CANADIAN PACIFIC RAILWAY LTD/CN
Form 10-Q
July 20, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark one)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016
OR
.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 001-01342
Canadian Pacific Railway Limited
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Canada | 98-0355078 |
| (State or Other Jurisdiction of Incorporation or Organization) | (IRS Employer Identification No.) |
| 7550 Ogden Dale Road S.E. Calgary, Alberta, Canada | T2C 4X9 |
| (Address of Principal Executive Offices) | (Zip Code) |

Registrant’s Telephone Number, Including Area Code: (403) 319-7000
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 þ No o
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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o
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.
Large accelerated filer þ Accelerated filer o Non-accelerated filer o Smaller reporting company o
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ
As of the close of business on July 18, 2016, there were 147,771,618 of the registrant’s Common Shares issued and outstanding.

CANADIAN PACIFIC RAILWAY LIMITED
FORM 10-Q
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PART I

ITEM 1. FINANCIAL STATEMENTS

INTERIM CONSOLIDATED STATEMENTS OF INCOME
(unaudited)

| | For the three months ended June 30 | | For the six months ended June 30 | |
|---|---|---|---|---|
| (in millions of Canadian dollars, except share and per share data) | 2016 | 2015 | 2016 | 2015 |
| Revenues | | | | |
| Freight | $1,406 | $1,610 | $2,954 | $3,240 |
| Non-freight | 44 | 41 | 87 | 76 |
| Total revenues | 1,450 | 1,651 | 3,041 | 3,316 |
| Operating expenses | | | | |
| Compensation and benefits | 284 | 308 | 613 | 686 |
| Fuel | 131 | 185 | 256 | 380 |
| Materials | 38 | 45 | 94 | 97 |
| Equipment rents | 44 | 46 | 89 | 88 |
| Depreciation and amortization | 161 | 145 | 323 | 291 |
| Purchased services and other (Note 4) | 241 | 276 | 462 | 516 |
| Total operating expenses | 899 | 1,005 | 1,837 | 2,058 |
| | | | | |
| Operating income | 551 | 646 | 1,204 | 1,258 |
| Less: | | | | |
| Other income and charges (Note 5) | (9) | (5) | (190) | 68 |
| Net interest expense | 115 | 84 | 239 | 169 |
| Income before income tax expense | 445 | 567 | 1,155 | 1,021 |
| Income tax expense (Note 6) | 117 | 177 | 287 | 311 |
| Net income | $328 | $390 | $868 | $710 |
| | | | | |
| Earnings per share (Note 7) | | | | |
| Basic earnings per share | $2.16 | $2.38 | $5.70 | $4.32 |
| Diluted earnings per share | $2.15 | $2.36 | $5.67 | $4.28 |
| | | | | |
| Weighted-average number of shares (millions) (Note 7) | | | | |
| Basic | 151.7 | 163.7 | 152.3 | 164.3 |
| Diluted | 152.6 | 165.0 | 153.2 | 165.7 |
| | | | | |
| Dividends declared per share | $0.5000 | $0.3500 | $0.8500 | $0.7000 |

See Notes to Interim Consolidated Financial Statements.

INTERIM CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited)

| Year ended (in millions of Canadian dollars) | For the three months ended June 30 | | For the six months ended June 30 | |
|---|---|---|---|---|
| (in millions of Canadian dollars) | 2016 | 2015 | 2016 | 2015 |
| Net income | $328 | $390 | $868 | $710 |
| Net gain (loss) in foreign currency translation adjustments, net of hedging activities | 3 | 7 | 40 | (30) |
| Change in derivatives designated as cash flow hedges | (29) | 36 | (76) | (33) |
| Change in pension and post-retirement defined benefit plans | 43 | 66 | 90 | 138 |
| Other comprehensive income before income taxes | 17 | 109 | 54 | 75 |
| Income tax (expense) recovery on above items | (7) | (35) | (48) | 11 |
| Other comprehensive income (Note 3) | 10 | 74 | 6 | 86 |
| Comprehensive income | $338 | $464 | $874 | $796 |

See Notes to Interim Consolidated Financial Statements.

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INTERIM CONSOLIDATED BALANCE SHEETS AS AT
(unaudited)

| | June 30 | December 31 |
|---|---|---|
| (in millions of Canadian dollars) | 2016 | 2015 |
| Assets | | |
| Current assets | | |
| Cash and cash equivalents | $92 | $650 |
| Accounts receivable, net | 577 | 645 |
| Materials and supplies | 195 | 188 |
| Other current assets | 59 | 54 |
| | 923 | 1,537 |
| Investments | 155 | 152 |
| Properties | 16,160 | 16,273 |
| Goodwill and intangible assets | 195 | 211 |
| Pension asset | 1,565 | 1,401 |
| Other assets | 70 | 63 |
| Total assets | $19,068 | $19,637 |
| Liabilities and shareholders’ equity | | |
| Current liabilities | | |
| Accounts payable and accrued liabilities | $1,247 | $1,417 |
| Long-term debt maturing within one year (Note 8) | 198 | 30 |
| | 1,445 | 1,447 |
| Pension and other benefit liabilities | 751 | 758 |
| Other long-term liabilities | 286 | 318 |
| Long-term debt | 8,383 | 8,927 |
| Deferred income taxes | 3,512 | 3,391 |
| Total liabilities | 14,377 | 14,841 |
| Shareholders’ equity | | |
| Share capital | 2,000 | 2,058 |
| Additional paid-in capital | 49 | 43 |
| Accumulated other comprehensive loss (Note 3) | (1,471) | (1,477) |
| Retained earnings | 4,113 | 4,172 |
| | 4,691 | 4,796 |
| Total liabilities and shareholders’ equity | $19,068 | $19,637 |

Contingencies (Note 13)
See Notes to Interim Consolidated Financial Statements.

