

Management's discussion and analysis (MD&A) relates to the financial condition and results of operations of Canadian National Railway Company, together with its wholly-owned subsidiaries, collectively "CN" or "the Company." Canadian National Railway Company's common shares are listed on the Toronto and New York stock exchanges. Except where otherwise indicated, all financial information reflected herein is expressed in Canadian dollars and determined on the basis of United States generally accepted accounting principles (U.S. GAAP). The Company's objective is to provide meaningful and relevant information reflecting the Company's financial condition and results of operations. In certain instances, the Company may make reference to certain non-GAAP measures that, from management's perspective, are useful measures of performance. The reader is advised to read all information provided in the MD&A in conjunction with the Company's 2006 Annual Consolidated Financial Statements and Notes thereto.

Business profile

CN is engaged in the rail and related transportation business. CN's network of approximately 20,300 route miles of track spans Canada and mid-America, connecting three coasts: the Atlantic, the Pacific and the Gulf of Mexico. CN's extensive network, in addition to co-production arrangements, routing protocols, marketing alliances, and interline agreements, provide CN customers access to all three North American Free Trade Agreement (NAFTA) nations.

CN's freight revenues are derived from seven commodity groups representing a diversified and balanced portfolio of goods transported between a wide range of origins and destinations. This product and geographic diversity positions the Company well to face economic fluctuations and enhances its potential for growth opportunities. In 2006, no individual commodity group accounted for more than 23% of revenues. From a geographic standpoint, 22% of revenues came from U.S. domestic traffic, 32% from transborder traffic, 23% from Canadian domestic traffic and 23% from overseas traffic. The Company originates approximately 87% of traffic moving along its network, which allows it both to capitalize on service advantages and build on opportunities to efficiently use assets.

Corporate organization

The Company manages its rail operations in Canada and the United States as one business segment. Financial information reported at this level, such as revenues, operating income and cash flow from operations, is used by the Company's corporate management in evaluating financial and operational performance and allocating resources across CN's network. The Company's strategic initiatives, which drive its operational direction, are developed and managed centrally by corporate management and are communicated to its regional activity centers (the Western Region, Eastern Region and Southern Region), whose role is to manage the day-to-day service requirements of their respective territories, control direct costs incurred locally, and execute the corporate strategy and operating plan established by corporate management.

See Note 16 – Segmented information, to the Company's Annual Consolidated Financial Statements for additional information on the Company's corporate organization, as well as selected financial information by geographic area.

Strategy overview

CN's focus is on running a safe and efficient railroad. While remaining at the forefront of the rail industry, CN's goal is to be internationally regarded as one of the best-performing transportation companies.

CN is committed to creating value for both its customers and shareholders. By providing quality and cost-effective service, CN seeks to create value for its customers. By striving for sustainable financial performance through profitable growth, solid free cash flow and a high return on investment, CN seeks to deliver increased shareholder value.

CN has a unique business model, which is anchored on five principles: providing quality service, controlling costs, focusing on asset utilization, committing to safety, and developing people. "Precision railroading" is at the core of CN's business model. It is a highly disciplined process whereby CN handles individual rail shipments according to a specific trip plan and manages all aspects of railroad operations to meet customer commitments efficiently and profitably.

Precision railroading demands discipline to execute the trip plan, the relentless measurement of results, and the use of such results to generate further execution improvements. Precision railroading increases velocity, improves reliability, lowers costs, enhances asset

utilization and, ultimately, helps the Company to grow the top line. It has been a key contributor to CN's continued earnings growth and improved return.

The Company sees further significant opportunities to grow the business and improve productivity. While the recent slowdown in the economy has affected CN in specific markets such as key forest products, construction materials and automotive products, there are several opportunities that extend beyond business-cycle considerations. In Intermodal, the opening of the Prince Rupert Intermodal Terminal in the fourth quarter of 2007 will allow CN to leverage the potential of the growing container trade between Asia and North America. In Bulk, the Company expects to continue to benefit from increased resource demand, particularly as it relates to the recent coal mine expansion. In Merchandise, the Company sees growth potential for a number of commodities, particularly pipes, machinery and equipment, condensate and other commodities associated with oil and gas development in western Canada. In Automotive, manufacturers continue to invest in CN-served plants in Michigan and Ontario. In general, while the Company expects a moderate slowdown in the North American economy in the near term, its business prospects assume positive economic conditions in North America and globally.

The opportunities to further improve productivity extend across all functions in the organization. In Transportation, the Company is aiming to continue to increase productivity on the track and in the yards. Yard throughput is being improved through SmartYard, an innovative use of real-time traffic information to sequence cars effectively and get them out on the line more quickly in the face of constantly changing conditions. In Engineering, the Company is working to increase the productivity of its field forces, again through better use of traffic information and, as a result, better management of its engineering forces on the track. The Company also intends to maintain a solid focus on reducing accidents and related costs, and also costs for legal claims and health care.

CN's capital programs support the Company's commitment to the five principles and its ability to grow the business profitably. In 2007, CN plans to spend \$1.6 billion on capital programs. Of this, more than \$1 billion is targeted towards track infrastructure to maintain a safe railway and to improve the productivity and fluidity of the network, and includes the replacement of rail, ties, and other track materials, as well as the improvement of bridges. This amount also includes funds for strategic initiatives, such as siding extensions to accommodate container traffic from the Prince Rupert Intermodal Terminal, the addition of new siding capacity between Winnipeg and Chicago, the upgrade of the Company's freight car classification yard in Memphis, Tennessee, and additional enhancements to the track infrastructure in western Canada to take advantage of growth prospects in North American trade with Asia and the boom in the west.

CN's equipment spending, targeted to reach approximately \$350 million, is intended to tap growth opportunities and to improve the quality of the fleet to meet customer requirements. This expenditure includes the acquisition of new fuel-efficient locomotives and freight cars, as well as improvements to the existing fleet. CN also expects to spend approximately \$200 million on facilities to grow the business, including transloads and distribution centers, on information technology to improve service and operating efficiency, and on other projects to increase productivity.

The Company's commitment to safety is reflected in the wide range of initiatives that CN is pursuing and the size of its capital programs. Comprehensive plans are in place addressing the issues of safety, security, employee well-being and environmental management. CN's Integrated Safety Plan is the framework for putting safety at the center of its day-to-day operations. This proactive plan is designed to minimize risk and drive continuous improvement in the reduction of injuries and accidents, is fully supported by senior management, and engages employees at all levels of the organization. CN also insists that its operations be conducted in compliance with all applicable regulations to maintain a safe, secure and healthy workplace.

Environmental protection is also an integral part of CN's day-to-day activities. A combination of key resource people, training, policies, monitoring and environmental assessments helps to ensure that the Company's operations comply with CN's Environmental Policy, a copy of which is available on CN's website.

CN's ability to develop the best railroaders in the industry has been a key contributor to the Company's success. CN recognizes that without the right people – no matter how good a service plan or business model a company may have – it will not be able to fully execute. The Company is focused on recruiting the right people, developing employees with the right skills, motivating them to do the right thing, and training them to be the future leaders of the Company.

The forward-looking statements provided in the above section and in other parts of this MD&A are subject to risks and uncertainties that could cause actual results or performance to differ materially from those expressed or implied in such statements and are based on certain factors and assumptions which the Company considers reasonable, about events, developments, prospects and opportunities that may not materialize or that may be offset entirely or partially by other events and developments. See the Business risks section of this MD&A for assumptions and risk factors affecting such forward-looking statements.

Financial and statistical highlights

\$ in millions, except per share data, or unless otherwise indicated

	2006	2005	2004
Financial results			
Revenues	\$ 7,716	\$ 7,240	\$ 6,548
Operating income	\$ 3,030	\$ 2,624	\$ 2,168
Net income ⁽¹⁾	\$ 2,087	\$ 1,556	\$ 1,258
Operating ratio	60.7%	63.8%	66.9%
Basic earnings per share ⁽¹⁾	\$ 3.97	\$ 2.82	\$ 2.21
Diluted earnings per share ⁽¹⁾	\$ 3.91	\$ 2.77	\$ 2.17
Dividend declared per share	\$ 0.65	\$ 0.50	\$ 0.39
Financial position			
Total assets	\$ 24,004	\$ 22,188	\$ 22,365
Total long-term financial liabilities	\$ 12,066	\$ 10,981	\$ 10,822
Statistical operating data and productivity measures			
Employees (average during period)	21,685	22,246	22,470
Gross ton miles (GTM) per average number of employees (thousands)	16,277	15,414	14,811
GTM's per U.S. gallon of fuel consumed	880	851	851

⁽¹⁾ The 2006 figures included a deferred income tax recovery of \$277 million (\$0.53 per basic share or \$0.51 per diluted share), resulting from the enactment of lower federal and provincial corporate tax rates in Canada and the resolution of matters pertaining to prior years' income taxes.

Financial results

2006 compared to 2005

In 2006, net income increased by \$531 million, or 34%, to \$2,087 million, when compared to 2005, with diluted earnings per share rising 41%, to \$3.91. Included in the 2006 figures was a deferred income tax recovery of \$277 million (\$0.53 per basic share or \$0.51 per diluted share), resulting from the enactment of lower federal and provincial corporate tax rates in Canada and the resolution of matters pertaining to prior years' income taxes.

Revenues increased by \$476 million, or 7%, to \$7,716 million, mainly due to freight rate increases and volume growth, particularly for grain, intermodal and metals and minerals, which were partly offset by the translation impact of the stronger Canadian dollar on U.S. dollar-denominated revenues.

Operating expenses increased by \$70 million, or 2%, to \$4,686 million, mainly due to increased fuel costs, purchased services and material expense and depreciation. Partly offsetting these factors was the translation impact of the stronger Canadian dollar on U.S. dollar-denominated expenses and lower casualty and other expense.

The operating ratio, defined as operating expenses as a percentage of revenues, was 60.7% in 2006 compared to 63.8% in 2005, a 3.1-point betterment.

Foreign exchange fluctuations have had an impact on the comparability of the results of operations. In 2006, the continued appreciation in the Canadian dollar relative to the U.S. dollar, which has affected the conversion of the Company's U.S. dollar-denominated revenues and expenses, has resulted in a reduction to net income of approximately \$60 million.

Revenues

	Year ended December 31,		2006	2005	% Change
Total revenues (millions)	\$	7,716	\$	7,240	7%
Rail freight:					
Revenues (millions)	\$	7,371	\$	6,905	7%
RTMs (millions)		185,610		179,701	3%
Revenue/RTM (cents)		3.97		3.84	3%
Carloads (thousands)		4,824		4,841	-
Revenue/carload (dollars)		1,528		1,426	7%

Revenues for the year ended December 31, 2006 totaled \$7,716 million compared to \$7,240 million in 2005. The increase of \$476 million, or 7%, was mainly due to freight rate increases of approximately \$500 million, of which approximately 40% was due to a higher fuel surcharge that mainly resulted from increases in crude oil prices; and volume growth, particularly for grain, intermodal and metals and minerals. Partly offsetting these gains was the \$255 million translation impact of the stronger Canadian dollar on U.S. dollar-denominated revenues.

In 2006, revenue ton miles (RTMs), measuring the relative weight and distance of rail freight transported by the Company, increased by 3% relative to 2005. Freight revenue per revenue ton mile, a measurement of yield defined as revenue earned on the movement of a ton of freight over one mile, increased by 3% in 2006 when compared to 2005, largely due to freight rate increases that were partly offset by the translation impact of the stronger Canadian dollar on U.S. dollar-denominated revenues and an increase in the average length of haul.

