

CANADIAN PACIFIC RAILWAY CO/NEW

Form 6-K

March 07, 2005

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 6-K

Report of Foreign Issuer

Pursuant to Rule 13a-16 or 15d-16 of

the Securities Exchange Act of 1934

For the month of March 2005

CANADIAN PACIFIC RAILWAY LIMITED
(Commission File No. 1-01342)
CANADIAN PACIFIC RAILWAY COMPANY
(Commission File No. 1-15272)
(translation of each Registrant's name into English)

Suite 500, Gulf Canada Square, 401 9th Avenue, S.W., Calgary, Alberta, Canada, T2P 4Z4
(address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover Form 20-F or Form 40-F.

Form 20-F Form 40-F

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes No

If Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b):
82-_____

This Report furnished on Form 6-K shall be incorporated by reference into each of the following Registration Statements under the Securities Act of 1933 of the registrant: Form S-8 No. 333-13962 (Canadian Pacific Railway Limited), and Form S-8 No. 333-13846 (Canadian Pacific Railway Limited).

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DOCUMENTS FILED AS PART OF THIS REPORT ON FORM 6-K

1. Annual Report for the year ended December 31, 2004.¹
2. Letter of Canadian Pacific Railway dated March 7, 2005 addressed to the Alberta Securities Commission attaching earnings coverage ratios for the twelve-month period ended December 31, 2004.²
3. Letter of PricewaterhouseCoopers LLP dated March 7, 2005 consenting to the incorporation by reference of its audit report dated February 11, 2005 in the short form prospectus of Canadian Pacific Railway Company dated May 6, 2004.
4. Shareholder Rights Plan Agreement dated as of July 30, 2001 and Amended and Restated as of February 19, 2002 between Canadian Pacific Railway Limited and Computershare Trust Company of Canada as Rights Agent.

¹ For the purposes of this Report on Form 6-K, all pages except pages 4 through 88 of the Registrants' 2004 Annual Report referred to above shall be deemed furnished to the Securities and Exchange Commission as part of this Report on Form 6-K. Pages 4 through 88 of the Registrants' 2004 Annual Report are being filed currently with the Securities and Exchange Commission as part of the Registrants' Annual Report on Form 40-F.

² The updated earnings coverage calculations included in this Report furnished on Form 6-K shall be incorporated by reference into, or as an exhibit to, as applicable, each of the following Registration Statements under the Securities Act of 1933 of the registrant: Form S-8 No. 333-13962 (Canadian Pacific Railway Limited), Form S-8 No. 333-13846 (Canadian Pacific Railway Limited), and Form F-9 No. 333-114696 (Canadian Pacific Railway Company).

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, each registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CANADIAN PACIFIC RAILWAY LIMITED
CANADIAN PACIFIC RAILWAY COMPANY
(Registrants)

Date: March 7, 2005

By: Signed: Robert V. Horte

Name: Robert V. Horte
Title: Corporate Secretary

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our company

Canadian Pacific Railway's 14,000-mile track network, ocean and Great Lakes port service, cross-border gateways and extensive connections with other railways provide shippers with access to fast-growing world markets and efficient reach into markets across North America, including major business centres in Mexico.

CPR aspires to be the most fluid railway in North America and intends to translate gains in fluidity into operating leverage that will generate value for shareholders.

Canadian Pacific Railway quickly expanded its inventory of co-operative arrangements with other railways in 2004 to generate greater fluidity and more capacity in key areas of its network and to increase traffic density and operating efficiencies on its track network in the northeastern United States.

The new arrangements include directional running, which turns the parallel tracks of two railways into dedicated eastbound and westbound lanes, trackage rights, which give one railway authority to operate its own trains over another railway's track, haulage services, under which one railway moves another's trains, and enhanced freight interchange and improved access to terminals and service areas.

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A CPR locomotive pulls a Norfolk Southern Railway locomotive and freight over the Nicholson Viaduct near Scranton, Pa. CPR entered into a series of co-operative arrangements with Norfolk Southern in 2004. The new arrangements have increased traffic density and revenue and reduced costs on CPR's network in the northeastern U.S.

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CPR's five key business thrusts:

Safety CPR continued to be an industry leader in safe train operations in 2004.

Freight Revenue grew by 11 % in 2004, excluding the impact of translating U.S. dollar-denominated revenues into the stronger Canadian dollar.

Yield the minimum growth target was 1.5 %, with a stretch goal of 2 % in 2004. We surpassed our stretch goal.

Productivity revenue-producing freight tonnage compared with train-miles accumulated in moving the tonnage provides a strong indicator of productivity, asset utilization and fluidity. In 2004, CPR grew revenue tonnage by 8 % while train miles increased by just one-quarter of that rate.

Capacity Management co-production, alliances and interline service agreements, right-sizing train crews and locomotive power, and disciplined execution of our Integrated Operating Plan, CPR's scheduled railway model, had a positive impact on fluidity in 2004. Improved fluidity is creating more revenue-generating capacity on CPR's existing track network and enhancing service quality – a benefit for shareholders and shippers.

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chairman's 2004 letter to shareholders

J.E. NEWALL

Chairman of the Board

This is an exciting time for Canadian Pacific Railway. The company and, indeed, the railway industry are reclaiming their position as an engine of economic expansion.

In a year of strong demand for rail freight services, CPR was demonstrating how to:

utilize every available ton of capacity in the existing rail infrastructure;

plan for potential expansion to deliver value to shareholders; and

take the lead in convincing disparate and sometimes dissenting parties to coalesce around the old-fashioned notion of working together for the greater good.

To these ends, the focus of the 16,000 employees of CPR in both Canada and the United States shifted squarely in 2004 on increasing fluidity over the network, using asset velocity to create more capacity in tight areas as demand escalated. The results in terms of freight volumes certainly surpassed expectations.

Looking ahead, management has developed an infrastructure expansion plan that would potentially see capital invested incrementally, matched to areas of high-value growth. Most importantly, management set conditions for investing capital that will ensure there is a compelling value proposition for shareholders associated with any future expansion.

CPR also facilitated the bringing together of governments, shippers, ports, railways, truckers and ocean shipping lines for frank discussions about economic expansion and its dependence on transportation infrastructure. The result is an emerging common recognition that the most effective infrastructure planning needs to involve all the players in the supply chain, supported by public policy that creates the right climate for investment.

These achievements in 2004 will serve shareholders well. Ultimately, they will result in CPR being able to grow its business while minimizing the capital required to accommodate the growth.

The Board's performance and that of its Committees was also satisfying in 2004. Our achievements included:

further strengthening financial controls and governance procedures;

advancing the company's strategic business plan; and

ensuring meaningful succession planning is in place across senior executive ranks.

I am pleased that CPR was among the top three in *The Globe and Mail* newspaper's 2004 rankings of best corporate governance practices by Canadian industrial companies.

CPR's balance sheet continued to strengthen and the company's net-debt to net-debt-plus-equity ratio improved to 43 % in 2004, from 52 % when CPR was spun off from Canadian Pacific Limited in 2001.

My message to shareholders this year would not be complete without recognizing the important contribution of Jacques Lamarre, President and Chief Executive Officer of SNC-Lavalin Group Inc., who left the CPR Board in 2004. Jacques' service, which began with CPR's spin-off, provided valuable experience and insight at a critical time in the company's evolution.

In serving shareholders, the Board is conscious of CPR's long and colourful history—one with a footprint in three centuries. Our focus is clearly on the future, and it should surprise no one that today, as world trade expands to unprecedented levels and as new economic giants emerge, CPR is more relevant than ever and stands ready to capitalize on the opportunities that lie ahead.

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president's 2004 letter to shareholders

ROBERT J. RITCHIE

President and Chief Executive Officer

Canadian Pacific Railway demonstrated the power and value of its business model and franchise in 2004, moving decisively to make the most of a robust transportation market. Across our railway, employees everywhere were engaged in exploiting growing world trade, including an explosion in trade with China, and putting railway muscle behind economic expansion in North America.

Our people showed what they can achieve when opportunity and challenge surface together. The result was a CPR that was firing on all cylinders – moving more freight than ever before and moving it increasingly faster – as demand for freight service escalated steadily. Pricing reflected the growing value that shippers are placing on CPR's transportation service in a market made tight by rising demand in almost every area.

Growth in intermodal, which consists mainly of containerized consumer goods, outstripped every other line of business and this highly service-sensitive area surpassed \$1 billion in revenue for the first time. The entire bulk sector was strong, led by revenue

growth in coal, sulphur and fertilizers. Industrial products revenue increased, reversing a three-year decline.

We earned these results by advancing our leading position as a low-cost bulk carrier, becoming an increasingly efficient and reliable intermodal service provider and offering an increasingly attractive alternative to trucks for merchandise freight. At the root of these improvements are investments CPR has made to build one of the most modern, reliable locomotive fleets in North America, provide customers higher capacity freight cars, increase track capacity and rebuild our IT foundation, together with innovation, ingenuity and discipline in train design and operations.

Greater fluidity emerged as the most compelling component of our business model and we generated strong results. During a year in which the North American rail industry had to cope with capacity strains, CPR was an industry leader in fluidity, as measured by train speed. Productivity also rose dramatically, with revenue tonnage growing 8 % while train-miles accumulated in moving the tonnage increased by just one-quarter of that rate.

The year's headwinds came in the form of extremely high world oil prices and continued strength in the Canadian dollar against the U.S. dollar. CPR countered with an improved fuel surcharge mechanism in 2004 that adjusts rates

more quickly as world

prices fluctuate, and continued to use long-term debt denominated in U.S. dollars as a natural hedge against the Canadian dollar's rise.

CPR exceeded its freight revenue growth target for 2004, generating a 7 % increase. Freight revenue would have grown 11 % had it not been for the substantial appreciation in the Canadian dollar.

All told, the combination of high fuel prices and the stronger Canadian dollar took approximately \$55 million out of operating income. Despite this impact, operating income, excluding other specified items ⁽¹⁾, rose 8 % to \$789 million in 2004, compared with \$730 million in 2003. CPR's operating ratio, excluding other specified items⁽¹⁾, improved to 79.8 % in 2004, compared with 80.1 % in 2003.

Income and earnings per share grew 10 % to \$361 million or \$2.27 per diluted share, excluding foreign exchange gains on long-term debt and other specified items ⁽¹⁾.

Across CPR, we are concentrating on execution, ensuring that all assets are being utilized to their fullest extent. This means maximizing train throughput in every track corridor, maximizing capacity on every train, keeping assets flowing with greater velocity and giving our people the tools and training to maximize their productivity.

Co-operative arrangements with other railways and disciplined execution of our Integrated Operating Plan are key

⁽¹⁾ Further information, including foreign exchange gains and losses on long-term debt and other specified items, is available on page 8.

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strategies behind our fluidity drive. CPR entered into a series of co-operative arrangements in 2004, including track-sharing and access to terminals. These arrangements in western Canada, central Canada and the northeastern U.S. will reduce costs, improve service for shippers, increase capacity in areas where traffic density is high and increase traffic density in areas where capacity is underutilized. They have helped address the high demand on our western corridor, particularly in the Greater Vancouver area, and have dramatically improved the financial performance of our northeastern U.S. franchise.

CPR is also ready to lay down track to expand our network in high-growth corridors if conditions are right. We have designed a phased, multi-year expansion program at a cost of approximately \$500 million, focused mainly on corridors between Moose Jaw, Saskatchewan, and Vancouver. Our program, with four discrete phases, would increase train capacity by one third. Importantly, the phased approach would enable CPR to meter the rate of expansion in lockstep with the rate of traffic growth to ensure the quickest possible payback on each incremental investment.

Currently, we are considering only the first phase, which would cost approximately \$160 million. It would be completed in a single construction season and increase train capacity west of Moose Jaw by more than 10%. However, this cannot happen before the Canadian government provides a clear signal of regulatory stability a position supported by the majority of our customers.

Should expansion go ahead, it will be a compelling value proposition for our shareholders. Meanwhile, we are committed to getting the most out of our current network. As fluidity improves, subsequent expansion phases could be deferred, conserving capital for shareholders while still growing our business.

CPR entered 2005 on a very solid footing, with commodity and transportation markets strong and 600 new train crew personnel trained and ready to handle the growing demand. Our focus on fluidity will be relentless. We expect

revenue growth of 6 % to 8 % in 2005 and we intend to drive more of this growth to the bottom line as productivity and efficiency continue to improve. We will grow strategically, targeting high-yield traffic against CPR's capacity. CPR will continue building on the innovative service design and operational improvements created in our bulk commodity and intermodal sectors. The best elements will be applied to the merchandise sector, where we will create a more efficient collection and delivery system to improve service and leverage more value in the marketplace.

Safety is and always will be our Number One priority. In 2004, CPR continued to be an industry leader in safe train operations and our employees achieved an all-time low in personal injuries. Sadly, these accomplishments were overshadowed by the loss in work-related incidents of three of our fellow employees, David Rutherford, Christopher Lewis and Gary Kinakin. These tragic events reinforce the importance of safety for our employees and their families.

In closing, I wish to recognize the support and guidance of our Chairman and Board of Directors and the accomplishments of our 16,000 talented employees. All of us share the excitement about CPR's prospects for the future. The Pacific in our company's name has never been more meaningful, nor more promising, as the world witnesses China's emergence as a trade powerhouse and India's economy is experiencing strong growth. Our railway serves some of the world's best farmland for growing grain. We serve the world's main source of potash for fertilizer. We link major ports with the consuming public. We have been doing this for 120 years and we are poised to do it better than ever before.

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management's discussion and analysis

February 21, 2005

This Management's Discussion and Analysis (MD&A) supplements the Consolidated Financial Statements and related notes for the year ended December 31, 2004. Except where otherwise indicated, all financial information reflected herein is expressed in Canadian dollars. All information has been prepared in accordance with Canadian generally accepted accounting principles (GAAP).

business profile and strategy

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. The Company provides rail and intermodal transportation services over a network of approximately 13,800 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 the U.S. heartland from the East and West coasts. Agreements and commercial arrangements 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 fertilizers. 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.