INTERIM CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

| Year ended (in millions of Canadian dollars) | For the three months ended June 30 | | For the six months ended June 30 | |
|---|---|---|---|---|
| (in millions of Canadian dollars) | 2016 | 2015 | 2016 | 2015 |
| Operating activities | | | | |
| Net income | $328 | $390 | $868 | $710 |
| Reconciliation of net income to cash provided by operating activities: | | | | |
| Depreciation and amortization | 161 | 145 | 323 | 291 |
| Deferred income taxes (Note 6) | 90 | 74 | 183 | 106 |
| Pension funding in excess of expense (Note 12) | (37) | (20) | (79) | (30) |
| Foreign exchange (gain) loss on long-term debt (Note 5) | (18) | (10) | (199) | 54 |
| Other operating activities, net | (47) | (28) | (113) | (69) |
| Change in non-cash working capital balances related to operations | 35 | 34 | (253) | 78 |
| Cash provided by operating activities | 512 | 585 | 730 | 1,140 |
| Investing activities | | | | |
| Additions to properties | (330) | (355) | (608) | (618) |
| Proceeds from sale of properties and other assets (Note 4) | 11 | 8 | 71 | 60 |
| Other | (2) | (7) | (2) | 13 |
| Cash used in investing activities | (321) | (354) | (539) | (545) |
| Financing activities | | | | |
| Dividends paid | (53) | (57) | (107) | (115) |
| Issuance of CP Common Shares | 4 | 11 | 9 | 27 |
| Purchase of CP Common Shares (Note 9) | (788) | (543) | (788) | (1,072) |
| Issuance of long-term debt, excluding commercial paper | — | — | — | 810 |
| Repayment of long-term debt, excluding commercial paper | (7) | (9) | (18) | (67) |
| Net issuance (repayment) of commercial paper (Note 8) | 176 | 369 | 176 | (224) |
| Other | (1) | — | (3) | — |
| Cash used in financing activities | (669) | (229) | (731) | (641) |
| Effect of foreign currency fluctuations on U.S. dollar-denominated cash and cash equivalents | (1) | (1) | (18) | 5 |
| Cash position | | | | |
| (Decrease) increase in cash and cash equivalents | (479) | 1 | (558) | (41) |
| Cash and cash equivalents at beginning of period | 571 | 184 | 650 | 226 |
| Cash and cash equivalents at end of period | $92 | $185 | $92 | $185 |
| Supplemental disclosures of cash flow information: | | | | |
| Income taxes paid | $65 | $62 | $257 | $59 |
| Interest paid | $92 | $94 | $247 | $161 |

See Notes to Interim Consolidated Financial Statements.

INTERIM CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(unaudited)

| (in millions of Canadian dollars, except common share amounts) | Common shares (in millions) | Share capital | Additional paid-in capital | Accumulated other comprehensive loss | Retained earnings | Total shareholders' equity |
|---|---|---|---|---|---|---|
| Balance at January 1, 2016 | 153.0 | $2,058 | $ 43 | $ (1,477) | $ 4,172 | $ 4,796 |
| Net income | — | — | — | — | 868 | 868 |
| Other comprehensive income (Note 3) | — | — | — | 6 | — | 6 |
| Dividends declared | — | — | — | — | (130) | (130) |
| Effect of stock-based compensation expense | — | — | 8 | — | — | 8 |
| CP Common Shares repurchased (Note 9) | (4.7) | (70) | — | — | (797) | (867) |
| Shares issued under stock option plan | 0.1 | 12 | (2) | — | — | 10 |
| Balance at June 30, 2016 | 148.4 | $2,000 | $ 49 | $ (1,471) | $ 4,113 | $ 4,691 |
| Balance at January 1, 2015 | 166.1 | $2,185 | $ 36 | $ (2,219) | $ 5,608 | $ 5,610 |
| Net income | — | — | — | — | 710 | 710 |
| Other comprehensive income (Note 3) | — | — | — | 86 | — | 86 |
| Dividends declared | — | — | — | — | (115) | (115) |
| Effect of stock-based compensation expense | — | — | 10 | — | — | 10 |
| CP Common Shares repurchased (Note 9) | (5.2) | (70) | — | — | (1,010) | (1,080) |
| Shares issued under stock option plan | 0.4 | 36 | (6) | — | — | 30 |
| Balance at June 30, 2015 | 161.3 | $2,151 | $ 40 | $ (2,133) | $ 5,193 | $ 5,251 |

See Notes to Interim Consolidated Financial Statements.

NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2016
(unaudited)

1 Basis of presentation

These unaudited interim consolidated financial statements of Canadian Pacific Railway Limited (“CP”, or “the Company”), expressed in Canadian dollars, reflect management’s estimates and assumptions that are necessary for their fair presentation in conformity with generally accepted accounting principles in the United States of America (“GAAP”). They do not include all disclosures required under GAAP for annual financial statements and should be read in conjunction with the 2015 annual consolidated financial statements and notes included in CP's 2015 Annual Report on Form 10-K. The accounting policies used are consistent with the accounting policies used in preparing the 2015 annual consolidated financial statements, except for the newly adopted accounting policy discussed in Note 2.

CP's operations can be affected by seasonal fluctuations such as changes in customer demand and weather-related issues. This seasonality could impact quarter-over-quarter comparisons.

In management’s opinion, the unaudited interim consolidated financial statements include all adjustments (consisting of normal and recurring adjustments) necessary to present fairly such information. Interim results are not necessarily indicative of the results expected for the fiscal year.

2 Accounting changes

Implemented in 2016

Amendments to the Consolidation Analysis

In February 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update (“ASU”) 2015-02, Amendments to the Consolidation Analysis under FASB Accounting Standards Codification ("ASC") Topic 810 Consolidation. The amendments required reporting entities to evaluate whether they should consolidate certain legal entities under the revised consolidation model. Specifically, the amendments modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities (“VIEs”) or voting interest entities, eliminated the presumption that a general partner should consolidate a limited partnership and affected the consolidation analysis of reporting entities involved with VIEs, particularly those that have fee arrangements and related party relationships. This ASU was effective for public entities for fiscal years, and interim periods within those years, beginning on or after December 15, 2015. Entities had the option of using either a full retrospective or a modified retrospective approach to adopt this ASU. The Company evaluated all arrangements that might give rise to a VIE and all existing VIEs; no changes to disclosure or financial statement presentation were required as a result of this evaluation.

Future changes

Leases

In February 2016, the FASB issued ASU 2016-02, Leases. The new FASB ASC Topic 842 Leases supersedes the lease recognition and measurement requirements in Topic 840 Leases. This new standard requires recognition of right-of-use assets and lease liabilities by lessees for those leases classified as finance and operating leases with a maximum term exceeding 12 months. This ASU will be effective for public entities for fiscal years, and interim periods within those years, beginning on or after December 15, 2018. Entities are required to use a modified retrospective approach to adopt this ASU. The Company is currently evaluating the impact adoption of this ASU will have on the consolidated financial statements.