Petroleum and chemicals

	Year ended December 31,		2006	2005	% Change
Revenues (millions)	\$	1,173	\$	1,096	7%
RTMs (millions)		31,868		31,235	2%
Revenue/RTM (cents)		3.68		3.51	5%

Petroleum and chemicals comprises a wide range of commodities, including chemicals, sulfur, plastics, petroleum and natural gas products. Although offshore markets continue to grow strongly, the primary markets for these commodities are still within North America. As such, the performance of this commodity group is closely correlated with the North American economy. Most of the Company's petroleum and chemicals shipments originate in the Louisiana petrochemical corridor between New Orleans and Baton Rouge; in northern Alberta, which is a major center for natural gas, feedstock, and world scale petrochemicals and plastics complex derivatives; and in eastern Canadian regional plants. These shipments are destined for customers in Canada, the United States and overseas. For the year ended December 31, 2006, revenues for this commodity group increased by \$77 million, or 7%, from 2005. The improvement in this commodity group was mainly due to freight rate increases and increased shipments of condensate for oil sands-related development, and plastics and petrochemicals. These gains were partly offset by the translation impact of the stronger Canadian dollar; lower petroleum products shipments in the second quarter of 2006 due to a temporary refinery shutdown; reduced spot shipments of heavy fuel oils in eastern Canada; lower liquefied petroleum gas shipments on account of warmer weather conditions; and a reduction in sulfur shipments in western Canada, particularly in the fourth quarter due to inclement weather. Revenue per revenue ton mile increased by 5% in 2006, largely due to freight rate increases that were partly offset by the translation impact of the stronger Canadian dollar and an increase in the average length of haul.

Percentage of revenues

Chemicals	40%
Petroleum and plastics	60%

	2002	2003	2004	2005	2006
Carloads*	543	564	596	594	590

(In thousands)

*Includes the former Great Lakes Transportation LLC's railroads and related holdings (GLT) from May 10, 2004 and the former BC Rail (BC Rail) from July 14, 2004.

Metals and minerals

	Year ended December 31,		2005	% Change
	2006	2005		
Revenues (millions)	\$ 885	\$ 837		6%
RTMs (millions)	17,467	16,848		4%
Revenue/RTM (cents)	5.07	4.97		2%

The metals and minerals commodity group consists primarily of nonferrous base metals, iron ore, steel, equipment and parts and construction materials. The Company's unique rail access to major mines, ports and smelters throughout North America has made the Company a leader in the transportation of copper, lead, zinc, concentrates, iron ore, refined metals and aluminum. Construction materials are mainly aggregates (stone and sand) and cement. The Company has access to major cement producers and aggregate mines in Canada as well as in the U.S. Metals and minerals traffic is sensitive to fluctuations in the economy. For the year ended December 31, 2006, revenues for this commodity group increased by \$48 million, or 6%, from 2005. The improvement in this commodity group was mainly due to freight rate increases; strong shipments of Canadian long steel products, primarily pipes for oil sands-related development; increased volumes of U.S. iron ore and raw materials for steel production due to higher demand, despite temporary fourth-quarter 2006 production issues at a customer plant; and strong machinery and dimensional loads traffic also for oil sands-related development. Partly offsetting these gains was the translation impact of the stronger Canadian dollar and reduced construction material shipments, particularly in the fourth quarter of 2006 due to softening demand. Revenue per revenue ton mile increased by 2% in 2006, mainly due to freight rate increases that were partly offset by the translation impact of the stronger Canadian dollar and an increase in the average length of haul.

Percentage of revenues

Metals	55%
Minerals	25%
Iron ore	20%

	2002	2003	2004	2005	2006
Carloads*	388	396	801	994	981

(In thousands)

*Includes GLT from May 10, 2004 and BC Rail from July 14, 2004.

Forest products

	Year ended December 31,		2005	% Change
	2006	2005		
Revenues (millions)	\$ 1,745	\$ 1,738		-
RTMs (millions)	42,488	42,330		-
Revenue/RTM (cents)	4.11	4.11		-

The forest products commodity group includes various types of lumber, panels, wood chips, wood pulp, printing paper, linerboard and newsprint. The Company has superior rail access to the western and eastern Canadian fiber-producing regions, which are among the largest fiber source areas in North America. In the United States, the Company is strategically located to serve both the Midwest and southern U.S. corridors with interline capabilities to other Class I railroads. The key drivers for the various commodities are: for newsprint, advertising lineage and overall economic conditions, primarily in the United States; for fibers (mainly wood pulp), the consumption of paper worldwide; and for lumber and panels, housing starts and renovation activities in the United States. Although demand for forest products can be cyclical, the Company's geographical advantages and product diversity tend to reduce the impact of market fluctuations. For the year ended December 31, 2006, revenues for this commodity group increased by \$7 million, remaining relatively flat when compared to 2005. The improvement in this commodity group was mainly due to freight rate increases and increased lumber shipments originating from western Canada in the first half of the year. Largely offsetting these gains was the translation impact of the stronger Canadian dollar; a reduction in pulp and paper shipments due to continued weak market conditions and related mill closures; and lower lumber shipments originating from eastern Canada, particularly driven by mill closures in the fourth

quarter of 2006. Revenue per revenue ton mile was flat in 2006 when compared to 2005, mainly due to freight rate increases that were offset by the translation impact of the stronger Canadian dollar and an increase in the average length of haul.

<u>Percentage of revenues</u>	
Lumber	34%
Fibers	31%
Paper	22%
Panels	13%

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Carloads*	626	618	678	712	667
<i>(In thousands)</i>					

*Includes GLT from May 10, 2004 and BC Rail from July 14, 2004.

Coal

	<u>Year ended December 31,</u>			
	<u>2006</u>	<u>2005</u>	<u>% Change</u>	
Revenues (millions)	\$ 375	\$ 331	13%	
RTMs (millions)	13,727	13,576	1%	
Revenue/RTM (cents)	2.73	2.44	12%	

The coal commodity group consists primarily of thermal grades of bituminous coal. Canadian thermal coal is delivered to power utilities primarily in eastern Canada, while in the United States, thermal coal is transported from mines served in southern Illinois, or from western U.S. mines via interchange with other railroads, to major utilities in the Midwest and southeast United States. The coal business also includes the transport of Canadian metallurgical coal, which is largely exported to Asian steel producers. For the year ended December 31, 2006, revenues for this commodity group increased by \$44 million, or 13%, from 2005. The improvement in this commodity group was mainly due to the expansion of metallurgical coal mines in western Canada and freight rate increases. Partly offsetting these gains was a decline in CN shipments originating from U.S. coal mines; the translation impact of the stronger Canadian dollar; and the loss of export shipments of petroleum coke due to adverse market conditions. The revenue per revenue ton mile increase of 12% in 2006 was mainly due to freight rate increases, which were partly offset by the translation impact of the stronger Canadian dollar and an increase in the average length of haul.

<u>Percentage of revenues</u>	
Coal	86%
Petroleum coke	14%

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Carloads*	435	406	429	448	411
<i>(In thousands)</i>					

*Includes GLT from May 10, 2004 and BC Rail from July 14, 2004.

Grain and fertilizers

	<u>Year ended December 31,</u>			
	<u>2006</u>	<u>2005</u>	<u>% Change</u>	
Revenues (millions)	\$ 1,259	\$ 1,119	13%	
RTMs (millions)	44,096	40,393	9%	
Revenue/RTM (cents)	2.86	2.77	3%	

The grain and fertilizers commodity group depends primarily on crops grown and fertilizers processed in western Canada and the U.S. Midwest. The grain segment consists of three primary commodities: food grains, mainly wheat; oilseeds and oilseed products, primarily canola seed, oil and meal; and feed grains, including feed barley, feed wheat and corn. Production of grain varies considerably from year to year, affected primarily by weather conditions. Grain exports are sensitive to the size and quality of the crop produced, international market conditions and foreign government policy. The majority of grain produced in western Canada and moved by CN is exported via

the ports of Vancouver, Prince Rupert and Thunder Bay. Certain of these rail movements are subject to government regulation and to a "revenue cap," which effectively establishes a maximum revenue entitlement that railways can earn. In the U.S., grain grown in Illinois and Iowa is exported, as well as transported to domestic processing facilities and feed markets. The Company also serves major producers of potash in Canada, as well as producers of ammonium nitrate, urea and other fertilizers across Canada and the U.S. For the year ended December 31, 2006, revenues for this commodity group increased by \$140 million, or 13%, from 2005. The improvement in this commodity group was mainly due to freight rate increases; higher shipments of U.S. corn mainly due to a larger harvest; stronger volumes of Canadian wheat due to a high quality crop; and increased shipments of canola. These gains were partly offset by the translation impact of the stronger Canadian dollar; decreased shipments of potash and other fertilizers due in part to soft North American market conditions; and decreased Canadian barley shipments. Revenue per revenue ton mile increased by 3% in 2006, largely due to freight rate increases that were partly offset by the translation impact of the stronger Canadian dollar and an increase in the average length of haul.

Percentage of revenues

Food grain	28%
Feed grain	27%
Oilseeds	27%
Fertilizers	10%
Potash	8%

	2002	2003	2004	2005	2006
Carloads* (In thousands)	539	552	577	566	594

*Includes GLT from May 10, 2004 and BC Rail from July 14, 2004.

Intermodal

	Year ended December 31,		2006	2005	% Change
Revenues (millions)		\$	1,420	\$ 1,270	12%
RTMs (millions)			32,922	32,184	2%
Revenue/RTM (cents)			4.31	3.95	9%

The intermodal commodity group is comprised of two segments: domestic and international. The domestic segment transports consumer products and manufactured goods, operating through both retail and wholesale channels, within domestic Canada, domestic U.S., Mexico and transborder, while the international segment handles import and export container traffic, directly serving the major ports of Vancouver, Montreal, Halifax and New Orleans. The domestic segment is driven by consumer markets, with growth generally tied to the economy. The international segment is driven by North American economic and trade conditions. For the year ended December 31, 2006, revenues for this commodity group increased by \$150 million, or 12%, from 2005. The improvement in this commodity group was mainly due to freight rate increases; growth in international container traffic, primarily from Asia; and increased domestic movements, particularly to transborder markets and western Canada. Partly offsetting these gains was the translation impact of the stronger Canadian dollar. The revenue per revenue ton mile increase of 9% in 2006 was largely due to freight rate increases and a decrease in the average length of haul, which were partly offset by the translation impact of the stronger Canadian dollar.

Percentage of revenues

Domestic	48%
International	52%

	2002	2003	2004	2005	2006
Carloads* (In thousands)	1,237	1,276	1,202	1,248	1,326

*Includes GLT from May 10, 2004 and BC Rail from July 14, 2004.

Automotive

	Year ended December 31,			
	2006	2005	% Change	
Revenues (millions)	\$ 514	\$ 514	-	
RTMs (millions)	3,042	3,135	(3%)	
Revenue/RTM (cents)	16.90	16.40	3%	

The automotive commodity group moves both finished vehicles and parts, originating in southern Ontario, Michigan and Mississippi, and destined for the United States, Canada and Mexico. The Company's broad coverage, including its access to all of the Canadian assembly plants, enables it to consolidate full trainloads of automotive traffic for delivery to connecting railroads at key interchange points. The Company also serves shippers of import vehicles via the ports of Halifax and Vancouver, and through interchange with other railroads. The Company's automotive revenues are closely correlated to automotive production and sales in North America. For the year ended December 31, 2006, revenues for this commodity group remained unchanged from 2005. The benefit of freight rate increases and higher shipments of import vehicles via CN-served ports was offset by the translation impact of the stronger Canadian dollar and reduced shipments from domestic producers, primarily driven by production slowdowns. Revenue per revenue ton mile increased by 3% in 2006, largely due to freight rate increases that were partly offset by the translation impact of the stronger Canadian dollar and an increase in the average length of haul.

Percentage of revenues

Finished vehicles	85%
Auto parts	15%

	2002	2003	2004	2005	2006
Carloads* (In thousands)	307	288	295	279	255

*Includes GLT from May 10, 2004 and BC Rail from July 14, 2004.

Other

In 2006, other revenues increased by \$10 million, when compared to 2005, mainly due to increased interswitching, rental and vessel revenues.

Operating expenses

Operating expenses amounted to \$4,686 million in 2006 compared to \$4,616 million in 2005. The increase of \$70 million, or 2%, in 2006 was mainly due to increased fuel costs, purchased services and material expense and depreciation. Partly offsetting these factors was the \$150 million translation impact of the stronger Canadian dollar on U.S. dollar-denominated expenses and lower casualty and other expense.