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 co-operation with customers and partners, and extending the reach of the franchise through marketing and operating partnerships, as well as agreements and commercial arrangements 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.

ADDITIONAL INFORMATION

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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, on EDGAR at www.sec.gov in the U.S. and on the Company's Website at www.cpr.ca.

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highlights summary

For the year ended December 31 (in millions, except per-share data)

	2004	2003 ⁽¹⁾	2002 ⁽¹⁾
Revenues	\$ 3,902.9	\$ 3,660.7	\$ 3,665.6
Operating expenses	3,114.4	2,931.1	2,821.6
Operating income, before the following:	788.5	729.6	844.0
Special (recovery) charge for labour restructuring and asset impairment	(19.0)	215.1	
Loss on transfer of assets to outsourcing firm		28.9	
Special charge for environmental remediation	90.9		
Operating income	716.6	485.6	844.0
Other charges	36.1	33.5	21.8
Foreign exchange gains on long-term debt (FX on LTD)	(94.4)	(209.5)	(13.4)
Interest expense	218.6	218.7	242.2
Income tax expense	143.3	41.6	105.9
Net income	\$ 413.0	\$ 401.3	\$ 487.5
Basic earnings per share	\$ 2.60	\$ 2.53	\$ 3.08
Diluted earnings per share	\$ 2.60	\$ 2.52	\$ 3.06

Total assets	\$ 10,499.8	\$ 9,956.7	\$ 9,664.3
Total long-term financial liabilities	\$ 5,229.2	\$ 5,347.5	\$ 4,798.2
Dividends paid (per share)	\$ 0.515	\$ 0.510	\$ 0.510

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

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operating results

CPR's net income for the year ended December 31, 2004, was \$413.0 million, up \$11.7 million from \$401.3 million in 2003 and down \$74.5 million from \$487.5 million in 2002. The increase in net income in 2004 from that in 2003 was due to higher revenues (discussed further in this MD&A under the heading "Revenues"), partially offset by:

increased costs for compensation and benefits, fuel, depreciation and amortization, and purchased services and other expenses (discussed further in this MD&A under the heading "Operating Expenses, Before Other Specified Items"); and

a decrease of \$115.1 million in before-tax (\$130 million after tax) foreign exchange gains on long-term debt ("FX on LTD") in 2004, compared with FX on LTD in 2003.

The increase in net income in 2004 was also due to:

a special charge of \$215.1 million before tax (\$141.4 million after tax) for a restructuring initiative and an asset impairment charge taken in the second quarter of 2003;

a loss on the transfer of assets to an outsourcing firm of \$28.9 million before tax (\$18.4 million after tax) taken in the fourth quarter of 2003; and

a positive adjustment of \$19.0 million before tax (\$12.4 million after tax) taken in 2004 for the reversal of a portion of the special charge for restructuring taken in 2003.

These charges were partially offset by adjustments to 2004 earnings for a special charge for environmental clean-up costs of \$90.9 million before tax (\$55.2 million after tax).

The above-mentioned items are discussed further under the subheading "Other Specified Items" in this MD&A.

Net income in 2003 decreased from that in 2002 mainly due to the special charge and the loss on transfer of assets taken in 2003, partially offset by an after-tax FX gain on LTD of \$224.4 million in 2003, compared with an after-tax FX gain on LTD of \$16.7 million in 2002. FX on LTD is discussed further under the subheading "Foreign Exchange Gains (Losses) on Long-Term Debt".

The Company had operating income in 2004 of \$716.6 million, an increase of \$231.0 million from \$485.6 million in 2003 and a decrease of \$127.4 million from \$844.0 million in 2002. The increase in 2004, compared with 2003, was mainly due to:

higher revenues resulting from increased freight volumes and rates in 2004;

the special charge and the loss on transfer of assets taken in 2003; and

the reversal in 2004 of a portion of the 2003 restructuring special charge.

These increases were partially offset by:

the special charge for environmental costs taken in 2004;

increased costs in 2004 for compensation and benefits, fuel, depreciation and amortization, and purchased services and other expenses; and

the net effect of Foreign Exchange on U.S. dollar-denominated revenues and expenses.

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The decline in 2003, compared with 2002, was mainly due to the net effect of Foreign Exchange on U.S. dollar-denominated revenues and expenses, the restructuring special charge and the loss on transfer of assets, lower grain volumes in the first half of 2003 due to drought on the Canadian prairies, higher fuel prices and increased costs as a result of service disruptions in the first quarter of 2003 caused by severe winter weather conditions and derailments.

Diluted earnings per share (EPS) in 2004 was \$2.60, an increase of \$0.08 from \$2.52 in 2003 and a decrease of \$0.46 from \$3.06 in 2002. 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.

The Company's operating ratio was 79.8 % in 2004, compared with 80.1 % in 2003 and 77.0 % in 2002. The operating ratio, which excludes other specified items, provides the percentage of revenues used to operate the railway.

EFFECT OF FOREIGN EXCHANGE ON CPR'S EARNINGS

Fluctuations in Foreign Exchange affect CPR's results because U.S. dollar-denominated revenues and expenses are translated into Canadian dollars. U.S. dollar-denominated revenues and expenses are reduced when the Canadian dollar strengthens in relation to the U.S. dollar. Operating income is also reduced, because more revenues than expenses are generated in U.S. dollars. Fluctuations were significant in 2004 and 2003, as the average foreign exchange rate for converting U.S. dollars to Canadian dollars decreased to \$1.30 in 2004 from \$1.41 in 2003 and \$1.57 in 2002. The table on page 8 shows the approximate effect of Foreign Exchange on CPR's revenues and expenses in 2004 and 2003. The effect of Foreign Exchange on 2002 revenues and expenses was not significant.

On average, a \$0.01 increase in the Canadian dollar reduces annual operating income by approximately \$3 million. As a result, Foreign Exchange fluctuations had a substantial impact on CPR's operating income in 2004 and 2003. From time to time, the Company uses foreign exchange forward contracts in respect of hedging the effects of Foreign Exchange transaction gains and losses and other economic effects on the Company's business. In addition, a portion of the U.S. dollar-denominated long-term debt has been designated as a hedge of the Company's net investment in self-sustaining foreign subsidiaries. CPR's hedging instruments are discussed further under the heading "Financial Instruments" in this MD&A. The effect of Foreign Exchange on CPR's results is further discussed under the heading "Foreign Exchange" in this MD&A.

The Company has assumed that the average foreign exchange rate for converting U.S. dollars to Canadian dollars will be \$1.25 in 2005. This assumption has been built into all forecasts discussed in this MD&A.

Table of Contentsdecrease in earnings due to foreign exchange ⁽¹⁾

For the year ended December 31 (in millions, except foreign exchange rate)	2004	2003
Average annual foreign exchange rate	\$ 1.30	\$ 1.41
Freight revenues		
Grain	\$ 25	\$ 38
Coal	8	12
Sulphur and fertilizers	14	17
Forest products	17	25
Industrial products	21	32
Automotive	16	25
Intermodal	26	37
Other revenues	3	6
Total revenues	130	192
Operating expenses		
Compensation and benefits	28	36
Fuel	24	29
Materials	3	5
Equipment rents	16	23
Depreciation and amortization	5	8
Purchased services and other	23	36
Total operating expenses	99	137
Operating income	31	55
Other expenses		
Other charges	3	1
Interest expense	13	22
Income tax expense, before FX on LTD and other specified items	3	10
Income, before FX on LTD and other specified items	\$ 12	\$ 22

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

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non-gAAP earnings

CPR 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 below.

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 GAAP and, therefore, are unlikely to be comparable to similar measures presented by other companies.

summarized statement of consolidated income

(reconciliation of non-GAAP earnings to GAAP earnings)

For the year ended December 31 (in millions) (unaudited)	2004	2003 ⁽¹⁾	2002 ⁽¹⁾
Revenues	\$ 3,902.9	\$ 3,660.7	\$ 3,665.6
Operating expenses, before other specified items ⁽²⁾	3,114.4	2,931.1	2,821.6
Operating income, before other specified items ⁽²⁾	788.5	729.6	844.0
Other charges	36.1	33.5	21.8
Interest expense	218.6	218.7	242.2
Income tax expense, before income tax on FX on LTD and other specified items ⁽²⁾	172.4	147.3	181.2
Income, before FX on LTD and other specified items ⁽²⁾	361.4	330.1	398.8
Foreign exchange gains on long-term debt			
FX on LTD gain	94.4	209.5	13.4
Income tax on FX on LTD		14.9	3.3
FX on LTD (net of tax)	94.4	224.4	16.7
Other specified items			
Special recovery (charge) for labour restructuring and asset impairment	19.0	(215.1)	
Loss on transfer of assets to outsourcing firm		(28.9)	
Special charge for environmental remediation	(90.9)		
Income tax on special charges	29.1	84.2	
Special charges and loss on transfer of assets (net of tax)	(42.8)	(159.8)	
Revaluation of future income taxes		59.3	

Effect of increase in tax rates		(52.7)	
Income tax recovery			72.0
Net income	\$ 413.0	\$ 401.3	\$ 487.5

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

(2) 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 .

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Income, before FX on LTD and other specified items, was \$361.4 million in 2004, an increase of \$31.3 million from \$330.1 million in 2003 and a decrease of \$37.4 million from \$398.8 million in 2002. Freight volumes increased in 2004, compared with 2003. Additional income generated by this growth was

partially offset by the negative effect of Foreign Exchange on U.S. dollar-denominated revenues and expenses, an increase in volume-related expenses and in labour costs due to inflation, incentive compensation, training and benefits, and costs and lost revenues associated with an avalanche in the first quarter of 2004. The Company

transported higher freight volumes in 2003, compared with 2002. However, additional income generated by this growth was more than offset by the negative effect of Foreign Exchange on U.S. dollar-denominated revenues and expenses, severe winter weather conditions, derailments and persistently high fuel prices.

non-gaap performance indicators

(reconciliation of non-GAAP EPS to GAAP EPS)

For the year ended December 31 (unaudited)	2004	2003 ⁽¹⁾	2002 ⁽¹⁾
Diluted EPS, as determined by GAAP	\$ 2.60	\$ 2.52	\$ 3.06
Diluted EPS, related to FX on LTD net of tax	(0.59)	(1.41)	(0.11)
Diluted EPS, related to other specified items net of tax	0.26	0.96	(0.45)
Diluted EPS, before FX on LTD and other specified items ⁽²⁾	\$ 2.27	\$ 2.07	\$ 2.50

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

⁽²⁾ 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 .

Diluted EPS, before FX on LTD and other specified items, was \$2.27 in 2004, an increase of \$0.20 from \$2.07 in 2003 and a decrease of \$0.23 from \$2.50 in 2002. Diluted EPS, before FX on LTD and other specified items, is 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 7.

FOREIGN EXCHANGE GAINS (LOSSES) ON LONG-TERM DEBT

Foreign exchange gains and losses on long-term debt arise mainly as a result of translating U.S. dollar-denominated debt into Canadian dollars. These gains and losses, which are calculated as the Canadian dollar strengthens or weakens relative to the U.S. dollar, are mainly unrealized and

can only be realized when net U.S. dollar-denominated long-term debt matures or is settled. Income, before FX on LTD and other specified items, as calculated on page 9, excludes FX on LTD from CPR's earnings in order to eliminate the impact of volatile short-term exchange rate fluctuations.

Foreign exchange gains on long-term debt were \$94.4 million before tax in 2004, \$209.5 million before tax in 2003 and \$13.4 million before tax in 2002. The changes were due to the effect of Foreign Exchange, 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 \$9 million to \$10 million.

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.

Other specified items included a special charge of \$55.2 million after tax (\$90.9 million before tax) taken in the fourth quarter of 2004 to reflect the estimated costs required to clean up environmental contamination at a property in Minnesota. This charge is discussed further in this MD&A in the section Future Trends, Commitments and Risks, under the sub-heading Environmental.

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In the fourth quarter of 2004, net income included a positive adjustment of \$12.4 million after tax (\$19.0 million before tax) to reflect a reversal of a portion of the labour liability included in the special charge taken in the second quarter of 2003. The labour liability included in the special charge was for original estimates of labour liabilities to be incurred to restructure CPR's northeastern U.S. operations. In 2004, CPR achieved a successful new arrangement with Norfolk Southern Railway for operations in the region. The arrangement, which received the first stage of regulatory approval in the fourth quarter of 2004, is delivering efficiency improvements. As a result, the Company did not incur the expected labour restructuring costs and the liability associated with restructuring CPR's northeastern U.S. operations was reversed.

In the second quarter of 2003, a special charge of \$141.4 million after tax (\$215.1 million before tax) was taken 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.

In the fourth quarter of 2003, CPR transferred assets to IBM Canada Ltd. (IBM) as part of a seven-year, \$200-million agreement reached with IBM to operate and enhance CPR's computing infrastructure. The arrangement will reduce CPR's costs over time and allow remaining information technology staff to focus on applications that improve efficiency and service. The Company recognized a loss of \$18.4 million after tax (\$28.9 million before tax) on the transfer of these assets. This loss is included in other specified items in 2003.

In December 2003, the Government of Ontario repealed previously announced future income tax rate reductions. The Company's future income taxes, which were previously based on these reduced rates, have been adjusted upwards by \$52.7 million to reflect the change.

Following a revaluation in 2003 of various other components that determine its future income tax liability, the Company reduced the estimate of its future income tax liability by \$59.3 million.