Revenue from Contracts with Customers

In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers: Principal versus Agent Considerations under FASB ASC Topic 606. The amendments clarify the principal versus agent guidance in determining whether to recognize revenue on a gross or net basis. The amendments are effective for public entities for annual reporting periods beginning on or after December 15, 2017, including interim periods within that reporting period. Entities have the option of using either a full retrospective or a modified retrospective approach to adopt this ASU. The Company is currently evaluating the impact adoption of this ASU will have on the consolidated financial statements.

Compensation - Stock Compensation

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation, under ASC Topic 718. The amendments clarify the guidance relating to treatment of excess tax benefits and deficiencies, acceptable forfeiture rate policies, and treatment of cash paid by an employer when directly withholding shares for tax-withholding purposes and the requirement to treat such cash flows as a financing activity. This ASU will be effective for public entities for fiscal years, and interim periods within those years, beginning on or after December 15, 2016. Early adoption is permitted. The Company is currently evaluating the impact adoption of this ASU will have on the consolidated financial statements.

3 Changes in accumulated other comprehensive loss ("AOCL") by component

| | For the three months ended June 30 | | | |
|---|---|---|---|---|
| (in millions of Canadian dollars, net of tax) | Foreign currency net of hedging activities | Derivatives and other | Pension and post-retirement defined benefit plans | Total |
| Opening balance, 2016 | $125 | $ (136) | $ (1,470) | $(1,481) |
| Other comprehensive income (loss) before reclassifications | (1) | (23) | (2) | (26) |
| Amounts reclassified from accumulated other comprehensive loss | — | 2 | 34 | 36 |
| Net current-period other comprehensive (loss) income | (1) | (21) | 32 | 10 |
| Closing balance, 2016 | $124 | $ (157) | $ (1,438) | $(1,471) |
| Opening balance, 2015 | $125 | $ (103) | $ (2,229) | $(2,207) |
| Other comprehensive income (loss) before reclassifications | — | 26 | — | 26 |
| Amounts reclassified from accumulated other comprehensive loss | — | — | 48 | 48 |
| Net current-period other comprehensive income | — | 26 | 48 | 74 |
| Closing balance, 2015 | $125 | $ (77) | $ (2,181) | $(2,133) |

| | For the six months ended June 30 | | | |
|---|---|---|---|---|
| (in millions of Canadian dollars, net of tax) | Foreign currency net of hedging activities | Derivatives and other | Pension and post-retirement defined benefit plans | Total |
| Opening balance, 2016 | $129 | $ (102) | $ (1,504) | $(1,477) |
| Other comprehensive income (loss) before reclassifications | (5) | (59) | (2) | (66) |
| Amounts reclassified from accumulated other comprehensive loss | — | 4 | 68 | 72 |
| Net current-period other comprehensive (loss) income | (5) | (55) | 66 | 6 |
| Closing balance, 2016 | $124 | $ (157) | $ (1,438) | $(1,471) |
| Opening balance, 2015 | $115 | $ (52) | $ (2,282) | $(2,219) |
| Other comprehensive income (loss) before reclassifications | 10 | (26) | 5 | (11) |
| Amounts reclassified from accumulated other comprehensive loss | — | 1 | 96 | 97 |
| Net current-period other comprehensive income (loss) | 10 | (25) | 101 | 86 |
| Closing balance, 2015 | $125 | $ (77) | $ (2,181) | $(2,133) |

Amounts in Pension and post-retirement defined benefit plans reclassified from AOCL

| | For the three months ended June 30 | | For the six months ended June 30 | |
|---|---|---|---|---|
| (in millions of Canadian dollars) | 2016 | 2015 | 2016 | 2015 |
| Amortization of prior service costs[(a)] | $(1) | $(2) | $(3) | $(3) |
| Recognition of net actuarial loss[(a)] | 48 | 67 | 97 | 134 |
| Total before income tax | 47 | 65 | 94 | 131 |
| Income tax recovery | (13) | (17) | (26) | (35) |
| Net of income tax | $34 | $48 | $68 | $96 |

[(a)] Impacts Compensation and benefits on the Interim Consolidated Statements of Income.

4 Gain on sale of properties

Gain on sale of Arbutus Corridor

In March 2016, the Company announced the sale of CP's Arbutus Corridor (the "Arbutus Corridor") to the City of Vancouver for gross proceeds of $55 million. The agreement allows the Company to share in future proceeds on the eventual development and/or sale of certain parcels of the Arbutus Corridor. The Company recorded a gain on sale of $50 million before tax ($43 million after tax) from the transaction during the first quarter of 2016.

Gain on settlement of legal proceedings related to the purchase and sale of a building

In 2013, CP provided an interest free loan pursuant to a court order to a corporation owned by a court appointed trustee ("the judicial trustee") to facilitate the acquisition of a building. The building was held in trust during the legal proceedings with regard to CP's entitlement to an exercised purchase option of the building. As at December 31, 2014, the loan of $20 million and the purchase option with a carrying value of $8 million, were recorded as "Other assets" in the Company's Consolidated Balance Sheets.

In the first quarter of 2015, CP reached a settlement with a third party that, following the sale of the building to an arm's length third party, resulted in resolution of legal proceedings. CP received $59 million for the sale of the building which included repayment of the aforementioned loan to the judicial trustee and recorded a gain of $31 million ($27 million after tax).

5 Other income and charges

| | For the three months ended June 30 | | For the six months ended June 30 | |
|---|---|---|---|---|
| (in millions of Canadian dollars) | 2016 | 2015 | 2016 | 2015 |
| Foreign exchange (gain) loss on long-term debt | $(18) | $(10) | $(199) | $ 54 |
| Other foreign exchange (gains) losses | — | — | (7) | 6 |
| Other | 9 | 5 | 16 | 8 |
| Total other income and charges | $(9) | $(5) | $(190) | $ 68 |

6 Income taxes

| | For the three months ended June 30 | | For the six months ended June 30 | |
|---|---|---|---|---|
| (in millions of Canadian dollars) | 2016 | 2015 | 2016 | 2015 |
| Current income tax expense | $27 | $103 | $104 | $205 |
| Deferred income tax expense | 90 | 74 | 183 | 106 |
| Income tax expense | $117 | $177 | $287 | $311 |

The estimated 2016 annual effective tax rate for the three and six months ended June 30, 2016, excluding the discrete item related to the foreign exchange gain on the Company's U.S. dollar-denominated debt, is 26.93% and 27.25%, respectively, compared to the estimate of 27.50% for the same periods in 2015.