<i>In millions</i>	<i>Year ended December 31,</i>		<i>2006</i>		<i>2005</i>	
	<i>Amount</i>	<i>% of revenue</i>	<i>Amount</i>	<i>% of revenue</i>	<i>Amount</i>	<i>% of revenue</i>
Labor and fringe benefits	\$ 1,800	23.3%	\$ 1,841	25.4%	\$ 1,841	25.4%
Purchased services and material	845	11.0%	814	11.2%	814	11.2%
Depreciation and amortization	650	8.4%	627	8.7%	627	8.7%
Fuel	890	11.5%	725	10.0%	725	10.0%
Equipment rents	198	2.6%	192	2.7%	192	2.7%
Casualty and other	303	3.9%	417	5.8%	417	5.8%
<i>Total</i>	<i>\$ 4,686</i>	<i>60.7%</i>	<i>\$ 4,616</i>	<i>63.8%</i>	<i>\$ 4,616</i>	<i>63.8%</i>

Labor and fringe benefits: Labor and fringe benefits expense includes wages, payroll taxes, and employee benefits such as incentive compensation, stock-based compensation, health and welfare, pensions and other post-employment benefits. Certain incentive and stock-based compensation plans are based on financial and market performance targets and the related expense is recorded in relation to the attainment of such targets. Labor and fringe benefits expense decreased by \$41 million, or 2%, in 2006 as compared to 2005. The decrease was mainly due to lower stock-based compensation expense, largely due to an acceleration of a grant payout in 2005; the translation impact of the stronger Canadian dollar; the impact of a reduced workforce and ongoing productivity improvements; and an increase in the first quarter of 2005 to the workforce reduction provision mainly for increased health care costs. Partly offsetting these factors were annual wage increases and an increase in net periodic benefit cost for pensions, mainly as a result of a decrease in the Company's discount rate used in 2006 relative to 2005.

Purchased services and material: Purchased services and material expense primarily includes the costs of services purchased from outside contractors, materials used in the maintenance of the Company's track, facilities and equipment, transportation and lodging for train crew employees, utility costs and the net costs of operating facilities jointly used by the Company and other railroads. These expenses increased by \$31 million, or 4%, in 2006 as compared to 2005. The increase was mainly due to higher expenses for various services, particularly for the Company's maritime activities, higher expenses for locomotive maintenance, lower income from joint facilities, and costs related to the upgrading of track shared with another railroad. Partly offsetting these factors was the translation impact of the stronger Canadian dollar.

Depreciation and amortization: Depreciation and amortization expense relates to the Company's rail operations. These expenses increased by \$23 million, or 4%, in 2006 as compared to 2005. The increase was mainly due to the impact of net capital additions and higher depreciation rates for the information technology asset class, which were partly offset by the translation impact of the stronger Canadian dollar.

Fuel: Fuel expense includes the cost of fuel consumed by locomotives, intermodal equipment and other vehicles. These expenses increased by \$165 million, or 23%, in 2006 as compared to 2005. The increase was mainly due to a 24% increase in the average price per U.S. gallon of fuel, net of the benefits from CN's fuel hedging program, from \$1.72 in 2005 to \$2.13 in 2006, and higher freight volumes. Partly offsetting these factors were the translation impact of the stronger Canadian dollar and productivity improvements.

Equipment rents: Equipment rents expense includes rental expense for the use of freight cars owned by other railroads or private companies and for the short- or long-term lease of freight cars, locomotives and intermodal equipment, net of rental income from other railroads for the use of the Company's cars and locomotives. These expenses increased by \$6 million, or 3%, in 2006 as compared to 2005. The increase was due to lower car hire income, mainly due to shorter routes and offline cycles, that was partly offset by lower lease and car hire expense, and the translation impact of the stronger Canadian dollar.

Casualty and other: Casualty and other expense includes expenses for personal injuries, environmental, freight and property damage, insurance, bad debt and operating taxes, as well as travel and travel-related expenses. These expenses decreased by \$114 million, or 27%, in 2006 as compared to 2005. The decrease was largely due to a net reduction to the provision for U.S. personal injuries following the 2006 actuarial studies; a lower expense for occupational disease claims; and lower derailment-related expenses, mainly due to costs that were incurred for the incident at Wabamun Lake in 2005 (see the Critical accounting policies section of this MD&A). Partly offsetting these items were higher operating taxes and increased environmental expenses for ongoing site restoration.

Other

Interest expense: Interest expense increased by \$13 million, or 4%, for the year ended December 31, 2006 as compared to 2005, mainly due to interest on 2006 debt issuances and higher capital lease obligations that were partly offset by the translation impact of the stronger Canadian dollar.

Other income (loss): In 2006, the Company recorded other income of \$11 million compared to \$12 million in 2005. The decrease was mainly due to lower investment income, which was largely offset by higher foreign exchange gains and lower costs related to the securitization program.

Income tax expense: The Company recorded income tax expense of \$642 million for the year ended December 31, 2006 compared to \$781 million in 2005. Included in the 2006 income tax expense was a deferred income tax recovery of \$277 million, resulting from the enactment of lower tax rates in Canada and the resolution of matters pertaining to prior years' income taxes. Excluding this tax recovery, the effective tax rate for the year ended December 31, 2006 was 33.7% compared to 33.4% in 2005.

2005 compared to 2004

In 2005, net income increased by \$298 million, or 24%, to \$1,556 million, when compared to 2004, with diluted earnings per share rising 28%, to \$2.77.

Revenues increased by \$692 million, or 11%, to \$7,240 million, mainly due to freight rate increases, an important part of which was due to a higher fuel surcharge as a result of increases in crude oil prices, the inclusion of a full year of GLT and BC Rail revenues, and a return to normal intermodal volumes following the first quarter 2004 Canadian Auto Workers (CAW) strike. Partly offsetting these gains was the translation impact of the stronger Canadian dollar on U.S. dollar-denominated revenues.

Operating expenses increased by \$236 million, or 5%, to \$4,616 million, primarily due to increased fuel costs, the inclusion of a full year of GLT and BC Rail expenses, and increased purchased services and material costs. Partly offsetting these factors were the translation impact of the stronger Canadian dollar on U.S. dollar-denominated expenses, lower equipment rents, and lower casualty and other expense.

The operating ratio, defined as operating expenses as a percentage of revenues, was 63.8% in 2005 compared to 66.9% in 2004, a 3.1-point betterment.

The years ended December 31, 2005 and 2004 included items affecting the comparability of the results of operations. The Company acquired and consolidated GLT and BC Rail effective May 10, 2004 and July 14, 2004, respectively. Accordingly, in the discussions herein, the Company's results of operations for 2005 include the results of operations of both GLT and BC Rail. The Company's results for 2004 included the results of operations of GLT as of May 10, 2004 and BC Rail as of July 14, 2004.

In 2005, the continued appreciation in the Canadian dollar relative to the U.S. dollar, which has affected the conversion of the Company's U.S. dollar-denominated revenues and expenses, resulted in a reduction to net income of approximately \$60 million.

For the year ended December 31, 2004, a first-quarter strike by the Company's employees represented by the CAW union negatively affected operating income and net income by \$35 million and \$24 million, respectively.

Revenues

	Year ended December 31,		2005	2004	% Change
Total revenues (millions)	\$	7,240	\$	6,548	11%
Rail freight:					
Revenues (millions)	\$	6,905	\$	6,252	10%
RTMs (millions)		179,701		174,240	3%
Revenue/RTM (cents)		3.84		3.59	7%
Carloads (thousands)		4,841		4,578	6%
Revenue/carload (dollars)		1,426		1,366	4%

Revenues for the year ended December 31, 2005 totaled \$7,240 million compared to \$6,548 million in 2004. The increase of \$692 million, or 11%, was mainly due to freight rate increases of approximately \$500 million, of which approximately 55% was due to a higher fuel surcharge as a result of increases in crude oil prices; the inclusion of a full year of GLT and BC Rail revenues; and a return to normal intermodal volumes following the first-quarter 2004 CAW strike. Partly offsetting these gains was the \$260 million translation impact of the stronger Canadian dollar on U.S. dollar-denominated revenues. In 2005, revenue ton miles increased by 3% relative to 2004. Freight revenue per revenue ton mile increased by 7% for 2005 when compared to 2004, largely due to freight rate increases.

Petroleum and chemicals

	Year ended December 31,		2005	2004	% Change
Revenues (millions)	\$	1,096	\$	1,059	3%
RTMs (millions)		31,235		31,421	(1%)
Revenue/RTM (cents)		3.51		3.37	4%

Revenues for the year ended December 31, 2005 increased by \$37 million, or 3%, from 2004. The improvement was mainly due to freight rate increases, the inclusion of a full year of BC Rail revenues, and an improved market position in petroleum products. These gains were partly offset by the translation impact of the stronger Canadian dollar, soft market conditions for plastics and liquefied petroleum gases, continued weakness in the U.S. molten sulfur market and reduced shipments of U.S. petrochemicals. Revenue per revenue ton mile increased by 4% as freight rate increases were partly offset by the translation impact of the stronger Canadian dollar.

Metals and minerals

	Year ended December 31,		2005	2004	% Change
Revenues (millions)	\$	837	\$	714	17%
RTMs (millions)		16,848		16,352	3%
Revenue/RTM (cents)		4.97		4.37	14%

Revenues for the year ended December 31, 2005 increased by \$123 million, or 17%, from 2004. The increase was mainly due to freight rate increases, the inclusion of a full year of GLT and BC Rail revenues, strong shipments of construction materials, aluminum and Canadian steel products, and an improvement in traffic mix. Partly offsetting these gains was the translation impact of the stronger Canadian dollar. Revenue per revenue ton mile increased by 14% in 2005, mainly due to shorter-haul traffic, particularly related to GLT, and freight rate increases. Partly offsetting these factors was the translation impact of the stronger Canadian dollar.

Forest products

	Year ended December 31,		2005	2004	% Change
Revenues (millions)	\$	1,738	\$	1,505	15%
RTMs (millions)		42,330		39,369	8%
Revenue/RTM (cents)		4.11		3.82	8%

Revenues for the year ended December 31, 2005 increased by \$233 million, or 15%, from 2004. The increase was mainly due to freight rate increases, continued solid demand for Canadian lumber and panels, the inclusion of a full year of BC Rail revenues, improvements in traffic mix and an improved market position for paper. The translation impact of the stronger Canadian dollar partly offset these gains. Revenue per revenue ton mile increased by 8% in 2005, mainly due to freight rate increases and a positive change in traffic mix, which were partly offset by the translation impact of the stronger Canadian dollar.

Coal

	Year ended December 31,		2005	2004	% Change
Revenues (millions)	\$	331	\$	284	17%
RTMs (millions)		13,576		12,684	7%
Revenue/RTM (cents)		2.44		2.24	9%

Revenues for the year ended December 31, 2005 increased by \$47 million, or 17%, from 2004. The increase was mainly due to new metallurgical coal mines in western Canada, freight rate increases and the inclusion of a full year of GLT and BC Rail revenues. Partly offsetting these gains was the translation impact of the stronger Canadian dollar. The revenue per revenue ton mile increase of 9% was mainly due to freight rate increases, which were partly offset by the translation impact of the stronger Canadian dollar.

Grain and fertilizers

	Year ended December 31,		2005	2004	% Change
Revenues (millions)	\$	1,119	\$	1,063	5%
RTMs (millions)		40,393		40,091	1%
Revenue/RTM (cents)		2.77		2.65	5%

Revenues for the year ended December 31, 2005 increased by \$56 million, or 5%, from 2004. The increase was mainly due to freight rate increases, higher export shipments of U.S. corn in a generally weak market, increased shipments of Canadian barley and canola and an improvement in traffic mix. These gains were partly offset by the translation impact of the stronger Canadian dollar and the decreased availability of high-quality Canadian wheat for export markets via west coast ports. Revenue per revenue ton mile increased by 5% in 2005, largely due to freight rate increases and a positive change in traffic mix, partly offset by the translation impact of the stronger Canadian dollar.

Intermodal

	Year ended December 31,		2005	2004	% Change
Revenues (millions)	\$	1,270	\$	1,117	14%
RTMs (millions)		32,184		31,002	4%
Revenue/RTM (cents)		3.95		3.60	10%

Revenues for the year ended December 31, 2005 increased by \$153 million, or 14%, from 2004. The increase was mainly due to freight rate increases, strong imports into the Port of Vancouver and an improvement in traffic mix. Also contributing to the increase in 2005 was the return to normal traffic levels following the first-quarter 2004 CAW strike. Partly offsetting these gains were the translation impact of the stronger Canadian dollar and a change in port of call for an overseas shipper. The revenue per revenue ton mile increase

of 10% in 2005 was largely due to freight rate increases and a positive change in traffic mix, which were partly offset by the translation impact of the stronger Canadian dollar and an increase in the average length of haul.