In 2002, there was one other specified item of \$72 million resulting from a favourable income tax ruling relating to prior years.

lines of business

VOLUMES

Higher freight volumes result in increases in revenues and certain variable expenses such as fuel, equipment rents and crew costs. In 2004, total carloads were 2,699 thousand, an increase of 160 thousand, or 6 %, from 2,539 thousand in 2003, and an increase of 252 thousand, or 10 %, from 2,447 thousand in 2002. In 2004, total revenue ton-miles (RTM) were 123,627 million, an increase of 9,028 million, or 8 %, from 114,599 million in 2003, and 15,938 million, or 15 %, from 107,689 million in 2002. These increases in volumes were largely responsible for an increase in freight revenues of 7 % in 2004, compared with the same period in 2003, and a 7 % increase in 2004, compared with 2002. There was also an increase in related variable expenses in 2004, compared with the prior years.

Table of Contents**VOLUMES**

For the year ended December 31	2004	2003	2002
Carloads (in thousands)			
Grain	321.2	308.7	291.1
Coal	395.2	359.6	351.8
Sulphur and fertilizers	211.8	189.0	174.4
Forest products	160.3	164.2	174.2
Industrial products	286.3	263.4	271.9
Automotive	171.7	177.2	178.1
Intermodal			
Intermodal	1,119.6	1,041.9	971.2
Food and consumer	32.7	35.2	34.6
Total Intermodal	1,152.3	1,077.1	1,005.8
Total carloads	2,698.8	2,539.2	2,447.3
Revenue ton-miles (in millions)			
Grain	23,805	23,040	20,808
Coal	25,241	22,155	21,904
Sulphur and fertilizers	20,418	18,186	15,737
Forest products	10,557	10,789	11,014
Industrial products	14,196	13,229	12,801
Automotive	2,291	2,564	2,932
Intermodal			
Intermodal	25,749	23,132	21,029
Food and consumer	1,370	1,504	1,464
Total Intermodal	27,119	24,636	22,493
Total revenue ton-miles	123,627	114,599	107,689

REVENUES

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

CPR maintains competitive freight rates and reviews its rates on a

regular basis, adjusting them for market conditions as warranted. Current strong demand in the transportation market has resulted in favourable pricing conditions for CPR.

Total revenues, which consist of freight and other revenues, were \$3,902.9 million in 2004, an increase of \$242.2 million from \$3,660.7 million in 2003, and an increase of \$237.3 million from \$3,665.6 million in 2002. Increases were achieved

through strong volume growth and freight rate improvements in 2004, compared with 2003, which more than offset the approximately \$130-million negative impact of Foreign Exchange on U.S. dollar-denominated revenues. Strong volume growth was achieved in 2003, compared with 2002. However, corresponding growth in freight revenues was significantly offset by a negative Foreign Exchange impact of approximately \$192 million.

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Table of Contents**REVENUES**

For the year ended December 31 (in millions)	2004	2003	2002
Grain	\$ 668.2	\$ 644.4	\$ 631.4
Coal	530.3	444.0	442.5
Sulphur and fertilizers	460.0	417.4	401.3
Forest products	322.0	328.8	360.3
Industrial products	430.2	400.4	422.1
Automotive	288.5	304.2	332.4
Intermodal			
Intermodal	978.4	880.6	818.8
Food and consumer	51.2	59.5	63.1
Total Intermodal	1,029.6	940.1	881.9
Total freight revenues	\$ 3,728.8	\$ 3,479.3	\$ 3,471.9
Other revenues			
Other intermodal	56.3	45.8	36.6
Non-freight and switching	117.8	135.6	157.1
Total other revenues	174.1	181.4	193.7
Total revenues	\$ 3,902.9	\$ 3,660.7	\$ 3,665.6

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 \$3,728.8 million in 2004, an increase of \$249.5 million, or 7 %, from \$3,479.3 million in 2003, and an increase of \$256.9 million, or 7 %, from \$3,471.9 million in 2002. Freight revenues increased in 2004 mainly as a result of volume growth, compared with 2003, partially offset by the approximately \$127-million effect of Foreign Exchange and the negative effect on volumes and revenues resulting from an avalanche that caused a disruption on the busiest portion of CPR's mainline in the first quarter of 2004. Volume growth in 2003, compared with 2002, helped offset the approximately \$186-million negative effect of Foreign Exchange. In 2003, revenues also increased due to higher intermodal volumes and

improved grain crops as shipments began to recover from the drought-induced decline experienced throughout 2002 and in the first half of 2003.

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. In 2004, the increase in fuel surcharge, included in freight revenues, recovered approximately two-thirds of CPR's fuel price increase

(including the effects of hedging).

At December 31, 2004, one customer comprised 11.7 % of total revenues and 12.4 % of CPR's total accounts receivable. At December 31, 2003 and 2002, no customer's revenues were greater than 10 % of total revenues.

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 2004 were \$668.2 million, an increase of \$23.8 million from \$644.4 million in 2003 and an increase of \$36.8 million from \$631.4 million in 2002. Canadian grain volumes and revenues increased in 2004, compared with 2003, as a result of strong world demand and larger crop production following a drought-induced decline experienced throughout 2002 and in the first half of 2003. U.S. grain volumes increased in 2004, but the associated revenue

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increase was partially offset by the effect of Foreign Exchange. Furthermore, total grain revenues were reduced by penalties paid for delays in grain shipments. U.S. and Canadian grain shipments also benefited in 2003, compared with 2002, from a larger crop production and favourable market conditions in the second half of 2003. This growth was partially offset by a reduction in revenues as a result of the effect of Foreign Exchange, the effect of the drought in the first half of 2003 and the repercussions from a Port of Vancouver labour disruption in the fourth quarter of 2002 that carried into the first quarter of 2003.

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 to the U.S. Midwest. CPR's U.S. coal business consists primarily of the transportation of thermal coal and petroleum coke within the U.S. Midwest. In 2004, coal revenues were \$530.3 million, an increase of \$86.3 million from \$444.0 million in 2003 and an increase of \$87.8 million from \$442.5 million in 2002. Revenues in 2004 increased largely due to a strong steel market, which created a higher world demand for metallurgical coal, increased freight rates and operational improvements that allowed CPR to transport more coal. Revenues also included a positive freight rate adjustment made in the fourth quarter of 2004 reflecting a rate settlement for eastbound coal shipments. Revenues in 2003 increased over 2002 due to strong world demand for metallurgical coal in the fourth quarter of 2003, offset by reduced export rail shipments in the first three quarters of 2003 and the effect of Foreign Exchange.

The Company is currently in dispute with its main coal customer, Elk Valley Coal Corporation (EVCC). CPR has included a reasonable accrual in its coal revenues for amounts that may be owing to CPR as a result of this dispute. The EVCC dispute is discussed further in this MD&A under the heading "Future Trends, Commitments and Risks".

Sulphur and Fertilizers

Sulphur and fertilizers include chemical fertilizers, potash and sulphur shipped mainly from western Canada to the ports of Vancouver and Portland, Oregon, and to other Canadian and U.S. destinations. Revenues were \$460.0 million in 2004, an increase of \$42.6 million from \$417.4 million in 2003 and an increase of \$58.7 million from \$401.3 million in 2002. Revenues were higher in 2004, compared with 2003, mainly due to increased export potash shipments driven by greater demand in Brazil and East Asia. Higher sulphur transportation rates and stronger export volumes of potash resulted in higher revenues in 2003, compared with 2002. The increase was partially offset by the effect of Foreign Exchange and declines in the chemical fertilizers market during 2003.

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 \$322.0 million in 2004, a decrease of \$6.8 million from \$328.8 million in 2003 and a decrease of \$38.3 million from \$360.3 million in 2002. Revenues were lower in 2004, compared with 2003, due mainly to the effect of Foreign Exchange and weather-related issues affecting CPR's car availability and customer rail car loading capacity

in the first half of 2004. These factors were partially offset by a shift to rail transportation from truck in the newsprint market in the second half of 2004, and increased freight rates. Revenues were lower in 2003 than in 2002 mainly as a result of the effect of Foreign Exchange and declines in the markets for wood pulp and newsprint.

Industrial Products

Industrial products include chemicals, plastics, aggregates, steel, and mine and energy-related products (other than coal) shipped throughout North America. In 2004, industrial products revenues were \$430.2 million, an increase of \$29.8 million from \$400.4 million in 2003 and an increase of \$8.1 million from \$422.1 million in 2002. Revenues increased in 2004, compared with 2003, as a result of higher freight rates, greater steel demand driven by economic expansion and pipeline projects, strong demand for aggregates in the construction and manufacturing sectors, increased market share for plastics, and higher rates for energy products. Increases in revenues were partially offset by the effect of Foreign Exchange. The decrease in revenues in 2003 from 2002 was mainly due to the effect of Foreign Exchange, partially offset by increased demand for aggregates and energy-related products in 2003.

Automotive

Automotive consists primarily 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 2004, automotive revenues were \$288.5 million, a decrease of \$15.7 million from \$304.2 million in 2003 and a decrease of \$43.9 million from \$332.4 million in 2002. Revenues were lower in 2004, compared with

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2003, due to the effect of Foreign Exchange, a decline in consumer demand for certain vehicle models in 2004 and the loss of certain business to a competing railway. This decrease was partially offset by a power outage that affected CPR's customers in eastern Canada and the northeastern U.S., resulting in reduced automotive shipments and revenues in the third quarter of 2003. Revenues in 2003 were lower than in 2002 due to the effect of Foreign Exchange, the power outage and a decline in consumer demand.

Intermodal

Intermodal consists of domestic and international (import-export) traffic. CPR's domestic segment handles a variety of products within Canada, as well as to and from the U.S., but primarily transports retail goods between eastern and western Canada. The international segment handles containers of mainly consumer goods between the ports of Vancouver, Montreal, New York/New Jersey and Philadelphia and inland Canadian and U.S. destinations. Intermodal revenues were \$1,029.6 million in 2004, an increase of \$89.5 million from \$940.1 million in 2003 and an increase of \$147.7 million from \$881.9 million in 2002. The growth in CPR's international business in 2004, compared with 2003, and in 2003, compared with 2002, was 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. In domestic intermodal, revenue growth in 2004, compared with 2003, was due to

higher demand in the retail market and rate increase initiatives. Domestic revenue growth in 2003, compared with 2002, was due largely to the success of CPR's co-location initiative, under which major retailers have built regional distribution facilities adjacent to certain CPR intermodal terminals. Increases in all intermodal revenues in 2004 and in 2003 were partially offset by the effect of Foreign Exchange.

CPR's food and consumer group has historically been reported as part of the intermodal business line. However, as a result of changes in CPR's market, management believes it would be more appropriate to include this group with the industrial products business line. As a result, the food and consumer reporting will transition to industrial products from the intermodal business line. The food and consumer portfolio consists of miscellaneous products, including sugar, meat by-products, railway equipment and building materials moving primarily from western Canada to various destinations in the United States.

Expectations for 2005

CPR anticipates revenues will increase in the range of 6 % to 8 % in 2005. The Company's revenue outlook is based on certain assumptions about events and developments that may not materialize or that may be offset entirely or partially by other events and developments. CPR's 2005 revenue outlook assumes freight volume growth will continue to be strong in the grain, fertilizer, international container and coal businesses, current positive economic trends in North America and Asia will continue, and freight transportation rates will increase.

OTHER REVENUES

Other revenues consist of other intermodal revenues and non-freight and switching revenues. Other revenues in 2004 were \$174.1 million, a decrease of \$7.3 million from \$181.4 million in 2003, and a decrease of \$19.6 million from \$193.7 million in 2002.

Other intermodal revenues are derived mainly from container storage and terminal service fees. Other intermodal revenues in 2004 were \$56.3 million, an increase of \$10.5 million from \$45.8 million in 2003, and an increase of

\$19.7 million from \$36.6 million in 2002. The increases in 2003 and 2004 reflect higher intermodal volumes resulting in higher container storage and terminal service fees.

Non-freight and switching revenues are comprised of leasing of certain assets, switching fees, land sales and income from business partnerships. These revenues in 2004 were \$117.8 million, a decrease of \$17.8 million from \$135.6 million in 2003, and a decrease of \$39.3 million from \$157.1 million in 2002. Other non-freight and switching revenues were lower in 2004, compared with 2003, mainly due to lower land and leasing revenues and lower equity income from business partnerships.

Other revenues in 2003 were lower than in 2002 due to the effect of Foreign Exchange, lower switching fees and reduced income from business partnerships. In addition, there were favourable adjustments in 2002 as a result of a gain on a property sale from a previous period, partially offset by increased land sales and container storage fees.

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revenue per carload

Freight revenue per carload is the amount of freight revenue earned for every carload moved, calculated by dividing the freight revenue for a commodity by the number of carloads

of the commodity transported in the period. Total freight revenue per carload was \$1,382 in 2004, an increase of \$12 from \$1,370 in 2003 and a decrease of \$37 from \$1,419 in 2002. The increase in 2004, compared with 2003, was due to higher freight

rates, which more than offset the effect of Foreign Exchange. In 2003, compared with 2002, revenue per carload decreased as the effect of Foreign Exchange more than offset freight rate increases.

freight revenue per carload

For the year ended December 31 (\$)(unaudited)	2004	2003	2002
Total freight revenue per carload	1,382	1,370	1,419
Grain	2,080	2,087	2,169
Coal	1,342	1,235	1,258
Sulphur and fertilizers	2,172	2,208	2,301
Forest products	2,009	2,002	2,068
Industrial products	1,503	1,520	1,552
Automotive	1,680	1,717	1,866
Intermodal (including Food and consumer)	894	873	877

performance indicators

The Company believes that the indicators listed in this table are the most accurate measures of its business performance.