The effective tax rate for the three and six months ended June 30, 2016, including the discrete item, is 26.40% and 24.86%, respectively, compared to 31.30% and 30.51%, respectively, for the same period in 2015.

7 Earnings per share

At June 30, 2016, the number of shares outstanding was 148.4 million (June 30, 2015 - 161.3 million).

Basic earnings per share have been calculated using net income for the period divided by the weighted-average number of shares outstanding during the period.

The number of shares used in earnings per share calculations is reconciled as follows:

| | For the three months ended June 30 | | For the six months ended June 30 | |
|---|---|---|---|---|
| (in millions) | 2016 | 2015 | 2016 | 2015 |
| Weighted-average basic shares outstanding | 151.7 | 163.7 | 152.3 | 164.3 |
| Dilutive effect of stock options | 0.9 | 1.3 | 0.9 | 1.4 |
| Weighted-average diluted shares outstanding | 152.6 | 165.0 | 153.2 | 165.7 |

For the three and six months ended June 30, 2016, there were 440,009 options and 443,000 options, respectively, excluded from the computation of diluted earnings per share because their effects were not dilutive (three and six months ended June 30, 2015 - 175,068 and 87,976, respectively).

8 Debt

Revolving credit facility

Effective June 28, 2016, the Company extended the maturity date by one year on its existing revolving U.S. $2.0 billion revolving credit facility, which includes a U.S. $1.0 billion five-year portion and U.S. $1.0 billion one-year plus one-year term-out portion. The maturity date on the U.S. $1.0 billion one-year plus one-year term-out portion has been extended to June 28, 2018; the maturity date on the U.S. $1.0 billion five-year portion was extended to June 28, 2021.

Commercial paper program

The Company has a commercial paper program which enables it to issue commercial paper up to a maximum aggregate principal amount of U.S. $1.0 billion in the form of unsecured promissory notes. The commercial paper is backed by the U.S. $1.0 billion one-year plus one-year term-out portion of the revolving credit facility. As at June 30, 2016, the Company had total commercial paper borrowings of U.S. $135 million ($174 million), presented in “Long-term debt maturing within one year” on the Interim Consolidated Balance Sheets (December 31, 2015 - $nil). The weighted-average interest rate on these borrowings was 0.67%.

The Company presents issuances and repayments of commercial paper in the Interim Consolidated Statements of Cash Flows on a net basis, all of which have a maturity of less than 90 days.

9 Shareholders' equity

On April 20, 2016, the Company announced a new normal course issuer bid ("bid"), commencing May 2, 2016 to May 1, 2017, to purchase up to 6.91 million of its outstanding Common Shares for cancellation.

All purchases are made in accordance with the bid at prevalent market prices plus brokerage fees, or such other prices that may be permitted by the Toronto Stock Exchange, with consideration allocated to share capital up to the average carrying amount of the shares, and any excess allocated to retained earnings. The following table provides activities under the share repurchase program:

| | For the three months ended June 30 | | For the six months ended June 30 | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Number of Common Shares repurchased[1] | 5,127,800 | 3,058,900 | 5,127,800 | 5,233,688 |
| Weighted-average price per share[2] | $ 169.13 | $ 193.10 | $ 169.13 | $ 206.40 |
| Amount of repurchase (in millions)[2] | $ 867 | $ 590 | $ 867 | $ 1,080 |

(1) Includes shares repurchased but not yet canceled at quarter end.
(2) Includes brokerage fees.

## 10 Financial instruments

### A. Fair values of financial instruments

The Company categorizes its financial assets and liabilities measured at fair value in line with the fair value hierarchy established by GAAP that prioritizes, with respect to reliability, the inputs to valuation techniques used to measure fair value. This hierarchy consists of three broad levels. Level 1 inputs consist of quoted prices (unadjusted) in active markets for identical assets and liabilities and give the highest priority to these inputs. Level 2 and 3 inputs are based on significant other observable inputs and significant unobservable inputs, respectively, and give lower priority to these inputs.

When possible, the estimated fair value is based on quoted market prices and, if not available, estimates from third party brokers. For non-exchange traded derivatives classified in Level 2, the Company uses standard valuation techniques to calculate fair value. Primary inputs to these techniques include observable market prices (interest, foreign exchange (“FX”) and commodity) and volatility, depending on the type of derivative and nature of the underlying risk. The Company uses inputs and data used by willing market participants when valuing derivatives and considers its own credit default swap spread as well as those of its counterparties in its determination of fair value.

The carrying values of financial instruments equal or approximate their fair values with the exception of long-term debt which has a fair value of approximately $10,335 million at June 30, 2016 (December 31, 2015 - $9,750 million) and a carrying value of $8,581 million at June 30, 2016 (December 31, 2015 - $8,957 million). The estimated fair value of current and long-term borrowings has been determined based on market information where available, or by discounting future payments of interest and principal at estimated interest rates expected to be available to the Company at period end. All derivatives and long-term debt are classified as Level 2.

### B. Financial risk management

#### Derivative financial instruments

Derivative financial instruments may be used to selectively reduce volatility associated with fluctuations in interest rates, FX rates, the price of fuel and stock-based compensation expense. Where derivatives are designated as hedging instruments, the relationship between the hedging instruments and their associated hedged items is documented, as well as the risk management objective and strategy for the use of the hedging instruments. This documentation includes linking the derivatives that are designated as fair value or cash flow hedges to specific assets or liabilities on the Interim Consolidated Balance Sheets, commitments or forecasted transactions. At the time a derivative contract is entered into, and at least quarterly thereafter, an assessment is made whether the derivative item is effective in offsetting the changes in fair value or cash flows of the hedged items. The derivative qualifies for hedge accounting treatment if it is effective in substantially mitigating the risk it was designed to address.

