Standard &amp; Poor's</b>                | <b>A-2</b>          |  | N/A      |
| <b>Moody's</b>                              | <b>P-2</b>          |  | N/A      |
| <b>DBRS</b>                                 | <b>R-2 (middle)</b> |  | N/A      |

<sup>(1)</sup> 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.

The Adjusted net debt to Adjusted earnings before interest, tax, depreciation and amortization ("EBITDA") ratio for the years ended December 31, 2016, 2015, and 2014 was 2.9, 2.8 and 2.2, respectively. The increase between 2016 and 2015 was primarily due to a lower ending cash balance as at December 31, 2016 compared to December 31, 2015, as well as a decrease in Adjusted EBITDA for 2016. The increase between 2015 and 2014 was due to additional debt issued during the 2015 fiscal year, partially offset by the improved Adjusted income for the year ended December 31, 2015. Adjusted net debt to Adjusted EBITDA ratio and the Adjusted income are defined and reconciled in Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

#### Free Cash

CP generated positive Free cash of \$1,007 million in 2016, a decrease of \$374 million from \$1,381 million in 2015. The decrease was primarily due to lower cash provided by operating activities and proceeds from the sale of D&H South in the third quarter of 2015, partially offset by lower additions to properties in 2016. Free cash is affected by seasonal fluctuations and by other factors including the size of the Company's capital programs. The 2016 capital programs are discussed further above in Investing Activities. Free cash is defined and reconciled in the Non-GAAP Measures of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

## SHARE CAPITAL

At February 14, 2017, the latest practicable date, there were 146,366,093 Common Shares and no preferred shares issued and outstanding, which consists of 14,931 holders of record of the Company's Common Shares. In addition, CP has a Management Stock Option Incentive Plan ("MSOIP"), under which key officers and employees are granted options to purchase CP Common Shares. Each option granted can be exercised for one Common Share. At February 14, 2017, 2.0 million options were outstanding under the Company's MSOIP and stand-alone option agreements entered into with Mr. Keith Creel and former CEO, Mr. E. Hunter Harrison. There are 1.5 million options available to be issued by the Company's MSOIP in the future.

CP has a Director's Stock Option Plan ("DSOP"), under which directors are granted options to purchase CP Common Shares. There are no outstanding options under the DSOP, which has 0.3 million options available to be issued in the future.

## NON-GAAP MEASURES

The Company presents non-GAAP measures and cash flow information 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.

## ADJUSTED PERFORMANCE MEASURES

The Company uses 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. These non-GAAP measures are presented in Item 6. Selected Financial Data and 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. As a result, these items are excluded for management 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, and certain items outside the control of management. 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 2016, there were two significant items included in Net income as follows:

- in the third quarter, a \$25 million expense (\$18 million after current tax) related to a legal settlement that unfavourably impacted Diluted EPS by 12 cents; and
- during the course of the year, a net non-cash gain of \$79 million (\$68 million after deferred tax) due to FX translation of the Company's U.S. dollar-denominated debt as follows:
  - in the fourth quarter, a \$74 million loss (\$64 million after deferred tax) that unfavourably impacted Diluted EPS by 43 cents;
  - in the third quarter, a \$46 million loss (\$40 million after deferred tax) that unfavourably impacted Diluted EPS by 27 cents;
  - in the second quarter, a \$18 million gain (\$16 million after deferred tax) that favourably impacted Diluted EPS by 10 cents; and
  - in the first quarter, a \$181 million gain (\$156 million after deferred tax) that favourably impacted Diluted EPS by \$1.01.

In 2015, there were four significant items included in Net income as follows:

- in the third quarter, a \$68 million gain (\$42 million after current tax) related to the sale of D&H South that favourably impacted Diluted EPS by 26 cents;
- in the third quarter, a \$47 million charge (\$35 million after deferred tax) related to the early redemption premium on notes that unfavourably impacted Diluted EPS by 22 cents;
- in the second quarter, a deferred income tax expense of \$23 million as a result of the change in the Alberta provincial corporate income tax rate that unfavourably impacted Diluted EPS by 14 cents; and
- during the course of the year, a net non-cash loss of \$297 million (\$257 million after deferred tax) due to FX translation of the Company's U.S. dollar-denominated debt as follows:
  - in the fourth quarter, a \$115 million loss (\$100 million after deferred tax) that unfavourably impacted Diluted EPS by 64 cents;
  - in the third quarter, a \$128 million loss (\$111 million after deferred tax) that unfavourably impacted Diluted EPS by 69 cents;
  - in the second quarter, a \$10 million gain (\$9 million after deferred tax) that favourably impacted Diluted EPS by 5 cents; and
  - in the first quarter, a \$64 million loss (\$55 million after deferred tax) that unfavourably impacted Diluted EPS by 34 cents.

In 2014, there were two significant items included in Net income as follows:

- in the fourth quarter, a net non-cash loss of \$12 million (\$9 million after deferred tax) due to FX translation on the Company's U.S. dollar-denominated debt that unfavourably impacted Diluted EPS by 5 cents; and
- in the first quarter, a recovery of \$4 million (\$3 million after current tax) was recorded for the Company's 2012 labour restructuring initiative due to favourable experience gains, recorded in Compensation and benefits that favourably impacted Diluted EPS by 1 cent.

In 2013, there were five significant items included in Net income as follows:

- in the fourth quarter, an asset impairment charge and accruals for future costs totalling \$435 million (\$257 million after deferred tax) relating to the sale of DM&E West, which closed in the second quarter of 2014 and unfavourably impacted Diluted EPS by \$1.46;
- in the fourth quarter, management transition costs related to the retirement of the Company's CFO and the appointment of the new CFO of \$5 million (\$4 million after current tax) that unfavourably impacted Diluted EPS by 2 cents;
- in the fourth quarter, a recovery of \$7 million (\$5 million after current tax) of the Company's 2012 labour restructuring initiative due to favourable experience gains that favourably impacted Diluted EPS by 3 cents;
- in the third quarter, a deferred income tax expense of \$7 million as a result of the change in the province of British Columbia's corporate income tax rate that unfavourably impacted Diluted EPS by 4 cents; and
- in the first quarter, a recovery of U.S. \$9 million (U.S. \$6 million after current tax) related to settlement of certain management transition amounts which had been subject to legal proceedings that favourably impacted Diluted EPS by 3 cents.