For the year ended December 31 (unaudited)	2004	2003 ⁽¹⁾	2002 ⁽¹⁾
Productivity indicators			
Gross ton-miles of freight (millions)	236,451	221,884	209,596
Train-miles (thousands)	41,344	40,470	38,299
Average train weights (tons)	5,719	5,483	5,473
Efficiency and other indicators			
U.S. gallons of fuel per 1,000 GTMs	1.20	1.24	1.24
Average number of active employees	16,056	16,126	16,116

Miles of road operated at end of period	13,817	13,848	13,874
Freight revenue per RTM (cents)	3.02	3.04	3.22
Safety indicators			
FRA personal injuries per 200,000 employee-hours	2.7	3.1	3.6
FRA train accidents per million train-miles	2.1	1.8	1.8

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

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PRODUCTIVITY INDICATORS

Productivity indicators reflect the Company's operational activity.

Train-miles is a measure reflecting the distance traveled by the lead locomotive on each train operating over CPR's track. An increase in gross ton-miles (GTM) 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. This indicator improved 3 % in 2004 from 2003 as a result of productivity initiatives and improved operating conditions. This statistic was unchanged in 2003 from 2002, as harsh operating conditions in the first quarter of 2003 were offset by the acquisition of new, more fuel-efficient locomotives and more efficient utilization of locomotives.

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 0.4 % in 2004, compared with 2003, as reductions made under restructuring initiatives were offset by hiring to handle business growth. CPR's average number of active employees rose 0.1 % in 2003, compared with 2002, as hiring to handle business growth offset job reductions made under restructuring initiatives.

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 slightly in 2004, compared with 2003, mainly due to the effect of Foreign Exchange, partially offset by initiatives for rate increases. This indicator decreased in 2003, compared with 2002, mainly due to changes in the mix of commodities moved and the effect of Foreign Exchange, 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 U.S. 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. CPR's continued reduction in personal injuries is the result of ongoing focused safety management processes, which involve more than 1,000 employees in planning and implementing safety-related activities.

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 meet or exceed the FRA reporting threshold of US\$6,700. This metric increased 17 % in 2004, compared with each of the two previous years. The increase occurred during the first two quarters of 2004, and in particular, during the colder than average weather experienced early in the year.

Table of Contentsoperating expenses, before other specified items ⁽¹⁾

For the year ended December 31 (in millions)	2004		2003 ⁽²⁾		2002 ⁽²⁾	
	Expense	% of revenue	Expense	% of revenue	Expense	% of revenue
Compensation and benefits	\$ 1,259.6	32.3	\$ 1,163.9	31.8	\$ 1,143.4	31.2
Fuel	440.0	11.3	393.6	10.8	358.3	9.8
Materials	178.5	4.6	179.2	4.9	168.7	4.6
Equipment rents	218.5	5.6	238.5	6.5	255.4	7.0
Depreciation and amortization	407.1	10.4	372.3	10.2	340.2	9.3
Purchased services and other	610.7	15.6	583.6	15.9	555.6	15.1
Total	\$ 3,114.4	79.8	\$ 2,931.1	80.1	\$ 2,821.6	77.0

⁽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.

Operating expenses, before other specified items, were \$3,114.4 million in 2004, an increase of \$183.3 million from \$2,931.1 million in 2003, and an increase of \$292.8 million from \$2,821.6 million in 2002. In 2004, compared with 2003, operating expenses increased due largely to inflation, higher fuel, depreciation and compensation and benefits costs, and higher costs associated with business growth, partially offset by an approximately \$99-million Foreign Exchange impact. In 2003, compared with 2002, Foreign Exchange had a favourable impact of approximately \$137 million on operating expenses, which was offset by inflation, higher depreciation and fuel prices, higher costs associated with business growth, and service disruptions in the first quarter of 2003 caused by severe winter weather conditions and derailments.

COMPENSATION AND BENEFITS

Compensation and benefits expense includes employee wages, salaries and fringe benefits. In 2004, compensation and benefits expense was \$1,259.6 million, an increase of \$95.7 million from \$1,163.9 million in

2003, and an increase of \$116.2 million from \$1,143.4 million in 2002. Performance-based incentive compensation expenses increased in 2004, compared with 2003 when these expenses were abnormally low. Expenses also increased in 2004 as a result of higher costs associated with inflation, pension expense, training costs for new train crew employees, selective hiring to handle increased freight volumes as well as favourable expense adjustments during the first quarter of 2003, partially offset by lower expenses resulting from restructuring initiatives. Expenses in 2003 increased over 2002 as higher costs associated with inflation, severe winter conditions, pension expense and selective hiring to handle increased freight volumes were partially offset by lower variable incentive compensation costs, restructuring initiatives, expense adjustments during the first quarter of 2003 and the positive impact of Foreign

Exchange.

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 2004, fuel expense was \$440.0 million, an increase of \$46.4 million from \$393.6 million in 2003, and an increase of \$81.7 million from \$358.3 million in 2002. Fuel expense increased in 2004, compared with 2003, due to higher crude oil prices and volumes, partially offset by the effect of Foreign Exchange on U.S. dollar-denominated fuel expenses, more efficient fuel consumption, favourable refining margins and positive inventory adjustments. Fuel expense in 2003 was higher than in 2002 as a result of significantly higher fuel prices and greater consumption associated with increased freight volumes and severe winter operating conditions. These increases were partially offset by CPR's fuel-hedging program and the positive effect of Foreign Exchange.

MATERIALS

Materials expense includes the cost of materials used for track, locomotive, freight car and building maintenance. This expense declined slightly to \$178.5 million in 2004 from \$179.2 million in 2003, and was up \$9.8 million from \$168.7 million in 2002. The decline in 2004, compared

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with 2003, was due to lower material usage for track maintenance, reduced computer hardware and software expenses beginning in January 2004 as a result of a new outsourcing agreement with IBM, and the effect of Foreign Exchange, offset by higher fuel costs for vehicles and increased locomotive repair and servicing materials. Expenses increased in 2003 over 2002 due to increased materials required for repairs, derailment costs and favourable adjustments made in 2002, partially offset by the effect of Foreign Exchange.

EQUIPMENT RENTS

Equipment rents expense includes the cost to lease freight cars, intermodal equipment and locomotives from other railways and companies. In 2004, equipment rents expense was \$218.5 million, a decrease of \$20.0 million from \$238.5 million in 2003, and a decrease of \$36.9 million from \$255.4 million in 2002. The decrease in 2004, compared with 2003, was due to the effect of Foreign Exchange, higher earnings from customers and railways for the use of CPR cars and an overall reduction in car rental rates, partially offset by additional leases acquired for locomotives and freight cars to handle growing freight volumes. The decrease in 2003, compared with 2002, primarily resulted from the positive impact of Foreign Exchange, reduced compensation to private freight car owners and the reduction of rent expense previously charged by the variable interest entity that was consolidated in the second quarter of 2003. These decreases in 2003 were partially offset by higher expenses that resulted from weather-related service issues and higher traffic volumes.

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 \$407.1 million in 2004, an increase of \$34.8 million from \$372.3 million in 2003, and an increase of \$66.9 million from \$340.2 million in 2002. The increase in 2004, compared with 2003, was due largely to additions to CPR's capital assets and higher depreciation rates on certain track assets, particularly rail. The increase was partially mitigated by the effect of Foreign Exchange and depreciation for assets transferred in the fourth quarter of 2003 to IBM under an outsourcing agreement. The increase in 2003 over 2002 was due largely to additions to CPR's capital assets and increased depreciation rates on certain assets, mostly related to information systems hardware. The increase was partially mitigated by the effect of Foreign Exchange.

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 \$610.7 million in 2004, an increase of \$27.1 million from \$583.6 million in 2003, and an increase of \$55.1 million from \$555.6 million in 2002. In 2004, compared with 2003, purchased services and other expense increased, mainly due to payments to IBM under an outsourcing agreement commencing in January 2004, property and other taxes, joint facility inter-railway costs, and intermodal equipment repairs, partially offset by the effect of Foreign Exchange and lower costs associated with derailments, mishaps and

personal injuries. Expenses increased in 2003 over 2002 due to higher insurance premiums, derailment costs, volume-related expenses and favourable adjustments made in 2002.

EXPECTATIONS FOR 2005

CPR anticipates that total operating expenses will increase in the range of 5 % to 6 % in 2005. The Company's expense outlook is based on certain assumptions about events and developments that may not materialize or that may be offset entirely or partially by other events and developments. CPR's 2005 expense outlook assumes fuel expense will increase 18 % to 20 %, including the benefits of hedging, and compensation and benefits expense will increase due to additional hiring to handle growing freight volumes, inflation and higher pension expense. CPR's expense outlook also assumes current positive economic trends in North America and Asia will continue. The higher fuel expense assumption is based on CPR's estimate that the West Texas Intermediate price will increase to an average of US\$48 per barrel (unhedged) in 2005, from an average of US\$40 per barrel (unhedged) in 2004, and that fuel consumption will increase as a result of higher freight volumes. Excluding fuel, total operating expenses are expected to increase in the range of 3 % to 4 %.

other income statement items

OTHER CHARGES

Other charges consist of amortization of the discounted portion of certain long-term accruals, gains and losses due to the effect of Foreign Exchange on working capital, various costs related to financing, gains and losses associated with changes in the fair value of non-hedging derivative instruments, and other miscellaneous

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income. Other charges were \$36.1 million in 2004, an increase of \$2.6 million from \$33.5 million in 2003, and an increase of \$14.3 million from \$21.8 million in 2002. The increase in 2004, compared with 2003, was 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 under the heading Changes in Accounting Policy in this MD&A, and the effect of Foreign Exchange on working capital accounts. The increase in 2003, compared with 2002, was due to a benefit in 2002 from interest income on a tax recovery and interest paid in 2003 on an income tax settlement.

INTEREST EXPENSE

Interest expense includes interest on long-term debt and capital leases, and interest income. Interest expense was \$218.6 million in 2004, down slightly from \$218.7 million in 2003 and a decrease of \$23.6 million from \$242.2 million in 2002. Interest expense decreased in 2004, compared with 2003, due to the positive effect of Foreign Exchange, savings from interest rate swaps on US\$200 million of the US\$400-million 6.25 % Medium Term Notes (discussed further under the heading Financial Instruments in this MD&A) and the replacement of higher-cost debt with lower-cost debt. These reductions were offset by interest on a new locomotive capital lease entered into in the first quarter of 2004, and interest on the \$350-million 4.9 % Medium Term Notes. The cancellation in July 2004 of the cross-currency swaps on \$105 million of the \$350-million 4.9 % Medium Term Notes (discussed further under the heading Financial Instruments in

this MD&A) resulted in lower cost savings and, therefore, an increase to 2004 interest expense. The decrease in 2003 from 2002 was due to the replacement of higher-cost debt with lower-cost debt and the positive impact of Foreign Exchange and interest rate swaps. The decrease was partially offset by interest on the \$350-million 4.9 % Medium Term Notes.

INCOME TAXES

Income tax expense in 2004 was \$143.3 million, compared with \$41.6 million in 2003 and \$105.9 million in 2002. Income tax expense increased in 2004, compared with 2003, mainly due to the recovery of income taxes for special charges in 2003. The recovery in 2003 was also the primary reason for the lower income tax expense in 2003, compared with 2002.

The effective income tax rate for 2004 was 25.9 %, compared with 9.4 % for 2003 and 17.9 % for 2002. The normalized rates (income tax rate based on income adjusted for FX on LTD and other specified items) for 2004, 2003 and 2002 were 32.3 %, 30.9 % and 31.2 %, respectively.

In December 2003, the Government of Ontario repealed previously announced future income tax rate reductions. The Company's future income tax liability, which was previously based on these reduced rates, was increased by \$52.7 million to reflect the change. This adjustment is also discussed in the section Non-GAAP Earnings, under the sub-heading Other Specified Items.

Following a revaluation in 2003 of various components used to determine its future income tax liability, the Company reduced the estimate of its future income tax liability by \$59.3 million. This adjustment is also

discussed in the section Non-GAAP Earnings, under the sub-heading Other Specified Items.

In 2002, the Company reported an income tax recovery of approximately \$72.0 million stemming from a favourable tax decision by the Federal Court of Appeal. This decision resulted in an effective tax rate of 17.9 %, compared with a normalized income tax rate of approximately 31.2 %. This adjustment is also discussed in the section Non-GAAP Earnings , under the sub-heading Other Specified Items .

EXPECTATIONS FOR 2005

The Company anticipates that expenses for interest, other charges and taxes will increase in the range of 4 % to 6 % in 2005. This outlook is based on certain assumptions about events and developments that may not materialize or that may be offset entirely or partially by other events and developments. These assumptions include a normalized tax rate of between 32 % and 34 % on higher earnings in 2005 and a slight increase in interest expense associated with new debt that may be issued in 2005. A normalized tax rate of between 32 % and 34 % would be similar to the normalized tax rate in 2004.

In recent years, CPR has been using certain tax loss carryforwards to offset taxable income. The Company anticipates that these loss carryforwards will be exhausted by 2007 and CPR will have an increase in tax payments during that year.

fourth-quarter summary

OPERATING RESULTS

In the fourth quarter of 2004, the Company transported 60,491 million GTMs and 31,603 million RTMs of

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freight, compared with 58,887 million GTMs and 30,792 million RTMs in the fourth quarter of 2003. The increases were largely responsible for a 7 % rise in freight revenues in the fourth quarter of 2004, compared with the same period in 2003. There was also an increase in related variable expenses in the fourth quarter of 2004, compared with fourth-quarter 2003.