It is not the Company’s intent to use financial derivatives or commodity instruments for trading or speculative purposes.

#### FX management

The Company conducts business transactions and owns assets in both Canada and the United States. As a result, the Company is exposed to fluctuations in value of financial commitments, assets, liabilities, income or cash flows due to changes in FX rates. The Company may enter into FX risk management transactions primarily to manage fluctuations in the exchange rate between Canadian and U.S. currencies. FX exposure is primarily mitigated through natural offsets created by revenues, expenditures and balance sheet positions incurred in the same currency. Where appropriate, the Company may negotiate with customers and suppliers to reduce the net exposure.

Net investment hedge

The FX gains and losses on long-term debt are mainly unrealized and can only be realized when U.S. dollar denominated long-term debt matures or is settled. The Company also has long-term FX exposure on its investment in U.S. affiliates. The majority of the Company’s U.S. dollar denominated long-term debt has been designated as a hedge of the net investment in foreign subsidiaries. This designation has the effect of mitigating volatility on net income by offsetting long-term FX gains and losses on U.S. dollar denominated long-term debt and gains and losses on its net investment. The effective portion recognized in “Other comprehensive income” for the three and six months ended June 30, 2016 was an unrealized FX gain of $24 million and $332 million, respectively (three and six months ended June 30, 2015 - unrealized FX gain of $58 million and an unrealized FX loss of $298 million, respectively). There was no ineffectiveness during the three and six months ended June 30, 2016 and June 30, 2015.

Interest rate management

The Company is exposed to interest rate risk, which is the risk that the fair value or future cash flows of a financial instrument will vary as a result of changes in market interest rates. In order to manage funding needs or capital structure goals, the Company enters into debt or capital lease agreements that are subject to either fixed market interest rates set at the time of issue or floating rates determined by on-going market conditions. Debt subject to variable interest rates exposes the Company to variability in interest expense, while debt subject to fixed interest rates exposes the Company to variability in the fair value of debt.

To manage interest rate exposure, the Company accesses diverse sources of financing and manages borrowings in line with a targeted range of capital structure, debt ratings, liquidity needs, maturity schedule, and currency and interest rate profiles. In anticipation of future debt issuances, the Company may enter into forward rate agreements, that are designated as cash flow hedges, to substantially lock in all or a portion of the effective future interest expense. The Company may also enter into swap agreements, designated as fair value hedges, to manage the mix of fixed and floating rate debt.

Forward starting swaps

As at December 31, 2015, the Company had forward starting floating-to-fixed interest rate swap agreements (“forward starting swaps”) totaling a notional U.S. $700 million to fix the benchmark rate on cash flows associated with highly probable forecasted issuances of long-term notes. The effective portion of changes in fair value on the forward starting swaps is recorded in “Accumulated other comprehensive loss”, net of tax, as cash flow hedges until the highly probable forecasted notes are issued. Subsequent to the notes issuance, amounts in “Accumulated other comprehensive loss” are reclassified to “Net interest expense”.

During the second quarter of 2016, the Company rolled the notional U.S. $700 million forward starting swaps. The Company de-designated the hedging relationship for U.S. $700 million of forward starting swaps. The Company did not cash settle these swaps. There was no ineffectiveness to record upon de-designation.

Concurrently the Company re-designated the forward starting swaps totaling U.S. $700 million to fix the benchmark rate on cash flows associated with a highly probable forecasted debt issuance of long-term notes.

As at June 30, 2016, the total fair value loss of $144 million (December 31, 2015 - fair value loss of $60 million) derived from the forward starting swaps was included in “Accounts payable and accrued liabilities”. Changes in fair value from the forward starting swaps for the three and six months ended June 30, 2016 was a loss of $32 million and $84 million, respectively (three and six months ended June 30, 2015 - a gain of $34 million and a loss of $39 million, respectively). The effective portion for the three and six months ended June 30, 2016 of a loss of $32 million and $82 million, respectively, (three and six months ended June 30, 2015 - a fair value gain of $34 million and a fair value loss of $37 million, respectively) is recorded in “Other comprehensive income”. For the three and six months ended June 30, 2016, the ineffective portion of $nil and $2 million loss, respectively (three and six months ended June 30, 2015 - $nil and $2 million loss, respectively) is recorded to “Net interest expense” on the Interim Consolidated Statements of Income.

For the three and six months ended June 30, 2016, a loss of $3 million and $5 million, respectively, related to previous forward starting swap hedges have been amortized to “Net interest expense” (three and six months ended June 30, 2015 - a loss of $1 million and $2 million, respectively). The Company expects that during the next 12 months $11 million of losses will be amortized to “Net interest expense”.

11 Stock-based compensation

At June 30, 2016, the Company had several stock-based compensation plans, including stock option plans, various cash settled liability plans and an employee stock savings plan. These plans resulted in an expense for the three and six months ended June 30, 2016 of $1 million and $15 million, respectively (three and six months ended June 30, 2015 - recovery of $5 million and an expense of $24 million, respectively).

Regular options

In the six months ended June 30, 2016, under CP's stock option plans, the Company issued 402,331 regular options at the weighted average price of $165.55 per share, based on the closing price on the grant date.

Pursuant to the employee plan, these regular options may be exercised upon vesting, which is between 12 months and 48 months after the grant date, and will expire after 10 years.

Under the fair value method, the fair value of the regular options at the grant date was approximately $16 million. The weighted average fair value assumptions were approximately:

| | For the six months ended June 30, 2016 |
|---|---|
| Grant price | $165.55 |
| Expected option life (years)[1] | 5.25 |
| Risk-free interest rate[2] | 1.21% |
| Expected stock price volatility[3] | 26.58% |
| Expected annual dividends per share[4] | $1.40 |
| Expected forfeiture rate[5] | 2.0% |
| Weighted-average grant date fair value per regular options granted during the period | $38.98 |

(1) Represents the period of time that awards are expected to be outstanding. Historical data on exercise behaviour, or when available, specific expectations regarding future exercise behaviour, were used to estimate the expected life of the option.
(2) Based on the implied yield available on zero-coupon government issues with an equivalent remaining term at the time of the grant.
(3) Based on the historical stock price volatility of the Company’s stock over a period commensurate with the expected term of the option.
(4) Determined by the current annual dividend at the time of grant. The Company does not employ different dividend yields throughout the contractual term of the option. On April 20, 2016, the Company announced an increase in its quarterly dividend to $0.50 per share, representing $2.00 on an annual basis.
(5) The Company estimated forfeitures based on past experience. This rate is monitored on a periodic basis.