Automotive

	Year ended December 31,		2005	2004	% Change
Revenues (millions)	\$		\$ 514	\$ 510	1%
RTMs (millions)			3,135	3,321	(6%)
Revenue/RTM (cents)			16.40	15.36	7%

Revenues for the year ended December 31, 2005 increased by \$4 million, or 1%, from 2004. The increase was driven by freight rate increases, higher import vehicles via the ports of Vancouver and Halifax, and the benefit of new finished vehicle traffic in the southern U.S. that began in the second half of 2004. These gains were partly offset by the translation impact of the stronger Canadian dollar and a reduction in automotive production at CN-served facilities in southern Ontario and Michigan. Revenue per revenue ton mile increased 7% in 2005 largely due to freight rate increases, which were partly offset by the translation impact of the stronger Canadian dollar.

Other

In 2005, other revenues increased by \$39 million, when compared to 2004, mainly due to the inclusion of a full year of revenues from the Company's maritime activities.

Operating expenses

Operating expenses amounted to \$4,616 million in 2005 compared to \$4,380 million in 2004. The increase of \$236 million, or 5%, in 2005 was mainly due to increased fuel costs, the inclusion of a full year of GLT and BC Rail expenses and increased purchased services and material costs. Partly offsetting these factors were the \$155 million translation impact of the stronger Canadian dollar on U.S. dollar-denominated expenses, lower equipment rents, and lower casualty and other expense.

In millions	Year ended December 31,		2005		2004	
		Amount	% of revenue	Amount	% of revenue	
Labor and fringe benefits	\$	1,841	25.4%	\$ 1,819	27.8%	
Purchased services and material		814	11.2%	746	11.4%	
Depreciation and amortization		627	8.7%	598	9.1%	
Fuel		725	10.0%	528	8.1%	
Equipment rents		192	2.7%	244	3.7%	
Casualty and other		417	5.8%	445	6.8%	
Total	\$	4,616	63.8%	\$ 4,380	66.9%	

Labor and fringe benefits: Labor and fringe benefits expense in 2005 increased by \$22 million, or 1%, as compared to 2004. The increase was attributable to higher stock-based compensation expense, the inclusion of a full year of GLT and BC Rail expenses, wage increases and a return to normal wage levels following the first-quarter 2004 CAW strike. Partly offsetting these factors was the translation impact of the stronger Canadian dollar, the impact of a reduced workforce, and adjustments made in 2004 to the workforce reduction provision.

Purchased services and material: Purchased services and material expense in 2005 increased by \$68 million, or 9%, as compared to 2004. The increase was primarily due to the inclusion of a full year of GLT and BC Rail expenses, and higher expenses for material and maintenance on rolling stock and track repairs. These factors were partly offset by the translation impact of the stronger Canadian dollar.

Depreciation and amortization: Depreciation and amortization expense in 2005 increased by \$29 million, or 5%, as compared to 2004. The increase was mainly due to the impact of net capital additions and to the inclusion of a full year of GLT and BC Rail depreciation expense, which were partly offset by the translation impact of the stronger Canadian dollar.

Fuel: Fuel expense in 2005 increased by \$197 million, or 37%, as compared to 2004. The increase was mainly due to a 32% increase in the average price per U.S. gallon of fuel, net of the benefits from CN's fuel hedging program, from \$1.30 in 2004 to \$1.72 in 2005; higher volumes, particularly in the first quarter; the inclusion of a full year of GLT and BC Rail fuel expense; and a second-quarter 2004 fuel excise tax refund. Partly offsetting these factors was the translation impact of the stronger Canadian dollar.

Equipment rents: Equipment rents expense in 2005 decreased by \$52 million, or 21%, as compared to 2004. The decrease was mainly due to lower car hire expense and higher car hire income, mainly as a result of the integration of the BC Rail fleet, and the translation impact of the stronger Canadian dollar. These factors were partly offset by higher car lease expense due to an increased fleet size, higher rates and the inclusion of a full year of BC Rail car lease expense.

Casualty and other: Casualty and other expense in 2005 decreased by \$28 million, or 6%, as compared to 2004. The decrease was mainly due to a reduction to the provision for U.S. personal injuries following the 2005 actuarial valuation, a 2004 adjustment made to the provision for personal injuries in Canada and the translation impact of the stronger Canadian dollar. Partly offsetting these factors were higher derailment-related expenses, in particular, \$28 million related to the incident at Wabamun Lake (see the Critical accounting policies section of this MD&A), the inclusion of a full year of GLT and BC Rail expenses and higher property taxes in the U.S.

Other

Interest expense: Interest expense increased by \$5 million, or 2%, for the year ended December 31, 2005 as compared to 2004, mainly due to the financing related to the Company's acquisitions in 2004 and higher interest rates on commercial paper borrowings. Partly offsetting these factors were the translation impact of the stronger Canadian dollar and the benefit of the repayment of matured Notes in March 2004 and May 2005.

Other income (loss): In 2005, the Company recorded income of \$12 million compared to a loss of \$20 million in 2004. The change from loss to income in 2005 was due to improvements in real estate and other business activities, realized foreign exchange gains and a first-quarter 2004 restructuring charge related to the Company's investment in English Welsh and Scottish Railway. Partly offsetting these factors were lower investment income, lower gains on disposal of surplus properties, and higher costs related to the securitization program.

Income tax expense: The Company recorded income tax expense of \$781 million for the year ended December 31, 2005 compared to \$596 million in 2004. The effective tax rate for the year ended December 31, 2005 was 33.4% compared to 32.1% in 2004. The increase in the effective tax rate was mainly due to higher provincial tax rates enacted in 2005.

Summary of quarterly financial data - unaudited

In millions, except per share data

	2006 Quarters				2005 Quarters			
	Fourth	Third	Second	First	Fourth	Third	Second	First
Revenues	\$ 1,942	\$ 1,981	\$ 1,946	\$ 1,847	\$ 1,886	\$ 1,810	\$ 1,838	\$ 1,706
Operating income	\$ 756	\$ 844	\$ 805	\$ 625	\$ 720	\$ 665	\$ 713	\$ 526
Net income	\$ 499	\$ 497	\$ 729	\$ 362	\$ 430	\$ 411	\$ 416	\$ 299
Basic earnings per share	\$ 0.97	\$ 0.95	\$ 1.38	\$ 0.68	\$ 0.80	\$ 0.75	\$ 0.75	\$ 0.53
Diluted earnings per share	\$ 0.95	\$ 0.94	\$ 1.35	\$ 0.66	\$ 0.78	\$ 0.74	\$ 0.73	\$ 0.52
Dividend declared per share	\$ 0.1625	\$ 0.1625	\$ 0.1625	\$ 0.1625	\$ 0.1250	\$ 0.1250	\$ 0.1250	\$ 0.1250

Revenues generated by the Company during the year are influenced by seasonal weather conditions, general economic conditions, cyclical demand for rail transportation, and competitive forces in the transportation marketplace. Operating expenses reflect the impact of freight volumes, seasonal weather conditions, labor costs, fuel prices, and the Company's productivity initiatives.

The Company's quarterly results included items that impacted the quarter-over-quarter comparability of the results of operations: the second quarter of 2006 included a deferred income tax recovery of \$250 million (\$0.48 per basic share or \$0.46 per diluted share), primarily resulting from the enactment of lower tax rates in Canada; the fourth quarter of 2006 included a deferred income tax recovery of \$27 million (\$0.05 per basic or diluted share), relating mainly to the resolution of matters pertaining to prior years' income taxes; and the continued appreciation in the Canadian dollar relative to the U.S. dollar has affected the conversion of the Company's U.S. dollar-denominated revenues and expenses and resulted in varying reductions in net income in the rolling eight quarters presented above.

Liquidity and capital resources

The Company's principal source of liquidity is cash generated from operations. The Company also has the ability to fund liquidity requirements through its revolving credit facility, the issuance of debt and/or equity, and the sale of a portion of its accounts receivable through a securitization program. In addition, from time to time, the Company's liquidity requirements can be supplemented by the disposal of surplus properties and the monetization of assets.

Operating activities: Cash provided from operating activities was \$2,950 million for the year ended December 31, 2006 compared to \$2,705 million for 2005. Net cash receipts from customers and other were \$7,733 million for the year ended December 31, 2006, an increase of \$358 million when compared to 2005, mainly due to higher revenues from operations that were partly offset by a decrease in the proceeds received under the Company's accounts receivable securitization program. In 2006, payments for employee services, suppliers and other expenses were \$3,918 million, an increase of \$46 million when compared to 2005. Also consuming cash in 2006 were payments for interest, workforce reductions and personal injury and other claims of \$294 million, \$45 million and \$107 million, respectively, compared to \$306 million, \$87 million and \$92 million, respectively, in 2005. In 2006, pension contributions were \$112 million, compared to \$127 million in 2005. Payments for income taxes in 2006 were \$307 million, an increase of \$121 million when compared to 2005, mainly due to the Company now being cash tax payable (see the Income taxes section of this MD&A). Payments in 2007 for workforce reductions are expected to be \$23 million, pension contributions are expected to be approximately \$100 million and payments for income taxes are expected to be approximately \$1,000 million (see the Income taxes section of this MD&A). There are currently no specific or unusual requirements relating to working capital other than the items disclosed.

Investing activities: Cash used by investing activities in 2006 amounted to \$1,349 million compared to \$1,075 million in 2005. The Company's investing activities in 2006 included property additions of \$1,298 million, an increase of \$118 million when compared to 2005; and \$84 million related to three acquisitions. The following table details property additions for 2006 and 2005:

<i>In millions</i>	<i>Year ended December 31,</i>		2006	2005
Track and roadway	\$	1,012	\$	868
Rolling stock		349		338
Buildings		35		44
Information technology		81		81
Other		82		71
Gross property additions		1,559		1,402
Less: capital leases		261		222
Property additions	\$	1,298	\$	1,180

The Company expects to spend approximately \$1,600 million on capital programs in 2007 due to increased expenditures required for the ongoing renewal of the basic plant, the acquisition of rolling stock and other acquisitions and investments required to improve the Company's productivity and the fluidity of the network.

Free cash flow

The Company generated \$1,343 million of free cash flow for the year ended December 31, 2006, compared to \$1,301 million in 2005. Free cash flow does not have any standardized meaning prescribed by GAAP and may, therefore, not be comparable to similar measures presented by other companies. The Company believes that free cash flow is a useful measure of performance as it demonstrates the Company's ability to generate cash after the payment of capital expenditures and dividends. The Company defines free cash flow as cash provided from operating activities, excluding changes in the accounts receivable securitization program, less investing activities and after the payment of dividends, calculated as follows:

<i>In millions</i>	<i>Year ended December 31,</i>		2006	2005
Cash provided from operating activities	\$	2,950	\$	2,705
Less:				
Investing activities		(1,349)		(1,075)
Cash provided before financing activities		1,601		1,630
Adjustments:				
Change in accounts receivable securitization (a)		82		(54)
Dividends paid		(340)		(275)
Free cash flow	\$	1,343	\$	1,301

(a) Changes in the Company's accounts receivable securitization program are considered a financing activity.

Financing activities: Cash used by financing activities totaled \$1,484 million for the year ended December 31, 2006 compared to \$1,715 million in 2005. On May 31, 2006, the Company issued U.S.\$250 million (Cdn\$275 million) of 5.80% Notes due 2016 and U.S.\$450 million (Cdn\$495 million) of 6.20% Debentures due 2036. The Company had used the net proceeds of U.S.\$692 million to reduce the Company's accounts receivable securitization program and to repay a portion of its outstanding commercial paper. In May 2005, the Company repaid U.S.\$100 million (Cdn\$125 million) of 7.75% 10-year Notes with cash on hand. In 2006 and 2005, issuances and repayments of long-term debt related principally to the Company's commercial paper borrowings.

During 2006, the Company recorded \$264 million (\$222 million in 2005) in assets it acquired through equipment leases, including \$3 million for assets held for sale, for which an equivalent amount was recorded in debt.