The Company reported net income of \$129.3 million in the fourth quarter of 2004, a decrease of \$44.7 million from \$174.0 million in the same period of 2003. The decrease was mainly due to a special charge of \$55.2 million after tax (\$90.9 million before tax) taken in the fourth quarter of 2004 to reflect clean-up costs for environmental contamination at a property in Minnesota (discussed further under the heading *Future Trends, Commitments and Risks* in this MD&A) and an FX gain on LTD. The FX gain on LTD in the fourth quarter of 2004 was \$55.8 million after tax, compared with \$72.0 million after tax in the same period in 2003. The decrease was partially offset by a \$12.4-million after-tax reversal (\$19.0 million before tax) of part of a restructuring charge taken in the second quarter of 2003, and a loss on the transfer of assets to an outsourcing firm of \$18.4 million after tax (\$28.9 million before tax) in the fourth quarter of 2003 (discussed further under the sub-heading *Other Specified Items* in this MD&A).

Operating income for the three-month period ended December 31, 2004, was \$161.1 million, a decrease of \$32.2 million from \$193.3 million in the same period of 2003. The decrease was mainly due to the special charge for environmental clean-up costs. This decrease was partially offset by higher

freight volumes, resulting in increased revenues in 2004 (discussed under the sub-heading *Revenues* below), partially offset by a corresponding increase in volume-related expenses. The decrease was also partially offset by the reversal of part of the restructuring charge taken in the second quarter of 2003, and the loss on the transfer of assets to an outsourcing firm in the fourth quarter of 2003.

Diluted EPS was \$0.81 in the fourth quarter of 2004, a decrease of \$0.28 from \$1.09 in the same period of 2003.

NON-GAAP EARNINGS

Income, excluding FX on LTD and other specified items, was \$116.3 million in the fourth quarter of 2004, an increase of \$2.5 million from \$113.8 million in fourth-quarter 2003. The increase was due to higher intermodal, grain, fertilizer and coal revenues, partially offset by an increase in fuel and compensation and benefits expenses (discussed in the *Revenues* and *Operating Expenses, before Other Specified Items* sections).

REVENUES

Total revenues were \$1,021.9 million in the fourth quarter of 2004, an increase of \$58.4 million from \$963.5 million in fourth-quarter 2003.

Grain

Grain revenues in the fourth quarter of 2004 were \$199.5 million, an increase of \$10.8 million from \$188.7 million in the same period of 2003, mainly due to higher volumes of U.S. grain for export, partially offset by the effect of Foreign Exchange.

Coal

Coal revenues were \$142.7 million, an increase of \$26.5 million from \$116.2 million, largely due to a strong steel market, which created higher

world demand for metallurgical coal, and a positive rate adjustment in the fourth quarter of 2004 as a result of a settlement for eastbound Canadian coal shipments.

Sulphur and Fertilizers

Sulphur and fertilizers revenues were \$108.7 million in the fourth quarter of 2004, an increase of \$10.2 million from \$98.5 million in 2003, mainly due to increased export potash shipments driven by higher demand in Brazil and East Asia.

Forest Products

Forest products revenues were \$79.0 million, an increase of \$5.3 million from \$73.7 million in 2003, mainly due to higher transportation rates, greater volumes for pulp and paper products and new newsprint business.

Industrial Products

Industrial products revenues were \$108.7 million in the fourth quarter of 2004, an increase of \$4.5 million from \$104.2 million in 2003 as a result of initiatives to increase rates, greater demand for steel driven by economic expansion and strong demand for export glycol.

Automotive

Automotive revenues were \$66.6 million in fourth-quarter 2004, a decrease of \$9.3 million from fourth-quarter 2003 revenues of \$75.9 million due to the effect of Foreign Exchange, a decline in demand for certain vehicle models in 2004 and reduced volumes related to the loss of certain business to a competing railway.

Intermodal

Intermodal revenues grew in the fourth quarter of 2004 to \$261.9 million, an increase of \$15.5 million from

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\$246.4 million in the same period of 2003. In the import/export business, growth was mainly due to increased volumes in the export sector 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 market was due to greater demand in retail businesses. Revenues in the import/export and domestic businesses also increased due to higher freight rates.

OPERATING EXPENSES, BEFORE OTHER SPECIFIED ITEMS

Operating expenses, before other specified items, in the fourth quarter of 2004 were \$788.9 million, an increase of \$47.6 million from \$741.3 million in the same period of 2003.

Compensation and Benefits

Compensation and benefits expense in fourth-quarter 2004 was \$326.8 million, an increase of \$20.9 million from \$305.9 million in the fourth quarter of 2003. The increase was largely due to higher incentive compensation and pension expenses, inflation and selective hiring to handle business growth, partially offset by the effect of Foreign Exchange and cost savings from workforce reductions.

Fuel

Fuel expense was \$123.4 million in fourth-quarter 2004, an increase of \$25.3 million from \$98.1 million in 2003 due to higher crude oil prices and volumes, partially offset by the positive results of CPR's fuel hedging program, the effect of Foreign Exchange, greater fuel efficiency and a refund of fuel excise taxes relating to prior years.

Materials

Materials expense was \$38.1 million, a decrease of \$3.2 million from \$41.3 million in 2003, mainly due to an adjustment to correct for overpayment to a supplier, partially offset by increased materials usage for locomotive repairs and servicing stemming from an increase in locomotive fleet size.

Equipment Rents

Equipment rents expense was \$46.6 million in the fourth quarter of 2004, a decrease of \$8.0 million from \$54.6 million in 2003 due to higher earnings from customers and railways for the use of CPR cars and the effect of Foreign Exchange, partially offset by additional leases acquired for locomotives and freight cars to handle additional freight volumes and higher freight car lease rates.

Depreciation and Amortization

Depreciation and amortization expense was \$102.1 million in 2004, an increase of \$5.2 million from \$96.9 million in the fourth quarter of 2003, due largely to additions to CPR's capital assets and increased depreciation rates on certain assets, particularly rail, partially mitigated by asset retirements.

Purchased Services and Other

Purchased services and other expense was \$151.9 million in fourth-quarter 2004, an increase of \$7.4 million from \$144.5 million in the same period of 2003. The increase was mainly due to payments to IBM under an outsourcing agreement that began in January 2004, higher joint-facility inter-railway expenditures and locomotive rebates in 2003, and increased consulting services, partially offset by lower costs

associated with derailments, mishaps and personal injury claims, and the positive effect of Foreign Exchange.

OTHER INCOME STATEMENT ITEMS

FX on LTD grew to \$57.2 million (\$55.8 million after tax) in fourth-quarter 2004, an increase of \$12.9 million from \$44.3 million (\$72.0 million after tax) in the same period of 2003. The increase was due to the effect of Foreign Exchange on U.S. dollar-denominated debt. Other charges were \$12.9 million in 2004, a slight decrease from \$13.4 million in 2003, reflecting a penalty payment for termination of a contract and interest paid on an income tax settlement in 2003, which offset the effect of Foreign Exchange on working capital accounts and gains realized on forward foreign exchange contracts. Interest expense was \$52.6 million in fourth-quarter 2004, an increase of \$2.3 million from \$50.3 million in 2003. The increase was due to interest on long-term debt issued to finance locomotives in the first quarter of 2004 and a rise in variable interest rates, partially offset by the effect of Foreign Exchange.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2004, the Company held \$353.0 million in cash and short-term investments, which was an increase of \$29.8 million during the fourth quarter of 2004. At December 31, 2003, CPR held \$134.7 million in cash and short-term investments, which was a decrease of \$225.3 million during the fourth quarter of 2003. The increase in cash was due primarily to lower pension contributions of \$112.9 million in the fourth quarter of 2004, compared with \$314.9 million (including a prepayment of pension funding of \$300.0 million) in the fourth quarter of 2003.

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quarterly financial data

(in millions, except per share data)	For the quarter ended							
	2004				2003 ⁽¹⁾			
(unaudited)	Dec. 31	Sept. 30	June 30	Mar. 31	Dec. 31	Sept. 30	June 30	Mar. 31
Total revenue	\$ 1,021.9	\$ 989.7	\$ 1,004.7	\$ 886.6	\$ 963.5	\$ 904.3	\$ 914.1	\$ 878.8
Operating income (loss)	\$ 161.1	\$ 218.9	\$ 220.6	\$ 116.0	\$ 193.3	\$ 203.6	\$ (29.2)	\$ 117.9
Net income	\$ 129.3	\$ 176.5	\$ 83.7	\$ 23.5	\$ 174.0	\$ 91.3	\$ 34.1	\$ 101.9
Basic earnings per share	\$ 0.81	\$ 1.11	\$ 0.53	\$ 0.15	\$ 1.10	\$ 0.57	\$ 0.22	\$ 0.64
Diluted earnings per share	\$ 0.81	\$ 1.11	\$ 0.53	\$ 0.15	\$ 1.09	\$ 0.57	\$ 0.22	\$ 0.64

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.

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 grain after the harvest, fall fertilizer programs and the transportation of consumer goods. First-quarter revenues can be lower mainly due 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.

Operating and net income in the fourth quarter of 2004 were negatively affected by a special charge for environmental clean-up costs associated with a property in Minnesota but were positively impacted by a

reversal of a portion of a special charge for restructuring that was originally recorded in the second quarter of 2003.

A special charge for restructuring and asset impairment recorded in the second quarter of 2003 and a loss on transfer of assets related to an outsourcing agreement with IBM in the fourth quarter of 2003 negatively 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 charges and the loss on transfer of assets.

changes in accounting policy

2004 ACCOUNTING CHANGES

The Company implemented the following new accounting policies during 2004 as a result of new developments in accounting standards.

Hedging Transactions

Effective January 1, 2004, the Company adopted the CICA Accounting Guideline 13 Hedging Relationships (AcG 13). AcG 13 addresses the identification, designation, documentation, and effectiveness of hedging transactions for the purpose of applying hedge

accounting. It also establishes conditions for applying, and the discontinuance of, hedge accounting and hedge effectiveness testing requirements. Under the new guideline, the Company is required to document its hedging transactions and explicitly demonstrate that hedges are effective in order to continue hedge accounting for positions hedged with derivatives. Any derivative financial instruments that fail to meet the hedging criteria are accounted for in accordance with Emerging Issues Committee Abstract 128 Accounting for Trading, Speculative or Non-Hedging Derivative Financial Instruments (EIC-128). These instruments are recorded on the Consolidated Balance Sheet at fair value and changes in fair value are recognized in income in the period in which the change occurs.

In connection with the implementation of AcG 13, the Company considered its hedging relationships at January 1, 2004, and determined that its cross-currency interest rate swap agreements, with a notional amount of \$105 million at December 31, 2003, no longer qualified for hedge accounting for Canadian GAAP purposes. These swap agreements are discussed further under the heading Financial Instruments .

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Beginning January 1, 2004, derivative instruments that do not qualify as hedges and those not designated as hedges are being carried on the Consolidated Balance Sheet at fair value and will result in gains and losses being recorded on the Statement of Consolidated Income. In 2004, a \$1.5-million pre-tax gain was reported in Other Charges on the Statement of Consolidated Income.

Further discussion of CPR's derivative instruments is provided under the heading Financial Instruments .

Asset Retirement Obligations

Effective January 1, 2004, the Company adopted retroactively with restatement the CICA Handbook Section 3110 Asset Retirement Obligations , which replaced the previous guidance on future removal costs included in the CICA Accounting Standard 3061 Property, Plant and Equipment . The new standard requires recognition of a liability at its fair value for any legal obligation associated with the retirement of property, plant and equipment when those obligations result from the acquisition, construction, development or normal operation of the assets. A corresponding asset retirement cost is added to the carrying amount of the related asset and amortized to expense on a systematic and rational basis. The standard does not allow the Company's prior practice of recognizing removal costs in excess of salvage proceeds over the life of the asset when the removal of the asset is not a legal obligation.

The effect on CPR's earnings from adopting this standard is discussed under the sub-heading Property, Plant and Equipment .

Stock-based Compensation

In the fourth quarter of 2003, CPR adopted the fair value-based approach of the CICA Handbook Section 3870 Stock-based Compensation and Other Stock-based Payments . The Company adopted the new accounting standard effective January 1, 2003, on a prospective basis for options issued for years beginning in 2003.

In 2004, Compensation and Benefits expense on the Statement of Consolidated Income increased \$5.8 million as a result of adopting this standard.

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, 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.

OPERATING ACTIVITIES

Cash provided by operating activities was \$786.0 million in 2004, an increase of \$480.3 million from \$305.7 million in 2003 and an increase of \$22.5 million from \$763.5 million in 2002. The increase in 2004 from 2003 was mainly due to a larger amount of cash being generated through earnings in 2004, an additional pension funding payment of \$300.0 million in the fourth quarter of 2003 and reduced restructuring

payments in 2004. The decrease in 2003 from 2002 was mainly due to the additional pension funding payment of \$300.0 million and lower net income in 2003.

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.

INVESTING ACTIVITIES

Cash used in investing activities was \$666.1 million in 2004, a decrease of \$34.2 million from \$700.3 million in 2003 and an increase of \$115.1 million from \$551.0 million in 2002. The decrease in 2004, compared with 2003, was mainly due to fewer locomotive acquisitions and a lower U.S. foreign exchange rate in 2004, partially offset by increases in capital spending on track projects. The increase in 2003, compared with 2002, was mainly due to higher capital spending on track projects, the purchase of new locomotives and increased funding to a joint venture.

Capital spending in 2005 is projected to be approximately \$760 million, mainly for track infrastructure renewal and locomotive acquisitions and overhauls. The Company's capital spending outlook is based on certain assumptions about events and developments that may not materialize or that may be offset entirely or partially by other events and developments. CPR's 2005 capital spending outlook assumes that capital additions will increase in 2005 from 2004 as a result of increased track-related investments, which are partly due to growing freight volumes.

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CPR intends to finance capital expenditures from free cash flow, but may finance some equipment with new debt, if required.