Performance share unit (“PSU”) plan

In the six months ended June 30, 2016, the Company issued 147,157 PSUs with a grant date fair value of approximately $24 million. These units attract dividend equivalents in the form of additional units based on the dividends paid on the Company’s Common Shares. PSUs vest and are settled in cash, or in CP Common Shares, approximately three years after the grant date, contingent upon CP’s performance ("performance factor"). The fair value of PSUs is measured periodically until settlement, using a latticed-based valuation model.

The performance period for PSUs issued in the six months ended June 30, 2016 is January 1, 2016 to December 31, 2018. The performance factors for these PSUs are Operating Ratio, Return on Invested Capital, Total Shareholder Return ("TSR") compared to the S&P/TSX 60 Index, and TSR compared to Class I railways.

The performance period for the PSUs issued in the fourth quarter of 2012 and in 2013 was January 1, 2013 to December 31, 2015. The performance factors for these PSUs were Operating Ratio, Free cash flow, TSR compared to the S&P/TSX 60 index, TSR compared to Class I railways. All performance factors met the 200% payout thresholds, in effect resulting in a target payout of 200% on 300,095 total outstanding awards as at December 31, 2015. A payout of $79 million on 217,179 outstanding awards occurred on December 31, 2015 and was calculated using the Company's average share price using the last 30 trading days preceding December 31, 2015. In the first quarter of 2016, final payouts occurred on the total outstanding awards, including dividends reinvested, totaling $31 million on 83,563 outstanding awards.

Deferred share unit (“DSU”) plan

In the six months ended June 30, 2016, the Company granted 25,050 DSUs with a grant date fair value of approximately $4 million. DSUs vest over various periods of up to 48 months and are only redeemable for a specified period after employment is terminated. An expense to income for DSUs is recognized over the vesting period for both the initial subscription price and the change in value between reporting periods.

12 Pension and other benefits

In the three and six months ended June 30, 2016, the Company made contributions of $14 million and $34 million, respectively(three and six months ended June 30, 2015 - $20 million and $41 million, respectively), to its defined benefit pension plans. The elements of net periodic benefit cost for defined benefit pension plans and other benefits recognized in the three and six months ended June 30, 2016 included the following components:

| | For the three months ended June 30 | | | |
|---|---|---|---|---|
| | Pensions | | Other benefits | |
| (in millions of Canadian dollars) | 2016 | 2015 | 2016 | 2015 |
| Current service cost (benefits earned by employees in the period) | $ 26 | $ 32 | $ 3 | $ 3 |
| Interest cost on benefit obligation | 116 | 116 | 5 | 5 |
| Expected return on fund assets | (211 ) | (212 ) | — | — |
| Recognized net actuarial loss | 47 | 66 | 1 | 1 |
| Amortization of prior service costs | (1 ) | (2 ) | — | — |
| Net periodic benefit (recovery) cost | $ (23 ) | $ — | $ 9 | $ 9 |

| | For the six months ended June 30 | | | |
|---|---|---|---|---|
| | Pensions | | Other benefits | |
| (in millions of Canadian dollars) | 2016 | 2015 | 2016 | 2015 |
| Current service cost (benefits earned by employees in the period) | $ 53 | $ 64 | $ 6 | $ 6 |
| Interest cost on benefit obligation | 233 | 231 | 10 | 10 |
| Expected return on fund assets | (423 ) | (413 ) | — | — |
| Recognized net actuarial loss | 95 | 132 | 2 | 2 |
| Amortization of prior service costs | (3 ) | (3 ) | — | — |
| Net periodic benefit (recovery) cost | $ (45 ) | $ 11 | $ 18 | $ 18 |

13 Contingencies

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to injuries and damage to property. The Company maintains provisions it considers to be adequate for such actions. While the final outcome with respect to actions outstanding or pending at June 30, 2016 cannot be predicted with certainty, it is the opinion of management that their resolution will not have a material adverse effect on the Company’s financial position or results of operations.

Legal proceedings related to Lac-Mégantic rail accident

On July 6, 2013, a train carrying crude oil operated by Montreal Maine and Atlantic Railway (“MMA”) and/or its subsidiary, Montreal Maine and Atlantic Canada Co. (“MMAC”, and collectively with MMA, the “MMA Group”) derailed and exploded in Lac-Mégantic, Quebec on a section of railway line owned by the MMA Group. The previous day CP had interchanged the train to the MMA Group, and after that interchange MMA Group exercised exclusive control over the train.

Following this incident, the Minister of Sustainable Development, Environment, Wildlife and Parks of Quebec issued an order directing certain named parties to recover the contaminants and to clean up and decontaminate the derailment site. CP was added as a named party on August 14, 2013 (the "Amended Cleanup Order"). CP has sought an administrative appeal of the Amended Cleanup Order to the Administrative Tribunal of Quebec. The proceedings before the Administrative tribunal have been stayed until September 2016. Directly related to this matter, the Province of Quebec filed a lawsuit against CP before the Quebec Superior Court on July 6, 2015 in which it claims $409 million for the damages sustained by the province as a result of the expenses incurred following the derailment, including costs incurred for the work carried out pursuant to the Amended Cleanup Order. The province alleges that CP had custody or control of the contaminants that were discharged in Lac-Mégantic on July 6, 2013, and that CP was otherwise negligent and therefore is solidarily (joint and severally) liable with the other third parties responsible for the accident. The province's lawsuit has been stayed until September 12, 2016. Also directly related to the this matter, the Quebec Minister of Sustainable Development and Environment has served a Notice of Claim on July 5, 2016 claiming nearly $95 million in compensation from CP for having to carry out the cleanup measures set out in the Amended Cleanup Order, alleging that CP had refused or neglected to carry out same. These proceedings are duplicative, in whole or in part.

