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Nuance Communications, Inc.
Form 10-Q
May 10, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2016

Or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 001-36056

NUANCE COMMUNICATIONS, INC.
(Exact name of registrant as specified in its charter)

Delaware	94-3156479
(State or Other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1 Wayside Road	01803
Burlington, Massachusetts	(Zip Code)
(Address of principal executive offices)	
Registrant's telephone number, including area code:	
(781) 565-5000	

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer <input checked="" type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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

The number of shares of the Registrant's Common Stock, outstanding as of April 30, 2016 was 279,217,323.

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Part I. Financial Information

Item 1. Condensed Consolidated Financial Statements (unaudited)

NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended March 31,		Six Months Ended March 31,	
	2016	2015	2016	2015
	(Unaudited)			
	(In thousands, except per share amounts)			
Revenues:				
Product and licensing	\$158,622	\$174,451	\$337,672	\$344,139
Professional services and hosting	240,196	224,504	467,331	450,674
Maintenance and support	79,915	76,104	159,845	154,265
Total revenues	478,733	475,059	964,848	949,078
Cost of revenues:				
Product and licensing	20,823	23,252	44,235	47,222
Professional services and hosting	154,712	150,701	307,971	307,574
Maintenance and support	13,626	13,392	26,922	27,389
Amortization of intangible assets	16,339	15,631	31,970	30,762
Total cost of revenues	205,500	202,976	411,098	412,947
Gross profit	273,233	272,083	553,750	536,131
Operating expenses:				
Research and development	67,226	73,723	137,751	155,149
Sales and marketing	92,837	93,249	193,427	204,499
General and administrative	45,940	47,115	86,441	99,237
Amortization of intangible assets	26,448	25,328	53,481	52,155
Acquisition-related costs, net	1,225	6,523	3,705	11,279
Restructuring and other charges, net	6,652	(333)	14,540	1,895
Total operating expenses	240,328	245,605	489,345	524,214
Income from operations	32,905	26,478	64,405	11,917
Other income (expense):				
Interest income	1,616	627	2,499	1,189
Interest expense	(32,328)	(30,034)	(62,208)	(59,931)
Other income (expense), net	6	(110)	(6,795)	(895)
Income (loss) before income taxes	2,199	(3,039)	(2,099)	(47,720)
Provision for income taxes	9,245	11,059	17,012	16,873
Net loss	\$(7,046)	\$(14,098)	\$(19,111)	\$(64,593)
Net loss per share:				
Basic	\$(0.02)	\$(0.04)	\$(0.06)	\$(0.20)
Diluted	\$(0.02)	\$(0.04)	\$(0.06)	\$(0.20)
Weighted average common shares outstanding:				
Basic	298,021	322,879	303,050	322,331
Diluted	298,021	322,879	303,050	322,331

See accompanying notes.

NUANCE COMMUNICATIONS, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

	Three Months		Six Months Ended	
	Ended March 31,		March 31,	
	2016	2015	2016	2015
	(Unaudited)			
	(In thousands)			
Net loss	\$(7,046)	\$(14,098)	\$(19,111)	\$(64,593)
Other comprehensive income (loss) income:				
Foreign currency translation adjustment	17,567	(49,522)	8,663	(77,740)
Pension adjustments	76	(759)	150	(734)
Unrealized gain on marketable securities	100	58	33	29
Total other comprehensive income (loss), net	17,743	(50,223)	8,846	(78,445)
Comprehensive income (loss)	\$10,697	\$(64,321)	\$(10,265)	\$(143,038)

See accompanying notes.

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CONSOLIDATED BALANCE SHEETS

	March 31, 2016	September 30, 2015
	(Unaudited)	
	(In thousands, except per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$250,690	\$479,449
Marketable securities	59,345	57,237
Accounts receivable, less allowances for doubtful accounts of \$10,358 and \$9,184	365,996	373,162
Prepaid expenses and other current assets	91,542	76,777
Total current assets	767,573	986,625
Marketable securities	30,782	32,099
Land, building and equipment, net	189,414	186,007
Goodwill	3,394,751	3,378,334
Intangible assets, net	719,744	796,285
Other assets	154,372	148,301
Total assets	\$5,256,636	\$5,527,651
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Short-term related party note payable	\$125,000	\$—
Current portion of long-term debt	—	4,834
Contingent and deferred acquisition payments	19,428	15,651
Accounts payable	58,789	56,581
Accrued expenses and other current liabilities	190,161	224,609
Deferred revenue	378,731	324,709
Total current liabilities	772,109	626,384
Long-term portion of debt	2,131,572	2,118,821
Deferred revenue, net of current portion	369,768	343,452
Deferred tax liabilities	110,857	104,782
Other liabilities	77,752	68,960
Total liabilities	3,462,058	3,262,399
Commitments and contingencies (Note 15)		
Stockholders' equity:		
Common stock, \$0.001 par value per share; 560,000 shares authorized; 282,629 and 313,531 shares issued and 278,878 and 309,781 shares outstanding, respectively	283	314
Additional paid-in capital	3,027,542	3,149,060
Treasury stock, at cost (3,751 shares)	(16,788)	(16,788)
Accumulated other comprehensive loss	(108,099)	(116,945)
Accumulated deficit	(1,108,360)	(750,389)
Total stockholders' equity	1,794,578	2,265,252
Total liabilities and stockholders' equity	\$5,256,636	\$5,527,651
See accompanying notes.		

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CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended March 31,	
	2016	2015
	(Unaudited)	
	(In thousands)	
Cash flows from operating activities:		
Net loss	\$ (19,111)	\$ (64,593)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	115,826	114,020
Stock-based compensation	80,511	78,271
Non-cash interest expense	21,215	14,918
Deferred tax provision	3,738	6,386
Loss on extinguishment of debt	4,851	—
Other	(135)	) 1,427
Changes in operating assets and liabilities, net of effects from acquisitions:		
Accounts receivable	22,110	16,988
Prepaid expenses and other assets	(16,765)	) (13,213)
Accounts payable	2,697	1,869
Accrued expenses and other liabilities	7,334	(50,017)
Deferred revenue	78,792	109,575
	301,063	215,631

Net cash provided by operating activities									
Cash flows from investing activities:									
Capital expenditures	(32,235)	)	(30,758))					
Payments for business and technology acquisitions, net of cash acquired	(27,399)	)	(31,891))					
Purchases of marketable securities and other investments	(32,757)	)	(91,348))					
Proceeds from sales and maturities of marketable securities and other investments	32,681		23,165						
Net cash used in investing activities	(59,710)	)	(130,832))					
Cash flows from financing activities:									
Payments of debt	(511,844)	)	(2,418))					
Proceeds from issuance of convertible debt, net of issuance costs	663,757		—						
Payments for repurchase of common stock	(574,338)	)	(109,838)	(3.0)	- Automotive	154.1	168.8	(14.7)
	259.0		238.2		20.8	8.7	- Intermodal	504.9	457.2
\$	959.0	\$	874.8	\$	84.2	9.6	Total Freight Revenues	\$ 1,812.7	\$ 1,709.7

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			Millions of Revenue Ton-Miles (RTM)				
5,702	5,228	474	9.1	- Grain	11,264	10,085	
6,613	5,852	761	13.0	- Coal	12,345	10,824	
5,854	4,896	958	19.6	- Sulphur and fertilizers	10,805	9,597	
2,723	2,746	(23)	(0.8)	- Forest products	5,218	5,493	
3,590	3,073	517	16.8	- Industrial products	7,057	6,331	
665	741	(76)	(10.3)	- Automotive	1,217	1,429	
6,826	6,244	582	9.3	- Intermodal	13,539	11,824	
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31,973	28,780	3,193	11.1	Total RTMs	61,445	55,583	
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			Freight Revenue per RTM (cents)			
2.84	2.74	0.10	3.6	- Grain	2.64	2.70
2.03	2.01	0.02	1.0	- Coal	2.02	2.04
2.23	2.28	(0.05)	(2.2)	- Sulphur and fertilizers	2.24	2.31
3.05	3.10	(0.05)	(1.6)	- Forest products	3.00	3.12
2.99	3.06	(0.07)	(2.3)	- Industrial products	2.96	3.11
12.45	11.52	0.93	8.1	- Automotive	12.66	11.81
3.79	3.81	(0.02)	(0.5)	- Intermodal	3.73	3.87
3.00	3.04	(0.04)	(1.3)	Freight Revenue per RTM	2.95	3.08

			Carloads (thousands)			
78.4	67.8	10.6	15.6	- Grain	150.2	132.7
101.7	93.4	8.3	8.9	- Coal	197.4	175.5
60.1	50.4	9.7	19.2	- Sulphur and fertilizers	110.7	98.4
41.0	41.9	(0.9)	(2.1)	- Forest products	80.5	84.5

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71.3	62.6	8.7	13.9	- Industrial products	141.8	129.1
47.0	48.0	(1.0)	(2.1)	- Automotive	90.3	93.8
295.4	274.4	21.0	7.7	- Intermodal	580.7	517.7
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694.9	638.5	56.4	8.8	Total Carloads	1,351.6	1,231.7
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				Freight Revenue per Carload		
\$	2,068	\$ 2,111	(\$43)	(2.0) - Grain	\$ 1,978	\$ 2,050
	1,320	1,259	61	4.8 - Coal	1,264	1,261
	2,173	2,212	(39)	(1.8) - Sulphur and fertilizers	2,184	2,252
	2,024	2,029	(5)	(0.2) - Forest products	1,943	2,030
	1,505	1,502	3	0.2 - Industrial products	1,473	1,527
	1,762	1,779	(17)	(1.0) - Automotive	1,707	1,800
	877	868	9	1.0 - Intermodal	869	883
\$	1,380	\$ 1,370	\$ 10	0.7 Freight Revenue per Carload	\$ 1,341	\$ 1,388

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Second Quarter					Year-to-date			
2004	2003⁽¹⁾	Variance	%		2004	2003⁽¹⁾	Variance	%
<u>Operations and Productivity</u>								
59,876	55,818	4,058	7.3	Freight gross ton-miles (GTM) (millions)	115,255	107,532	7,723	7.2
31,973	28,780	3,193	11.1	Revenue ton-miles (RTM) (millions)	61,445	55,583	5,862	10.5
10,281	10,272	9	0.1	Train-miles (thousands)	20,125	20,072	53	0.3
3.00	3.04	(0.04)	(1.3)	Freight revenue per RTM (cents)	2.95	3.08	(0.13)	(4.2)
2.45	2.53	(0.08)	(3.2)	Total operating expenses per RTM ⁽²⁾ (cents)	2.53	2.68	(0.15)	(5.6)
1.31	1.30	0.01	0.8	Total operating expenses per GTM ⁽²⁾ (cents)	1.35	1.38	(0.03)	(2.2)
76.27	70.89	5.38	7.6	Total operating expenses per train-mile ⁽²⁾ (dollars)	77.25	74.19	3.06	4.1
16,535	16,641	(106)	(0.6)	Number of active employees at end of period	16,535	16,641	(106)	(0.6)
16,393	16,507	(114)	(0.7)	Average number of active employees	15,830	15,933	(103)	(0.6)
13,848	13,898	(50)	(0.4)	Miles of road operated at end of period ⁽³⁾	13,848	13,898	(50)	(0.4)
3,653	3,381	272	8.0	GTMs per average active employee (000)	7,281	6,749	532	7.9
4,324	4,016	308	7.7	GTMs per mile of road operated ⁽³⁾ (000)	8,323	7,737	586	7.6
671	674	(3)	(0.4)	GTMs per active locomotive per day (000)	656	651	5	0.8
5,824	5,434	390	7.2	Average train weights (tons)	5,727	5,357	370	6.9
4,109	4,081	28	0.7	Average train length (feet)	4,082	3,994	88	2.2
24.3	25.7	(1.4)	(5.4)	Average train speed (mph)	23.8	25.6	(1.8)	(7.0)
165	152	13	8.6	On-line car-miles per car-day	155	145	10	6.9
1.20	1.24	(0.04)	(3.2)	U.S. gallons of fuel per 1,000 GTMs	1.25	1.29	(0.04)	(3.1)
1.01	0.95	0.06	6.3	Average fuel price excluding provincial fuel taxes	0.99	0.92	0.07	7.6

				(U.S. dollar per U.S. gallon)				
71.8	69.2	2.6	3.8	Diesel fuel consumed freight & yard (million U.S. gallons)	143.8	138.7	5.1	3.7
2.6	3.1	(0.5)	(16.1)	FRA personal injuries per 200,000 employee-hours	3.0	3.1	(0.1)	(3.2)
2.0	1.7	0.3	17.6	FRA train accidents per million train-miles	2.1	1.7	0.4	23.5

- (1) Prior period has been restated to conform with presentation in 2004.
- (2) Excludes special charge for labour restructuring and asset impairment.
- (3) Excludes track on which CPR has haulage rights.