In 2012, there were six significant items included in Net income as follows:

- in the fourth quarter, an asset impairment charge of \$185 million (\$111 million after deferred tax) with respect to the option to build into the Powder River Basin and another investment that unfavourably impacted Diluted EPS by 64 cents;
- in the fourth quarter, an asset impairment charge of \$80 million (\$59 million after deferred tax) related to a certain series of locomotives that unfavourably impacted Diluted EPS by 34 cents;
- in the fourth quarter, a labour restructuring charge of \$53 million (\$39 million after current tax) as part of a restructuring initiative that unfavourably impacted Diluted EPS by 22 cents;
- in the second quarter, a charge of \$42 million (\$29 million after current tax) with respect to compensation and other management transition costs that unfavourably impacted Diluted EPS by 17 cents;
- in the first and second quarters, advisory fees of \$27 million (\$20 million after current tax) related to shareholder matters that unfavourably impacted Diluted EPS by 12 cents; and
- in the second quarter, a deferred income tax expense of \$11 million as a result of the change in the province of Ontario's corporate income tax rate that unfavourably impacted Diluted EPS by 6 cents.

## RECONCILIATION OF NON-GAAP PERFORMANCE MEASURES TO GAAP PERFORMANCE MEASURES

The following tables reconcile non-GAAP measures presented in Item 6. Selected Financial Data and discussed further in other sections of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations to the most directly comparable measures presented in accordance with GAAP for the years ended December 31, 2016, 2015, 2014, 2013 and 2012:

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

| Net income<br>(in millions)                              | For the year ended December 31 |          |          |          |        |
|--|--------------------------------|----------|----------|----------|--------|
|  | 2016                           | 2015     | 2014     | 2013     | 2012   |
| <b>Adjusted income</b>                                   | <b>\$ 1,549</b>                | \$ 1,625 | \$ 1,482 | \$ 1,132 | \$ 753 |
| Add significant items (pretax):                          |                                |          |          |          |        |
| Legal settlement charge                                  | (25)                           | —        | —        | —        | —      |
| Gain on sale of D&H South                                | —                              | 68       | —        | —        | —      |
| Labour restructuring                                     | —                              | —        | 4        | 7        | (53)   |
| Asset impairments  | —                              | —        | —        | (435)    | (265)  |
| Management transition costs                              | —                              | —        | —        | 4        | (42)   |
| Advisory fees related to shareholder matters             | —                              | —        | —        | —        | (27)   |
| Impact of FX translation on U.S. dollar-denominated debt | 79                             | (297)    | (12)     | —        | —      |
| Early redemption premium on notes                        | —                              | (47)     | —        | —        | —      |
| Income tax rate change                                   | —                              | (23)     | —        | (7)      | (11)   |
| Tax effect of adjustments <sup>(1)</sup>                 | (4)                            | 26       | 2        | 174      | 129    |
| <b>Net income as reported</b>                            | <b>\$ 1,599</b>                | \$ 1,352 | \$ 1,476 | \$ 875   | \$ 484 |

<sup>(1)</sup> Tax effect of adjustments was calculated as the pretax effect of the adjustments multiplied by the effective tax rate for each of the above items for the periods presented.

Adjusted diluted earnings per share is calculated using Adjusted income, as defined above, divided by the weighted-average diluted shares outstanding during the period as determined in accordance with GAAP.

| Diluted earnings per share                               | For the year ended December 31 |          |         |         |         |
|--|--------------------------------|----------|---------|---------|---------|
|  | 2016                           | 2015     | 2014    | 2013    | 2012    |
| <b>Adjusted diluted earnings per share</b>               | <b>\$ 10.29</b>                | \$ 10.10 | \$ 8.50 | \$ 6.42 | \$ 4.34 |
| Add significant items (pretax):                          |                                |          |         |         |         |
| Legal settlement charge                                  | (0.17)                         | —        | —       | —       | —       |
| Gain on sale of D&H South                                | —                              | 0.42     | —       | —       | —       |
| Labour restructuring                                     | —                              | —        | 0.02    | 0.04    | (0.31)  |
| Asset impairments  | —                              | —        | —       | (2.47)  | (1.53)  |
| Management transition costs                              | —                              | —        | —       | 0.02    | (0.24)  |
| Advisory fees related to shareholder matters             | —                              | —        | —       | —       | (0.16)  |
| Impact of FX translation on U.S. dollar-denominated debt | 0.53                           | (1.84)   | (0.07)  | —       | —       |
| Early redemption premium on notes                        | —                              | (0.30)   | —       | —       | —       |
| Income tax rate change                                   | —                              | (0.14)   | —       | (0.04)  | (0.06)  |
| Tax effect of adjustments <sup>(1)</sup>                 | (0.02)                         | 0.16     | 0.01    | 0.99    | 0.75    |
| <b>Diluted earnings per share as reported</b>            | <b>\$ 10.63</b>                | \$ 8.40  | \$ 8.46 | \$ 4.96 | \$ 2.79 |

<sup>(1)</sup> Tax effect of adjustments was calculated as the pretax effect of the adjustments multiplied by the effective tax rate for each of the above items for the periods presented.