A class action lawsuit has also been filed in the Superior Court of Quebec on behalf of a class of persons and entities residing in, owning or leasing property in, operating a business in or physically present in Lac-Mégantic (the "Class Action"). The lawsuit seeks damages caused by the derailment including for wrongful deaths, personal injuries, and property damages. CP was added as a defendant on August 16, 2013. On May 8, 2015, the Superior Court of Quebec authorized the institution of the Class Action as against CP and as against the shipper, Western Petroleum, and the shipper's parent, World Fuel Services (collectively, the "World Fuel Defendants"). The World Fuel Defendants have since settled. No timetable governing the conduct of this lawsuit has been ordered by the Superior Court of Quebec.

On July 4, 2016, CP was served with subrogated insurance claims brought by 8 insurers for a claimed amount of approximately $16 million. On July 11, 2016, CP was served with subrogated insurance claims brought by an additional 2 insurers for a claimed amount of approximately $3 million. These insurers have not identified in their respective lawsuit the identity of the parties to whose claims they are subrogated and thus it is difficult to determine the extent to which these claims overlap with other claims and the extent to which their claim would be satisfied after their proof of claim has been reviewed and distribution is received from the Plans of arrangements referred to below.

In the wake of the derailment and ensuing litigation, MMAC filed for bankruptcy in Canada (the "Canadian Proceeding") and MMA filed for bankruptcy in the United States (the "U.S. Proceeding"). Plans of arrangement have been approved both in the Canadian Proceeding and the U.S. Proceeding (the "Plans"). These Plans provide for the distribution of a fund of approximately $440 million amongst those who claimed loss or damage as a result of the derailment and will release those parties which contributed to the fund from any further liability. The Plans also provide for broadly worded third-party releases and injunctions that prevent actions against settling parties. CP has not participated in the settlement and hence will not benefit from any third-party releases or injunctions. In addition, both Plans contain judgment reduction provisions. Pursuant to these provisions, in the event of a judgment against CP in a case arising from the Lac-Mégantic derailment, CP will receive a credit for the greater of (i) the settlement monies received by the plaintiff(s) for the claim, or (ii) the amount which, but for the third-party non-debtor injunctions, CP would have been entitled to obtain from third parties other than MMA and MMAC through contribution or indemnification. CP may also have rights to judgment reduction, as part of the contribution/indemnification credit, for the fault of MMA and/or MMAC. The provisions of the Plans also provide for a potential re-allocation of of the MMA Group's liability among plaintiffs and CP, the only non-settling party.

An Adversary Proceeding filed by the MMA U.S. bankruptcy trustee against CP, Irving Oil and the World Fuel Defendants accuses CP of failing to ensure that World Fuel Defendants or Irving Oil properly classified the oil lading and of not refusing to ship the oil in DOT-111 tank cars. The trustee has since settled with the World Fuel Defendants and Irving Oil and now maintains that CP misfeasance is based upon the railroad's failure to abide by a Canadian regulation in North Dakota that supposedly would have caused the originating railroad to refuse to carry the crude oil based upon reason to suspect inaccurate classification. In response to CP's motion to withdraw the Adversary Proceedings from the bankruptcy reference, the trustee maintained that Canadian law rather than U.S. law controlled, and the Article III court found that if the federal regulations governed, the case was not complex enough to warrant withdrawal. In bankruptcy court CP moved to dismiss for want of personal jurisdiction, but that motion, which was heard on August 18, 2015, has been denied. Motions to dismiss on procedural grounds are pending. The trustee recently withdrew objection to the trial of the Adversary Proceedings to a jury before the Article III district court.

There are also a class action and a mass action instituted Texas and wrongful death and personal injury actions instituted in Illinois and Maine. All the various lawsuits have been removed to federal court and have since been consolidated in Maine. These actions generally charge CP with negligence in the misclassification and mis-packaging (that is the use of inappropriate DOT-111 tank cars). Motions to dismiss have been filed and heard regarding jurisdiction and venue. Decisions on CP's motions and other parties' cross-motions are pending.

CP has received two damage to cargo notices of claims from the shipper of the oil on the derailed train, Western Petroleum. Western Petroleum submitted U.S. and Canadian notices of claims for the same damages and, under the Carmack Amendment (49 U.S.C. Section 11706), seeks to recover for all injuries associated with, and indemnification for the derailment. Both jurisdictions permit a shipper to recover the value of damaged lading against any carrier in the delivery chain, subject to limitations in the carrier's tariffs. CP's tariffs significantly restrict shipper damage claim rights. Western Petroleum is part of the World Fuel Services group, and those entities settled with the trustee.

On April 12, 2016, Trustee (the "WD Trustee") of a wrongful death trust (the "WD Trust"), as defined and established under the confirmed Plan, filed an action against CP in federal court in North Dakota seeking to establish Carmack Amendment liability under 49 U.S.C. Section 11706. The WD Trustee asserts the WD Trust was assigned Carmack claim rights by the bankruptcy estate representative. The parties that settled Lac Megantic derailment liability in connection with MMA's confirmed Plan supposedly gave the bankruptcy estate representative the right to assign Carmack claims. The WD Trustee seeks to recover losses associated with the lost lading (approximately $6 million), as well as settlement amounts the consignor (i.e, the shipper, World Fuel Entities) and the consignee (Irving Oil) paid to the MMA bankruptcy estate to settle all Lac Megantic derailment claims, which are alleged to be $110 million and $60 million respectively. The WD Trustee maintains that Carmack liability extends beyond lading losses to cover all derailment related damages incurred by the World Fuel Services group or Irving Oil. CP disputes this interpretation of damages to lading law and maintains that CP's tariffs, if applicable, would preclude such a result.
At this early stage of the legal proceedings, any potential liability and the quantum of potential loss cannot be determined. Nevertheless, CP denies liability for the MMA derailment and intends to vigorously defend itself in the proceedings described above and in any proceeding that may be commenced in the future.

Legal proceedings initiated by Canadian National Railway Company

On August 13, 2015, Canadian National Railway Company (“CN”) issued a statement of claim against the Company and an employee. The statement of claim was amended on January 7, 2016 to include an additional employee and an officer of the Company. The principal allegations against the Company are that the Company obtained and benefited from certain confidential CN customer data. CN is seeking damages but has not yet provided evidence to substantiate its damages claim. The Company plans to defend this claim and the amount of loss, if any, to the Company as a result of the claim cannot be reasonably estimated.

Environmental liabilities

Environmental remediation accruals, recorded on an undiscounted basis unless a reliable, determinable estimate as to an amount and timing of costs can be established, cover site-specific remediation programs.