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This Management's Discussion and Analysis (MD&A) supplements the consolidated financial statements and related notes for the three months and six months ended June 30, 2004. Except where otherwise indicated, all financial information reflected herein is expressed in Canadian dollars.

July 28, 2004

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Business Profile and Strategy

n Business Profile

Canadian Pacific Railway Limited and its subsidiaries (collectively CPR or the Company) operate a transcontinental railway in Canada and the United States and provide logistics and supply chain expertise worldwide. The Company provides rail and intermodal transportation services over a network of approximately 14,000 miles, serving the principal business centres of Canada, from Montreal, Quebec to Vancouver, British Columbia and the U.S. Northeast and Midwest regions. CPR feeds directly into America s heartland from the East and West coasts. Agreements and alliances with other carriers extend CPR s market reach east of Montreal in Canada, throughout the U.S. and into Mexico. CPR transports bulk commodities, merchandise freight, and intermodal traffic. Bulk commodities include grain, coal, sulphur and potash. Merchandise freight consists of finished vehicles and automotive parts, and forest and industrial products. Intermodal traffic consists largely of high-value, time-sensitive consumer products transported in overseas containers that can be handled by train, ship and truck, and in domestic containers and trailers that can be moved by train and truck.

n Strategy

CPR s goals are to become the preferred business partner for rail-based transportation services in North America and to be at the forefront of the railway industry in operating profitability and return on capital employed. Its principal strategies to accomplish these goals include maximizing the strengths of its North American railway franchise by operating a low-cost scheduled railway, developing new products and services in cooperation with customers and partners, and extending the reach of the franchise through marketing and operating partnerships and alliances with other railways and transport companies in North America. CPR s overall marketing and sales activities within each of its lines of business are focused on targeted growth, product efficiency and maximizing value from existing assets.

n Additional Information

Additional information about CPR, including Consolidated Financial Statements, MD&A, Annual Information Form, press releases and other required filing documents is available on SEDAR at www.sedar.com in Canada and on EDGAR at www.sec.gov in the U.S.

Table of Contents**Operating Results**

CPR's net income for the three months ended June 30, 2004, was \$83.7 million, up \$49.6 million from \$34.1 million in the same period of 2003. Net income for the six months ended June 30, 2004 was \$107.2 million, decreasing \$28.8 million from \$136.0 million for the same six months in 2003. The increase for the second quarter of 2004 was mainly the result of a special charge of \$141.4 million, after tax (\$215.1 million before tax), taken in the second quarter of 2003 for a restructuring initiative and asset impairment charge, partially offset by a \$19.8-million foreign exchange loss on long-term debt (LTD), after tax, in the second quarter of 2004, compared with a \$91.6-million foreign exchange gain on LTD, after tax, in the same period of 2003. In addition, net income increased due to an increase in revenues in the second quarter of 2004, compared with revenues in the same period of 2003, which is discussed further in this MD&A under the heading Revenues. Year-to-date net income was down due mainly to an after-tax foreign exchange loss on LTD of \$34.1 million in the first six months of 2004, compared with an after-tax foreign exchange gain on LTD of \$156.2 million in the same period of 2003, substantially offset by the special charge taken in 2003.

The foreign exchange gains and losses on LTD, discussed in the previous paragraph, arose as a result of the Canadian dollar strengthening and weakening, as applicable, relative to the U.S. dollar (FX). FX on LTD is discussed further under the sub-heading Foreign Exchange Gains (Losses) on Long-Term Debt.

The Company had operating income in the second quarter of 2004 of \$220.6 million, compared with an operating loss of \$29.2 million in second-quarter 2003. Operating income for the first six months of 2004 was \$336.6 million, up \$247.9 million from \$88.7 million for the same period in 2003. The increases in the second quarter and year-to-date in 2004, compared with the same periods in 2003, were due mainly to the special charge taken in the second quarter of 2003 and to higher revenues resulting from increased freight volumes in 2004. The year-to-date increase was partially offset by costs and lost revenues associated with a major avalanche on the busiest portion of CPR's mainline and severe weather in the first quarter of 2004, as well as the net effect of FX on U.S. dollar-denominated revenues and expenses.

Diluted earnings per share (EPS) for the three months ended June 30, 2004 was \$0.53, increasing \$0.31 from \$0.22 in the second quarter in 2003. Diluted EPS for the first six months in 2004 was \$0.67, down \$0.19 from \$0.86 for the first six months in 2003. Diluted EPS is calculated by dividing net income by the weighted average number of shares outstanding, adjusted for the dilutive effect of outstanding stock options, as calculated using the Treasury Stock Method. This method assumes options that have an exercise price below their market price are exercised and the proceeds are used to purchase common shares at the average market price during the period.

Fluctuations in the value of the Canadian dollar affect CPR's results because U.S. dollar-denominated revenues and expenses are translated into Canadian dollars. A stronger Canadian dollar reduces U.S. dollar-denominated revenues and expenses. Operating income is also reduced, as more revenues than expenses are generated in U.S. dollars.

During the second quarter, the average foreign exchange rate for converting Canadian dollars to U.S. dollars increased to \$0.74 from \$0.70 for the same period in 2003. The average foreign exchange rate increased to \$0.75 for the first six months of 2004 compared with \$0.68 for the same six-month period of 2003. This reduced revenues in the second quarter of 2004 by approximately \$22 million and by \$81 million year-to-date. Operating expenses were reduced in the second quarter of 2004 by approximately \$18 million and \$64 million year-to-date. The Canadian dollar's gain reduced operating income in second-quarter 2004 by approximately \$4 million. Operating income for the first half of

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2004 was reduced by approximately \$17 million and after-tax income before FX on LTD was reduced by approximately \$4 million. The effect of FX on the Company's financial statements is discussed further under the heading "Foreign Exchange". FX has been a significant influence on CPR's financial results since early 2003 when the Canadian dollar began appreciating considerably against the U.S. dollar, however, as 2004 progresses, FX is expected to be less of an influence on the Company's financial results.

The Company's operating ratio improved to 78.0% in the second quarter and 82.2% in the first half of 2004, from 79.7% in second-quarter 2003 and 83.1% for the first six months of 2003. Operating ratios for 2003 exclude the special charge. The operating ratio is calculated by dividing total operating expenses by total revenues. The operating ratio demonstrates the percentage of revenues used to operate the railway. A lower percentage indicates higher efficiency and, therefore, higher profitability.

Non-GAAP Earnings

(1) These earnings measures have no standardized meanings prescribed by Canadian GAAP and, therefore, are unlikely to be comparable to similar measures of other companies. Other specified items are described under the sub-heading "Other Specified Items".

(2) Certain prior period figures have been restated to conform with presentation adopted in 2004.

CPR also presents non-GAAP earnings to provide a basis for evaluating underlying earnings trends that can be compared with results in the prior periods. Non-GAAP earnings exclude foreign currency translation effects on long-term debt, which can be volatile and short term, as well as other specified items that are not among CPR's normal ongoing revenues and operating expenses. A reconciliation of income, before FX on LTD and other specified items, to net income as presented in the financial statements is detailed in the table above.

It should be noted that CPR's earnings, before FX on LTD and other specified items, as described in this MD&A, have no standardized meanings and are not defined by Canadian generally accepted

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accounting principles (GAAP) and, therefore, are unlikely to be comparable to similar measures presented by other companies. In recent disclosure documents, CPR has referred to certain items excluded from non-GAAP earnings measures as non-recurring items . However, in this MD&A and accompanying documents, items (other than FX on LTD) excluded from non-GAAP earnings measures have been identified as other specified items in compliance with Revised Canadian Securities Administrators (CSA) Staff Notice 52-306, as it is not possible to conclude with certainty that an item or items similar to one or more of those so designated is not likely to occur within the next two years.

ⁿ Non-GAAP Results

Income, before FX on LTD and other specified items, was \$103.5 million in the second quarter of 2004, up \$19.6 million from \$83.9 million for the same three months in 2003. Income, before FX on LTD and other specified items, was \$141.3 million for the first half of 2004, up \$20.1 million from \$121.2 million for the same six months in 2003. The Company continued to transport higher freight volumes in the second quarter of 2004, compared with the same period of 2003. Additional income generated by this growth was partially offset by an increase in volume-related expenses and labour costs due to inflation, training and benefits. Year-to-date income was also reduced by the negative effect of FX on U.S. dollar-denominated revenues and expenses, and costs and lost revenues associated with an avalanche.

Non-GAAP performance indicators (reconciliation of non-GAAP EPS to GAAP EPS) (unaudited)	For the three months ended June 30		For the six months ended June 30	
	2004	2003⁽²⁾	2004	2003⁽²⁾
Basic and Diluted EPS, as determined by GAAP	\$ 0.53	\$ 0.22	\$ 0.67	\$ 0.86
Basic and Diluted EPS, related to FX on LTD - net of tax	0.12	(0.58)	0.22	(0.99)
Basic and Diluted EPS, related to other specified items - net of tax	-	0.89	-	0.89
Basic and Diluted EPS, before FX on LTD and other specified items ⁽¹⁾	\$ 0.65	\$ 0.53	\$ 0.89	\$ 0.76

(1) These earnings measures have no standardized meanings prescribed by Canadian GAAP and, therefore, are unlikely to be comparable to similar measures of other companies. Other specified items are described under the sub-heading Other Specified Items .

(2) Certain prior period figures have been restated to conform with presentation adopted in 2004.

Diluted EPS, before FX on LTD and other specified items, was \$0.65 in the second quarter of 2004, an increase of \$0.12 from \$0.53 in the same quarter in 2003. Diluted EPS, before FX on LTD and other specified items, was \$0.89 for the first six months of 2004, an increase of \$0.13 from \$0.76 for the same period in 2003. Diluted EPS, before FX on LTD and other specified items, are calculated by dividing income, before FX on LTD and other specified items, by the weighted average number of shares outstanding, adjusted for outstanding stock options using the Treasury Stock Method, as described on page 3.

ⁿ Foreign Exchange Gains (Losses) on Long-Term Debt

These gains or losses, which are mainly unrealized, are excluded to eliminate the impact of volatile short-term exchange rate fluctuations, which can only be realized when net U.S. dollar-denominated long-term debt matures or is settled. Foreign exchange losses on long-term debt were \$20.0 million, before tax, in the second quarter of 2004, compared with foreign exchange gains on long-term debt of \$98.3 million, before tax, in the same period of 2003. Year-to-date before-tax foreign exchange losses were \$33.3 million in 2004, compared with before-tax gains of \$169.1 million for the first six months in 2003. The changes were due to the effect of FX, net of hedging, on U.S. dollar-denominated long-term debt. For every \$0.01 the Canadian dollar strengthens relative to the U.S. dollar, the conversion of U.S. dollar-denominated long-term debt to Canadian dollars creates a pre-tax foreign exchange gain of approximately \$8 million to \$9 million.

Table of Contents**n Other Specified Items**

Other specified items may include, but are not limited to, restructuring and asset impairment charges, gains and losses on non-routine sales of assets, unusual income tax adjustments, and other items that do not typify normal business activities.

The single other specified item was a special charge taken in the second quarter of 2003 of \$141.4 million after tax (\$215.1 million before tax) to reflect the costs associated with a restructuring initiative that is expected to eliminate 820 jobs by the end of 2005 and to adjust the value of certain under-performing assets to fair value. There are no other specified items for 2004.

Volumes

Higher freight volumes result in increases in revenues and certain variable expenses such as fuel, equipment rents and crew costs. A 9% increase in carloads and an 11% increase in revenue ton-miles (RTM) in the second quarter of 2004 were largely responsible for a 10% increase in freight revenues and an increase in related variable expenses, compared with the same period in 2003.

Volumes	For the three months ended June 30		For the six months ended June 30	
	2004	2003	2004	2003
Carloads (in thousands)				
Grain	78.4	67.8	150.2	132.7
Coal	101.7	93.4	197.4	175.5
Sulphur and fertilizers	60.1	50.4	110.7	98.4
Forest products	41.0	41.9	80.5	84.5
Industrial products	71.3	62.6	141.8	129.1
Automotive	47.0	48.0	90.3	93.8
Intermodal	295.4	274.4	580.7	517.7
Total carloads	694.9	638.5	1,351.6	1,231.7
Revenue ton-miles (in millions)				
Grain	5,702	5,228	11,264	10,085
Coal	6,613	5,852	12,345	10,824
Sulphur and fertilizers	5,854	4,896	10,805	9,597
Forest products	2,723	2,746	5,218	5,493
Industrial products	3,590	3,073	7,057	6,331
Automotive	665	741	1,217	1,429
Intermodal	6,826	6,244	13,539	11,824
Total revenue ton-miles	31,973	28,780	61,445	55,583

RTMs were 31,973 million in the second quarter of 2004, up 3,193 million, or 11%, from 28,780 million in the same period of 2003. For the year to date, RTMs were 61,445 million in 2004, an increase of 5,862 million, or 11%, from 55,583 million for the first half of 2003. RTMs are defined as the movement of a revenue-producing ton of freight one mile.