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

| Operating income<br>(in millions)   | For the year ended December 31 |          |          |          |          |
|-------------------------------------|--------------------------------|----------|----------|----------|----------|
|                                     | 2016                           | 2015     | 2014     | 2013     | 2012     |
| <b>Adjusted Operating income</b>    | <b>\$ 2,578</b>                | \$ 2,620 | \$ 2,335 | \$ 1,844 | \$ 1,309 |
| Add significant items:              |                                |          |          |          |          |
| Gain on sale of D&H South           | —                              | 68       | —        | —        | —        |
| Labour restructuring                | —                              | —        | 4        | 7        | (53)     |
| Asset impairments                   | —                              | —        | —        | (435)    | (265)    |
| Management transition costs         | —                              | —        | —        | 4        | (42)     |
| <b>Operating income as reported</b> | <b>\$ 2,578</b>                | \$ 2,688 | \$ 2,339 | \$ 1,420 | \$ 949   |

Adjusted operating ratio excludes those significant items that are reported within Operating income.

| Operating ratio                    | For the year ended December 31 |        |       |        |       |
|------------------------------------|--------------------------------|--------|-------|--------|-------|
|                                    | 2016                           | 2015   | 2014  | 2013   | 2012  |
| <b>Adjusted operating ratio</b>    | <b>58.6%</b>                   | 61.0%  | 64.7% | 69.9%  | 77.0% |
| Add significant items:             |                                |        |       |        |       |
| Gain on sale of D&H South          | —%                             | (1.0)% | —%    | —%     | —%    |
| Labour restructuring               | —%                             | —%     | —%    | (0.1)% | 0.9%  |
| Asset impairments                  | —%                             | —%     | —%    | 7.1%   | 4.7%  |
| Management transition costs        | —%                             | —%     | —%    | (0.1)% | 0.7%  |
| <b>Operating ratio as reported</b> | <b>58.6%</b>                   | 60.0%  | 64.7% | 76.8%  | 83.3% |

## ROIC AND ADJUSTED ROIC

ROIC is calculated as Operating income less Other income and charges, tax effected at the Company's annualized effective tax rate, on a rolling twelve-month basis, divided by the sum of Total shareholders' equity, Long-term debt, Long-term debt maturing within one year and Short-term borrowing, as presented in the Company's Consolidated Financial Statements, averaged between the beginning and ending balance over a rolling twelve-month period. Adjusted ROIC excludes significant items reported in Operating income and Other income and charges in the Company's Consolidated Financial Statements, as these significant items are not considered indicative of future financial trends either by nature or amount.

ROIC and Adjusted ROIC are all-encompassing performance measures that measure how productively the Company uses its long-term capital investments, representing critical indicators of good operating and investment decisions made by management and are important performance criteria in determining certain elements of the Company's long-term incentive plan. ROIC and Adjusted ROIC are presented in Item 6. Selected Financial Data and discussed further in Results of Operations of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

### Calculation of ROIC and Adjusted ROIC

| (in millions, except for percentages)   | 2016         | 2015      | 2014      | 2013      | 2012     |
|---|--------------|-----------|-----------|-----------|----------|
| Operating income for the year ended December 31   | \$ 2,578     | \$ 2,688  | \$ 2,339  | \$ 1,420  | \$ 949   |
| Less:   |              |           |           |           |          |
| Other income and charges  | (45)         | 335       | 19        | 17        | 37       |
| Tax <sup>(1)</sup>  | 675          | 728       | 640       | 312       | 218      |
|   | \$ 1,948     | \$ 1,625  | \$ 1,680  | \$ 1,091  | \$ 694   |
| Average for the twelve months of total shareholders' equity, long-term debt, long-term debt maturing within one year and short-term borrowing | \$ 13,532    | \$ 12,561 | \$ 11,653 | \$ 10,842 | \$ 9,564 |
| <b>ROIC</b>   | <b>14.4%</b> | 12.9%     | 14.4%     | 10.1%     | 7.3%     |

<sup>(1)</sup> Tax was calculated at the annualized effective tax rate of 25.72%, 30.95%, 27.59%, 22.21%, 23.95% for each of the above items for the years presented, respectively.

| (in millions, except for percentages)   | 2016         | 2015      | 2014      | 2013      | 2012     |
|---|--------------|-----------|-----------|-----------|----------|
| Adjusted operating income for the year ended December 31  | \$ 2,578     | \$ 2,620  | \$ 2,335  | \$ 1,844  | \$ 1,309 |
| Less:   |              |           |           |           |          |
| Other income and charges  | (45)         | 335       | 19        | 17        | 37       |
| Add significant items (pretax):   |              |           |           |           |          |
| Legal settlement charge   | 25           | —         | —         | —         | —        |
| Advisory fees related to shareholder matters  | —            | —         | —         | —         | 27       |
| Impact of FX translation on U.S. dollar-denominated debt  | (79)         | 297       | 12        | —         | —        |
| Early redemption premium on notes   | —            | 47        | —         | —         | —        |
| Less: tax <sup>(1)</sup>  | 673          | 716       | 642       | 491       | 344      |
|   | \$ 1,896     | \$ 1,913  | \$ 1,686  | \$ 1,336  | \$ 955   |
| Average for the twelve months of total shareholders' equity, long-term debt, long-term debt maturing within one year and short-term borrowing | \$ 13,532    | \$ 12,561 | \$ 11,653 | \$ 10,842 | \$ 9,564 |
| <b>Adjusted ROIC</b>  | <b>14.0%</b> | 15.2%     | 14.5%     | 12.3%     | 10.0%    |

<sup>(1)</sup> Tax was calculated at the adjusted annualized effective tax rate of 26.20%, 27.25%, 27.58%, 26.88%, 26.49% for each of the above items for the years presented, respectively.