FINANCING ACTIVITIES

Cash provided by financing activities was \$98.4 million in 2004, a decrease of \$146.0 million from \$244.4 million in 2003 and an increase of \$582.9 million from cash used in financing activities of \$484.5 million in 2002. The decrease in cash provided in 2004, compared with 2003, was due to lower debt issuances in 2004. In 2004, debt was issued as described below, compared with the issue of 5.75 % US\$250-million Debentures and the \$350-million Medium Term Notes in 2003 (described below), partially offset by the redemption of the 6.875 % US\$250-million Debentures in the second quarter of 2003. The increase in 2003 over 2002 was due to the issuance of debt in 2003, partially offset by the redemption of debt in 2003 (described below) and the repayment of US\$250 million of debt in the second quarter of 2002.

CPR completed one Senior 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 completed two unsecured debt offerings in 2003 5.75 % US\$250-million Debentures issued March 2003, maturing March 2033, and 4.9 % \$350-million Medium Term Notes issued July 2003, maturing June 2010. The former was to refinance CPR's 6.875 % US\$250-million Notes that matured in April 2003. The latter was to take advantage of the low interest rate environment and provide funds for general operating purposes.

CPR has available, as sources of financing, credit facilities of up to \$545.0 million. CPR believes it can raise capital, within limits, 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 May 2004 to provide the financial flexibility to offer debt securities for sale. The Company plans to issue Medium Term Notes in the first half of 2005, primarily to finance the purchase of additional locomotives.

At December 31, 2004, CPR's net-debt to net-debt-plus-equity ratio improved to 42.9 %, compared with 46.9 % and 47.4 % at December 31, 2003 and 2002, respectively. The improvement in 2004, compared with 2003, was due primarily to the increase in equity from 2004 earnings and increased cash balances. The improvement in 2003, compared with 2002, was due primarily to the increase in equity from 2003 earnings, offset by decreased cash balances and a net increase in debt. 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 capital employed so that it retains solid investment-grade credit.

FREE CASH

Free cash is a non-GAAP measure that management considers an indicator of CPR's liquidity and ability to re-invest in the Company. 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 \$38.2 million in 2004, compared with negative free cash of \$475.4 million in 2003 and positive free cash of \$131.7 million in 2002. The increase in free cash in 2004, compared with 2003, was due largely to an increase in cash generated by operating activities (as discussed previously) and decreased capital expenditures in 2004. Negative free cash in 2003 resulted mainly from an extra pension funding payment of \$300.0 million in the fourth quarter of 2003 and lower net income and increased capital expenditures in 2003, compared with 2002.

CPR expects to generate free cash of \$50 million to \$100 million for the 2005 fiscal year, achieved mainly with higher earnings and lower restructuring payments, partially offset by an increase in capital expenditures.

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The Company's capital spending outlook is based on certain assumptions about events and developments that may not materialize or that may be offset entirely or partially by other events and developments. CPR's free cash

outlook relies on the assumptions established for earnings and capital expenditures, which were discussed previously in this MD&A under the sub-heading Revenues, and

under the headings Operating Expenses, Before Other Specified Items, Other Income Statement Items and Liquidity and Capital Resources.

CALCULATION OF FREE CASH
(reconciliation of free cash to GAAP cash position)

For the year ended December 31 (in millions) (unaudited)	2004	2003 ⁽¹⁾	2002 ⁽¹⁾
Cash provided by operating activities	\$ 786.0	\$ 305.7	\$ 763.5
Cash used in investing activities	(666.1)	(700.3)	(551.0)
Dividends paid on Common Shares	(81.7)	(80.8)	(80.8)
Free cash ⁽²⁾	38.2	(475.4)	131.7
Cash provided by (used in) financing activities, before dividend payment	180.1	325.2	(403.7)
Increase (decrease) in cash, as shown on the Statement of Consolidated Cash Flows	218.3	(150.2)	(272.0)
Net cash at beginning of period	134.7	284.9	556.9
Net cash at end of period	\$ 353.0	\$ 134.7	\$ 284.9

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

⁽²⁾ These measures have no standardized meanings prescribed by Canadian GAAP and, therefore, are unlikely to be comparable to similar measures of other companies.

balance sheet

Assets totalled \$10,499.8 million at December 31, 2004, compared with \$9,956.7 million at December 31, 2003, and \$9,664.3 million at December 31, 2002. The increase in 2004, compared with 2003, was mainly due to capital additions, most of which were locomotives and track replacement programs, and a larger cash balance from debt issuance in the first quarter of 2004. The increase in assets in 2003, compared with 2002, was mainly due to capital additions for locomotives and track replacement programs, and a larger pension asset from additional funding during 2003.

CPR's combined short-term and long-term liabilities were \$6,517.4 million at December 31, 2004, compared with total liabilities of \$6,302.1 million

at December 31, 2003, and \$6,296.0 million at December 31, 2002. The increases were mainly due to higher accrued payroll liabilities, most of which were for a more normal level of incentive compensation, and larger future income tax balances resulting from tax rate increases by the Province of Ontario. Trade accounts payable also increased, mainly for amounts owing to other railways for transporting CPR customers' freight.

At December 31, 2004, the Company's Consolidated Balance Sheet reflected \$3,982.4 million in equity, compared with equity balances of \$3,654.6 million and \$3,368.3 million at December 31, 2003 and 2002, respectively. The majority of the increases were due to CPR's growth in retained income in 2004 and 2003.

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 December 31, 2004, 158.8 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. CPR has authorized a maximum of 11.0 million Common Shares for issuance under the MSOIP. At December 31, 2004, 7.6 million of these options were outstanding.

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On July 21, 2003, CPR's Board of Directors suspended the Company's Directors' Stock Option Plan (DSOP), under which members of the Board of Directors were granted options to purchase CPR shares. The DSOP allowed each option granted to be exercised for one Common Share. The maximum number of Common Shares approved for issuance under the DSOP was 500,000. Outstanding options granted prior to suspension of the DSOP remain in effect with no amendments. At December 31, 2004, 160,000 of these options remained in effect. The DSOP was suspended as a result of a review by external

compensation consultants of the Company's compensation philosophy for its Board of Directors.

DIVIDENDS**Declared Dividends and Dividend Policy**

The Board of Directors will give consideration on a quarterly basis to the payment of future dividends. The amount of any future quarterly dividends will be determined based on a number of factors that may include the results of operations, financial condition, cash requirements and future prospects of the Company. The Company is, however, under no obligation to declare dividends

and the declaration of dividends is wholly within the Board of Directors' discretion. Further, the Board of Directors may cease declaring dividends or may declare dividends in amounts that are different from those previously declared. Restrictions in the credit or financing agreements entered into by the Company or the provisions of applicable law may preclude the payment of dividends in certain circumstances.

The details of dividends declared by the Board of Directors since the initial listing of CPR's Common Shares on the Toronto and New York stock exchanges in October 2001 are as follows:

Dividend amount	Record date	Payment date
\$0.1275	December 27, 2001	January 28, 2002
\$0.1275	March 27, 2002	April 29, 2002
\$0.1275	June 27, 2002	July 29, 2002
\$0.1275	September 27, 2002	October 28, 2002
\$0.1275	December 27, 2002	January 27, 2003
\$0.1275	March 28, 2003	April 28, 2003
\$0.1275	June 27, 2003	July 28, 2003
\$0.1275	September 26, 2003	October 27, 2003
\$0.1275	December 24, 2003	January 26, 2004
\$0.1275	March 26, 2004	April 26, 2004

\$0.1275	June 25, 2004	July 26, 2004
\$0.1325	September 24, 2004	October 25, 2004
\$0.1325	December 31, 2004	January 31, 2005
\$0.1325	March 25, 2005	April 25, 2005

financial instruments

The Company's policy with respect to hedging of risk exposure is to selectively reduce volatility associated with fluctuations in interest and foreign exchange rates and in the price of diesel fuel. CPR's policy is to prohibit the utilization of derivative financial and commodity instruments for trading or speculative purposes.

INTEREST RATE MANAGEMENT

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 interest rate locks as part of its interest rate risk management strategy.

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

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quarterly based on the London Interbank Offered Rate (LIBOR). These swaps expire in 2011 and are accounted for as a fair value hedge. Savings from these swaps reduced Interest Expense on the Statement of Consolidated Income by \$6.7 million in 2004. An unrealized gain of \$8.8 million from these interest rate swaps was calculated based on their fair value at December 31, 2004. The fair value of these swaps has not been recorded on the Consolidated Balance Sheet. Swap, currency and basis-spread curves from Reuters were utilized to establish the fair market value of the swaps. Values may vary marginally due to either the terms of the contract or minor variations in the time of day when the data was collected.

Concurrent with the issuance of its 4.9 % \$350-million Medium Term Notes in 2003, 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, which is discussed further under the heading Changes in Accounting Policy in this MD&A. The Company's unrealized gain from these swaps is being amortized over the life of the debt. At December 31, 2004, Deferred Liabilities on the Consolidated Balance Sheet included \$1.8 million for this deferred gain. Amortization of this gain reduced Other Charges on the Statement of Consolidated Income by \$0.4 million in 2004. Other Charges also included the additional costs or savings that arose when the swaps

were settled. The Company recorded savings of \$1.5 million from these agreements in 2004. In July 2004, the Company terminated these agreements and a loss of \$2.2 million from this settlement was included in Other Charges .

Interest Rate Locks

In the fourth quarter of 2004, CPR entered into eight treasury rate locks totalling US\$200 million to fix the benchmark interest rate on certain U.S. Medium Term Notes the Company plans to issue in the first half of 2005. Any gains or losses from this arrangement, which is accounted for as a cash flow hedge, are expected to be amortized over the life of the related debt issuance. An unrealized gain of \$1.8 million was calculated from these locks at December 31, 2004, using swap, currency and basis spread curves from Reuters to establish the fair market value of the locks. No realized or unrealized gains or losses from these locks were included in CPR's financial statements at December 31, 2004.

In 2003, CPR entered into six treasury rate locks totalling US\$124 million to fix the benchmark interest rate on the 5.41 % US\$145-million Senior Secured Notes offering, maturing in 2024. Upon termination of these locks in the first quarter of 2004, CPR realized a loss of \$2.0 million, which is being deferred and amortized over the 20-year life of the existing financing. At December 31, 2004, Other Assets and Deferred Charges on the Consolidated Balance Sheet included an unamortized loss of \$1.9 million from these agreements. Interest Expense on the 2004 Statement of Consolidated Income included \$0.1 million for amortization of this loss.

At December 31, 2004, Other Assets and Deferred Charges on the Consolidated Balance Sheet included an unamortized loss of \$18.3 million from interest rate locks settled in 2003 on \$200 million of long-term debt. The total loss is being amortized over seven years, which is the term of the underlying debt. Interest Expense on the 2004 Statement of Consolidated Income included \$3.3 million for amortization of this loss.

At December 31, 2004, Deferred Liabilities on the Consolidated Balance Sheet included an unamortized gain of \$8.9 million from interest rate locks settled in 2003 on US\$250 million of long-term debt. The total gain is being amortized over 30 years, which is the term of the underlying debt. Interest Expense on the 2004 Statement of Consolidated Income included \$0.3 million for amortization of this gain.

FOREIGN EXCHANGE MANAGEMENT

The Company enters into foreign exchange risk management transactions primarily to manage fluctuations in the exchange rate between Canadian and U.S. currencies. From time to time, the Company uses foreign exchange forward contracts as part of its foreign exchange risk management strategy. A portion of the U.S. dollar-denominated long-term debt has been designated as a hedge of the Company's net investment in self-sustaining foreign subsidiaries.

Foreign Exchange Forward Contracts

CPR hedged a portion of its U.S. dollar-denominated freight revenues earned in Canada by selling forward U.S. dollars. At December 31, 2004, the Company had US\$98.3 million of forward sales of U.S. dollars

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outstanding to be settled in 2005 and 2006. The unrealized gain on these forward contracts, calculated using the trading value of the U.S. dollar on the New York Stock Exchange, was \$0.2 million at December 31, 2004. No realized or unrealized gains or losses for these forwards were included in CPR's financial statements at December 31, 2004.

CPR also purchased forward contracts to manage some of its exposure to fluctuations related to certain short-term commitments in U.S. dollars due to changes in exchange rates between Canadian and U.S. dollars. These forward contracts were not designated as hedges. The contracts settled in the second quarter of 2004. Other Charges on the 2004 Statement of Consolidated Income were reduced by \$1.8 million as a result of realized gains from these contracts.

Cash Hedge

CPR designated US\$70 million of cash as a hedge of the Company's planned purchase of 41 locomotives in the first quarter of 2005. Any foreign exchange gain or loss realized on the cash will be applied against the purchase price of the locomotives. As at December 31, 2004, an unrealized foreign exchange loss of \$1.1 million was calculated on this hedge using the closing U.S. dollar foreign exchange rate obtained from the Bank of Canada on December 31, 2004. No realized or unrealized gains or losses for these forwards were included in CPR's financial statements at December 31, 2004.

FUEL PRICE MANAGEMENT

Crude Oil Futures

CPR enters into crude oil swap contracts to help mitigate future price increases related to the purchase of fuel. The Company generally enters into commodity swap purchase contracts. These contracts are marked-to-market every reporting period and the related unrealized gains or losses on these swaps are deferred until the related fuel purchases are realized.

An unrealized gain of \$32.0 million was calculated based on the fair value of the swaps, which was derived from the price of West Texas Intermediate (WTI), as quoted by recognized dealers or as developed based upon the present value of expected future cash flows discounted at the applicable U.S. Treasury Rate, LIBOR or swap spread. No unrealized gains or losses have been included in the Company's financial statements in 2004.

Fuel purchases and commodity swap contracts have an element of foreign exchange variability. The Company uses from time to time foreign exchange forward contracts to manage this element of fuel-price risk. The Company enters into purchase contracts of U.S. dollars because the Canadian dollar cost of fuel increases if the U.S. dollar appreciates relative to the Canadian dollar. Gains and losses on the crude oil swaps, coupled with foreign exchange forward contracts, offset increases and decreases in the cash cost of fuel.