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CPR handled 694.9 thousand carloads in the second quarter of 2004, increasing 56.4 thousand carloads, or 9%, from 638.5 thousand in the same period of 2003. In the first half of 2004, 1,351.6 thousand carloads were moved, an increase of 119.9 thousand, or 10%, from 1,231.7 thousand in the same six months in 2003. Carloads are comprised of revenue-generating shipments of containers, trailers and loaded freight cars.

Table of Contents**Revenues**

The Company's revenues are derived primarily from the transportation of freight. Other revenues are generated mainly from leasing of CPR track and other assets, container storage and terminal services fees, switching fees, land sales and income from business partnerships.

CPR believes that maintaining competitive freight rates is important and reviews its rates on a regular basis, adjusting them for market conditions as warranted.

Total revenues, which consist of freight and other revenues, were \$1,004.7 million in the second quarter of 2004, increasing \$90.6 million from \$914.1 million in the same period of 2003. Revenues for the first half of 2004 were \$1,891.3 million, up \$98.4 million from \$1,792.9 million in the first six months of 2003. Strong volume growth was achieved in the second quarter and the first half of 2004, compared with the same periods in 2003.

Revenues (in millions) (unaudited)	For the three months ended June 30		For the six months ended June 30	
	2004	2003	2004	2003
Grain	\$ 162.1	\$ 143.1	\$ 297.1	\$ 272.1
Coal	134.2	117.6	249.5	221.3
Sulphur and fertilizers	130.6	111.5	241.8	221.6
Forest products	83.0	85.0	156.4	171.5
Industrial products	107.3	94.0	208.9	197.2
Automotive	82.8	85.4	154.1	168.8
Intermodal	259.0	238.2	504.9	457.2
Total freight revenues	\$ 959.0	\$ 874.8	\$ 1,812.7	\$ 1,709.7
Other revenues	45.7	39.3	78.6	83.2
Total revenues	\$ 1,004.7	\$ 914.1	\$ 1,891.3	\$ 1,792.9

Freight Revenues

Freight revenues are earned from transportation of bulk, merchandise and intermodal goods and include fuel surcharges billed to CPR customers. Freight revenues were \$959.0 million in the second quarter of 2004, an increase of \$84.2 million from \$874.8 million for the same period of 2003. For the first half of 2004, freight revenues were \$1,812.7 million, a \$103.0 million increase from \$1,709.7 million for the same period in 2003. Volume growth in the second quarter of 2004, compared to the same period in 2003, more than offset the approximately \$21-million negative effect of FX. Volumes also increased in the first six months of 2004, compared with the same period in 2003, which more than offset the negative effect of FX of approximately \$79 million. Revenues increased in the grain, intermodal, coal, industrial products and sulphur and fertilizers businesses. An avalanche that caused a disruption on the busiest portion of CPR's mainline negatively affected year-to-date volumes and revenues.

ⁿ Grain

Canadian grain products, consisting mainly of durum, spring wheat, barley, canola, flax, rye and oats, are primarily transported to Canadian and U.S. markets for domestic consumption and to Canadian ports for export. U.S. grain products mainly include durum, spring wheat, corn, soybeans and barley shipped from the midwestern U.S. to other points in the Midwest, the Pacific Northwest and the northeastern U.S. Grain revenues in the second quarter of 2004 were \$162.1 million, up \$19.0 million (up \$22 million, excluding the effect of FX) from \$143.1 million in the same

period in 2003. For the

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year to date, grain revenues were \$297.1 million, an increase of \$25.0 million (up \$39 million, excluding the effect of FX) from \$272.1 million for the same period in 2003. Canadian grain volumes and revenues increased in the second quarter and first half of 2004, compared to the same periods of 2003, as a result of strong world demand and larger crop production following a drought-induced decline experienced throughout 2002 and the first half of 2003. U.S. grain shipments increased due to strong world demand and prices. The growth in the second quarter and year-to-date of 2004 was partially offset by penalties paid for delays in grain shipments.

n Coal

CPR's Canadian coal business consists primarily of metallurgical coal transported from southeastern British Columbia to the ports of Thunder Bay, Ontario and Vancouver, and the U.S. Midwest. CPR transports U.S. coal, primarily thermal coal and petroleum coke, mainly within the U.S. Midwest. In the second quarter of 2004, coal revenues were \$134.2 million, increasing \$16.6 million (up \$18 million, excluding the effect of FX) from \$117.6 million in the same period of 2003. Coal revenues were \$249.5 million for the first six months of 2004, an increase of \$28.2 million (up \$33 million, excluding the effect of FX) from \$221.3 million for the first half of 2003. Revenues in the second quarter and first six months of 2004 increased largely due to a strong steel market which created a higher world demand for metallurgical coal. In addition, revenues improved due to excellent operating conditions and improved train weights for most of the second quarter in 2004.

n Sulphur and Fertilizers

Sulphur and fertilizers include chemical fertilizers, potash and sulphur that are shipped mainly from western Canada to the ports of Vancouver and Portland, Oregon, as well as other Canadian and U.S. destinations. Revenues were \$130.6 million in second-quarter 2004, rising \$19.1 million (up \$22 million, excluding the effect of FX) from \$111.5 million in the same period in 2003. For the first half of 2004, these revenues were \$241.8 million, an increase of \$20.2 million (up \$30 million, excluding the effect of FX) from \$221.6 million for the same six months in 2003. Second-quarter revenues were higher in 2004, compared with the same period in 2003, mainly due to increased export and domestic potash shipments. Export potash shipments were driven by increased demand in Brazil and East Asia, whereas increased demand for fertilizer for North American corn and soybeans drove domestic potash increases. Year-to-date revenues for 2004 were also positively affected by increased export shipments of potash.

n Forest Products

Forest products include lumber, wood pulp, paper products and panel transported from key producing areas in western Canada, Ontario and Quebec to various destinations in North America. Forest products revenues were \$83.0 million in second-quarter 2004, decreasing by \$2.0 million (up \$1 million, excluding the effect of FX) from \$85.0 million in the second quarter of 2003. Revenues were \$156.4 million for the first six months of 2004, a decrease of \$15.1 million (down \$4 million, excluding the effect of FX) from \$171.5 million for the same period in 2003. Second-quarter revenues for 2004 were slightly lower than in the same period of 2003 due largely to the effect of FX and increased times to obtain centrebeam cars as a result of U.S. Class I railroad congestion. Year-to-date revenues were down due mainly to the effect of FX and weather-related issues affecting CPR's car availability as well as certain CPR customers ability to prepare their products for transport.

n Industrial Products

Industrial products include chemicals, plastics, aggregates, steel, mine and energy-related products (other than coal) shipped throughout North America. In the second quarter of 2004, industrial products

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revenues were \$107.3 million, up \$13.3 million (up \$17 million, excluding the effect of FX) from \$94.0 million in the same period of 2003. Revenues were \$208.9 million for the first six months of 2004, an increase of \$11.7 million (up \$25 million, excluding the effect of FX) from \$197.2 million for the same period in 2003. Revenues increased in the second quarter and first half of 2004, compared with the same periods of 2003, as a result of increased steel demand driven by economic expansion and for pipeline projects, strong demand for aggregates driven by non-residential construction and oil drilling, increased market share for plastics, along with rate increases for energy products in the second quarter of 2004.

n Automotive

Automotive business consists of the transportation of domestic and import vehicles, and automotive parts from North American assembly plants and the Port of Vancouver to destinations in the Canadian and U.S. marketplaces. In the second quarter of 2004, automotive revenues were \$82.8 million, down \$2.6 million (relatively unchanged, excluding the effect of FX) from \$85.4 million in second-quarter 2003. Revenues were \$154.1 million for the first half of 2004, a decrease of \$14.7 million (down \$4 million, excluding the effect of FX) from \$168.8 million for the same period in 2003. Revenues were lower in the second quarter and first six months of 2004, compared with the same periods in 2003, due to the effect of FX and a decline in consumer demand in the Canadian market for certain vehicle models.

n Intermodal

Intermodal business consists of domestic and international (import-export) traffic. CPR's domestic segment handles primarily retail goods between eastern and western Canada. The international segment handles mainly containers of consumer goods between the ports of Vancouver, Montreal, New York/New Jersey and Philadelphia and inland Canadian and U.S. destinations. Intermodal revenues were \$259.0 million in second-quarter 2004, increasing \$20.8 million (up \$25 million, excluding the effect of FX) from \$238.2 million in second-quarter 2003. For the first six months of 2004, revenues were \$504.9 million, an increase of \$47.7 million (up \$63 million, excluding the effect of FX) from \$457.2 million for the first half of 2003. CPR's international business grew in the second quarter and first half of 2004, compared with the same periods in 2003, mainly due to increased volumes at the ports of Vancouver and Montreal as a result of improved world economic conditions and a general trend toward containerized traffic. Growth in the domestic intermodal market was due to increased demand in the food and retail businesses.

Other Revenues

Other revenues are derived mainly from leasing of CPR track and other assets, switching fees, container storage and terminal services fees, land sales and income from business partnerships. Other revenues in the second quarter of 2004 were \$45.7 million, an increase of \$6.4 million (up \$7 million, excluding the effect of FX) from \$39.3 million for the same period in 2003. Year-to-date revenues were \$78.6 million, a decrease of \$4.6 million (down \$3 million, excluding the effect of FX) from \$83.2 million for the same six months in 2003. The increase in second-quarter revenues was due to a land sale gain, increased container terminal services and storage fees as a result of higher international volumes, partially offset by a final dividend received in 2003 from a former partnership. The year-to-date decline was due to lower land sale revenues and reduced income from business partnerships, partially offset by higher terminal services and switching revenues.

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Performance indicators	For the three months ended June 30		For the six months ended June 30	
	2004	2003	2004	2003
<i><u>Productivity indicators</u></i>				
Gross ton-miles (GTM) of freight (millions)	59,876	55,818	115,255	107,532
Train-miles (thousands)	10,281	10,272	20,125	20,072
Average train weights (tons)	5,824	5,434	5,727	5,357
<i><u>Efficiency and other indicators</u></i>				
U.S. gallons of fuel per 1,000 GTMs	1.20	1.24	1.25	1.29
Average number of active employees	16,393	16,507	15,830	15,933
Miles of road operated at end of period	13,848	13,898	13,848	13,898
Freight revenue per RTM (cents)	3.00	3.04	2.95	3.08
<i><u>Safety indicators</u></i>				
FRA personal injuries per 200,000 employee-hours	2.6	3.1	3.0	3.1
FRA train accidents per million train-miles	2.0	1.7	2.1	1.7

Productivity Indicators

Productivity indicators reflect the Company's operational activity.

GTMs of freight measure the movement of total train weight over a distance of one mile. The total train weight is comprised of the weight of the freight cars, their contents and any inactive locomotives.

Train-miles is a measure reflecting the distance traveled by the lead locomotive on each train operating over CPR's track. An increase in GTMs without a corresponding increase in train miles indicates higher efficiency.

Average train weight is the result of dividing GTMs by train miles. It represents the average total weight of all CPR trains operating over CPR's track and track on which CPR has running rights.

Fluctuations in these indicators normally drive corresponding fluctuations in certain variable costs such as fuel and crew costs.

Efficiency and Other Indicators

U.S. gallons of fuel per 1,000 GTMs represents the total fuel consumed in freight and yard operations for every 1,000 GTMs traveled. This metric is calculated by dividing the total amount of fuel issued to CPR locomotives, excluding commuter and non-freight activities, by the total freight-related GTMs. The result indicates how efficiently the Company is using fuel.

Average number of active employees is the average number of actively employed workers for the period. The number of actively employed workers includes employees who are taking vacation and statutory holidays and other forms of short-term paid leave, and excludes individuals who have a continuing employment relationship with CPR but are not currently working. This indicator is calculated by adding the monthly average employee counts and dividing this total by the number of months in the period. CPR's average number of active employees

decreased slightly in the second quarter of 2004, compared with the same period in 2003, as employment additions made to handle business growth was more than offset by reductions made under restructuring initiatives.

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Miles of road operated is the total length of all rail lines over which CPR operates, excluding track on which it has haulage rights. An increase in GTMs without a corresponding increase in miles of road operated indicates higher utilization of assets.

Freight revenue per RTM is the amount of freight revenue earned for every RTM moved, calculated by dividing the total freight revenue by the total RTMs in the period. This indicator decreased in the second quarter and first half of 2004, compared to the same periods in 2003, due mainly to the effect of FX, partially offset by an increase in rates.

Safety Indicators

Safety is a key priority for CPR's management and its Board of Directors. CPR uses two key safety indicators, each of which follows strict Federal Railroad Administration (FRA) reporting guidelines:

FRA personal injuries per 200,000 employee-hours 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. Employee-hours are the total hours worked, excluding vacation and sick time, by all employees, excluding contractors.