### 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. Free cash is a measure that management considers to be an indicator of liquidity. Free cash is useful to investors and other external users of the consolidated financial statements as it assists with the evaluation of the Company's ability to generate cash from its operations without incurring additional external financing. Positive Free cash indicates the amount of cash available for reinvestment in the business, or cash that can be returned to investors through dividends, stock repurchase programs, debt retirements or a combination of these. Conversely, negative Free cash indicates the amount of cash that must be raised from investors through new debt or equity issues, reduction in available cash balances or a combination of these. Free cash should be considered in addition to, rather than as a substitute for, Cash provided by operating activities. Free cash is presented in Item 6. Selected Financial Data and discussed further in Liquidity and Capital Resources of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

## Reconciliation of Cash Provided by Operating Activities to Free Cash

| (in millions)  | For the year ended December 31 |          |          |          |          |
|--|--------------------------------|----------|----------|----------|----------|
|  | 2016                           | 2015     | 2014     | 2013     | 2012     |
| <b>Cash provided by operating activities</b>   | <b>\$ 2,089</b>                | \$ 2,459 | \$ 2,123 | \$ 1,950 | \$ 1,328 |
| Cash used in investing activities <sup>(1)</sup>   | <b>(1,069)</b>                 | (1,123)  | (1,161)  | (1,186)  | (1,011)  |
| Effect of foreign currency fluctuations on U.S. dollar-denominated cash and cash equivalents | <b>(13)</b>                    | 45       | 7        | 10       | (1)      |
| <b>Free cash<sup>(2)</sup></b>   | <b>\$ 1,007</b>                | \$ 1,381 | \$ 969   | \$ 774   | \$ 316   |

<sup>(1)</sup> 2013 and 2014 comparative figures have been restated by \$411 million and (\$411) million, respectively, due to the early adoption of Accounting Standards Update ("ASU") 2016-18. See further discussion in Item 8. Financial Statements and Supplemental Data, Note 2 Accounting changes. As a result of the change, the offsetting adjustments for changes in restricted cash were also removed from this calculation in both years, resulting in no net change to Free cash.

<sup>(2)</sup> The definition of Free cash has been revised to exclude the deduction of dividends paid. As a result of this change, Free cash was increased by \$226 million in 2015, \$244 million in 2014, \$244 million in 2013, and \$223 million in 2012.

## FOREIGN EXCHANGE ADJUSTED VARIANCE

FX adjusted variance 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 variances are discussed in Operating Revenues and Operating Expenses of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

| (in millions)                   | Reported 2016   | Reported 2015 | Reported 2014 | 2016 vs. 2015      |                  |           | 2015 vs. 2014      |                  |           |
|---------------------------------|-----------------|---------------|---------------|--------------------|------------------|-----------|--------------------|------------------|-----------|
|                                 |                 |               |               | Variance due to FX | FX Adjusted 2015 | FX Adj. % | Variance due to FX | FX Adjusted 2014 | FX Adj. % |
| Freight revenues                | <b>\$ 6,060</b> | \$ 6,552      | \$ 6,464      | \$ 145             | \$ 6,697         | (10)      | \$ 549             | \$ 7,013         | (7)       |
| Non-freight revenues            | <b>172</b>      | 160           | 156           | 1                  | 161              | 7         | 4                  | 160              | —         |
| <b>Total revenues</b>           | <b>6,232</b>    | 6,712         | 6,620         | 146                | 6,858            | (9)       | 553                | 7,173            | (6)       |
| Compensation and benefits       | <b>1,189</b>    | 1,371         | 1,348         | 18                 | 1,389            | (14)      | 62                 | 1,410            | (3)       |
| Fuel                            | <b>567</b>      | 708           | 1,048         | 25                 | 733              | (23)      | 143                | 1,191            | (41)      |
| Materials                       | <b>180</b>      | 184           | 193           | 2                  | 186              | (3)       | 5                  | 198              | (7)       |
| Equipment rents                 | <b>173</b>      | 174           | 155           | 5                  | 179              | (3)       | 18                 | 173              | 1         |
| Depreciation and amortization   | <b>640</b>      | 595           | 552           | 5                  | 600              | 7         | 18                 | 570              | 4         |
| Purchased services and other    | <b>905</b>      | 1,060         | 985           | 21                 | 1,081            | (16)      | 60                 | 1,045            | 1         |
| Gain on sale of D&H South       | <b>—</b>        | (68)          | —             | 1                  | (67)             | (100)     | —                  | —                | 100       |
| <b>Total operating expenses</b> | <b>3,654</b>    | 4,024         | 4,281         | 77                 | 4,101            | (11)      | 306                | 4,587            | (12)      |
| <b>Operating income</b>         | <b>\$ 2,578</b> | \$ 2,688      | \$ 2,339      | \$ 69              | \$ 2,757         | (6)       | \$ 247             | \$ 2,586         | 4         |

## INTEREST COVERAGE RATIO

Interest coverage ratio is measured, on a rolling twelve-month basis, as EBIT divided by Net interest expense. This ratio provides investors, analysts, and lenders with useful information on how the Company's debt servicing capabilities have changed, period over period and in comparison to the Company's peers. Interest coverage 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.

Adjusted interest coverage ratio is calculated as Adjusted EBIT divided by Net interest expense. By excluding significant items which affect EBIT, Adjusted interest coverage ratio assists management in comparing the Company's performance over various reporting periods on a consistent basis. Adjusted interest coverage 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 Interest Coverage Ratio and Adjusted Interest Coverage Ratio

| (in millions, except for ratios)        | 2016       | 2015     | 2014     |
|---|------------|----------|----------|
| EBIT                                    | \$ 2,623   | \$ 2,353 | \$ 2,320 |
| Adjusted EBIT                           | 2,569      | 2,629    | 2,328    |
| Net interest expense                    | 471        | 394      | 282      |
| <b>Interest coverage ratio</b>          | <b>5.6</b> | 6.0      | 8.2      |
| <b>Adjusted interest coverage ratio</b> | <b>5.5</b> | 6.7      | 8.3      |

### Reconciliation of Adjusted earnings before interest, tax, depreciation and amortization and Earnings before interest and tax

Adjusted EBITDA is calculated as Adjusted EBIT plus Depreciation and amortization, net periodic pension and other benefit cost other than current service costs, and operating lease expense. EBIT is calculated as Operating income, less Other income and charges. Adjusted EBIT excludes significant items reported in Operating income and Other income and charges.