Cash received from options exercised during 2006 and 2005 was \$101 million and \$115 million, respectively, and the related tax benefits realized upon exercise were \$19 million and \$21 million, respectively.

In 2006, the Company repurchased 29.5 million common shares for \$1,483 million under its share repurchase programs; 15.5 million common shares for \$766 million (average price of \$49.43 per share) under its new 28.0 million share repurchase program and 14.0

million common shares for \$717 million (average price of \$51.24 per share) under its previous 32.0 million share repurchase program which was ended in June 2006. In 2005, the Company used \$1,418 million to repurchase 36.0 million common shares under its previous share repurchase programs.

During 2006, the Company paid dividends totaling \$340 million to its shareholders at the quarterly rate of \$0.1625 per share compared to \$275 million at the quarterly rate of \$0.1250 per share, in 2005.

CN's debt-to-total capitalization ratio was 36.3% at December 31, 2006 compared to 35.5% at December 31, 2005. As at December 31, 2006, the adjusted debt-to-total capitalization ratio was 40.4% compared to 41.1% at December 31, 2005. Management believes that adjusted debt-to-total capitalization is a useful measure of performance that aims to show the true leverage of the Company. However, since this adjusted measure does not have any standardized meaning prescribed by GAAP, it may not be comparable to similar measures presented by other companies and, as such, should not be considered in isolation.

	<i>December 31,</i>	2006	2005
Debt-to-total capitalization ratio (a)		36.3%	35.5%
<i>Add:</i>			
Present value of operating lease commitments plus securitization financing (b)		4.1%	5.6%
Adjusted debt-to-total capitalization ratio (c)		40.4%	41.1%

(a) *Debt-to-total capitalization is calculated as total long-term debt plus current portion of long-term debt divided by the sum of total debt plus total shareholders' equity.*

(b) *The operating lease commitments have been discounted using the Company's implicit interest rate for each of the years presented.*

(c) *Adjusted debt-to-total capitalization is calculated as adjusted debt (total long-term debt, plus current portion of long-term debt, plus the present value of operating lease commitments, plus securitization financing) divided by the sum of adjusted debt plus total shareholders' equity.*

The Company has access to various financing arrangements:

Shelf prospectus and registration statement

On May 9, 2006, the Company filed a shelf prospectus and registration statement providing for the issuance, from time to time, of up to U.S.\$1,500 million of debt securities in one or more offerings expiring in June 2008. Pursuant to the filing, on May 31, 2006, the Company issued U.S.\$250 million (Cdn\$275 million) of 5.80% Notes due 2016 and U.S.\$450 million (Cdn\$495 million) of 6.20% Debentures due 2036. The Company used the net proceeds of U.S.\$692 million to reduce its accounts receivable securitization program and to repay a portion of its outstanding commercial paper.

On July 15, 2006, the interest rate on the Company's U.S.\$250 million Puttable Reset Securities PURSSM (PURS) was reset at a new rate of 6.71% for the remaining 30-year term ending July 15, 2036. The PURS were originally issued in July 1998 at the rate of 6.45% with an option to call the securities on July 15, 2006 (the reset date). The call option holder exercised the call option, which resulted in the remarketing of the original PURS. The new interest rate was determined according to a pre-set mechanism based on prevailing market conditions. The Company did not receive any cash proceeds from the remarketing.

The remarketing did not trigger an extinguishment of debt, as the provisions for the reset of the interest rate were set forth in the original PURS. As such, the original PURS remain outstanding but accrue interest at the new rate until July 2036. Under securities laws, the remarketing required utilization of the Company's shelf prospectus and registration statement.

Following the issuance and remarketing of debt as explained herein, the amount available under the shelf prospectus and registration statement has been reduced to U.S.\$550 million.

Revolving credit facility

In October 2006, the Company amended its U.S.\$1,000 million revolving credit facility, improving the pricing parameters and extending the maturity from March 2010 to October 2011. Other terms of the facility remained substantially the same. The credit facility is available for general corporate purposes, including back-stopping the Company's commercial paper program, and provides for borrowings at various interest rates, including the Canadian prime rate, bankers' acceptance rates, the U.S. federal funds effective rate

and the London Interbank Offer Rate, plus applicable margins. The credit facility agreement has one financial covenant, the customary limitation on debt as a percentage of total capitalization, with which the Company has been in compliance. The Company's borrowings of U.S.\$15 million (Cdn\$17 million) outstanding at December 31, 2005 (average interest rate of 4.66%) were entirely repaid in the first quarter of 2006. As at December 31, 2006, the Company had no outstanding borrowings under its revolving credit facility and had letters of credit drawn of \$308 million (\$316 million as at December 31, 2005).

Commercial paper

The Company's commercial paper program is backed by a portion of its revolving credit facility, enabling it to issue commercial paper up to a maximum aggregate principal amount of \$800 million, or the U.S. dollar equivalent. Commercial paper debt is due within one year but is classified as long-term debt, reflecting the Company's intent and contractual ability to refinance the short-term borrowings through subsequent issuances of commercial paper or drawing down on the long-term revolving credit facility. As at December 31, 2006, the Company had no commercial paper outstanding, and U.S.\$367 million (Cdn\$427 million) outstanding at an average interest rate of 4.40%, as at December 31, 2005.

The Company's access to current and alternate sources of financing at competitive costs is dependent on its credit rating. The Company is not currently aware of any adverse trend, event or condition that would affect the Company's credit rating.

All forward-looking information provided in this section is subject to risks and uncertainties and is based on assumptions about events and developments that may not materialize or that may be offset entirely or partially by other events and developments. See the Business risks section of this MD&A for a discussion of assumptions and risk factors affecting such forward-looking statements.

Contractual obligations

In the normal course of business, the Company incurs contractual obligations. The following table sets forth the Company's contractual obligations for the following items as at December 31, 2006:

<i>In millions</i>	Total	2007	2008	2009	2010	2011	2012 & thereafter
Long-term debt obligations (a)	\$ 4,583	\$ 60	\$ 203	\$ 351	\$ -	\$ 465	\$ 3,504
Interest on long-term debt obligations	5,794	284	274	267	252	252	4,465
Capital lease obligations (b)	1,405	216	119	138	79	147	706
Operating lease obligations (c)	740	184	144	116	95	69	132
Purchase obligations (d)	773	541	124	53	47	8	-
Other long-term liabilities reflected on the balance sheet (e)	1,036	82	71	54	48	44	737
Total obligations	\$ 14,331	\$ 1,367	\$ 935	\$ 979	\$ 521	\$ 985	\$ 9,544

(a) Presented net of unamortized discounts, of which \$836 million relates to non-interest bearing Notes due in 2094, and excludes capital lease obligations of \$1,021 million which are included in "Capital lease obligations."

(b) Includes \$1,021 million of minimum lease payments and \$384 million of imputed interest at rates ranging from approximately 3.0% to 7.9%.

(c) Includes minimum rental payments for operating leases having initial non-cancelable lease terms of one year or more. The Company also has operating lease agreements for its automotive fleet with minimum one-year non-cancelable terms for which its practice is to renew monthly thereafter. The estimated annual rental payments for such leases are approximately \$30 million and generally extend over five years.

(d) Includes commitments for railroad ties, rail, freight cars, locomotives and other equipment and services, and outstanding information technology service contracts and licenses.

(e) Includes expected payments for workers' compensation, workforce reductions, postretirement benefits other than pensions and environmental liabilities that have been classified as contractual settlement agreements.

For 2007 and the foreseeable future, the Company expects cash flow from operations and from its various sources of financing to be sufficient to meet its debt repayments and future obligations, and to fund anticipated capital expenditures. The Company is not aware

of any trends, events or conditions or expected fluctuations in liquidity that would create any deficiencies. See the Business risks section of this MD&A for a discussion of assumptions and risk factors affecting such forward-looking statement.

Off balance sheet arrangements

Accounts receivable securitization

The Company has a five-year agreement, expiring in May 2011, to sell an undivided co-ownership interest of up to a maximum of \$600 million in a revolving pool of freight receivables to an unrelated trust. Pursuant to the agreement, the Company sells an interest in its receivables and receives proceeds net of the required reserves as stipulated in the agreement. This program replaced the Company's previous accounts receivable securitization program that was set to expire in June 2006.

The Company has retained the responsibility for servicing, administering and collecting the receivables sold. At December 31, 2006, the servicing asset and liability were not significant. Subject to customary indemnifications, the trust's recourse is generally limited to the receivables.

The Company accounted for the securitization programs as sales, because control over the transferred accounts receivable was relinquished. Due to the relatively short collection period and the high quality of the receivables sold, the fair value of the undivided interest transferred to the trust approximated the book value thereof.

The Company is subject to customary reporting requirements for which failure to perform could result in termination of the program. In addition, the trust is subject to customary credit rating requirements, which if not met, could also result in termination of the program. The Company monitors the reporting requirements and is currently not aware of any trends, events or conditions that could cause such termination.

The accounts receivable securitization program provides the Company with readily available short-term financing for general corporate use. In the event the program is terminated before its scheduled maturity, the Company expects to meet its future payment obligations through its various sources of financing, including its revolving credit facility and commercial paper program, and/or access to capital markets.

At December 31, 2006, the Company had sold receivables that resulted in proceeds of \$393 million under the new accounts receivable securitization program (\$489 million at December 31, 2005 under the previous program), and recorded the retained interest, which represents the required reserves, of approximately 10% of this amount in Other current assets (retained interest of approximately 10% recorded at December 31, 2005).

Guarantees and indemnifications

In the normal course of business, the Company, including certain of its subsidiaries, enters into agreements that may involve providing certain guarantees or indemnifications to third parties and others, which may extend beyond the term of the agreement. These include, but are not limited to, residual value guarantees on operating leases, standby letters of credit and surety and other bonds, and indemnifications that are customary for the type of transaction or for the railway business.

The Company is required to recognize a liability for the fair value of the obligation undertaken in issuing certain guarantees on the date the guarantee is issued or modified. In addition, where the Company expects to make a payment in respect of a guarantee, a liability will be recognized to the extent that one has not yet been recognized.

The nature of these guarantees or indemnifications, the maximum potential amount of future payments, the carrying amount of the liability, if any, and the nature of any recourse provisions are disclosed in Note 18 – Major commitments and contingencies, to the Company's Annual Consolidated Financial Statements.

Stock-based compensation plans

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), "Share-Based Payment," which requires the expensing of all options issued, modified or settled based on the grant date fair value over the period during which an employee is required to provide service (vesting period). The standard also requires that cash settled awards be measured at fair value at each reporting date until ultimate settlement.

The Company adopted SFAS No. 123(R) using the modified prospective approach, which requires application of the standard to all awards granted, modified, repurchased or cancelled on or after January 1, 2006, and to all awards for which the requisite service had not been rendered as at such date. Since January 1, 2003, the Company has been following the fair value based approach prescribed by SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure," for stock option awards granted, modified or settled on or after such date, while cash settled awards were measured at their intrinsic value at each reporting period until December 31, 2005. As such, the application of SFAS No. 123(R) on January 1, 2006 to all awards granted prior to its adoption did not have a significant impact on the financial statements. In accordance with the modified prospective approach, prior period financial statements have not been restated to reflect the impact of SFAS No. 123(R).

For the year ended December 31, 2006, the application of SFAS No. 123(R) had the effect of increasing stock-based compensation expense and decreasing net income by \$16 million and \$12 million, respectively, or \$0.02 per basic and diluted earnings per share.

The Company has various stock-based incentive plans for eligible employees. A description of the plans is provided in Note 12 – Stock plans, to the Company's Annual Consolidated Financial Statements. Compensation cost for awards under all stock-based compensation plans was \$79 million, \$120 million and \$65 million for the years ended December 31, 2006, 2005 and 2004, respectively. The total tax benefit recognized in income in relation to stock-based compensation expense for the years ended December 31, 2006, 2005 and 2004 was \$22 million, \$34 million and \$18 million, respectively. Additional disclosures required under SFAS No. 123(R) and Staff Accounting Bulletin (SAB) No. 107 are provided herein.