FRA train accidents per million train-miles is calculated as the number of train accidents, multiplied by 1,000,000 and divided by total train-miles. Train accidents included in this metric are those that meet or exceed the current FRA reporting threshold of US\$6,700.

A decrease in the above measures reflects an improvement in safety.

Operating Expenses, Excluding Other Specified Items

Operating expenses, excluding other specified items were \$784.1 million in second-quarter 2004, increasing \$55.9 million from \$728.2 million in the second quarter of 2003. For the first six months of 2004, expenses were \$1,554.7 million, an increase of \$65.6 million from \$1,489.1 million for the same period in 2003. In the second quarter of 2004, FX had a favourable impact of approximately \$18 million on operating expenses, excluding other specified items. For the year to date, the favourable impact of FX was approximately \$64 million. The benefit achieved from FX was more than offset by inflation, higher depreciation and compensation and benefits costs, and higher costs associated with business growth.

Operating expenses, excluding other specified items (in \$ millions) (unaudited)	For the three months ended June 30				For the six months ended June 30			
	2004		2003 ⁽¹⁾		2004		2003 ⁽¹⁾	
	Expense	% of revenue	Expense	% of revenue	Expense	% of revenue	Expense	% of revenue
Compensation and benefits	\$ 318.1	31.7	\$ 281.6	30.8	\$ 627.1	33.2	\$ 568.5	31.7
Fuel	107.9	10.7	105.4	11.5	207.6	11.0	211.0	11.8
Materials	45.5	4.5	47.7	5.2	99.3	5.2	98.0	5.5
Equipment rents	60.9	6.1	63.2	6.9	119.5	6.3	130.1	7.3
Depreciation and amortization	102.7	10.2	90.9	10.0	202.3	10.7	181.6	10.1
Purchased services and other	149.0	14.8	139.4	15.3	298.9	15.8	299.9	16.7
Total	\$ 784.1	78.0	\$ 728.2	79.7	\$ 1,554.7	82.2	\$ 1,489.1	83.1

(1) Certain prior period figures have been restated to conform with presentation adopted in 2004.

Table of Contents**n Compensation and Benefits**

Compensation and benefits expense includes employee wages, salaries and fringe benefits. In the second quarter of 2004, compensation and benefits expense was \$318.1 million, an increase of \$36.5 million (up \$41 million, excluding the effect of FX) from \$281.6 million in the same quarter of 2003. For the first six months of 2004, this expense was \$627.1 million, an increase of \$58.6 million (up \$76 million, excluding the effect of FX) from \$568.5 million for the first half of 2003. For second-quarter and year-to-date 2004, expenses increased, in comparison with the same periods in 2003, due mainly to higher incentive compensation costs. Expenses also increased as a result of higher costs associated with inflation, pension expense, training costs for new train crew employees and selective hiring to handle larger freight volumes, partially offset by restructuring initiatives and the positive impact of FX. In addition, year-to-date expenses increased in 2004, compared with the same period in 2003, as a result of favourable expense adjustments during the first quarter of 2003.

n Fuel

Fuel expense consists of the cost of fuel used by locomotives and includes provincial, state and federal fuel taxes and the favourable impact of CPR's hedging program. In the second quarter of 2004, fuel expense was \$107.9 million, increasing \$2.5 million (up \$7 million, excluding the effect of FX) from \$105.4 million in the same period of 2003. This expense was \$207.6 million for the first half of 2004, a decrease of \$3.4 million (up \$12 million, excluding the effect of FX) from \$211.0 million for the same six months in 2003. Fuel expense increased in the second quarter of 2004, compared with the second quarter of 2003, due to higher volumes and crude oil prices, partially offset by more efficient fuel consumption, favourable refining margins and the positive effect of FX. Year-to-date fuel expense was also reduced by positive inventory adjustments.

n Materials

Materials expense includes the cost of materials used for track, locomotive, freight car and building maintenance. This expense was \$45.5 million in second-quarter 2004, decreasing \$2.2 million (down \$2 million, excluding the effect of FX) from \$47.7 million in second-quarter 2003. Materials expense was \$99.3 million for the first six months of 2004, an increase of \$1.3 million (up \$4 million, excluding the effect of FX) from \$98.0 million for the same six months in 2003. In the second quarter of 2004, compared with the same period in 2003, materials expense was down as a result of lower material usage for track maintenance, reduced computer hardware and software expenses that began in January 2004 as a result of a new outsourcing agreement with IBM Canada Ltd. (IBM), and the positive effect of FX. The year-to-date increase was also due to increased materials required for repairs and favourable inventory adjustments in 2003.

n Equipment Rents

Equipment rents expense includes the cost to lease freight cars, intermodal equipment and locomotives from other railways and companies. In the second quarter of 2004, equipment rents expense was \$60.9 million, a decrease of \$2.3 million (up \$1 million, excluding the effect of FX) from \$63.2 million for the same period of 2003. This expense was \$119.5 million for the first six months of 2004, a decrease of \$10.6 million (relatively unchanged, excluding the effect of FX) from \$130.1 million for the same period in 2003. Equipment rents expense decreased in the second quarter of 2004, compared with the second quarter in 2003, due to higher earnings from customers and railroads for the use of CPR cars, partially offset by additional leases acquired for locomotives and freight cars to handle additional freight volumes. In addition to these factors, the decrease in the first six months of 2004, compared with the same period in 2003, resulted from the positive impact of FX and the reduction of rent expense previously charged by a variable-interest entity, as the entity was consolidated beginning in the second quarter of 2003.

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n Depreciation and Amortization

Depreciation and amortization expense represents the charge associated with the use of track and roadway, buildings, locomotives, freight cars and other depreciable assets. This expense was \$102.7 million in second-quarter 2004, increasing \$11.8 million (up \$13 million, excluding the effect of FX) from \$90.9 million in the second quarter of 2003. Year-to-date expense was \$202.3 million, an increase of \$20.7 million (up \$24 million, excluding the effect of FX) from \$181.6 million for the same six months in 2003. Depreciation expense increased in the second quarter and first half of 2004, compared with the same periods in 2003, due largely to additions to CPR's capital assets and increased depreciation rates on certain assets, in particular rail. The increase was partially mitigated by the effect of FX and depreciation for assets transferred in the fourth quarter of 2003 to IBM under an outsourcing agreement.

n Purchased Services and Other

Purchased services and other expense encompasses a wide range of costs, including expenses for joint facilities, personal injury and damage, environmental, property and other taxes, contractor and consulting fees, and insurance. This expense was \$149.0 million in the second quarter of 2004, increasing \$9.6 million (up \$14 million, excluding the effect of FX) from \$139.4 million for the same period in 2003. For the first six months in 2004, purchased services and other expense was \$298.9 million, a decrease of \$1.0 million (up \$14 million, excluding the effect of FX) from \$299.9 million for the same period in 2003. In the second quarter of 2004, compared with the same period in 2003, purchased services and other expenses increased due mainly to payments to IBM under the outsourcing agreement which started in January 2004, property tax increases in 2004, favourable joint facility credits in 2003 and increased intermodal equipment repairs, partially offset by the positive effect of FX and lower costs associated with derailments and mishaps. In addition, expenses for the first six months in 2004 increased compared to the same period in 2003 due to clean-up costs associated with an avalanche in the first quarter of 2004.

Other Income Statement Items

n Other Charges

Other charges consist of amortization of the discounted portion of long-term accruals, gains and losses due to the effect of FX on working capital, various costs related to financing, gains and losses associated with the changes in the fair value of non-hedging derivative instruments and other miscellaneous income. Other charges were \$10.1 million in the second quarter of 2004, an increase of \$1.9 million (up \$3 million, excluding the effect of FX) when compared to \$8.2 million for the same period of 2003. Year-to-date other charges were \$14.7 million, an increase of \$2.0 million (up \$4 million, excluding the effect of FX) from \$12.7 million for the same six months in 2003. In the second quarter of 2004, compared with second-quarter 2003, this expense increased due to changes in the fair value of derivative instruments that were not eligible for hedge accounting under the Canadian Institute of Chartered Accountants (CICA) Accounting Guideline 13 (AcG 13, discussed previously in CPR's first-quarter MD&A), partially offset by the effect of FX on working capital accounts. In the first six months of 2004, compared with the same period in 2003, other charges expense was negatively impacted by the effect of FX on working capital accounts and the changes in the fair value of derivative instruments that were not eligible for hedge accounting.

Table of Contents**n Interest Expense**

Interest expense includes interest on long-term debt and capital leases, and interest income. Interest expense was \$57.1 million in the second quarter of 2004, an increase of \$3.2 million (up \$6 million, excluding the effect of FX) from \$53.9 million for the same period in 2003. Interest expense was \$111.1 million in the first half of 2004, a decrease of \$1.1 million (up \$8 million, excluding the effect of FX) from \$112.2 million for the same period in 2003. Interest expense increased in the second quarter of 2004, compared with the second quarter in 2003, due to interest on a new locomotive capital lease acquired in the first quarter of 2004 and the \$350 million 4.9% debentures issued July 2003, partially offset by the positive impact of FX and lower interest cost associated with the replacement of higher-cost debt with lower-cost debt. For the first six months in 2004, compared with the same period in 2003, the positive effect of FX more than offset the above-mentioned factors resulting in a decrease in interest expense.

n Income Taxes

Income tax expense for the second quarter of 2004 was \$49.7 million, compared with a credit of \$27.1 million in the same period of 2003. The effective income tax rate for the second quarter of 2004 was 37.3%, compared with a tax recovery for the same period in 2003 due to tax reductions resulting from expenses associated with the special charge. The normalized rates (income tax rate based on income adjusted for FX on LTD and other specified items) for the second quarter of 2004 and 2003 were 32.6% and 32.2%, respectively.

Income tax expense for the first six months of 2004 was \$70.3 million, compared with a credit of \$3.1 million in the same period of 2003. The effective income tax rate for the first half of 2004 was 39.6%, compared with a tax recovery of 2.3% for the same period of 2003 due to reduced taxes as a result of the special charge. The normalized rates (income tax rate based on income adjusted for FX on LTD and other specified items) for the first half of 2004 and 2003 were 33.0% and 32.3%, respectively.

The normalized rate for 2004 fiscal year is expected to be between 32% and 34%. The increase in the 2004 normalized rate over the 2003 rate of 31.16% is due mainly to an increase in tax rates by the Province of Ontario.

Quarterly Financial Data

(in \$ millions, except per share data) (unaudited)	For the quarter ended							
	2004			2003 ⁽¹⁾		2002 ⁽¹⁾		
	June 30	Mar 31	Dec 31	Sept 30	June 30	Mar 31	Dec 31	Sept 30
Total revenue	1,004.7	886.6	963.5	904.3	914.1	878.8	950.4	917.3
Operating income (loss)	220.6	116.0	193.2	203.6	(29.2)	117.9	234.2	218.1
Net income	83.7	23.5	173.9	91.3	34.1	101.9	123.0	61.7
Basic earnings per share	\$ 0.53	\$ 0.15	\$ 1.10	\$ 0.57	\$ 0.22	\$ 0.64	\$ 0.78	\$ 0.39
Diluted earnings per share	\$ 0.53	\$ 0.15	\$ 1.09	\$ 0.57	\$ 0.22	\$ 0.64	\$ 0.77	\$ 0.39

This information is in Canadian dollars and has been prepared in accordance with Canadian GAAP.

(1) Certain prior period figures have been restated to conform with presentation adopted in 2004.

ⁿ Quarterly Trends

Volumes of and, therefore, revenues from certain goods are stronger during different periods of the year. Revenues are typically strongest in the fourth quarter primarily as a result of the transportation of

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grain after the harvest, fall fertilizer programs and the transportation of consumer goods. First-quarter revenues can be lower due mainly to winter weather conditions, closure of the Great Lakes ports and reduced transportation of consumer goods. Second- and third-quarter revenues generally improve over the first quarter as fertilizer volumes are typically highest during the second quarter and demand for construction-related goods is generally highest in the third quarter.

Operating income is also affected by seasonal fluctuations. Operating income is typically lowest in the first quarter due to higher operating costs as a result of winter weather.

A special charge for restructuring and asset impairment recorded in the second quarter of 2003 and a loss on transfer of assets related to the IBM outsourcing agreement in the fourth quarter of 2003 affected operating and net income for that year.

Net income is influenced by seasonal fluctuations, including weather-related costs, as well as FX on LTD, the special charge and the loss on transfer of assets.

Changes in Accounting Policy

There were no further accounting developments except for the changes in accounting policy disclosed in CPR's MD&A for the year ended December 31, 2003 and the first quarter of 2004.