An unrealized loss of \$8.8 million related to forward purchases of U.S. dollars was calculated based on the fair value of these forwards at December 31, 2004. Forward curves from Reuters were utilized to establish the fair value. The unrealized loss has not been recorded in the Company's financial statements in 2004.

Fuel expense was reduced by \$36.5 million in 2004 as a result of realized gains and losses arising from settled swaps and collars. No amounts

for the foreign exchange forwards have been included in the Company's financial statements for 2004, as none of the contracts has been realized.

For every US\$1 increase in the price of WTI, fuel expense, before hedging, will increase by approximately \$8 million, assuming current foreign exchange rates and fuel consumption levels. The Company has fuel hedges for approximately 31 % of its fuel purchases in 2005, representing unrealized gains of \$17.9 million at December 31, 2004.

off-balance sheet arrangements

SALE OF ACCOUNTS RECEIVABLE

In September 2004, the Company renewed its accounts receivable securitization program for a term of five years to September 2009. Under the terms of the renewal, the Company sold an undivided co-ownership interest in \$120.0 million of eligible freight receivables to an unrelated trust. The trust is a multi-seller trust and CPR is not the primary beneficiary. The Company may increase this sale amount up to a program limit of \$200.0 million. At December 31, 2004, the outstanding undivided co-ownership interest held by the trust under the accounts receivable securitization program was \$120.0 million (2003 \$120.0 million). Due to a relatively short collection cycle, the fair value of the undivided interest transferred to the trust in the accounts receivable securitization program approximated book value and the loss on the transaction was limited to the costs of funding and administering the program. The Company's loss of \$2.9 million (2003 \$4.1 million) on the securitization program was included in Other Charges on CPR's Statement of Consolidated Income. The Company

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has a retained interest of approximately 15 % of receivables sold, which is recorded in Accounts Receivable on CPR's Consolidated Balance Sheet. The Company cannot enter into an agreement with a third party with respect to its retained interest.

Receivables funded under the securitization program may not include delinquent, defaulted or written-off receivables, nor receivables that do not meet certain obligor-specific criteria, including concentrations in excess of prescribed limits. The Company maintains an adequate allowance for doubtful accounts based on expected collectibility of accounts receivable. Credit losses are based on specific identification of uncollectible accounts and the application of historical percentages by aging category. At December 31, 2004, allowances of \$3.6 million (2003 \$5.6 million) were recorded in Accounts Receivable. In 2004, \$2.8 million (2003 \$1.1 million) of accounts receivable were written off to Freight Revenues.

The Company has retained the responsibility for servicing, administering and collecting freight receivables sold. However, even though the Company acts as collector of all of the securitized receivables, it has no claim against the trust's co-ownership interest in the securitized receivables. No servicing asset or liability has been recorded, as the benefits CPR receives for servicing the receivables approximate the related costs. Proceeds from collections reinvested in the accounts receivable securitization program were \$382.4 million in 2004.

The securitization program is subject to standard reporting and credit-rating requirements for CPR and includes a provision of a monthly portfolio report that the pool of eligible receivables satisfies pre-established criteria that are reviewed and approved by Dominion Bond Rating Services and are standard for agreements of this nature. 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 Company complied with all termination tests in 2004.

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:

At December 31, 2004 (in millions)	Total	Payments due by period			
		Less than 1 year	1 - 3 years	3 - 5 years	After 5 years
Long-term debt	\$ 3,014.9	\$ 271.0	\$ 185.8	\$ 39.0	\$ 2,519.1
Capital lease obligations	336.1	4.7	14.5	17.2	299.7
Operating lease obligations ⁽¹⁾	633.8	146.7	215.9	112.4	158.8
Supplier purchase obligations	603.1	94.8	158.9	119.9	229.5
Other long-term liabilities reflected on the Company's Consolidated Balance Sheet ⁽²⁾	953.6	120.2	227.8	231.1	374.5

Total contractual obligations	\$ 5,541.5	\$ 637.4	\$ 802.9	\$ 519.6	\$ 3,581.6
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(1) CPR has guaranteed residual values on certain leased equipment with a maximum exposure of \$218.9 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. Pension payments are not included due to the volatility in calculating them. Pension payments are discussed further under the heading "Future Trends, Commitments and Risks" under the sub-heading "Pension Plan Deficit".

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foreign exchange

The Company is exposed to foreign exchange fluctuations on 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 8 % year-over-year in 2004, compared with 2003. The impact of this foreign exchange rate fluctuation on the Company's financial results is reflected on the Statement of Consolidated Income and the Consolidated Balance Sheet, net of the hedge discussed above.

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 \$0.01 change in the Canadian dollar affects operating income by approximately \$3 million.

U.S. dollar-denominated Consolidated 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.

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

CAPACITY CHALLENGES

Significant increases in rail traffic volumes have created capacity challenges for the 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 Coast. CPR is maximizing its freight handling capacity by purchasing or leasing new and more powerful locomotives, replacing older freight cars with more efficient and higher-capacity freight cars and hiring train crews, as

well as redesigning rail service and using

highly disciplined scheduled operating practices to increase productivity and efficiency. CPR is also employing a capacity allocation system for the rapidly expanding import container business on the Canadian West Coast and has entered into joint railway agreements that will improve capacity and service levels in the Vancouver area. CPR is considering a phased infrastructure expansion program that would increase network capacity in increments, beginning with the corridor west of Moose Jaw, Saskatchewan. The phased approach would enable CPR to expand with the rate of traffic growth, helping CPR derive maximum value from its investment, or to delay or reduce the scope of the phases as capacity improves on the existing network. However, network expansion will only begin should several preconditions be met, including the sustainability of traffic growth, improved margins and regulatory stability.

COMPANY GROWTH AND FLEXIBILITY

CPR has a substantial investment in fixed plant and equipment, and has limited flexibility to adjust output levels and expenditures in response to short-term declines in traffic, potentially resulting in a cyclical adverse impact on future earnings levels. However, CPR actively manages its processes and resources to control variable costs, increase efficiency and mitigate the negative effects of declines in freight traffic.

In 2005, CPR will continue its focus on revenue growth and cost reduction as well as improved utilization of its asset base. Targeted initiatives and price improvements are expected to drive revenue growth, including growth from value-added services provided by Canadian Pacific Logistics Solutions, CPR's logistics and supply chain division.

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CPR anticipates continued revenue gains in bulk commodities, assuming global demand remains strong.

CPR's traffic volumes and revenues are largely dependent upon the health and growth of the North American and global economies, exchange rates, and other factors affecting the volume and patterns of international trade. CPR's future grain transportation revenues may be negatively affected if there is a recurrence of drought conditions that existed in its grain collection areas in 2001, 2002 and the first half of 2003. CPR will attempt to mitigate the effects of any downward pressure on transportation revenues primarily through cost-containment measures.

Continuing cost-containment programs are vital to CPR achieving its financial performance targets. CPR plans to eliminate approximately 175 job positions in 2005 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.

Improved asset utilization is expected to result from further railcar modernization and from recent investments in information technology. Overall, the rail industry is continuing to leverage information technology to facilitate its dealings with suppliers and shippers. CPR's ongoing strategy is to apply information technology to improve its competitive position.

CPR's covered hopper car fleet consists of a mixture of owned and leased cars. A portion of the fleet used for the export of grain is leased from the Government of Canada, which has indicated a desire to sell or otherwise dispose of its cars. The potential impact of this on CPR's grain business cannot be ascertained until the government's decision is announced. However, in the event of a disposition, CPR has advocated a process that is market-driven and open to all interested parties.

CRUDE OIL PRICES

Diesel prices escalated further in 2004 and remain volatile due to supply disruptions, as well as political, labour and military unrest in some major oil-producing countries. CPR will continue to mitigate increases in fuel prices through fuel hedging, discussed under the heading "Financial Instruments" in this MD&A, and fuel surcharges. During December 2004, CPR decreased its exposure to rising fuel prices by increasing its hedged position to 31 % from 10 % of its anticipated fuel needs for 2005. In January 2005, CPR further increased its hedged purchases to 33 %. The Company is also reducing fuel costs by acquiring more fuel-efficient locomotives and employing fuel-efficiency initiatives in its Integrated Operating Plan (IOP), which is designed to increase system fluidity. Under the IOP, trains are scheduled based on available capacity to minimize congestion across CPR's network, which leads to fewer gallons of locomotive fuel being consumed. Additionally, the IOP optimizes locomotive utilization, allowing for increased train weights and a better match of horsepower to tonnage. Each of these improvements leads to lower fuel consumption per GTM.

BORDER SECURITY

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 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 implemented several regulatory security frameworks in 2004 that focused on the provision of advanced electronic cargo information. CPR is fully automated with both CBSA and CBP and provides the requisite shipment information electronically, well in advance of border arrival.

Under the joint Declaration of Principles signed in April 2003, CPR committed to work with CBSA and CBP to install a new Vehicle and Cargo Inspection System (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 CPR is currently working with CBP and CBSA on the fifth installation, located in Windsor, Ontario, which is expected to be complete by the third quarter of 2005. The Government of Canada and CPR have each committed up to \$4.1 million to secure the rail corridor between the Windsor VACIS facility and the U.S. border. This joint government-industry initiative is expected to enhance the security of

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U.S.-bound rail shipments while helping to ensure uninterrupted access to the U.S. market for CPR customers.

LABOUR RELATIONS

Train crew employees in Canada elected the Teamsters Canada Rail Conference (TCRC) as their bargaining agent in June 2004. CPR 's collective agreement with the former bargaining agent expired on December 31, 2002. A Memorandum of Settlement for a four-year collective agreement extending to the end of 2006 was achieved with the TCRC on November 13, 2004, and ratified by employees on January 17, 2005.

The Teamsters Canada Rail Conference, Maintenance of Way Employees Division (TCRC-MWD) was certified in July 2004 as bargaining agent for employees who maintain CPR 's track. The Company 's collective agreement with the former bargaining agent expired on December 31, 2003. A Memorandum of Settlement for a three-year collective agreement extending to the end of 2006 was achieved with the TCRC-MWD on January 14, 2005, and is currently being voted upon by employees.

CPR 's collective agreement with the Canadian Auto Workers (CAW), which represent employees who maintain and repair locomotives and freight cars, expired on December 31, 2004. A Memorandum of Settlement for a three-year collective agreement extending to the end of 2007 was achieved on February 11, 2005, and is being voted upon by employees.

Negotiations commenced in September 2004 with the International Brotherhood of Electrical Workers (IBEW), which represents signal maintainers. CPR 's collective agreement

with the IBEW expired at the end of 2004. Negotiations are continuing.

The Company is preparing for negotiations with the Rail Canada Traffic Controllers and the Canadian Pacific Police Association that are scheduled to commence in September 2005.

In the U.S., CPR is party to collective agreements with 29 bargaining units: 15 on its Soo Line Railroad (Soo Line) subsidiary and 14 on its Delaware and Hudson Railway (D&H) subsidiary.

Soo Line has renewed agreements with seven unions representing track maintainers, freight car repair employees, clerks, train dispatchers, signal repair employees, machinists and conductors. Tentative settlements have been reached with two other bargaining units, which represent electricians and communication workers, and yard supervisors. Negotiations are continuing with the six remaining bargaining units, which represent locomotive and car foremen, mechanical labourers, blacksmiths and boilermakers, sheet metal workers, police, and locomotive engineers. Negotiations with the Teamsters, representing locomotive engineers, are being assisted through mediation.

D&H has renewed agreements with five unions representing freight car repair employees, clerks, locomotive engineers, signal repair employees and mechanical supervisors. Negotiations are continuing with the remaining nine bargaining units, which represent track maintainers, conductors and trainpersons, engineering supervisors, machinists, yard supervisors, electricians, labourers, police, and pipefitters.

ENVIRONMENTAL

CPR has implemented a comprehensive Environmental Management System (EMS), which includes a general Environmental Protection Policy as well as policies and procedures that address specific issues and facilitate the

reduction of environmental risk. CPR also prepares an annual Corporate Environmental Plan that states the Company's environmental goals and objectives as well as strategies and tactics.

CPR has developed specific environmental programs to address areas such as air emissions, wastewater, management of vegetation, chemicals and waste, storage tanks and fuelling facilities, and environmental impact assessment. In addition, CPR continues to focus on preventing spills and other incidents that have a negative impact on the environment. As a precaution, the Company has established a Strategic Emergency Response Contractor network and located spill equipment kits across Canada and the U.S. to ensure a rapid and efficient response in the event of an environmental incident. CPR also regularly updates and tests emergency preparedness and response plans.

CPR has developed an environmental audit program that comprehensively, systematically and regularly assesses CPR's facilities for compliance with legal requirements and conformance of CPR's policies to accepted industry standards. Audits are followed by a formal Corrective Action Planning process to ensure findings are addressed in a timely manner. In addition, CPR's Board of Directors has established an Environmental and

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Safety Committee, which conducts a semi-annual comprehensive review of environmental issues.

In the fourth quarter of 2004, the Company recorded a \$90.9-million charge for costs associated with investigation, characterization, remediation and other applicable actions related to environmental contamination at a property in Minnesota, which includes areas previously leased to third parties. CPR is participating in the State of Minnesota's voluntary investigation and clean-up program at the east side of the property. The property is the subject of ongoing fieldwork being undertaken in conjunction with the appropriate State of Minnesota authorities to determine the extent and magnitude of the contamination and the appropriate remediation plan. CPR now has sufficient information to reasonably estimate clean-up and other applicable costs for the entire property. CPR expects to file with the State of Minnesota in 2005 a response action plan for the east side of the property.

The charge was taken in the fourth quarter of 2004 because future liability increases for this property became probable and subject to reasonable estimation, in accordance with applicable accounting standards, based on the present scientific and engineering knowledge about the property. The estimate may change as new information becomes available or new developments occur. The costs are expected to be incurred over approximately 10 years.