The following table provides additional disclosures as required by SFAS No. 123(R) and SAB No. 107 pertaining to all awards:

<i>In millions, unless otherwise indicated</i>	Cash settled awards						Stock option awards ⁽³⁾		
	RSUs ⁽¹⁾		Vision ⁽¹⁾		VIDP ⁽²⁾	Mid-term ⁽²⁾			
	2006 ⁽⁴⁾	2005	2004	2005	2003 onwards	2001	2006 ⁽⁴⁾	2005	Prior to 2005
Stock-based compensation expense recognized over vesting period									
Year ended December 31, 2006	\$ 21	\$ 19	\$ 6	\$ 8	\$ 11	N/A	\$ 8	\$ 3	\$ 3
Year ended December 31, 2005	N/A	\$ 15	\$ 74	\$ -	\$ 13	N/A	N/A	\$ 2	\$ 16
Year ended December 31, 2004	N/A	N/A	\$ 36	N/A	\$ 7	\$ 13	N/A	N/A	\$ 9
Liability outstanding									
December 31, 2006	\$ 21	\$ 34	\$ 8	\$ 8	\$ 99	N/A	N/A	N/A	N/A
December 31, 2005	N/A	\$ 15	\$ 66	\$ -	\$ 83	N/A	N/A	N/A	N/A
Fair value per unit									
At period-end (\$)	\$ 36.32	\$ 49.36	\$ 50.07	\$ 19.98	\$ 50.07	N/A	N/A	N/A	N/A
At grant date (\$)	N/A	N/A	N/A	N/A	N/A	N/A	\$13.80	\$ 9.19	\$ 8.61
Fair value of awards vested during period									
Year ended December 31, 2006	\$ -	\$ -	\$ 4	\$ -	\$ 5	N/A	\$ -	\$ 3	\$ 34
Year ended December 31, 2005	N/A	\$ -	\$ 105	\$ -	\$ 2	N/A	N/A	\$ -	\$ 34
Year ended December 31, 2004	N/A	N/A	\$ 3	N/A	\$ -	\$ 20	N/A	N/A	\$ 35
Nonvested awards at December 31, 2006									
Unrecognized compensation cost	\$ 15	\$ 17	\$ 8	\$ 8	\$ 13	N/A	\$ 6	\$ 6	\$ -
Remaining recognition period (years)	2.0	1.0	2.0	2.0	3.0	N/A	3.1	2.1	-
Assumptions ⁽⁵⁾									
Stock price (\$)	\$ 50.07	\$ 50.07	\$ 50.07	\$ 50.07	\$ 50.07	N/A	\$51.51	\$ 36.33	\$ 23.59
Expected stock price volatility ⁽⁶⁾	19%	18%	N/A	20%	N/A	N/A	25%	25%	30%
Expected term (years) ⁽⁷⁾	2.0	1.0	N/A	2.0	N/A	N/A	5.17	5.20	6.22
Risk-free interest rate ⁽⁸⁾	4.02%	4.16%	N/A	4.47%	N/A	N/A	4.04%	3.50%	5.13%
Dividend rate (\$) ⁽⁹⁾	\$ 0.65	\$ 0.65	N/A	\$ 0.65	N/A	N/A	\$ 0.65	\$ 0.50	\$ 0.30

⁽¹⁾ Beginning in 2006, compensation cost was based on the fair value of the awards at period-end using the lattice-based valuation model that uses the assumptions as presented herein, except for time-vested RSUs. In 2005 and 2004, compensation cost was measured using intrinsic value for all awards.

⁽²⁾ Compensation cost for all periods presented was based on intrinsic value.

⁽³⁾ Compensation cost for all periods presented was based on the grant date fair value using the Black-Scholes option-pricing model that uses the assumptions presented herein.

⁽⁴⁾ Includes the accelerated recognition of awards granted to retirement-eligible employees. For these individuals, compensation cost is recognized over the period from the grant date to the date the requisite service period has been achieved.

⁽⁵⁾ Assumptions used to determine fair value are at period-end for cash settled awards and at grant date for stock option awards.

⁽⁶⁾ Based on the historical volatility of the Company's stock over a period commensurate with the expected term of the award.

⁽⁷⁾ Represents the remaining period of time that awards are expected to be outstanding.

For option awards only, the Company uses historical data to estimate option exercise and employee termination, and groups of employees that have similar historical exercise behavior are considered separately.

⁽⁸⁾ Based on the implied yield available on zero-coupon government issues with an equivalent term commensurate with the expected term of the awards.

⁽⁹⁾ Based on the annualized dividend rate.

Financial instruments

The Company has limited involvement with derivative financial instruments and does not use them for trading purposes. At December 31, 2006, the Company did not have any derivative financial instruments outstanding.

Fuel

To mitigate the effects of fuel price changes on its operating margins and overall profitability, the Company had a hedging program which called for entering into swap positions on crude and heating oil to cover a target percentage of future fuel consumption up to two years in advance. However, with an increased application of fuel surcharge on revenues, no additional swap positions were entered into since September 2004. As such, the Company terminated this program in late 2006.

Since the changes in the fair value of the swap positions were highly correlated to changes in the price of fuel, the fuel hedges were being accounted for as cash flow hedges, whereby the effective portion of the cumulative change in the market value of the derivative instruments had been recorded in Accumulated other comprehensive loss.

During 2006, the Company's remaining swap positions matured and were settled. As a result, the related unrealized gains previously recorded in Accumulated other comprehensive loss were reclassified into income as realized gains (unrealized gains of \$57 million, \$39 million after tax at December 31, 2005). At December 31, 2006, the Company is no longer hedged through financial markets.

Realized gains from the Company's fuel hedging activities, which are recorded in fuel expense, were \$64 million, \$177 million and \$112 million for the years ended December 31, 2006, 2005 and 2004, respectively.

The Company did not recognize any material gains or losses in each of 2006, 2005 and 2004 due to hedge ineffectiveness as the Company's derivative instruments were highly effective in hedging the changes in cash flows associated with forecasted purchases of diesel fuel.

Interest rate

In 2004, the Company realized a gain of \$12 million upon settlement of treasury lock transactions that was recorded in Accumulated other comprehensive loss. This gain is being recorded into income, as a reduction of interest expense, over the term of the related debt (30-year term) based on the interest payment schedule. At December 31, 2006, Accumulated other comprehensive loss included an unamortized gain of \$12 million, \$8 million after tax (\$12 million, \$8 million after tax at December 31, 2005).

Income taxes

Cash tax payments

In 2005, the Company utilized its then remaining tax loss carryforwards and is now cash tax payable in both Canada and the U.S. Accordingly, the Company makes scheduled installment payments as prescribed by the tax authorities. In the U.S., tax installments are based on the forecasted income taxes payable for the current fiscal year. Payments made in 2006 were \$177 million and are expected to remain at the same level for 2007. In Canada, tax installments for the current year were based on the 2005 taxes payable, which were net of the loss carryforwards claimed. Consequently, payments in 2006 were \$130 million and the expected amount payable in the first quarter of 2007 for Canadian income taxes in respect of the current fiscal year amounts to approximately \$350 million. For the 2007 fiscal year, the Company expects to pay approximately \$440 million of taxes in Canada based on the 2006 taxes payable.

See the Business risks section of this MD&A for a discussion of assumptions and risk factors affecting such forward-looking statements.

Future rate enactments

In 2006, the Manitoba government announced reductions to the provincial corporate income tax rates as part of its Provincial Budget, which will be phased in through to July 1, 2008. As a result, the Company's net deferred income tax liability will be reduced when the new income tax rates are enacted into law.

Common stock

Share repurchase programs

In July 2006, the Board of Directors of the Company approved a new share repurchase program which allows for the repurchase of up to 28.0 million common shares between July 25, 2006 and July 24, 2007 pursuant to a normal course issuer bid, at prevailing market prices. As at December 31, 2006, under this current share repurchase program, 15.5 million common shares have been repurchased for \$766 million, at an average price of \$49.43 per share.

The Company's previous share repurchase program, initiated in 2005, allowed for the repurchase of up to 32.0 million common shares between July 25, 2005 and July 24, 2006 pursuant to a normal course issuer bid, at prevailing market prices. In June 2006, the Company ended this share repurchase program, repurchasing a total of 30.0 million common shares for \$1,388 million, at an average price of \$46.26 per share. Of this amount, 14.0 million common shares were repurchased in 2006 for \$717 million (average price per share of \$51.24) and 16.0 million common shares in 2005 for \$670 million (average price per share of \$41.90).

Common stock split

On January 24, 2006, the Board of Directors of the Company approved a two-for-one common stock split which was effected in the form of a stock dividend of one additional common share of CN payable for each share held. The stock dividend was paid on February 28, 2006, to shareholders of record on February 22, 2006. All equity-based benefit plans and the previous share repurchase program were adjusted to reflect the issuance of additional shares or options due to the stock split. All share and per share data have been adjusted to reflect the stock split.

Outstanding share data

As at February 12, 2007, the Company had 511.5 million common shares outstanding.

Recent accounting pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)," which requires an employer to measure the defined benefit plan assets and the projected benefit obligation as of the date of the employer's fiscal year-end statement of financial position. The requirement is effective for fiscal years ending after December 15, 2008. Pursuant to the Statement, this requirement will be applied prospectively. Although the Company uses a measurement date of September 30 for its U.S. pension and other postretirement plans, the Company does not expect this standard to have a significant impact on its financial statements. SFAS No. 158 also requires the recognition of the funded status of a benefit plan as well as other disclosure requirements, which were adopted on December 31, 2006. See the Critical accounting policies section of this MD&A and Note 2 – Accounting changes, to the Company's Annual Consolidated Financial Statements.

In September 2006, the U.S. Securities and Exchange Commission (SEC) issued SAB No. 108 to address diversity in practice in quantifying financial statement misstatements. SAB No. 108 requires consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB No. 108 did not have an impact on the Company's financial statements.

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, "Accounting for Uncertainty in Income Taxes," which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, disclosure and transition, and is effective for fiscal years beginning after December 15, 2006. Based on the Company's preliminary assessment of the impact of FIN No. 48, the adoption of this Interpretation on January 1, 2007 is expected to decrease the net deferred income tax liability and increase Retained earnings by approximately \$100 million.

Critical accounting policies

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of revenues and expenses during the period, the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities at the date of the financial statements. On an ongoing basis, management reviews its estimates based upon currently available information. Actual results could differ from these estimates. The Company's policies for personal injury and other claims, environmental claims, depreciation, pensions and other postretirement benefits, and income taxes, require management's more significant judgments and estimates in the preparation of the Company's consolidated financial statements and, as such, are considered to be critical. The following information should be read in conjunction with the Company's Annual Consolidated Financial Statements and Notes thereto.

Management discusses the development and selection of the Company's critical accounting estimates with the Audit Committee of the Company's Board of Directors, and the Audit Committee has reviewed the Company's related disclosures.

Personal injury and other claims

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to personal injuries, occupational disease and damage to property.

Canada

Employee injuries are governed by the workers' compensation legislation in each province whereby employees may be awarded either a lump sum or future stream of payments depending on the nature and severity of the injury. Accordingly, the Company accounts for costs related to employee work-related injuries based on actuarially developed estimates of the ultimate cost associated with such injuries, including compensation, health care and third-party administration costs. For all other legal actions, the Company maintains, and regularly updates on a case-by-case basis, provisions for such items when the expected loss is both probable and can be reasonably estimated based on currently available information.

At December 31, 2006, 2005 and 2004, the Company's provision for personal injury and other claims in Canada was as follows:

<i>In millions</i>	2006	2005	2004
Balance January 1	\$ 205	\$ 204	\$ 169
Accruals and other	60	46	64
Payments	(70)	(45)	(29)
Balance December 31	\$ 195	\$ 205	\$ 204

Assumptions used in estimating the ultimate costs for Canadian employee injury claims consider, among others, the discount rate, the rate of inflation, wage increases and health care costs. The Company periodically reviews its assumptions to reflect currently available information. Over the past three years, the Company has not significantly changed any of these assumptions. For all other legal claims in Canada, estimates are based on the specifics of the case, trends and judgment.