Liquidity and Capital Resources

CPR believes that adequate amounts of cash and cash equivalents are available in both the short term and the long term to provide for ongoing operations and planned growth, including the obligations identified in the tables under the heading Contractual Commitments and the sub-heading Financial Commitments. CPR is not aware of any trends or expected fluctuations in its liquidity that would create any deficiencies. The following discussion of operating, investing and financing activities describes CPR's indicators of liquidity and capital resources.

ⁿ Operating Activities

Cash provided by operating activities was \$249.4 million in the second quarter of 2004, an increase of \$148.9 million from \$100.5 million for the same quarter in 2003. Year-to-date, cash provided by operating activities was \$352.0 million in 2004, an increase of \$197.8 million from \$154.2 million for the same six months in 2003. The second-quarter and year-to-date increases were due mainly to a larger amount of cash being generated through income, smaller year-over-year changes in working capital balances and reduced restructuring payments.

There are no specific or unusual requirements relating to CPR's working capital. In addition, there are no unusual restrictions on any subsidiary's ability to transfer funds to CPR.

ⁿ Investing Activities

Cash used in investing activities was \$184.0 million in the second quarter of 2004, increasing \$8.4 million from \$175.6 million in the same period of 2003. Year-to-date, cash used in investing activities was \$322.8 million in 2004, a decrease of \$32.9 million from \$355.7 million for the same period in 2003. The increase for the second quarter in 2004, compared with 2003, was due mainly to increased spending on track programs in the first half of 2004. The decrease for the first six months of 2004, compared with the same period in 2003, was due mainly to fewer locomotive acquisitions and a lower U.S. foreign exchange rate.

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Capital spending in 2004 is projected to be \$670 million to \$710 million for mainly track projects and locomotive and freight car acquisitions. CPR is financing the locomotives with new debt and other capital acquisitions are expected to be financed with cash from operations.

n Financing Activities

Cash used in financing activities was \$20.8 million in the second quarter of 2004, a decrease of \$360.0 million from \$380.8 million in the same quarter of 2003. Year-to-date, cash provided by financing activities was \$141.5 million in 2004, compared with \$33.6 million of cash used for financing activities for the same period in 2003. The decrease in cash used in the second quarter of 2004, compared with the same period in 2003, was due to the redemption of the 6.875% US\$250 million debentures in the second quarter of 2003. The year-to-date increase in cash generated by financing activities was due to the redemption of the 6.875% US\$250 million debentures offsetting the issue of 5.75% US\$250 million debentures in 2003, and the issuance of debt in 2004 as described below.

CPR completed one secured notes offering in the first quarter of 2004 5.41% US\$145 million issued March 2004, maturing March 2024, to fund the acquisition of locomotives.

CPR has available, as sources of financing, credit facilities of up to \$504.6 million. CPR believes it can raise capital in excess of these amounts, if required, while maintaining its credit quality in international debt markets. CPR's unsecured long-term debt securities are rated Baa2, BBB and BBB by Moody's Investors Service, Inc., Standard and Poor's Corporation and Dominion Bond Rating Service, respectively.

CPR filed a US\$750-million base shelf prospectus with the U.S. Securities and Exchange Commission in April 2004 to provide the financial flexibility to offer for sale debt securities, but at the present time does not have any immediate plans to issue debt.

In the second quarter of 2004, CPR's net-debt to net-debt-plus-equity ratio increased to 47.0%, compared with 46.9% at June 30, 2003. The increase is due to the total of increased debt from the issuance of the 4.9% \$350 million Medium Term Notes in July 2003, and US\$145 million secured notes in March 2004, which were not completely offset by increased cash balances and shareholders' equity, in the first six months of 2004 compared with the same period in 2003. Net debt is the sum of long-term debt, long-term debt maturing within one year and short-term borrowing, less cash and short-term investments. This is divided by the sum of net debt plus total shareholders' equity as presented on CPR's Consolidated Balance Sheet.

Management is committed to maintaining its net-debt to net-debt-plus-equity ratio at an acceptable level and intends to continue to manage the Company's financial capital employed so that it retains solid investment-grade credit.

n Free Cash

Free cash is a non-GAAP measure that management feels is an indicator of the Company's liquidity and ability to re-invest in the future. Free cash, after dividends, is calculated as cash provided by operating activities, less cash used in investing activities and dividends.

The Company generated positive free cash, after dividends, of \$45.1 million in the second quarter of 2004, compared with negative free cash of \$95.3 million in the same period of 2003. For the first six months of 2004, free cash was negative \$11.3 million, compared with negative free cash of \$241.9 million for the same period in 2003. The increase in free cash for the second quarter and first six months of 2004, compared with the same periods in 2003, is due largely to an increase in cash

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generated by operations. For the first half of 2004, free cash also increased due to fewer locomotive acquisitions.

Calculation of free cash (reconciliation of free cash to GAAP cash position) (in millions)	For the three months ended June 30		For the six months ended June 30	
	2004	2003⁽²⁾	2004	2003⁽²⁾
Cash provided by operating activities	\$ 249.4	\$ 100.5	\$ 352.0	\$ 154.2
Cash used in investing activities	(184.0)	(175.6)	(322.8)	(355.7)
Dividends paid on common shares	(20.3)	(20.2)	(40.5)	(40.4)
Free cash ⁽¹⁾	45.1	(95.3)	(11.3)	(241.9)
Cash provided by (used in) financing activities, before dividend payment	(0.5)	(360.6)	182.0	6.8
Increase (decrease) in cash, as shown on the Statement of Consolidated Cash Flows	44.6	(455.9)	170.7	(235.1)
Net cash at beginning of period	260.8	505.7	134.7	284.9
Net cash at end of period	\$ 305.4	\$ 49.8	\$ 305.4	\$ 49.8

(1) These measures have no standardized meanings prescribed by Canadian GAAP and, therefore, are unlikely to be comparable to similar measures of other companies.

(2) Certain prior period figures have been restated to conform with presentation adopted in 2004.

CPR expects to generate moderately positive free cash for the fiscal year of 2004, achieved mainly with higher earnings and lower pension contributions than in 2003.

Balance Sheet

Assets totalled \$10,394.2 million at June 30, 2004, compared with \$9,956.7 million at December 31, 2003. The increase was due mainly to capital additions, largely locomotives and capital track projects, and a larger cash balance from the debt issuance during the first quarter of 2004.

CPR's combined short-term and long-term liabilities were \$6,668.7 million at June 30, 2004, compared with total liabilities of \$6,302.1 million at December 31, 2003. The increase was due mainly to increases in long-term debt, as discussed in the section "Liquidity and Capital Resources" under the sub-heading "Financing Activities", and larger future income tax balances resulting from tax rate increases by the Province of Ontario.

At June 30, 2004, the Company's Consolidated Balance Sheet reflected \$3,725.5 million in equity, compared with equity balances of \$3,654.6 million at December 31, 2003. The majority of the increase was due to CPR's growth in retained income in the first half of 2004.

Share Capital

The Company's Articles of Incorporation authorize for issuance an unlimited number of Common Shares and an unlimited number of First Preferred Shares and Second Preferred Shares. At June 30, 2004, 158.7 million Common Shares and no Preferred Shares had been issued.

CPR also has a Management Stock Option Incentive Plan (MSOIP) under which key officers and employees are granted options to purchase CPR shares. Each option granted can be exercised for one Common Share. The maximum number of Common Shares approved for issuance under the MSOIP is 11.0 million. At June 30, 2004, 7.7 million of these options were outstanding.

In addition, CPR has a Directors' Stock Option Plan (DSOP) under which members of CPR's Board of Directors are granted options to purchase CPR shares. Each option granted can be exercised for one Common Share. The maximum number of Common Shares approved for issuance under the DSOP is 500,000. Outstanding options granted prior to the suspension of the DSOP remain in effect with no amendments. At June 30, 2004, 160,000 of these options were outstanding. On July 21, 2003, as a

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result of a review of the Company's compensation philosophy for its Board of Directors by external compensation consultants, the Board of Directors suspended all further grants of options under the DSOP.

ⁿ Dividends

For the second quarter of 2004, dividends of \$0.1275 per Common Share declared by the Board of Directors on April 20, 2004, for shareholders on record at June 25, 2004, were paid on July 26, 2004. For the first quarter of 2004, dividends of \$0.1275 per Common Share declared by the Board of Directors on February 19, 2004, for shareholders on record at March 26, 2004, were paid on April 26, 2004. Dividends for the fourth quarter of 2003 of \$0.1275 per Common Share were paid on January 26, 2004.

On July 28, 2004, the Board of Directors declared a dividend of \$0.1325 per Common Share, for shareholders on record at September 24, 2004, which will be payable on October 25, 2004.

Financial Instruments

The Company's policy is to prohibit the utilization of derivative financial and commodity instruments for trading or speculative purposes. CPR's policy with respect to hedging of risk exposure is to selectively reduce volatility associated with interest rates, foreign exchange fluctuations and fluctuations in the price of diesel fuel. A portion of the U.S. dollar-denominated long-term debt has been designated as a hedge of the net investment in self-sustaining foreign subsidiaries. Further discussion of the Company's financial instruments is provided under the heading "Foreign Exchange", and under the sub-headings "Interest Rate Swaps" and "Crude Oil Futures" under the heading "Future Trends, Commitments and Risks".

The Company enters into interest rate risk management transactions to manage exposure to fluctuations in interest rates, to protect against increases in interest rates in anticipation of future debt issuances, and to convert a portion of its fixed-rate long-term debt to floating-rate debt. From time to time, the Company uses interest rate swaps, bond forwards and treasury locks as part of its interest rate risk management strategy.

Concurrent with the issuance of its 4.9% \$350-million Medium Term Notes, CPR entered into cross-currency, fixed-to-floating interest rate swap agreements for the purpose of converting \$105 million of fixed-rate debt to US\$77.3 million of floating-rate U.S. dollar-denominated debt. Beginning January 1, 2004, management determined that these agreements no longer qualified for hedge accounting treatment under a new Canadian GAAP pronouncement, AcG 13, discussed in CPR's first-quarter MD&A. As a result, the Company recorded an unrealized gain on the Consolidated Balance Sheet for these swaps, which is being amortized over the life of the debt. At June 30, 2004, "Deferred Liabilities" on the Consolidated Balance Sheet included \$2.0 million for this deferred gain. Amortization of this gain reduced "Other Charges" on the Statement of Consolidated Income by \$0.1 million in the second quarter and \$0.2 million year-to-date. The fair values of the swaps are revalued each quarter with the gains or losses included in income and at June 30, 2004, "Deferred Liabilities" included a \$1.7 million loss for the revaluation of the swaps. Unrealized losses from the revaluation of the swaps increased "Other Charges" by \$7.0 million in the second quarter of 2004 and \$3.9 million year-to-date. Savings realized from the swaps reduced "Other Charges" by \$1.6 million in the second quarter of 2004 and \$1.6 million year-to-date. Subsequent to June 30, 2004, the Company terminated these agreements, for which CPR received \$0.1 million.

CPR entered into six treasury rate locks totalling US\$124 million to fix the benchmark interest rate on the 5.41% US\$145-million secured notes offering, maturing in 2024. Upon termination of these locks in the first quarter of 2004, CPR realized a loss of \$1.6 million, which is being deferred and amortized over the 20-year life of the existing financing.

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CPR has managed some of its exposure to changes arising from fluctuations in exchange rates between Canadian and U.S. dollars on future revenue streams by selling forward U.S. dollars at fixed rates in future periods. These forward contracts were short term and not designated as hedges. The contracts settled in the second quarter of 2004. At June 30, 2004, Other Charges on the Statement of Consolidated Income included realized gains of \$0.1 million in the second quarter of 2004 and \$1.4 million for the year-to-date.

At June 30, 2004, Other Assets and Deferred Charges on the Consolidated Balance Sheet included a loss of \$20.0 million from an interest rate lock settled in 2003 on \$200 million of long-term debt. This loss is being amortized over seven years, which is the term of the underlying debt. Interest Expense on the Statement of Consolidated Income included \$0.8 million in the second quarter and \$1.7 million in the first six months of 2004 for amortization of this loss.

Off-Balance Sheet Arrangements

In July 1996, guarantees were provided by CPR and the Government of Quebec to enable CPR's former railway subsidiary, Quebec Central Railway Company (QCR), to obtain a loan following the sale of CPR's interest in the QCR. CPR's guarantee is in favour of a Canadian bank for up to \$5 million, plus removal and transportation costs, to repurchase track material in the event of default on the loan by QCR. The fair value of the track material has not been estimated at this time.

The bank has indicated that it will only refinance the QCR loan if the Government of Quebec and CPR renew their guarantees. The guarantors are to indicate whether or not they will renew by the fall of 2004. It is not known at this time whether the Government of Quebec will renew its guarantee. As indicated by the bank, if QCR is not able to service its interest and principal payment obligations over time or does not have sufficient funds to make necessary railway network safety and efficiency improvements, CPR and the Government of Quebec may be called upon to fulfill their obligations under their respective guarantees.