CPR has initiated litigation against two former lessees that it believes are responsible for a large portion of the contamination. Under applicable accounting rules, no recovery has

been accrued since any recovery is dependent upon the outcome of the lawsuit, which at present is scheduled for trial in 2007.

AGREEMENTS AND CONTRACT NEGOTIATIONS

On June 30, 2004, CPR and Norfolk Southern Railway (NSR) entered into a Memorandum of Understanding in an effort to improve the efficiency of railway operations and enhance rail service to customers in the northeastern U.S. On September 30, 2004, CPR and NSR entered into definitive agreements under which NSR will provide yard services to CPR at Buffalo, New York, and haul CPR traffic between Buffalo and Binghamton, New York. NSR also agreed to grant CPR trackage rights over certain NSR lines in the vicinity of Buffalo. Also on September 30, 2004, CPR and NSR entered into definitive agreements under which CPR will grant trackage rights to NSR between Binghamton and Saratoga Springs, New York. CPR will haul NSR traffic between Rouses Point, New York, and Saratoga Springs and CPR will provide yard services to NSR at Binghamton. The trackage rights between Binghamton and Saratoga Springs, and in the vicinity of Buffalo, were exempted from approval by the United States Surface Transportation Board (STB) on October 27, 2004, and petitions to revoke this exemption were dismissed on January 19, 2005. In addition, the Memorandum of Understanding contemplates that NSR will enter into an agreement granting CPR trackage rights over NSR lines between Detroit, Michigan, and Chicago, Illinois. These trackage rights will require the approval of or exemption by the STB as well as the construction by NSR of a short connecting track on the route between Detroit and Chicago. It is expected that

implementation of the agreements and the trackage rights between Detroit and Chicago will improve the profitability of CPR's operations in the northeastern U.S., and reduce costs and significantly improve service in the Detroit-Chicago corridor. These savings are expected to be realized beginning in 2005.

Coal shipper Elk Valley Coal Corporation (EVCC), pursuant to the rules of the Canadian Transportation Agency (CTA), referred the matter of rates and services for the transportation by CPR of coal from EVCC's Elkview mine in southeastern B.C. to the Port of Vancouver to an independent arbitrator. Notwithstanding that CPR maintains that this matter is governed by a confidential contract, which CPR claims governs the movement of coal from all five of EVCC's mines in southeastern B.C., the arbitrator ruled in CPR's favour. In a closely related matter, CPR has filed a

statement of claim against EVCC in respect of all five mines for failure to pay applicable rail freight charges in accordance with the confidential contract. In January 2005, EVCC and CPR agreed to suspend all legal proceedings and entered into non-binding mediation in an attempt to resolve all disputes between the parties. The disputes are not expected to affect the continued shipment of coal by CPR from EVCC's mines. The outcome of this matter could have a material impact on CPR's revenues and financial position.

PENSION PLAN DEFICIT

The Company's defined benefit pension plans' deficit was \$604.3 million at December 31, 2004. 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

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pension obligation is discounted using a discount rate that is a blended interest rate of high-quality corporate debt instruments. 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 debt securities 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. Adverse experience with respect to these factors could eventually increase funding and pension expense significantly, while favourable experience with respect to these factors could eventually decrease funding and pension expense significantly.

Between 51 % and 57 % of the plans' assets are invested in equity securities. As a result, stock market performance is the key driver in determining the pension fund's asset performance. Most of the plans' remaining assets are invested in debt securities, which, as mentioned above, provide a partial offset to the increase (or decrease) in CPR's pension deficit caused by decreases (or increases) in the discount rate.

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 deficit that, as a minimum, meet requirements as prescribed by Canadian pension supervisory authorities.

The Company made contributions of \$175.7 million to the defined benefit pension plans in 2004. The 2004 contribution amount reflected the Company's decision to treat the voluntary extra contribution of \$300.0 million made in December 2003 as a prepayment of contributions for 2004, 2005 and 2006.

The last actuarial valuation of CPR's main pension plan was completed as at January 1, 2004. The Company is currently undergoing an updated actuarial valuation of this plan as at January 1, 2005 (which will be completed by June 2005) and also expects to undergo an updated actuarial valuation as at January 1, 2006. The Company expects its pension contributions in 2005 and 2006 to be approximately \$300 million for the two years combined, with at least \$60 million of this total contributed in 2005. In deriving these amounts, the Company took into account the estimated impact of both of these valuations, along with other factors. The actual amount required to be contributed in 2005 and 2006 will also depend on CPR's actual experience in 2005 with such variables as investment returns, interest rate fluctuations and demographic changes.

FINANCIAL COMMITMENTS

In addition to the financial commitments of the Company mentioned previously under the headings "Off-Balance Sheet Arrangements" and "Contractual Commitments", the Company is party to certain other financial commitments discussed below.

Certain Other Financial Commitments

Amount of commitment per period

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At December 31, 2004 (in millions)	Total	2005	2006 & 2007	2008 & 2009	2010 & beyond
Letters of credit	\$ 314.9	\$ 314.9	\$	\$	\$
Surety bonds	22.1	22.1			
Capital commitments ⁽¹⁾	577.3	307.2	68.2	72.1	129.8
Offset financial liability	159.6	159.6			
Total commitments	\$ 1,073.9	\$ 803.8	\$ 68.2	\$ 72.1	\$ 129.8

⁽¹⁾ The Company has several contracts outstanding with termination payments ranging from \$nil to \$41.1 million per contract, and resulting in a minimum exposure of \$3.3 million and a maximum exposure of \$60.5 million, depending on the date of termination. These contracts terminate mainly between 2006 and 2013.

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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 letters of credit contract amounts currently included within CPR's revolving credit facility.

Capital Commitments

CPR remains committed to maintaining its current high level of plant quality and renewing its franchise. As part of this commitment, the Company is obligated to make various capital purchases for track programs, locomotive acquisitions and overhauls, freight cars, and land. At December 31, 2004, CPR had multi-year capital commitments of \$577.3 million in the form of signed contracts or letters of intent, mainly for locomotive overhaul agreements. Payments for these commitments are due in 2005 through 2018. These expenditures are expected to be financed by cash generated from operations.

Offset Financial Liability

The Company entered into a bank loan to finance the acquisition of certain equipment. At December 31, 2004, the loan had a balance of \$163.8 million, which was offset by a financial asset of \$159.6 million with the same financial institution. The remainder is included in Long-Term Debt on CPR's Consolidated Balance Sheet.

RESTRUCTURING

In the second quarter of 2003, CPR announced a restructuring program to eliminate 820 positions, which required an accrual of \$105.5 million for a labour liability. At that time, 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, and a further 296 positions by the end of 2004. CPR expects to complete the program's originally targeted 820 reductions by the end of 2005.

Productivity improvements stemming from these job eliminations are expected to reduce compensation and benefits expense by approximately \$58 million in 2005 and \$67 million annually in future years, compared with 2002, which was the last full year prior to the start of the restructuring program. Job reductions associated with the restructuring program contributed \$36 million in savings in 2004 (compared with \$35 million in anticipated savings in 2004), including \$11 million in the fourth quarter.

Cash payments for the elimination of these positions are expected to be \$13 million in 2005, \$9 million in 2006 and a total of \$19 million in the remaining years to 2010. 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.

CPR had cash payments related to severance under all restructuring initiatives and to CPR's environmental remediation program, described in this MD&A under the sub-heading "Critical Accounting Estimates", totalling \$88.8 million in 2004, compared with \$107.0 million in 2003 and \$119.3 million in 2002. Payments in 2005 are estimated to be \$80 million to \$90 million.

The total accrued restructuring and environmental liability included in CPR's Consolidated Balance Sheet at December 31, 2004, was \$448.7 million, of which \$95.0 million was included in "Accounts Payable" and \$353.7 million was included in "Deferred Liabilities".

The total liability included restructuring liabilities of \$275.8 million at December 31, 2004, compared with \$367.4 million at December 31, 2003.

Labour liabilities totalling \$269.7 million were included in total restructuring liabilities of \$275.8 million at December 31, 2004. Labour liabilities totalling \$358.2 million were included in total restructuring liabilities of \$367.4 million at December 31, 2003.

In 2004, payments made for all restructuring liabilities amounted to \$65.5 million, compared with payments of \$86.8 million in 2003.

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Payments in 2004 relating to the labour liabilities were \$62.2 million, compared with \$78.4 million in 2003.

Also included in the restructuring liabilities were 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 \$1.2 million in 2005. In 2004, payments relating to these liabilities were \$2.8 million.

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.

ENVIRONMENTAL LIABILITIES

Management estimates the probable costs to be incurred in the remediation of property 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.

Liabilities for environmental remediation may change from time to time as new information about previously untested sites becomes known. The net liability may also vary as the courts decide legal proceedings against outside parties responsible for contamination. These potential charges, which cannot be quantified at this time, are not expected to be material to the Company's financial position, but may materially affect income in the period in which the charge is recognized. Increased costs would be reflected as increases to Deferred Liabilities on CPR's Consolidated Balance Sheet and to Purchased Services and Other on CPR's Statement of Consolidated Income. Favourable court settlements would increase Accounts Receivable on

CPR's Consolidated Balance Sheet and decrease operating expenses.

In 2004, environmental liabilities were increased by \$101.0 million, largely due to a \$90.9-million charge for a property in Minnesota, as discussed under the heading Future Trends, Commitments and Risks in this MD&A. In 2003, the liabilities increased by \$5.5 million as the accruals were adjusted for various sites in the multi-year soil remediation program.

At December 31, 2004, the accrual for environmental remediation on CPR's Consolidated Balance Sheet amounted to \$172.9 million, of which the long-term portion amounting to \$149.9 million was included in Deferred Liabilities and the short-term portion amounting to \$23.0 million was included in Accounts Payable and Accrued Liabilities. Costs incurred under CPR's environmental remediation program are charged against the accrual. Total payments were \$23.3 million in 2004. The U.S. dollar-denominated portion of the liability was affected by Foreign Exchange, resulting in an increase in environmental liabilities of \$0.4 million in 2004.

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 and post-retirement benefits liabilities are subject to various external influences and

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uncertainties, as described under the sub-heading Pension Plan Deficit .

Pension costs are actuarially determined using the projected-benefit method prorated over the credited service periods of employees. This method incorporates management's best estimate of expected plan investment performance, salary escalation and retirement ages of employees. The expected return on fund assets is calculated using market-related asset values developed from a five-year average of market values for the fund's equity securities (with each prior year's market value adjusted to the current date for assumed investment income during the intervening period) plus the market value of the fund's fixed income and real estate securities. The discount rate used to determine the benefit obligation is based on market interest rates on high-quality corporate debt instruments with matching cash flows. Unrecognized actuarial gains and losses in excess of 10 % of the greater of the benefit obligation and the market-related value of plan assets are amortized over the expected average remaining service period of active employees expected to receive benefits under the plan (approximately 12 years). Prior service costs arising from plan amendments are amortized over the expected average remaining service period of active employees who were expected to receive benefits under the plan at the date of amendment. A transitional asset and obligation arising from implementing the CICA Accounting Standard Section 3461 Employee Future Benefits , effective January 1, 2000, is being amortized

over the expected average remaining service period of active employees who were expected to receive benefits under the plan at January 1, 2000 (approximately 13 years).

Other Assets and Deferred Charges on CPR's December 31, 2004, Consolidated Balance Sheet included prepaid pension costs of \$838.3 million. This accrued benefit asset is increased by amounts contributed to the plans by the Company, offset by the amount of pension expense for the year, with the major influence being the amount of the contributions. CPR's Consolidated Balance Sheet also included \$4.5 million in Accounts Receivable for prepaid pension costs, and \$0.3 million in Accounts Payable and Accrued Liabilities and \$1.9 million in Deferred Liabilities for pension obligations.

The obligations with respect to post-retirement benefits, including health care, workers' compensation in Canada and life insurance, are actuarially determined and accrued using the projected-benefit method prorated over the credited service periods of employees. Fluctuations in the post-retirement benefit obligation are caused by changes in the discount rate used. A 1.0 percentage point increase (decrease) in the discount rate would decrease (increase) the liability by approximately \$50 million. Post-retirement benefits accruals of \$147.3 million were included in Deferred Liabilities , and post-retirement benefits accruals of \$3.7 million were included in Accounts Payable and Accrued Liabilities on CPR's December 31, 2004, Consolidated Balance Sheet.

Pension and post-retirement benefits expenses (excluding workers' compensation benefits) were included in Compensation and Benefits on CPR's December 31, 2004, Statement of Consolidated Income. In 2004, pension expense was \$28.0 million, consisting of defined benefit pension expense of \$25.1 million plus defined contribution pension expense (equal to contributions) of \$2.9 million. Post-retirement benefits expense in 2004 was \$40.8 million, resulting in combined pension and post-retirement benefits expenses of \$68.8 million for the year.

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.

Depreciation represents a significant part of the Company's operating expenses. 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 December 31, 2004, Consolidated Balance Sheet. Depreciation expense relating to properties amounted to \$407.1 million in 2004. At December 31, 2004, accumulated depreciation was \$4,482.6 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

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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 expense. For example, if the estimated average life of road locomotives, the Company's largest asset group, increased (or decreased) by 5 %, annual depreciation expense would decrease (or increase) by approximately \$3 million.

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. Estimated service lives and salvage rates are based on historical retirement records whenever feasible. In cases where there are new asset types or there is insufficient retirement experience, the depreciation lives and salvage parameters are based on engineering or other expert opinions in the field. In 2004, depreciation expense increased \$23 million due to rate revisions for track-related assets.

In the first quarter of 2004, the Company adopted the CICA accounting standard for Asset Retirement Obligations, discussed previously in CPR's first-quarter 2004 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 of the asset is not a legal obligation. Adopting this standard retroact