| (in millions)  | For the year ended December 31 |          |          |          |          |
|--|--------------------------------|----------|----------|----------|----------|
|  | 2016                           | 2015     | 2014     | 2013     | 2012     |
| <b>Adjusted EBITDA</b>   | <b>\$ 3,153</b>                | \$ 3,281 | \$ 2,864 | \$ 2,464 | \$ 1,957 |
| Add:   |                                |          |          |          |          |
| Net periodic pension and other benefit cost other than current service costs | 167                            | 70       | 137      | 82       | 63       |
| Operating lease expense  | (111)                          | (127)    | (121)    | (154)    | (182)    |
| Depreciation and amortization  | (640)                          | (595)    | (552)    | (565)    | (539)    |
| <b>Adjusted EBIT</b>   | <b>2,569</b>                   | 2,629    | 2,328    | 1,827    | 1,299    |
| Add Significant items (pretax):  |                                |          |          |          |          |
| Legal settlement charge  | (25)                           | —        | —        | —        | —        |
| Gain on sale of D&H South  | —                              | 68       | —        | —        | —        |
| Labour restructuring   | —                              | —        | 4        | 7        | (53)     |
| Asset impairments  | —                              | —        | —        | (435)    | (265)    |
| Management transition  | —                              | —        | —        | 4        | (42)     |
| Advisory costs related to shareholder matters                                | —                              | —        | —        | —        | (27)     |
| Impact of FX translation on U.S. dollar-denominated debt                     | 79                             | (297)    | (12)     | —        | —        |
| Early redemption premium on notes  | —                              | (47)     | —        | —        | —        |
| <b>EBIT</b>  | <b>2,623</b>                   | 2,353    | 2,320    | 1,403    | 912      |
| Less:  |                                |          |          |          |          |
| Net interest expense   | 471                            | 394      | 282      | 278      | 276      |
| Income tax expense   | 553                            | 607      | 562      | 250      | 152      |
| <b>Net income as reported</b>  | <b>\$ 1,599</b>                | \$ 1,352 | \$ 1,476 | \$ 875   | \$ 484   |

### ADJUSTED NET DEBT TO ADJUSTED EBITDA RATIO

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, the net present value of operating leases, which is discounted by the Company's effective interest rate for each of the years presented, and Cash and cash equivalents. Adjusted net debt to adjusted EBITDA ratio is calculated as Adjusted net debt divided by Adjusted EBITDA.

The Adjusted net debt to adjusted EBITDA ratio is one of the key metrics used by credit rating agencies in assessing the Company's financial capacities and constraints and determining the credit rating of the Company. By excluding the impact of certain items that are not considered by management in developing a minimum threshold, Adjusted net debt to Adjusted EBITDA ratio provides a metric that management uses to evaluate the Company's financial discipline with respect to capital markets credit sensitivities from management's perspective and communicates it publicly with investors, analysts and credit rating agencies. Adjusted net debt to 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 Adjusted Net Debt to Adjusted EBITDA Ratio

| (in millions, except for ratios)                  | 2016       | 2015     | 2014     |
|---|------------|----------|----------|
| Adjusted net debt as at December 31               | \$ 9,154   | \$ 9,041 | \$ 6,268 |
| Adjusted EBITDA for the year ended December 31    | 3,153      | 3,281    | 2,864    |
| <b>Adjusted net debt to Adjusted EBITDA ratio</b> | <b>2.9</b> | 2.8      | 2.2      |

## Reconciliation of Adjusted Net Debt to Long-term Debt

| (in millions)   | 2016            | 2015     | 2014     |
|---|-----------------|----------|----------|
| <b>Adjusted net debt as at December 31</b>  | <b>\$ 9,154</b> | \$ 9,041 | \$ 6,268 |
| Add:  |                 |          |          |
| Pension plans deficit   | (273)           | (295)    | (288)    |
| Net present value of operating leases <sup>(1)</sup>                                      | (361)           | (439)    | (447)    |
| Cash and cash equivalents   | 164             | 650      | 226      |
| <b>Long-term debt including long-term debt maturing within one year as at December 31</b> | <b>\$ 8,684</b> | \$ 8,957 | \$ 5,759 |

<sup>(1)</sup> Operating leases were discounted at the Company's effective interest rate for each of the years presented.

## OFF-BALANCE SHEET ARRANGEMENTS

### Guarantees

At December 31, 2016, the Company had residual value guarantees on operating lease commitments of \$19 million, compared to \$28 million at December 31, 2015. The maximum amount that could be payable under these and all of the Company's other guarantees cannot be reasonably estimated due to the nature of certain guarantees. All or a portion of amounts paid under certain guarantees could be recoverable from other parties or through insurance. As at December 31, 2016, the fair value of these guarantees recognized as a liability was \$5 million, compared to \$4 million at December 31, 2015.

### Contractual Commitments

The accompanying table indicates the Company's obligations and commitments to make future payments for contracts, such as debt, capital lease and commercial arrangements as at December 31, 2016.

| Payments due by period (in millions)         | Total            | 2017     | 2018 & 2019 | 2020 & 2021 | 2022 & beyond |
|--|------------------|----------|-------------|-------------|---------------|
| Contractual commitments                      |                  |          |             |             |               |
| Interest on long-term debt and capital lease | \$ 12,526        | \$ 491   | \$ 889      | \$ 803      | \$ 10,343     |
| Long-term debt                               | 8,614            | 20       | 1,259       | 443         | 6,892         |
| Capital leases                               | 166              | 4        | 10          | 11          | 141           |
| Operating lease <sup>(1)</sup>               | 450              | 97       | 118         | 84          | 151           |
| Supplier purchase                            | 2,476            | 609      | 1,083       | 177         | 607           |
| Other long-term liabilities <sup>(2)</sup>   | 519              | 72       | 108         | 103         | 236           |
| <b>Total contractual commitments</b>         | <b>\$ 24,751</b> | \$ 1,293 | \$ 3,467    | \$ 1,621    | \$ 18,370     |

<sup>(1)</sup> Residual value guarantees on certain leased equipment with a maximum exposure of \$19 million are not included in the minimum payments shown above, as management believes that CP will not be required to make payments under these residual guarantees.