United States

Employee work-related injuries, including occupational disease claims, are compensated according to the provisions of the Federal Employers' Liability Act (FELA), which requires either the finding of fault through the U.S. jury system or individual settlements, and represent a major liability for the railroad industry. The Company follows an actuarial-based approach and accrues the expected cost for personal injury and property damage claims and asserted and unasserted occupational disease claims, based on actuarial estimates of their ultimate cost. Prior to 2005, the Company's provisions for unasserted occupational disease claims constituted the minimum amount that could be reasonably estimated, reflecting a 25-year horizon as the Company expected that a large majority of the cases would be received over such period. In 2005, changes in the legislative and judicial environment, as well as in the methodology used by the courts and the Company to diagnose claims, enabled the Company to actuarially determine a best estimate for unasserted occupational disease claims, thereby increasing the expected number of claims to be received. These changes also rendered the recent claim experience to be more representative of future anticipated settlements for asserted occupational disease claims, thereby reducing the average cost per claim. Accordingly, in 2005, the Company recorded an increase in the provision for unasserted occupational disease claims, which was substantially offset by a reduction in the provision for asserted occupational disease claims.

In 2006, the Company recorded a net reduction to its provision for U.S. personal injury and other claims pursuant to the 2006 external actuarial studies. The reduction was mainly attributable to a decrease in the Company's claims inventory as a result of its ongoing risk mitigation strategy focused on prevention, mitigation of claims and containment of injuries and lower settlements for existing claims.

Due to the inherent uncertainty involved in projecting future events related to occupational diseases, which include but are not limited to, the number of expected claims, the average cost per claim and the legislative and judicial environment, the Company's future obligations may differ from current amounts recorded.

At December 31, 2006, 2005 and 2004, the Company's provision for U.S. personal injury and other claims was as follows:

<i>In millions</i>		2006		2005		2004
Balance January 1	\$	452	\$	438	\$	421
Accruals and other		(8)		61		94
Payments		(37)		(47)		(77)
Balance December 31	\$	407	\$	452	\$	438

For the U.S. personal injury and other claims liability, historical claim data is used to formulate assumptions relating to the expected number of claims and average cost per claim (severity) for each year. Changes in any one of these assumptions could materially affect Casualty and other expense as reported in the Company's results of operations. For example, a 5% change in the probability level for the number of claims or severity would have the effect of changing the provision by approximately \$35 million and the annual expense by approximately \$6 million.

Environmental claims

Regulatory compliance

A risk of environmental liability is inherent in railroad and related transportation operations; real estate ownership, operation or control; and other commercial activities of the Company with respect to both current and past operations. As a result, the Company incurs significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railroad operations and relating to its past and present ownership, operation or control of real property. Environmental expenditures that relate to current operations are expensed unless they relate to an improvement to the property. Expenditures that relate to an existing condition caused by past operations and which are not expected to contribute to current or future operations are expensed.

Known existing environmental concerns

The Company is subject to environmental clean-up and enforcement actions. In particular, the Federal Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), also known as the Superfund law, as well as similar state laws generally impose joint and several liability for clean-up and enforcement costs on current and former owners and operators of a site without regard to fault or the legality of the original conduct. The Company has been notified that it is a potentially responsible party for study and clean-up costs at approximately 23 sites governed by the Superfund law (and other similar federal and state laws) for which investigation and remediation payments are or will be made or are yet to be determined and, in many instances, is one of several potentially responsible parties.

The ultimate cost of known contaminated sites cannot be definitely established, and the estimated environmental liability for any given site may vary depending on the nature and extent of the contamination, the available clean-up techniques, the Company's share of the costs and evolving regulatory standards governing environmental liability. As a result, liabilities are recorded based on the results of a four-phase assessment conducted on a site-by-site basis. Cost scenarios established by external consultants based on extent of contamination and expected costs for remedial efforts are used by the Company to estimate the costs related to a particular site. A liability is initially recorded when environmental assessments occur and/or remedial efforts are likely, and when costs, based on a specific plan of action in terms of the technology to be used and the extent of the corrective action required, can be reasonably estimated. Adjustments to initial estimates are recorded as additional information becomes available. Based on the information currently available, the Company considers its provisions to be adequate.

In 2005, the Company recorded a liability related to a derailment at Wabamun Lake, Alberta, representing clean-up costs for the shoreline, fronting residences and First Nations Land, as explained in Note 18 – Major commitments and contingencies, to the Company's Annual Consolidated Financial Statements. In 2006, this liability was adjusted for additional environmental and legal claims

and reduced by payments made pursuant to the clean-up performed. At December 31, 2006, the Company has a receivable for the remaining estimated recoveries from the Company's insurance carriers since the Company's insurance policies are expected to cover substantially all expenses related to the derailment above the self-insured retention. Operating expenses in 2005 included approximately \$28 million, of which \$25 million was for environmental matters, related to this derailment, which represented the Company's retention under its insurance policies and other uninsured costs. The ultimate liability for clean-up costs is not expected to materially differ from the current amount recorded, but any additional costs are expected to be offset by a corresponding change in the insurance receivable. The Company expects its insurance coverage to be adequate to cover any additional clean-up costs related to the derailment above its self-insured retention.

At December 31, 2006, most of the Company's properties not acquired through recent acquisitions have reached the final assessment stage and therefore costs related to such sites have been anticipated. The final assessment stage can span multiple years. For properties acquired through recent acquisitions, the Company obtains assessments from both external and internal consultants and a liability has been or will be accrued based on such assessments.

Unknown existing environmental concerns

The Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities. The magnitude of such additional liabilities and the costs of complying with environmental laws and containing or remediating contamination cannot be reasonably estimated due to:

- (i) the lack of specific technical information available with respect to many sites;
- (ii) the absence of any government authority, third-party orders, or claims with respect to particular sites;
- (iii) the potential for new or changed laws and regulations and for development of new remediation technologies and uncertainty regarding the timing of the work with respect to particular sites;
- (iv) the ability to recover costs from any third parties with respect to particular sites;

and as such, costs related to future remediation will be accrued in the period they become known.

Future occurrences

In railroad and related transportation operations, it is possible that derailments, explosions or other accidents may occur that could cause harm to human health or to the environment. As a result, the Company may incur costs in the future, which may be material, to address any such harm, including costs relating to the performance of clean-ups, natural resource damages and compensatory or punitive damages relating to harm to individuals or property.

In 2006, the Company's expenses relating to specific environmental sites and remediation, net of recoveries, were \$17 million (\$37 million in 2005). Payments for such matters were \$10 million, net of potential insurance recoveries, in 2006 (\$24 million in 2005 and \$8 million in 2004). As at December 31, 2006, the Company had aggregate accruals for such environmental costs of \$131 million (\$124 million as at December 31, 2005). The Company anticipates that the majority of the liability at December 31, 2006 will be paid out over the next five years. The Company also incurs expenses related to environmental regulatory compliance and clean-up requirements. Such expenses amounted to \$10 million in 2006 (\$9 million in 2005 and \$10 million in 2004).

Depreciation

Railroad properties are carried at cost less accumulated depreciation including asset impairment write-downs. The Company follows the group method of depreciation for railroad properties and, as such, depreciates the cost of railroad properties, less net salvage value, on a straight-line basis over their estimated useful lives. In addition, under the group method of depreciation, the cost of railroad properties, less net salvage value, retired or disposed of in the normal course of business, is charged to accumulated depreciation.

Assessing the reasonableness of the estimated useful lives of properties requires judgment and is based on currently available information, including periodic depreciation studies conducted by the Company. The Company's U.S. properties are subject to comprehensive depreciation studies conducted by external consultants as required by the Surface Transportation Board (STB). Depreciation studies for Canadian properties are not required by regulation and are therefore conducted internally. Studies are performed on specific asset groups on a periodic basis. The studies consider, among others, the analysis of historical retirement data

using recognized life analysis techniques, and the forecasting of asset life characteristics. Changes in circumstances, such as technological advances, changes to the Company's business strategy, changes in the Company's capital strategy or changes in regulations can result in the actual useful lives differing from the Company's estimates.

A change in the remaining useful life of a group of assets, or their estimated net salvage, will affect the depreciation rate used to amortize the group of assets and thus affect depreciation expense as reported in the Company's results of operations. A change of one year in the composite useful life of the Company's fixed asset base would impact annual depreciation expense by approximately \$14 million.

Depreciation studies are a means of ensuring that the assumptions used to estimate the useful lives of particular asset groups are still valid and where they are not, they serve as the basis to establish the new depreciation rates to be used on a prospective basis. In 2007, the Company expects to finalize a comprehensive depreciation study of its U.S. rolling stock and equipment and to complete a depreciation study for its Canadian properties, plant and equipment and its U.S. track and roadway assets.

In 2006, the Company recorded total depreciation and amortization expense of \$653 million (\$630 million in 2005 and \$602 million in 2004). At December 31, 2006, the Company had Properties of \$21,053 million, net of accumulated depreciation of \$9,458 million (\$20,078 million in 2005, net of accumulated depreciation of \$9,347 million).

Pensions and other postretirement benefits

The Company has several pension plans with measurement dates of December 31 for the Canadian plans, and September 30 for the U.S. plans. The descriptions in the following paragraphs pertaining to pensions relate generally to the Company's main pension plan, the CN Pension Plan (the Plan), unless otherwise specified.

Recognition of the funded status of benefit plans

On December 31, 2006, the Company adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)," which requires the Company to recognize the over- or underfunded status of its various benefit plans in its Consolidated Balance Sheet. As such, on December 31, 2006, the Company increased its pension asset by \$599 million, to \$1,275 million, and decreased its pension and other postretirement benefits liability by \$7 million, to \$481 million. The Company will recognize changes in the funded status in the year in which the changes occur, through Other comprehensive income (loss). The actuarial gains/losses and prior service costs/credits that arise during the period but are not recognized as components of net periodic benefit cost will be recognized as a component of Other comprehensive income (loss), net of tax. These amounts recognized in Accumulated other comprehensive loss will be adjusted as they are subsequently recognized as components of net periodic benefit cost. Prior to December 31, 2006, actuarial gains/losses and prior service costs/credits were deferred in their recognition, and amortized into net periodic benefit cost over the expected average remaining service life of the employee group covered by the plans. The adoption of SFAS No. 158 had no impact on years prior to 2006 as retrospective application was not allowed. This standard had no effect on the 2006 computation of net periodic benefit cost for pensions and other postretirement benefits. See Note 9 – Other liabilities and deferred credits and Note 13 – Pensions, to the Company's Annual Consolidated Financial Statements, for the prospective application of SFAS No. 158 to the Company's benefit plans.

The following table illustrates the incremental effect of applying SFAS No. 158 on individual line items in the Company's Consolidated Balance Sheet at December 31, 2006:

<i>In millions</i>	Assets		Liabilities				Shareholders' equity	
	Pension	Total	Other postretirement benefits	Pension ⁽¹⁾	Net deferred income tax	Total	Accumulated other comprehensive loss	Total
Balance at December 31, 2006 before application of SFAS No. 158	\$ 676	\$ 23,405	\$ 313	\$ 175	\$ 4,939	\$ 13,995	\$ (458)	\$ 9,410
Adjustments	599	599	(27)	20	192	185	414	414
Balance at December 31, 2006 after application of SFAS No. 158	\$ 1,275	\$ 24,004	\$ 286	\$ 195	\$ 5,131	\$ 14,180	\$ (44)	\$ 9,824

⁽¹⁾ On December 31, 2006, just prior to the adoption of SFAS No. 158, the Company had a minimum pension liability recorded of \$17 million, with the offsetting amount recorded in Accumulated other comprehensive loss (\$11 million after tax).

At December 31, 2006 and 2005, the pension benefit obligation, accumulated postretirement benefit obligation (APBO), and other postretirement benefits liability were as follows:

<i>In millions</i>	<i>December 31,</i>	2006	2005
Pension benefit obligation	\$	14,545	\$ 14,346
Accumulated postretirement benefit obligation		286	300
Other postretirement benefits liability		286	313

Calculation of net periodic benefit cost

The Company accounts for net periodic benefit cost for pensions and other postretirement benefits as required by SFAS No. 87, "Employers' Accounting for Pensions," and SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," respectively. Under these standards, assumptions are made regarding the valuation of benefit obligations and performance of plan assets. In the calculation of net periodic benefit cost, these standards allow for a gradual recognition of changes in benefit obligations and fund performance over the expected average remaining service life of the employee group covered by the plans.