Contractual Commitments

The following table indicates CPR's known contractual obligations and commitments to make future payments for contracts such as debt, capital lease arrangements and commercial commitments:

Contractual commitments at June 30, 2004 (in millions)	Total	Payments due by period			
		Remainder of 2004	2005 & 2006	2007 & 2008	2009 & beyond
Long-term debt	\$3,241.0	\$ 9.2	\$288.7	\$202.2	\$2,740.9
Capital lease obligations	373.9	1.0	12.5	18.2	342.2
Operating lease obligations ⁽¹⁾	522.6	74.0	225.9	124.7	98.0
Supplier purchase obligations	748.2	84.2	203.6	144.5	315.9
Other long-term liabilities reflected on the Company's balance sheet ⁽²⁾	918.4	73.8	266.6	210.6	367.4
Total contractual obligations	\$5,804.1	\$242.2	\$997.3	\$700.2	\$3,864.4

- (1) CPR has guaranteed residual values on certain leased equipment with a maximum exposure of \$81.2 million, primarily in 2006 and beyond. Management estimates that CPR will have no net payments under these residual guarantees and, as such, has not included any amounts with respect to these guaranteed residual values in the minimum payments shown above.
- (2) Includes expected cash payments for restructuring, environmental remediation, asset retirement obligations, post-retirement benefits and workers' compensation benefits. Projected payments for post-retirement benefits and workers' compensation benefits include the anticipated payments for years 2004 to 2013.

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In the second quarter of 2004, the Company had the following significant changes to its contractual commitments, other than in the ordinary course of business:

ⁿ CPR entered into a long-term operating lease for 34 new locomotives. CPR expects to take delivery of these locomotives in the fourth quarter of 2004.

ⁿ CPR entered into a long-term operating lease for 41 new locomotives. CPR received these locomotives in the second quarter of 2004.

ⁿ CPR also entered into or renewed other agreements, including smaller, long-term leases for rolling stock.

In addition to the above-mentioned changes, the first six months of 2004 included the following significant changes to the Company's contractual commitments, other than in the ordinary course of business:

ⁿ CPR financed the acquisition of locomotives with the US\$145-million notes, discussed previously under the sub-heading Financing Activities. The Company previously had an operating lease for some of the locomotives. This transaction resulted in an increase to long-term debt of US\$145 million and a reduction to operating lease obligations of \$28 million.

ⁿ CPR extended a long-term lease for building space which resulted in an increase to operating lease obligations of \$40 million.

Foreign Exchange

The Company is exposed to foreign exchange fluctuations in the U.S. dollar. A stronger Canadian dollar reduces U.S. dollar-denominated revenues and expenses. Operating income is also reduced because more revenues than expenses are generated in U.S. dollars. The Company has arranged a significant portion of its long-term debt in U.S. dollars as a hedge against a stronger Canadian dollar, as the negative impact on operating income is largely offset by a reduction in U.S. dollar-denominated interest cost.

The Canadian dollar strengthened against the U.S. dollar by approximately 5% year-over-year in the second quarter of 2004 and by approximately 10% year-over-year in the first six months of 2004, compared with the same periods in 2003. The impact of this foreign exchange rate fluctuation on the Company's financial results is reflected in the Statement of Consolidated Income and the Consolidated Balance Sheet.

Translation of the Company's Accounts, Excluding Foreign Subsidiaries

U.S. dollar-denominated revenues and expenses are translated at the exchange rate in effect on the dates of the related transactions, with all gains and losses included immediately in income. On average, a one-cent change in the Canadian dollar affects operating income by approximately \$3.0 million.

U.S. dollar-denominated balance sheet accounts are translated into Canadian dollars at the period-end exchange rate for monetary items such as working capital, long-term debt and cash, and at historical exchange rates for non-monetary items. Unrealized gains and losses arising from the translation of the monetary items are included in income immediately in Other Charges, and as Foreign Exchange Gains (Losses) on Long-Term Debt for U.S. dollar-denominated long-term debt.

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Translation of Foreign Subsidiaries' Accounts

The accounts of the Company's foreign subsidiaries are translated into Canadian dollars using the period-end exchange rate for assets and liabilities and the average exchange rates in effect during the period for revenues and expenses. Unrealized foreign exchange gains and losses arising from translation of foreign subsidiaries' accounts are included as a separate component of Shareholders' Equity on the Consolidated Balance Sheet. The Company has designated a portion of its U.S. dollar-denominated long-term debt in Canada as a hedge against its net investment in self-sustaining foreign subsidiaries. As such, foreign exchange gains and losses on translation of foreign subsidiaries' accounts are partially offset by the foreign exchange gains and losses on U.S. dollar-denominated long-term debt held in Canada.

Future Trends, Commitments and Risks

The future trends, commitments and risks disclosed in CPR's MD&A for the year ended December 31, 2003, and the first quarter of 2004, remain substantially unchanged, except for the following recent developments:

Continuing cost-containment programs are vital to CPR achieving its financial performance targets. CPR plans to eliminate approximately 300 positions in 2004 as a result of previously announced initiatives designed to achieve cost reductions through consolidation and rationalization of administrative functions, redesign of yard processes and more efficient maintenance of freight car and locomotive fleets. CPR will continue to selectively hire in specific areas of the business as required by growth or changes in traffic patterns.

CPR remains committed to maintaining its current high level of plant quality and renewing its franchise. At June 30, 2004, CPR had committed to future multi-year capital expenditures amounting to \$563.4 million, which are expected to be financed by cash generated from operations.

Significant increases in rail traffic volumes have created capacity challenges for the entire North American rail sector. An unanticipated surge in bulk exports and container imports has created pressure on CPR's delivery system to and from the Pacific Ocean. CPR is managing network fluidity and capacity by investing in new locomotives, replacing older freight cars with more efficient and higher-capacity freight cars, expanding network infrastructure capacity in strategic areas, hiring train crews, and introducing a rail capacity allocation system for the import container business on the Canadian West Coast. In addition, CPR is consulting with customers to determine the sustainability of the current high demand for rail service prior to committing to major investments in fixed infrastructure.

CPR is a certified carrier with the U.S. Customs and Border Protection's (CBP) Customs - Trade Partnership Against Terrorism (C-TPAT) program and the Canada Border Services Agency's (CBSA) Partners in Protection (PIP) program. C-TPAT and PIP are partnership programs that seek to strengthen overall supply chain and border security. CPR is also an approved carrier under CBSA's Customs Self-Assessment (CSA) program.

CPR works closely with Canadian and U.S. customs officials and with other railways to ensure the safe and secure movement of goods between Canada and the U.S. The Company has prepared for the implementation of several regulatory security frameworks in 2004 that will focus on the provision of advanced electronic cargo information. CPR is already fully automated with both CBSA and U.S. CBP and currently provides the requisite shipment information electronically well in advance of border arrival.

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Under the joint Declaration of Principles signed in April 2003, CPR committed to work with CBSA and CBP to install Vehicle and Cargo Inspection Systems (VACIS) at five of CPR 's border crossings. Rail VACIS systems use non-intrusive gamma ray technology to scan U.S.-bound rail shipments. Four of the VACIS systems are now fully operational, and the fifth installation is expected to be complete in 2005. This joint government-industry initiative is expected to enhance the security of U.S.-bound rail shipments while helping to ensure uninterrupted access to the U.S. market for CPR customers.

Train crew employees have elected the Teamsters Canada Rail Conference (TCRC) as their bargaining agent, replacing the Canadian Council of Railway Operating Unions (CCROU). CPR 's collective agreement with the CCROU expired on December 31, 2002. Previously suspended negotiations have resumed with the TCRC.

The Company 's collective bargaining agreement with the Brotherhood of Maintenance of Way Employees expired on December 31, 2003. Negotiations were delayed earlier this year because of union representational issues that resulted in the Teamsters Canada Rail Conference, Maintenance of Way Employees Division (TCRC-MWED) being certified as bargaining agent. Negotiations recommenced with the TCRC-MWED in July 2004.

Collective agreements with the Canadian Auto Workers (CAW), which represents employees who repair locomotives and freight cars, and the International Brotherhood of Electrical Workers (IBEW), which represents signal maintainers, expire at the end of 2004. Negotiations with the CAW and IBEW are expected to commence in September 2004.

The Province of British Columbia announced on November 25, 2003, its intention to sell most of the freight operations of BC Rail to Canadian National Railway Company, a competitor of CPR. The proposed transaction was reviewed by the Commissioner of Competition in accordance with the Competition Act, and on July 2, 2004, the Commissioner filed a Consent Agreement with the Competition Tribunal approving the transaction subject to certain conditions. The conditions will permit CPR to protect its market position and presence in northern British Columbia. The Company does not expect a material adverse impact as a result of the transaction.

Investigation and characterization of environmental contamination is under way at a location in Minnesota formerly leased to third parties by the Company. CPR is participating in the State of Minnesota 's voluntary investigation and clean-up program and the site is the subject of ongoing fieldwork, being undertaken in conjunction with the appropriate state authorities, to determine the extent and magnitude of the contamination and the appropriate remediation plan. At this time, the investigative fieldwork has not been completed, the extent and magnitude of the contamination have not yet been determined and, consequently, no remediation action plan has been developed. CPR has initiated civil litigation against its former lessees and expects to ultimately recover a substantial portion of its investigative and clean-up costs.

On June 30, 2004, CPR and the Norfolk Southern Railway (NSR) signed a comprehensive Memorandum of Understanding to improve the efficiency of railway operations and enhance rail service to customers in the Northeast U.S. Under the agreement, the NSR will provide yard services to CPR at Buffalo, New York and CPR will provide yard services to NSR at Binghamton, New York, CPR will haul NSR traffic between Rouses Point, New York and Saratoga Springs, New York and NSR will haul CPR traffic between Binghamton and Buffalo. CPR will operate its own trains over NSR lines between Detroit, Michigan and Chicago, Illinois and NSR will operate its own trains over CPR 's line between Saratoga Springs and Binghamton. The trackage rights included in the agreement require the approval of the Surface Transportation Board and the construction of a connection between Detroit and Chicago by NSR. It is expected that implementation of the agreement will improve the

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profitability of CPR's operations in the Northeast U.S., and reduce costs and significantly improve service in the Detroit-Chicago corridor. The savings from this agreement are expected to be realized beginning in 2005. CPR will continue to look for options that might improve performance of its operations in the Northeast U.S.

CPR is currently involved in discussions with its largest customer with the objective of resolving a difference of opinion with respect to what rates apply under their contract for moving coal from the customer's mines to the Port of Vancouver. At this time, CPR has filed a statement of claim against this customer in respect of the latter's failure to pay the full amount of applicable rail freight charges as per its transportation contract with CPR. The dispute relates to the shipment of coal from the customer's mines in southeastern British Columbia to Vancouver area ports for overseas export. The contract continues through to March 31, 2007. The dispute is not expected to affect the continued shipment of coal by CPR from the customer's mines. The outcome of the dispute and rate discussions are not expected to have a material effect on financial results recorded to date.

In response to rapidly rising fuel prices, the Company has revised its method of calculating the surcharge applied to help recover fuel costs. A new fuel surcharge program provides customers with surcharges that are more closely tied to current fuel prices and enables CPR to adjust its rates more quickly as fuel prices fluctuate.

ⁿ Financial Commitments

In addition to the financial commitments of the Company mentioned previously under the heading "Contractual Commitments", the Company is party to certain other financial commitments discussed below.

Certain other financial commitments at June 30, 2004 (in millions)	Amount of commitment per period				
	Total	Remainder of 2004	2005 & 2006	2007 & 2008	2009 & beyond
Letters of credit	\$ 313.6	\$ 307.5	\$ 6.1	\$ -	\$ -
Capital commitments ⁽¹⁾	563.4	206.4	110.7	55.5	190.8
Surety bonds	23.6	1.5	22.1	-	-
Offset financial liability	154.9	154.9	-	-	-
Sale of accounts receivable	120.0	120.0	-	-	-
Interest rate swaps on long-term debt - unrealized gain	(4.1)	(4.1)	-	-	-
Crude oil futures - unrealized gain	(38.6)	(15.1)	(19.9)	(3.6)	-
Total commitments	\$ 1,132.8	\$ 771.1	\$ 119.0	\$ 51.9	\$ 190.8

⁽¹⁾ The Company has several contracts outstanding with termination payments ranging from \$nil to \$26.4 million per contract, and resulting in a minimum exposure of \$4.3 million and a maximum exposure of \$30.9 million, depending on the date of termination. These contracts terminate between 2006 and 2013.

Letters of Credit and Surety Bonds

Letters of credit and surety bonds are obtained mainly to provide security to third parties as part of agreements. The Company is liable for these contract amounts in the case of non-performance under third-party agreements. As a result, CPR's available line of credit is adjusted for the contract amounts currently included within CPR's revolving credit facility.