<sup>(2)</sup> Includes expected cash payments for restructuring, environmental remediation, asset retirement obligations, post-retirement benefits, workers' compensation benefits, long-term disability benefits, pension benefit payments for the Company's non-registered supplemental pension plan and certain other long-term liabilities. Projected payments for post-retirement benefits, workers' compensation benefits and long-term disability benefits include the anticipated payments for years 2017 to 2026. Pension contributions for the Company's registered pension plans are not included due to the volatility in calculating them. 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.

### Certain Other Financial Commitments

In addition to the financial commitments mentioned previously in Off-Balance Sheet Arrangements and Contractual Commitments of this Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations, the Company is party to certain other financial commitments discussed below.

*Letters of Credit*

Letters of credit are obtained mainly to provide security to third parties under the terms of various agreements, including the supplemental pension plan. CP is liable for these contractual amounts in the case of non-performance under these agreements. Letters of credit are accommodated through a revolving credit facility and the Company's bilateral letter of credit facilities.

*Capital Commitments*

The Company remains committed to maintaining the current high level of plant quality and renewing the franchise. As part of this commitment, CP has entered into contracts with suppliers to make various capital purchases related to track programs. Payments for these commitments are due in 2017 through 2020. These expenditures are expected to be financed by cash generated from operations or by issuing new debt.

The accompanying table indicates the Company's commitments to make future payments for letters of credit and capital expenditures as at December 31, 2016.

| Payments due by period (in millions)             | Total         | 2017          | 2018 & 2019  | 2020 & 2021 | 2022 & beyond |
|--|---------------|---------------|--------------|-------------|---------------|
| Certain other financial commitments              |               |               |              |             |               |
| Letters of credit                                | \$ 320        | \$ 320        | \$ —         | \$ —        | \$ —          |
| Capital commitments                              | 186           | 129           | 53           | 4           | —             |
| <b>Total certain other financial commitments</b> | <b>\$ 506</b> | <b>\$ 449</b> | <b>\$ 53</b> | <b>\$ 4</b> | <b>\$ —</b>   |

**CRITICAL ACCOUNTING ESTIMATES**

To prepare 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, including those related to environmental liabilities, pensions and other benefits, property, plant and equipment, deferred income taxes, and legal and personal injury liabilities.

The development, selection and disclosure of these estimates, and this MD&A, have been reviewed by the Board of Directors' Audit Committee, which is composed entirely of independent directors.

**Environmental Liabilities**

CP estimates the probable cost to be incurred in the remediation of property contaminated by past railway use. The Company screens and classifies sites according to typical activities and scale of operations conducted, and develops 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. CP 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.

Liabilities for environmental remediation may change from time to time as new information about previously untested sites becomes known. The net liability 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. Material increases to costs 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.

At December 31, 2016 and 2015, the accrual for environmental remediation on the Company's Consolidated Balance Sheets amounted to \$85 million and \$93 million respectively, of which the long-term portion amounting to \$76 million in 2016 and \$80 million in 2015 was included in "Other long-term liabilities" and the short-term portion amounting to \$9 million in 2016 and \$13 million in 2015 was included in "Accounts payable and accrued liabilities". Cash payments related to the Company's environmental remediation program totalled \$12 million in 2016, compared with \$18 million in 2015. The U.S. dollar-denominated portion of the liability was affected by the change in FX, resulting in a decrease in environmental liabilities of \$2 million in 2016 and an increase \$12 million in 2015.

Cash payments for environmental initiatives are estimated to be approximately \$9 million in 2017, \$10 million in 2018, \$11 million in 2019 and a total of approximately \$55 million over the remaining years through 2026, which will be paid in decreasing amounts. All payments will be funded from general operations.

CP continues to be responsible for remediation work on portions of a property in the state of Minnesota and continues to retain liability accruals for remaining future expected costs. The costs are expected to be incurred over approximately 10 years. The state regulators will oversee the work to ensure it is completed in accordance with applicable standards.

### **Pensions and Other Benefits**

CP 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 Legal and Personal Injury Liabilities section below. Pension and post-retirement benefits liabilities are subject to various external influences and uncertainties.

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

#### *Pension Liabilities and Pension Assets*

As at December 31, 2016, the Company included on its Consolidated Balance Sheet:

- pension benefit liabilities of \$263 million (\$285 million in 2015) in "Pension and other benefit liabilities" and \$10 million (\$10 million in 2015) in "Accounts payable and accrued liabilities";
- post-retirement benefits liabilities of \$383 million (\$387 million in 2015) in "Pension and other benefit liabilities" and \$21 million (\$21 million in 2015) in "Accounts payable and accrued liabilities";
- accruals for self-insured workers' compensation and long-term disability benefit plans, including \$88 million (\$86 million in 2015) in "Pension and other benefit liabilities", which are discussed in the Legal and Personal Injury Liabilities section below; and
- pension benefit assets of \$1,070 million (\$1,401 million in 2015) in "Pension assets".

#### *Net Periodic Benefit Costs*

Net periodic benefit costs for pensions and post-retirement benefits were included in "Compensation and benefits" on the Company's Consolidated Statements of Income. Combined net periodic benefit credits for pensions and post-retirement benefits (excluding self-insured workers' compensation and long-term disability benefits) were \$55 million in 2016, compared with net periodic benefit costs of \$66 million in 2015.

Net periodic benefit credits for pensions were \$81 million in 2016, compared with net periodic benefit costs of \$41 million in 2015. The benefit credit portion related to defined benefit pensions was \$90 million in 2016, compared with the benefit cost portion of \$32 million in 2015. The benefit cost portion related to defined contribution pensions (equal to contributions) was \$9 million in 2016, compared with \$9 million for 2015. Net periodic benefit costs for post-retirement benefits were \$26 million in 2016, compared with \$25 million in 2015.