The accruals for environmental remediation represent CP’s best estimate of its probable future obligation and include both asserted and unasserted claims, without reduction for anticipated recoveries from third parties. Although the recorded accruals include CP’s best estimate of all probable costs, CP’s total environmental remediation costs cannot be predicted with certainty. Accruals for environmental remediation may change from time to time as new information about previously untested sites becomes known, and as environmental laws and regulations evolve and advances are made in environmental remediation technology. The accruals may also vary as the courts decide legal proceedings against outside parties responsible for contamination. These potential charges, which cannot be quantified at this time, are not expected to be material to CP’s financial position, but may materially affect income in the particular period in which a charge is recognized. Costs related to existing, but as yet unknown, or future contamination will be accrued in the period in which they become probable and reasonably estimable.

The expense included in “Purchased services and other” for the three and six months ended June 30, 2016 was $1 million and $2 million, respectively (three and six months ended June 30, 2015 - $3 million and $6 million, respectively). Provisions for environmental remediation costs are recorded in “Other long-term liabilities”, except for the current portion which is recorded in “Accounts payable and accrued liabilities”. The total amount provided at June 30, 2016 was $86 million (December 31, 2015 - $93 million). Payments are expected to be made over 10 years through 2026.

14 Condensed consolidating financial information

Canadian Pacific Railway Company, a 100%-owned subsidiary of Canadian Pacific Railway Limited (“CPRL”), is the issuer of certain debt securities, which are fully and unconditionally guaranteed by CPRL. The following tables present condensed consolidating financial information (“CCFI”) in accordance with Rule 3-10(c) of Regulation S-X.

Investments in subsidiaries are accounted for under the equity method when presenting the CCFI.

The tables include all adjustments necessary to reconcile the CCFI on a consolidated basis to CPRL’s consolidated financial statements for the periods presented.

Interim Condensed Consolidating Statements of Income
For the three months ended June 30, 2016

| (in millions of Canadian dollars) | CPRL (Parent Guarantor) | CPRC (Subsidiary Issuer) | Non-Guarantor Subsidiaries | Consolidating Adjustments and Eliminations | CPRL Consolidated |
|---|---|---|---|---|---|
| Revenues | | | | | |
| Freight | $ — | $ 1,007 | $ 399 | $ — | $ 1,406 |
| Non-freight | — | 33 | 98 | (87) | 44 |
| Total revenues | — | 1,040 | 497 | (87) | 1,450 |
| Operating expenses | | | | | |
| Compensation and benefits | — | 181 | 102 | 1 | 284 |
| Fuel | — | 103 | 28 | — | 131 |
| Materials | — | 27 | 8 | 3 | 38 |
| Equipment rents | — | 53 | (9) | — | 44 |
| Depreciation and amortization | — | 107 | 54 | — | 161 |
| Purchased services and other | — | 193 | 139 | (91) | 241 |
| Total operating expenses | — | 664 | 322 | (87) | 899 |
| Operating income | — | 376 | 175 | — | 551 |
| Less: | | | | | |
| Other income and charges | (4) | (12) | 7 | — | (9) |
| Net interest expense (income) | 10 | 111 | (6) | — | 115 |
| (Loss) income before income tax expense and equity in net earnings of subsidiaries | (6) | 277 | 174 | — | 445 |
| Less: Income tax (recovery) expense | (6) | 70 | 53 | — | 117 |
| Add: Equity in net earnings of subsidiaries | 328 | 121 | — | (449) | — |
| Net income | $ 328 | $ 328 | $ 121 | $ (449) | $ 328 |

Interim Condensed Consolidating Statements of Income
For the three months ended June 30, 2015

| (in millions of Canadian dollars) | CPRL (Parent Guarantor) | CPRC (Subsidiary Issuer) | Non-Guarantor Subsidiaries | Consolidating Adjustments and Eliminations | CPRL Consolidated |
|---|---|---|---|---|---|
| Revenues | | | | | |
| Freight | $ — | $ 1,131 | $ 479 | $ — | $ 1,610 |
| Non-freight | — | 34 | 90 | (83) | 41 |
| Total revenues | — | 1,165 | 569 | (83) | 1,651 |
| Operating expenses | | | | | |
| Compensation and benefits | — | 198 | 110 | — | 308 |
| Fuel | — | 134 | 51 | — | 185 |
| Materials | — | 35 | 10 | — | 45 |
| Equipment rents | — | 52 | (6) | — | 46 |
| Depreciation and amortization | — | 102 | 43 | — | 145 |
| Purchased services and other | — | 192 | 167 | (83) | 276 |
| Total operating expenses | — | 713 | 375 | (83) | 1,005 |
| Operating income | — | 452 | 194 | — | 646 |
| Less: | | | | | |
| Other income and charges | (3) | (8) | 6 | — | (5) |
| Net interest expense (income) | — | 98 | (14) | — | 84 |
| Income before income tax expense and equity in net earnings of subsidiaries | 3 | 362 | 202 | — | 567 |
| Less: Income tax expense | 2 | 93 | 82 | — | 177 |
| Add: Equity in net earnings of subsidiaries | 389 | 120 | — | (509) | — |
| Net income | $ 390 | $ 389 | $ 120 | $ (509) | $ 390 |

Interim Condensed Consolidating Statements of Income
For the six months ended June 30, 2016

| (in millions of Canadian dollars) | CPRL (Parent Guarantor) | CPRC (Subsidiary Issuer) | Non-Guarantor Subsidiaries | Consolidating Adjustments and Eliminations | CPRL Consolidated |
|---|---|---|---|---|---|
| Revenues | | | | | |
| Freight | $ — | $ 2,104 | $ 850 | $ — | $ 2,954 |
| Non-freight | — | 66 | 194 | (173) | 87 |
| Total revenues | — | 2,170 | 1,044 | (173) | 3,041 |
| Operating expenses | | | | | |
| Compensation and benefits | — | 382 | 228 | 3 | 613 |
| Fuel | — | 206 | 50 | — | 256 |
| Materials | — | 65 | 18 | 11 | 94 |
| Equipment rents | — | 107 | (18) | — | 89 |
| Depreciation and amortization | — | 214 | 109 | — | 323 |
| Purchased services and other | — | | | | |