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Capital Commitments

The Company is obligated to make various capital purchases for track programs, locomotive acquisitions and overhauls, freight cars and land. At June 30, 2004, CPR had multi-year capital commitments of \$563.4 million, in the form of signed contracts or letters of intent, mainly for locomotive overhaul agreements. Payments for these commitments are due in 2004 through 2018.

Offset Financial Liability

The Company entered into a bank loan to finance the acquisition of certain equipment. At June 30, 2004, the loan had a balance of \$159.1 million, which was offset by a financial asset of \$154.9 million with the same financial institution. The remainder is included in Long-Term Debt on CPR's Consolidated Balance Sheet.

Sale of Accounts Receivable

CPR sold a portion of its accounts receivable to a financing institution in order to raise funds through the monetization of receivables. At June 30, 2004, the receivables sold amounted to \$132 million under a securitization program that involves the non-recourse sale of accounts receivable on a revolving basis. Cash proceeds on this revolving arrangement affecting receivables were \$120 million, with \$12 million having been held back as a reserve to be released to the Company upon termination of the agreement.

The Company uses this arrangement as a cost-efficient secondary source of financing for its operations. Charges related to this agreement, included in Other Charges on CPR's Statement of Consolidated Income, amounted to \$0.8 million in the second quarter of 2004 and \$1.6 million for the first six months of 2004, compared with \$1.2 million for the same quarter of 2003 and \$2.1 million for the first half of 2003.

The program is subject to standard reporting and credit-rating requirements and includes provisions such as the revolving transfer of receivables satisfying certain pre-established criteria such as an acceptable credit standing. Failure to comply with these provisions would trigger termination of the program. In the event the program is terminated prior to maturity, CPR expects to have sufficient liquidity remaining in its revolving credit facility to meet its payment obligations. The securitization program will expire in August 2004. The Company is currently evaluating the program in the context of its overall financing plan to determine whether it will renew or replace the program upon its expiry.

Interest Rate Swaps

The Company has entered into fixed-to-floating interest rate swap agreements totalling US\$200 million, to convert a portion of its US\$400-million 6.25% Notes to floating-rate debt. CPR pays an average floating rate that fluctuates quarterly based on the London Interbank Offered Rate (LIBOR). These swaps expire in 2011 and are accounted for using hedge accounting treatment. During the second quarter of 2004, savings from these swaps reduced Interest Expense on the Statement of Consolidated Income by \$1.4 million, and by \$2.8 million for the year-to-date.

The unrealized gain shown in the Certain Other Financial Commitments table was calculated based on the fair value, at June 30, 2004, of interest swaps or locks that are not recorded at their fair value on the Consolidated Balance Sheet. Swap, currency and basis spread curves from Reuters.com were utilized to establish the fair market value of the swaps. Values may vary marginally due to either the terms of the contract or because of minor variations in the time of day when the data was collected.

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Crude Oil Futures

CPR sells and purchases crude oil futures to hedge its exposure against the possibility of fuel price increases. The Company's exposure is represented by the unrealized gains or losses on these futures.

The unrealized gain shown in the Certain Other Financial Commitments table was calculated based on the fair value of the futures, which was the market settle price of West Texas Intermediate (WTI) on the New York Mercantile Exchange (NYMEX) at June 30, 2004. Fair market value of collars is included in the calculation of the unrealized gain or loss if the weighted average future settle price is greater than the ceiling price or less than the floor price of the collars. At June 30, 2004, the price of WTI was greater than the ceiling price of the collars. As a result, the gains associated with the collars have been included in the unrealized gain. No unrealized gains or losses have been included in the Statement of Consolidated Income or the Consolidated Balance Sheet.

As a result of gains and losses arising from settled futures and collars, fuel expense was reduced by \$7.9 million in the second quarter of 2004 and by \$14.3 million in the first half of 2004.

For every US\$1 increase in the price of WTI, fuel expense, before hedging, will increase by approximately \$9 million, assuming current foreign exchange rates and fuel consumption levels. The Company has fuel hedges for approximately 24% of its fuel purchases for the balance of 2004, representing unrealized gains of \$15.1 million.

n Pension Plan Deficit

The deficit for the Company's defined benefit pension plans was disclosed as \$753.7 million at December 31, 2003. A valuation of the real estate portion of the invested assets of the CPRC Pension Plan trust fund revealed in May 2004 that the market value of these assets was approximately \$70 million lower than previously assessed. The valuation was performed on the trust fund by an independent appraiser. In the past, such appraisals have occurred approximately once every three years. The reappraised market value is not expected to affect CPR's financial position and expense for the 2004 fiscal year. The impact of the reappraisal will be reflected as an investment experience loss in Actual Return on Fund Assets included in the pension disclosure of CPR's Notes to Consolidated Financial Statements for December 31, 2004. At this time, this loss is offset by experience gains that have been achieved with other pension assets.

The Company complies with the applicable funding requirements, which are federally regulated. A plan surplus or deficit is calculated as the difference between an actuarially estimated future obligation for pension payments and the fair market value of the assets available to pay this liability. The pension obligation is discounted using a discount rate that is a blended interest rate of high-quality corporate bonds. The discount rate is one of the factors that can influence a plan's deficit. Other factors include the actual return earned on the assets and rates used, based on management's best estimates, for future salary increases and inflation. For example, every 1.0 percentage point the actual discount rate varies above (or below) the estimated discount rate can cause the deficit to decrease (or increase) by approximately \$600 million (after reflecting the expected loss (gain) on the value of the pension fund's bond holdings with respect to corresponding changes in long-term interest rates). Similarly, every 1.0 percentage point the actual return on assets varies above (or below) the estimated return for the year can cause the deficit to decrease (or increase) by approximately \$60 million. As such, adverse experience with respect to these elements could eventually increase funding and pension expense significantly, while favourable experience with respect to these elements could eventually decrease funding and pension expense significantly.

The deficit will fluctuate according to future market conditions and funding will be revised as necessary to reflect such fluctuations. The Company will continue to make contributions towards this

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deficit that, as a minimum, meet requirements as prescribed by the Pension Benefits Standards Act for Canadian-registered plans and the Employee Retirement Income Security Act for U.S.-registered plans. CPR estimates that it will be required to contribute \$122 million in 2004. Contributions of \$15.5 million were made in the second quarter of 2004 and contributions of \$30.8 million were made in the first six months of 2004.

An updated actuarial valuation of the CPRC Pension Plan as at January 1, 2004 was completed in June 2004. The Company took into account the estimated impact of this valuation, along with other factors, in deriving the expected funding contribution of \$122 million in 2004. While a similar level of contribution is expected for 2005, the actual amount required to be contributed will depend on CPR's actual experience in 2004 with such variables as investment returns, interest rate fluctuations and demographic changes.

ⁿ Restructuring

In the second quarter of 2003, CPR announced a restructuring program to eliminate 820 positions, which required the accrual of a labour liability of \$105.5 million. Annual job reductions were expected to be: 370 in 2003, 330 in 2004 and 120 in 2005. CPR eliminated 360 positions by the end of 2003. During 2004, 89 positions were eliminated in the first six months, including 54 positions in the second quarter. CPR's current plan is to eliminate approximately 300 positions during 2004, and to achieve the originally targeted 820 positions by the end of 2005.

Productivity improvements stemming from eliminating these job positions are expected to reduce compensation and benefits expense by approximately \$35 million in 2004, \$58 million in 2005 and \$65 million in future years, compared with compensation and benefits expense in 2002. Job reductions associated with the restructuring program contributed \$15 million in savings year-to-date, including \$8 million in the second quarter of 2004.

Cash payments for the elimination of these positions are expected to be \$23 million in 2004, \$41 million in 2005, \$17 million in 2006 and a total of \$28 million in the remaining years to 2009. CPR expects to fund these payments from general operations.

The restructuring liabilities also include residual payments to protected employees for previous restructuring plans that are substantially complete. These payments are expected to continue in decreasing amounts until 2025 and will be funded from CPR's general operations.

Cash payments in second-quarter 2004 related to severance under all restructuring initiatives and CPR's environmental remediation program, described in this MD&A under the sub-heading "Critical Accounting Estimates", amounted to \$19.5 million, compared with \$24.1 million in 2003. Payments for the first six months of 2004 were \$38.0 million, compared with \$46.2 million for the same period in 2003. The total accrued restructuring and environmental liability at June 30, 2004, was \$435.0 million, of which \$117.1 million is included in current liabilities.

At June 30, 2004, CPR's labour liabilities totalled \$336.9 million, compared with \$396.8 million at June 30, 2003. Payments in second-quarter 2004 relating to these liabilities were \$14.1 million, compared with \$17.3 million in the same period of 2003. Payments for the first six months in 2004 were \$30.8 million, compared with \$36.9 million for the same period in 2003.

Also included in the restructuring liabilities are accruals for costs associated with the rental of properties no longer being used by the Company. Cash payments for these liabilities are anticipated to be \$2.1 million for the remainder of 2004, \$3.9 million for 2005, and \$0.3 million annually thereafter until 2009. In the second quarter of 2004, payments relating to these liabilities were \$0.8 million. Payments were \$1.1 million for the first half of 2004.

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At June 30, 2004, total restructuring liabilities were \$345.2 million, compared with \$408.5 million at June 30, 2003. In the second quarter of 2004, payments made for all restructuring liabilities amounted to \$14.9 million, compared with payments of \$21.0 million for the same period in 2003. Payments for the first six months in 2004 were \$31.9 million, compared with \$42.0 million for the same period in 2003.

Critical Accounting Estimates

To prepare financial statements that conform with Canadian GAAP, management 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 financial statements, and the reported amounts of revenues and expenses during the reporting period. Using the most current information available, management reviews its estimates on an ongoing basis, including those related to environmental liabilities, pensions and other benefits, property, plant and equipment, future income taxes and legal and personal injury liabilities.

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

The critical accounting estimates disclosure in CPR's MD&A for the year ended December 31, 2003, and the first quarter of 2004, remain substantially unchanged, except for the following recent developments:

n Environmental Liabilities

Management estimates the probable costs to be incurred in the remediation of property sites contaminated by past railway use. Sites are screened and classified according to typical activities and scale of operations conducted, and remediation strategies are developed 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. Management 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 ground water. The details of the estimates reflect the environmental liability at each property. CPR is committed to fully meeting its regulatory and legal obligations with respect to environmental matters.

At June 30, 2004, the accrual for environmental remediation amounted to \$89.8 million, of which the long-term portion amounting to \$73.8 million was included in deferred liabilities and the short-term portion amounting to \$16.0 million was included in accrued liabilities. Total payments in the second quarter of 2004 were \$4.6 million and \$6.1 million for the year-to-date. The U.S. dollar-denominated portion of the liability was affected by FX, resulting in an increase in environmental liabilities of \$0.5 million in second-quarter 2004 and \$1.0 million for the first six months in 2004. Costs incurred under CPR's environmental remediation program are charged against the accrual.

n Pensions and Other Benefits

The Company has defined benefit and defined contribution pension plans. Other benefits include post-retirement medical and life insurance for pensioners, and post-employment workers' compensation benefits. Workers' compensation benefits are included in the Legal and Personal Injury Liabilities section of this MD&A. Pension, post-retirement and workers' compensation liabilities are subject to

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various external influences and uncertainties, as described under the sub-heading Pension Plan Deficit .

Pension and post-retirement benefits expenses (excluding workers' compensation benefits) are included in Compensation and Benefits in CPR's Statement of Consolidated Income. For the second quarter of 2004, pension expense was \$9.4 million, consisting of defined benefit pension expense of \$8.7 million plus defined contribution pension expense (equal to contributions) of \$0.7 million. Post-retirement benefits expense in the second quarter of 2004 was \$10.4 million, resulting in combined pension and post-retirement benefits expenses of \$19.8 million for the quarter. For the first six months of 2004, pension expense was \$18.2 million, consisting of defined benefit pension expense of \$16.8 million plus defined contribution pension expense of \$1.4 million. Post-retirement benefits expense for this period was \$20.9 million, resulting in combined pension and post-retirement benefits expenses of \$39.1 million for the year-to-date.

On CPR's June 30, 2004 Consolidated Balance Sheet, Other Assets and Deferred Charges included prepaid pension costs of \$711.5 million, offset by accrued pension costs of \$4.8 million and post-retirement benefits accruals of \$137.2 million included in Deferred Liabilities, and post-retirement benefits accruals of \$4.8 million included in Accounts Payable and Accrued Liabilities .

n Property, Plant and Equipment

CPR follows the group depreciation method and depreciates the cost of properties, net of salvage, on a straight-line basis over the estimated useful life of the property group.

The estimated useful lives of properties have a direct impact on the amount of depreciation expense charged by the Company and the amount of accumulated depreciation recorded as a component of Net Properties on CPR's Consolidated Balance Sheet. Depreciation expense relating to properties amounted to \$102.7 million in the second quarter of 2004 and \$202.3 million for the year to date. At June 30, 2004, accumulated depreciation was \$4,514.6 million.