CP estimates net periodic benefit credits for defined benefit pensions to be approximately \$190 million in 2017, and net periodic benefit costs for defined contribution pensions to be approximately \$8 million in 2017. Net periodic benefit costs for post-retirement benefits in 2017 are not expected to differ materially from the 2016 costs.

#### *Pension Plan Contributions*

The Company made contributions of \$48 million to the defined benefit pension plans in 2016, compared with \$81 million in 2015. The Company's main Canadian defined benefit pension plan accounts for 96% of CP'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 of \$600 million in 2011, \$650 million in 2010 and \$500 million in 2009 to the Company's main Canadian defined benefit pension plan. CP has applied \$1,281 million of these voluntary prepayments to reduce its pension funding requirements in 2012–2016, leaving \$469 million of the voluntary prepayments still available at December 31, 2016 to reduce CP's pension funding requirements in 2017 and future years. CP 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 CP to manage the volatility of future pension funding requirements. At this time, CP estimates it will apply \$50 million of the remaining voluntary prepayments against its 2017 pension funding requirements.

CP estimates its aggregate pension contributions, including its defined benefit and defined contribution plans, to be in the range of \$50 million to \$60 million in 2017, and in the range of \$50 million to \$100 million per year from

2018 to 2020. These estimates reflect the Company's current intentions with respect to the rate at which CP will apply the remaining voluntary prepayments against contribution requirements in the next few years.

Future pension contributions will be highly dependent on the Company's actual experience with such variables 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. CP will continue to make contributions to the pension plans that, at a minimum, meet pension legislative requirements.

#### *Pension Plan Risks*

Fluctuations in the liability and net periodic benefit costs for pensions result from favourable or unfavourable 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 rates on pension obligations is partially offset by their impact on the pension funds' investments in fixed income assets.

The plans' investment policy provides a target allocation of approximately 46% 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 funds' asset performance. If the rate of investment return on the plans' public equity securities in 2016 had been 10 percentage points higher (or lower) than the actual 2016 rate of investment return on such securities, 2017 net periodic benefit costs for pensions would be lower (or higher) by approximately \$25 million.

Changes in bond yields can result in changes to discount rates and to changes in the value of fixed income assets. If the discount rate as at December 31, 2016 had been higher (or lower) by 0.1% with no related changes in the value of the pension funds' investment in fixed income assets, 2017 net periodic benefit costs for pensions would be lower (or higher) by approximately \$13 million. However, a change in bond yields would also lead to a change in the value of the pension funds' investment 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 \$155 million, and estimates that a decrease in the discount rate of 0.1% would increase the defined benefit pension plans' projected benefit obligations by approximately \$157 million. Similarly, for every 0.1% 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 \$12 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 \$5 million.

CP reviews its pensioner mortality experience to ensure that the mortality assumption continues to be appropriate, or to determine what changes to the assumption is 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. CP performs depreciation studies of each property group approximately every three years to update depreciation rates. The depreciation studies are based on statistical analysis of historical retirements of properties in the group and incorporate engineering estimates of changes in current operations and of technological advances. CP depreciates the cost of properties, net of salvage, on a straight-line basis over the estimated useful life of the property group. The estimates of economic lives are uncertain and can vary due to technological changes or in the rate of wear. Additionally, the depreciation rates are updated to reflect the change in residual values of the assets in the class. Under the group depreciation method, retirements or disposals of properties in the normal course of business are accounted for by charging the cost of the property less any net salvage to accumulated depreciation. For the sale or retirement of larger groups of depreciable assets that are unusual that were not predicted in the Company's depreciation studies, CP records a gain or loss for the difference between net proceeds and net book value of the assets sold or retired.

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. At December 31, 2016 and 2015, accumulated depreciation was \$7,125 million and \$6,952 million, respectively.

Revisions to the estimated useful lives and net salvage projections for properties constitute a change in accounting estimate and are addressed prospectively by amending depreciation rates. It is anticipated that there will be changes in the estimates of weighted average useful lives and net salvage for each property group 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 road locomotives, the largest asset group, increased (or decreased) by 5%, annual depreciation expense would decrease (or increase) by approximately \$3 million.

The Company reviews the carrying amounts of properties when circumstances indicate that such carrying amounts may not be recoverable based on future undiscounted cash flows. When such properties are determined to be impaired, recorded asset values are revised to their fair values and an impairment loss is recognized.

### **Deferred Income Taxes**

CP 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. 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. Deferred income taxes are calculated using enacted federal, provincial, and state future income tax rates, which may differ in future periods.

A deferred income tax expense of \$320 million was included in "Income tax expense" for 2016 and \$234 million in 2015 on the Company's Consolidated Statements of Income. The increase in deferred income tax expense in 2016 was primarily due to the 2015 reclassification of deferred tax expense to current tax expense related to the D&H South sale. In addition, the Company recorded deferred income tax expense related to FX translation on U.S. dollar-denominated debt, whereas this was a recovery in 2015. At December 31, 2016 and 2015, deferred income tax liabilities of \$3,571 million and \$3,391 million, respectively, were recorded as a long-term liability and are composed largely of temporary differences related to accounting for properties.

### **Legal and Personal Injury Liabilities**

The Company is involved in litigation related to CP's business in Canada and the U.S. Management is required to establish estimates of the potential liability arising from incidents, claims and pending litigation, including personal injury claims by employees and third parties, and certain occupation-related claims and property damage claims.

Accruals for incidents, claims and litigation, including workers' compensation benefit accruals, totalled \$130 million, net of insurance recoveries, at December 31, 2016 and \$133 million at December 31, 2015. At December 31, 2016 and 2015 respectively, the total accrual included \$88 million and \$86 million in "Pension and other benefit liabilities", \$18 million and \$18 million in "Other long-term liabilities" and \$26 million and \$30 million in "Accounts payable and accrued liabilities", partially offset by \$2 million and \$1 million in "Other assets" on the Company's Consolidated Balance Sheets. An expense totalling \$67 million in 2016 and \$62 million in 2015 was included in "Purchased services and other" on the Company's Consolidated Statements of Income.

These estimates are determined on a case-by-case basis. They are based on an assessment of the actual damages incurred and current legal advice with respect to settlements in other similar cases. CP employs experienced claims adjusters who investigate and assess the validity of individual claims made against CP and estimate the damages incurred.

A provision for incidents, claims or litigation is recorded based on the facts and circumstances known at the time. CP accrues for likely 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. Additionally, for administrative expediency, a general provision for lesser value injury cases is kept. Facts and circumstances related to asserted claims can change, and a process is in place to monitor accruals for changes in accounting estimates.

These estimates are determined on a case-by-case basis with input from defense counsel and are based on an assessment of the actual damages incurred and current legal advice with respect to settlements in other similar cases. CP employs experienced claims adjusters and experts who investigate and assess the validity of individual claims made against CP and estimate the damages incurred.

A provision for lawsuits or other claims will be accrued according to applicable accounting standards, reflecting the assessment of the actual damages incurred based upon the facts and circumstances known at the time. CP accrues

for likely 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. Additionally, for administrative expediency, a general provision for lesser value injury cases is kept. Facts and circumstances related to asserted claims can change, and a process is in place to monitor accruals for changes in accounting estimates.

In the Canadian provinces of Quebec, Ontario, Manitoba and B.C., occupational-injury claims are administered through the Workers' Compensation Board ("WCB") and are actuarially determined. 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.

U.S. railway employees are covered by federal law under the 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.

### Forward-Looking Information

This MD&A 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 other relevant securities legislation. These forward-looking statements include, but are not limited to, statements concerning the Company's defined benefit pension expectations for 2017 and through 2020, our expectations for 2017 which includes: adjusted diluted EPS growth to be in the high single-digit percentages from full-year 2016 Adjusted diluted EPS of \$10.29, capital expenditures of \$1.25 billion, an increase of 6% over the \$1.18 billion spent in 2016, assumptions regarding the Canadian-to-U.S. dollar exchange rate being in the range of \$1.30 to \$1.35, the average price of WTI being approximately U.S. \$45 to \$55 per barrel, 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 and pension contributions, and capital expenditures. Forward-looking information typically contains statements with words such as "financial expectations", "key assumptions", "anticipate", "believe", "expect", "plan", "will", "outlook", "should" or similar words suggesting future outcomes. To the extent that CP has provided guidance using non-GAAP financial measures, the Company may not be able to provide a reconciliation to a GAAP measure, due to unknown variables and uncertainty related to future results.

Readers are cautioned not to place undue reliance on forward-looking information because it is possible that CP will not achieve predictions, forecasts, projections and other forms of forward-looking information. Current economic conditions render assumptions, although reasonable when made, subject to greater uncertainty. In addition, except as required by law, CP undertakes no obligation to update publicly or otherwise revise any forward-looking information, whether as a result of new information, future events or otherwise.

By its nature, forward-looking information involves numerous assumptions, inherent risks and uncertainties, including but not limited to the following factors: changes in business strategies; general North American and global economic, credit and business conditions; risks in 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; inflation; changes in laws and regulations, including regulation of rates; changes in taxes and tax rates; potential increases in maintenance and operating costs; 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 on the financial position of pension plans and investments; and various events that could disrupt operations, including severe weather, droughts, floods, avalanches and earthquakes as well as security threats and the governmental response to them, and technological changes.

There are more specific factors that could cause actual results to differ materially from those described in the forward-looking statements contained in this MD&A. 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 CP with securities regulators in Canada and the United States.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

### FOREIGN EXCHANGE RISK

Although CP conducts business primarily in Canada, a significant portion of its revenues, expenses, assets and liabilities including debt 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, and Canadian, U.S. and international monetary policies. Consequently, the Company's results are affected by fluctuations in the exchange rate between these currencies. On an annualized basis, a \$0.01 weakening (or strengthening) of the Canadian dollar positively (or negatively) impacts freight revenues by approximately \$25 million and negatively (or positively) impacts operating expenses by approximately \$13 million.

CP uses U.S. denominated debt to hedge its net investment in U.S. operations. As at December 31, 2016, the net investment in U.S. operations is less than the total U.S. denominated debt. Consequently, FX translation on the Company's undesignated U.S. dollar-denominated long-term debt causes additional impacts on earnings in Other income and charges.

To manage this exposure to fluctuations in exchange rates between Canadian and U.S. dollars, CP 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.

### SHARE PRICE IMPACT ON STOCK-BASED COMPENSATION

Based on information available at December 31, 2016 and expectations for 2017 grants, for every \$1.00 change in share price, stock-based compensation expense has a corresponding change of approximately \$0.4 million to \$0.6 million. This excludes the impact of changes in share price relative to the S&P/TSX 60 index and relative to Class I railways, which may trigger different performance share unit payouts. Share 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 21 Stock-based compensation.

### INTEREST RATE RISK

In order to meet the Company's capital structure requirements, CP may enter into long-term debt agreements. These debt agreements expose CP to increased interest costs on future fixed debt instruments and existing variable rate debt instruments, should market rates increase. In addition, the present value of the Company's assets and liabilities will also vary with interest rate changes. To manage interest rate exposure, CP 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. CP 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.

As at December 31, 2016 and 2015, the Company had forward starting floating-to-fixed interest rate swap agreements totalling a notional U.S. \$700 million to fix the benchmark rate on cash flows associated with highly probable forecasted issuances of long-term notes.

Information concerning market risks is supplemented in Item 8. Financial Statements and Supplementary Data, Note 17 Financial Instruments.

## ITEM 9A. CONTROLS AND PROCEDURES

### EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

As of December 31, 2016, an evaluation was carried out under the supervision of and with the participation of CP'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, 2016, 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, 2016. 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, 2016 has been audited by Deloitte LLP, the Company's independent registered public accounting firm, as stated in their report, which is included herein.

### CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

During the three months ended December 31, 2016, 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.