Revisions to the estimated useful lives and net salvage projections for properties constitute a change in accounting estimate and are dealt with prospectively by amending depreciation rates. It is anticipated that there will be changes in the weighted average useful life and salvage estimates for each property group as assets are acquired, used and retired. Significant changes in either the useful lives of properties or the salvage assumptions could result in material changes to depreciation expenses.

CPR undertakes regular depreciation studies to establish the estimated useful life of each property group and is currently undergoing a depreciation review of certain track related properties in 2004 that could result in changes to the estimated useful lives and salvage rates of these assets. Management anticipates that the results of these reviews will increase depreciation expense by approximately \$20 million in 2004, compared with 2003. In the second quarter of 2004, \$5.0 million was recorded for these depreciation revisions, with a year-to-date total of \$10.0 million.

In the first quarter of 2004, the Company adopted the CICA accounting standard for Asset Retirement Obligations, discussed previously in CPR's first-quarter MD&A. This standard does not allow the Company's previous practice of recognizing removal costs in excess of salvage proceeds over the life of the asset when the removal costs are not legal obligations. Adopting this standard retroactively resulted in a decrease in depreciation expense of \$1.8 million in the second quarter of 2004 and \$2.3 million in second-quarter 2003. For the year to date, depreciation expense decreased \$4.0 million in 2004 and \$4.9 million in 2003.

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n Future Income Taxes

In determining its future income taxes, the Company makes estimates and assumptions regarding future tax matters, including estimating the timing of the realization and settlement of future income tax assets (including the benefit of tax losses) and liabilities. Future income taxes are calculated using the current substantively enacted federal and provincial future income tax rates, which may differ in future periods.

Future income tax expense totalling \$49.6 million was included in income taxes for the second quarter of 2004 and \$65.6 million for the first half of 2004. At June 30, 2004, future income tax liabilities of \$1,352.3 million were recorded as a long-term liability, comprised largely of temporary differences related to accounting for properties. Future income tax benefits of \$89.4 million realizable within one year were recorded as a current asset. The Company believes that its future income tax provisions are adequate.

Future income tax expense and liability increased by \$52.7 million in the fourth quarter of 2003 to reflect the new Government of Ontario income tax rates, and decreased by \$59.3 million as a result of the revaluation of several components of the future income tax liability.

n Legal and Personal Injury Liabilities

CPR and its subsidiaries are involved in litigation in both Canada and the U.S. related to their businesses. Management is required to establish estimates of potential liability arising from incidents, claims and pending litigation, including personal injury claims, certain occupation-related claims and claims relating to property damage.

Provisions for incidents, claims and litigation charged to income are included in Purchased Services and Other on CPR's Consolidated Statement of Income and amounted to \$11.4 million in the second quarter of 2004 and \$34.7 million for the first six months of 2004.

Accruals for incidents, claims and litigation, including WCB accruals, totalled \$170.0 million, net of insurance recoveries, at June 30, 2004. The total accrual includes: \$124.1 million in Deferred Liabilities and \$87.9 million in Accounts Payable and Accrued Liabilities, offset by \$33.9 million in Other Assets and Deferred Charges and \$8.1 million in Accounts Receivable.

Systems, Procedures and Controls

Management is responsible for establishing appropriate information systems, procedures and controls to ensure that all financial information disclosed externally, including this MD&A, and used internally by management is complete and reliable. These procedures include a review of the financial statements and associated information, including this MD&A, by the Audit, Finance and Risk Management Committee of the Board of Directors. The Company's Chief Executive Officer and Chief Financial Officer have a process to evaluate the applicable systems, procedures and controls and are satisfied they are adequate for ensuring that complete and reliable financial information is produced.

Forward-Looking Information

This MD&A contains certain forward-looking statements within the meaning of the *Private Securities Litigation Reform Act of 1995* (United States) relating but not limited to CPR's operations, anticipated financial performance, business prospects and strategies. Forward-looking information typically contains statements with words such as anticipate, believe, expect, plan or similar words suggesting future outcomes.

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Readers are cautioned to not place undue reliance on forward-looking information because it is possible that predictions, forecasts, projections and other forms of forward-looking information will not be achieved by CPR. In addition, CPR 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, CPR's forward-looking information involves numerous assumptions, inherent risks and uncertainties, including but not limited to the following factors: changes in business strategies; general global economic and business conditions; the availability and price of energy commodities; the effects of competition and pricing pressures; industry overcapacity; shifts in market demands; changes in laws and regulations, including environmental and regulatory laws; potential increases in maintenance and operating costs; uncertainties of litigation; labour disputes; 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; various events that could disrupt operations, including severe weather conditions; and technological changes.

The performance of the North American and global economies remains uncertain. Grain production and yield in Canada improved in the most recent crop year, after a period of significant drought-induced decline. However, factors over which CPR has no control, such as weather conditions and insect populations, affect crop production and yield in CPR's grain collection areas. Fuel prices also remain uncertain, as they are influenced by many factors, including worldwide oil demand, international politics, and the ability of major oil-producing countries to comply with agreed-upon production quotas.

The sustainability of recent increases in the value of the Canadian dollar relative to the U.S. dollar is unpredictable, as the value of the Canadian dollar is affected by a number of domestic and international factors, including, among other things, economic performance and government monetary policy.

There is also continuing uncertainty with respect to security issues involving the transportation of goods in populous areas of the U.S. and Canada and the protection of North America's rail infrastructure, including the movement of goods across the Canada-U.S. border.

New rules governing railway mergers were established by the U.S. Surface Transportation Board (STB) in 2001. The new rules have broadened the scope of competition-enhancing conditions that the STB may impose in connection with railway mergers and will likely result in increased scrutiny by the STB of proposed railway mergers.

In Canada, draft legislation prepared following the federal government's 2001 review of the *Canada Transportation Act* (CTA) did not proceed when Parliament terminated its session in late 2003. The legislative review did affirm the importance of market forces in achieving a viable, sustainable rail industry.

In addition to the foregoing general factors, there are more specific factors that could cause actual results to differ from those described in the forward-looking statements contained in this MD&A. These more specific factors are identified and discussed elsewhere in this MD&A with the particular forward-looking statement in question.

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Suite 920 Gulf Canada Square
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Tel (403) 319-6171 Fax (403) 319-6770*

Canadian Pacific Railway

August 6, 2004

Alberta Securities Commission

**EXHIBIT TO CANADIAN PACIFIC RAILWAY LIMITED CONSOLIDATED FINANCIAL
STATEMENTS FOR PERIOD ENDED JUNE 30, 2004**

Pursuant to section 8.4 of National Instrument 44-102 Shelf Distributions, attached are updated earnings coverage calculations for the period ended June 30, 2004. This information is provided in connection with the filing by Canadian Pacific Railway Limited (CPRL) of its consolidated financial statements for the six months ended June 30, 2004, and in relation to the base shelf Short Form Prospectus of Canadian Pacific Railway Company, a wholly-owned subsidiary of CPRL, relating to the offering by Canadian Pacific Railway Company of up to US\$750,000,000 of debt securities filed with the Alberta Securities Commission on May 6, 2004.

***CANADIAN PACIFIC RAILWAY LIMITED
CANADIAN PACIFIC RAILWAY COMPANY***

(signed) Robert V. Horte

Robert V. Horte
Corporate Secretary

Table of Contents**UPDATED EARNINGS COVERAGE RATIOS**

The following ratios are provided in connection with Canadian Pacific Railway Company's base shelf Short Form Prospectus filed with the Alberta Securities Commission on May 6, 2004, relating to the offering of up to US\$750,000,000 of debt securities, and are based on the consolidated financial statements that have been prepared in accordance with accounting principles generally accepted in Canada. The asset coverage ratios are calculated at the dates indicated, and the interest coverage ratios are for the 12-month period then ended.

Interest coverage ratios (times)	June 30	December 31
	2004 ⁽¹⁾	2003 ⁽¹⁾
Interest coverage on long-term debt		
Interest coverage on long-term debt before other specified items and foreign exchange on long-term debt	3.3	3.1
Interest coverage on long-term debt after other specified items and foreign exchange on long-term debt	3.2	3.0
Net tangible asset coverage on long-term debt Before the effect of future income taxes	2.4	2.5
After the effect of future income taxes	2.1	2.1

(1) Effective January 1, 2004, CPRL adopted retroactively new accounting policies for asset retirement obligations and stock based compensation as prescribed by Canadian GAAP. The coverages have been calculated based on restated results for periods prior to January 1, 2004.

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August 6, 2004

To the Alberta Securities Commission

Canadian Pacific Railway

We are the auditors of Canadian Pacific Railway Limited (CPRL) and Canadian Pacific Railway Company (the Company), and under date of February 6, 2004, reported to the shareholders of CPRL on the following financial statements incorporated by reference in the short form prospectus of the Company dated May 6, 2004 relating to the sale and issue of debt securities in an aggregate principal amount of up to US\$750,000,000 or its equivalency in any other currency (the prospectus).

Consolidated balance sheets as at December 31, 2003 and 2002; and

Consolidated statements of income, retained income and cash flows for each of the years in the three-year period ended December 31, 2003.

The prospectus also incorporates by reference the following unaudited interim financial statements:

Consolidated balance sheets as at March 31, 2004 and June 30, 2004;

Statements of consolidated income, retained income and cash flows for the three-month periods ended March 31, 2004 and 2003; and for the three and six-month periods ended June 30, 2004 and 2003.

We are advised by the Company and understand the Company is permitted under applicable securities laws and an exemption order issued by Canadian securities regulatory authorities to incorporate by reference, financial statements of CPRL in the prospectus in lieu of financial statements of the Company.

PricewaterhouseCoopers refers to the Canadian firm of PricewaterhouseCoopers LLP and the other member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

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We have not audited any financial statements of CPRL as at any date or for any period subsequent to December 31, 2003. Although we have performed an audit for the year ended December 31, 2003, the purpose and therefore the scope of the audit, was to enable us to express our opinion on the consolidated balance sheets as at December 31, 2003 and 2002 and the statements of consolidated income, retained earnings and cash flows for each of years in the three-year period ended December 31, 2003 but not on the financial statements for any interim period within those years or subsequent to them. Therefore, we are unable to and do not express an opinion on above-mentioned unaudited interim financial statements, nor on the financial position, results of operations or cash flows of CPRL as at any date or for any period subsequent to December 31, 2003.

We have, however, performed a review of the unaudited interim financial statements of CPRL as at March 31, 2004 and June 30, 2004, and for the three-month period ended March 31, 2004 and 2003, and for the three and six-month periods ended June 30, 2004 and 2003. We performed our review in accordance with Canadian generally accepted standards for a review of interim financial statements by an entity's auditor. Such an interim review consists principally of applying analytical procedures to financial data, and making enquiries of, and having discussions with, persons responsible for financial and accounting matters. An interim review is substantially less in scope than an audit, whose objective is the expression of an opinion regarding the financial statements. An interim review does not provide assurance that we would become aware of any or all-significant matters that might be identified in an audit.

Based on our review, we are not aware of any material modification that needs to be made for these interim financial statements to be in accordance with Canadian generally accepted accounting principles.

This letter is provided solely for the purpose of assisting the securities regulatory authorities to which it is addressed in discharging their responsibilities and should not be used for any other purpose. Any use that a third party makes of this letter, or any reliance or decisions made based on it, are the responsibility of such third parties. We accept no responsibility for loss or damages, if any, suffered by any third party as a result of decisions made or actions taken based on this letter.

Yours very truly,

(Signed) PricewaterhouseCoopers LLP

Chartered Accountants

(2)

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FORM 52-109FT2

CERTIFICATION OF INTERIM FILINGS DURING TRANSITION PERIOD

I, R.J. Ritchie, President and Chief Executive Officer of Canadian Pacific Railway Limited, certify that:

1. I have reviewed the interim filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers - Annual and Interim Filings*) of Canadian Pacific Railway Limited (the issuer) for the interim period ending June 30, 2004;
2. Based on my knowledge, the interim filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings; and
3. Based on my knowledge, the interim financial statements together with the other financial information in the interim filings fairly represent in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings.

Date: August 6, 2004

Signed: R.J. Ritchie

R.J. Ritchie

President and Chief Executive Officer

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FORM 52-109FT2

CERTIFICATION OF INTERIM FILINGS DURING TRANSITION PERIOD

I, M.T. Waites, Executive Vice-President and Chief Financial Officer of Canadian Pacific Railway Limited, certify that:

1. I have reviewed the interim filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers - Annual and Interim Filings*) of Canadian Pacific Railway Limited (the issuer) for the interim period ending June 30, 2004;
2. Based on my knowledge, the interim filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings; and
3. Based on my knowledge, the interim financial statements together with the other financial information in the interim filings fairly represent in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings.

Date: August 6, 2004

Signed: M.T. Waites

M.T. Waites

Executive Vice-President and Chief Financial Officer