In accounting for pensions and other postretirement benefits, assumptions are required for, among others, the discount rate, the expected long-term rate of return on plan assets, the rate of compensation increase, health care cost trend rates, mortality rates, employee early retirements, terminations and disability. Changes in these assumptions result in actuarial gains or losses, which pursuant to SFAS No. 158, will be recognized in Other comprehensive income (loss) effective December 31, 2006. In accordance with SFAS No. 87 and SFAS No. 106, the Company has elected to amortize these gains or losses into net periodic benefit cost over the expected average remaining service life of the employee group covered by the plans only to the extent that the unrecognized net actuarial gains and losses are in excess of the corridor threshold, which is calculated as 10% of the greater of the beginning of year balances of the projected benefit obligation or market-related value of plan assets. The Company's net periodic benefit cost for future periods is dependent on demographic experience, economic conditions and investment performance. Recent demographic experience has revealed no material net gains or losses on termination, retirement, disability and mortality. Experience with respect to economic conditions and investment performance is further discussed herein.

The Company recorded consolidated net periodic benefit cost for pensions of \$66 million, \$17 million and \$22 million in 2006, 2005 and 2004, respectively. Consolidated net periodic benefit cost for other postretirement benefits was \$17 million, \$24 million and \$29 million in 2006, 2005 and 2004, respectively.

Discount rate assumption

The Company's discount rate assumption, which is set annually at the end of each year, is used to determine the projected benefit obligation at the end of the year and the net periodic benefit cost for the following year. The discount rate is used to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments with a rating of AA or better, would provide the necessary cash flows to pay for pension benefits as they become due. The discount rate is determined by management with the aid of third-party actuaries. The Company's methodology for determining the discount rate is based on a zero-coupon bond yield curve, which is derived from a semi-annual bond yield curve provided by a leading Canadian financial institution. The portfolio of hypothetical zero-coupon bonds is expected to generate cash flows that match the estimated future benefit payments of the plans as the bond rate for each maturity year is applied to the plans' corresponding expected benefit payments of that year. A discount rate of 5.12%, based on bond yields prevailing at December 31, 2006 (5.0% at December 31, 2005), was considered appropriate by the Company to match the approximately 12-year average duration of estimated future benefit payments. As a result, in 2007, the Company's net periodic benefit cost for all plans is expected to decrease by approximately \$35 million, since the cumulative unrecognized actuarial loss has decreased to \$1,804 million at December 31, 2006 from \$2,145 million at December 31, 2005, mainly resulting from an increase in the level of interest rates. The current estimate for the expected average remaining service life of the employee group covered by the plans is approximately nine years.

For the year ended December 31, 2006, a one-percentage-point decrease in the 5.0% discount rate used to determine net periodic benefit cost at January 1, 2006 would have resulted in an increase of approximately \$150 million in net periodic benefit cost, whereas a one-percentage-point increase would have resulted in a decrease of approximately \$90 million, given that the Company amortizes actuarial gains and losses over the expected average remaining service life of the employee group covered by the plans, only to the extent they are in excess of the corridor threshold.

Expected long-term rate of return assumption

To develop its expected long-term rate of return assumption used in the calculation of net periodic benefit cost applicable to the market-related value of assets, the Company considers both its past experience and future estimates of long-term investment returns, the expected composition of the plans' assets as well as the expected long-term market returns in the future. The Company has elected to use a market-related value of assets, whereby realized and unrealized gains/losses and appreciation/depreciation in the value of the investments are recognized over a period of five years, while investment income is recognized immediately. If the Company had elected to use the market value of assets, which at December 31, 2006 exceeded the market-related value of Plan assets by \$2,465 million, net periodic benefit cost would decrease by approximately \$260 million for 2006, assuming all other assumptions remained constant. The Company follows a disciplined investment strategy, which limits concentration of investments by asset class, foreign currency, sector or company. The Investment Committee of the Board of Directors has approved an investment policy that establishes long-term asset mix targets based on a review of historical returns achieved by worldwide investment markets. Investment managers may deviate from these targets but their performance is evaluated in relation to the market performance of the target mix. The Company does not anticipate the return on plan assets to fluctuate materially from related capital market indices. The Investment Committee reviews investments regularly with specific approval required for major investments in illiquid securities. The policy also permits the use of derivative financial instruments to implement asset mix decisions or to hedge existing or anticipated exposures. The Plan does not invest in the securities of the Company or its subsidiaries. During the last 10 years ended December 31, 2006, the Plan earned an annual average rate of return of 10.0%. The actual, market-related value, and expected rates of return on plan assets for the last five years were as follows:

Rates of return	2006	2005	2004	2003	2002
<i>Actual</i>	10.7%	20.5%	11.7%	9.6%	(0.3)%
<i>Market-related value</i>	11.4%	8.6%	6.3%	7.0%	7.4%
<i>Expected</i>	8.0%	8.0%	8.0%	8.0%	9.0%

The Company's expected long-term rate of return on plan assets reflects management's view of long-term investment returns and the effect of a 1% variation in such rate of return would result in a change to the net periodic benefit cost of approximately \$60 million.

Plan asset allocation

Based on the fair value of the assets held as at December 31, 2006, the Plan assets are comprised of 52% in Canadian and foreign equities, 38% in debt securities, 2% in real estate assets and 8% in other assets. The long-term asset allocation percentages are not expected to differ materially from the current composition.

Rate of compensation increase and health care cost trend rate

Another significant assumption in the actuarial model for pension accounting is the rate of compensation increase, which is determined by the Company based upon its long-term plans for such increases. For 2006, a rate of compensation increase of 3.50% was used to determine the benefit obligation and 3.75% for the net periodic benefit cost.

For postretirement benefits other than pensions, the Company reviews external data and its own historical trends for health care costs to determine the health care cost trend rates. For measurement purposes, the projected health care cost trend rate for prescription drugs was assumed to be 13% in 2006, and it is assumed that the rate will decrease gradually to 6% in 2013 and remain at that level thereafter. For the year ended December 31, 2006, a one-percentage-point change in either the rate of compensation increase or the health care cost trend rate would not cause a material change to the Company's net periodic benefit cost for both pensions and other postretirement benefits.

Funding of pension plans

For pension funding purposes, an actuarial valuation is required at least on a triennial basis. However, the Company has conducted actuarial valuations on an annual basis to account for pensions. The latest actuarial valuation of the CN Pension Plan was conducted as at December 31, 2005 and indicated a funding excess. Total contributions for all of the Company's pension plans are expected to be approximately \$100 million in each of 2007, 2008 and 2009 based on the plans' current position. The assumptions discussed above are not expected to have a significant impact on the cash funding requirements of the pension plans. In 2005, the Canadian Institute of Actuaries (CIA) adopted a new standard to be used to calculate the values that pension plan members are entitled to receive upon termination of employment. This standard impacts the calculation of the pension plan liabilities under a solvency or wind-up scenario when the Company conducts an actuarial valuation for purposes of determining the funding position of the Company's Canadian

pension plans. This standard applies to current and future actuarial valuations and may significantly impact future funding requirements.

Information disclosed by major pension plan

The following table provides the Company's plan assets by category, benefit obligation at end of year, and Company and employee contributions by major pension plan:

<i>In millions</i>	<i>December 31, 2006</i>	CN Pension Plan	BC Rail Ltd Pension Plan	U.S. and other plans	Total
Plan assets by category					
Equity securities		\$ 7,672	\$ 289	\$ 128	\$ 8,089
Debt securities		5,708	255	68	6,031
Real estate		236	9	1	246
Other		1,196	44	19	1,259
Total		\$ 14,812	\$ 597	\$ 216	\$ 15,625
Benefit obligation at end of year		\$ 13,590	\$ 556	\$ 399	\$ 14,545
Company contributions in 2006		\$ 85	\$ 6	\$ 21	\$ 112
Employee contributions in 2006		\$ 55	\$ -	\$ -	\$ 55

Income taxes

The Company follows the asset and liability method of accounting for income taxes. Under the asset and liability method, the change in the net deferred income tax asset or liability is included in the computation of net income. Deferred income tax assets and liabilities are measured using enacted income tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. As a result, a projection of taxable income is required for those years, as well as an assumption of the ultimate recovery/settlement period for temporary differences. The projection of future taxable income is based on management's best estimate and may vary from actual taxable income. On an annual basis, the Company assesses its need to establish a valuation allowance for its deferred income tax assets, and if it is deemed more likely than not that its deferred income tax assets will not be realized based on its taxable income projections, a valuation allowance is recorded. As at December 31, 2006, the Company expects that its deferred income tax assets will be recovered from future taxable income and therefore, has not set up a valuation allowance. In addition, Canadian and U.S. tax rules and regulations are subject to interpretation and require judgment by the Company that may be challenged by the taxation authorities upon audit of the filed income tax returns. In 2006, the taxation authorities completed their assessments of income tax returns filed for the years 1998 to 2001. Accordingly, the Company has made adjustments to its provision for income taxes in 2006. The Company believes that its provisions for income taxes at December 31, 2006 are adequate pertaining to any future assessments from the taxation authorities.

The Company's deferred income tax assets are mainly composed of temporary differences related to accruals for workforce reductions, personal injury and other claims, environmental and other postretirement benefits, and losses and tax credit carryforwards. The majority of these accruals will be paid out over the next five years. The Company's deferred income tax liabilities are mainly composed of temporary differences related to properties and the net pension asset. The reversal of temporary differences is expected at future-enacted income tax rates which could change due to fiscal budget changes and/or changes in income tax laws. As a result, a change in the timing and/or the income tax rate at which the components will reverse, could materially affect deferred income tax expense as recorded in the Company's results of operations. A one-percentage-point change in the Company's reported effective income tax rate would have the effect of changing the income tax expense by \$27 million in 2006.

From time to time, the federal, provincial, and state governments enact new corporate tax rates resulting in either lower or higher tax liabilities. Such enactments occurred in each of 2006, 2005 and 2004 and resulted in a deferred income tax recovery of \$228 million, a deferred income tax expense of \$14 million and a deferred income tax recovery of \$5 million, respectively, with corresponding adjustments to the Company's net deferred income tax liability.

In 2006, for certain items reported in Accumulated other comprehensive loss (a separate component of Shareholders' equity), the Company adjusted its deferred income tax liability for changes in income tax rates applied to certain temporary differences and also for the income tax effect on the currency translation amount resulting from the difference between the accounting and tax basis of its net investment in foreign subsidiaries. As a result, the Company recorded a \$180 million net charge for deferred income taxes in Other comprehensive income (loss).

For the year ended December 31, 2006, the Company recorded total income tax expense of \$642 million (\$781 million in 2005 and \$596 million in 2004) of which \$3 million was for deferred income taxes, including the deferred income tax recovery of \$277 million, resulting from the enactment of lower federal and provincial corporate tax rates in Canada and the resolution of matters pertaining to prior years' income taxes (\$547 million in 2005 and \$366 million in 2004). The Company's net deferred income tax liability at December 31, 2006 was \$5,131 million (\$4,752 million at December 31, 2005).

Business risks

Certain information included in this report may be "forward-looking statements" within the meaning of the United States Private Securities Litigation Reform Act of 1995 and under Canadian securities laws. Implicit in these statements, particularly in respect of growth opportunities, is the assumption that although a moderate slowdown in the North American economy is expected in the near term, the positive economic conditions in North America and globally are expected to continue. This assumption, although considered reasonable by the Company at the time of preparation, may not materialize. Such forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors which may cause the actual results or performance of the Company or the rail industry to be materially different from the outlook or any future results or performance implied by such statements. Such factors include the specific risks set forth below as well as other risks detailed from time to time in reports filed by the Company with securities regulators in Canada and the United States.

Competition

The Company faces significant competition from a variety of carriers, including Canadian Pacific Railway Company (CP) which operates the other major rail system in Canada, serving most of the same industrial and population centers as the Company; long distance trucking companies; and in many markets, major U.S. railroads and other Canadian and U.S. railroads. Competition is generally based on the quality and reliability of services provided, price, and the condition and suitability of carriers' equipment. Competition is particularly intense in eastern Canada where an extensive highway network and population centers, located relatively close to one another, have encouraged significant competition from trucking companies. In addition, much of the freight carried by the Company consists of commodity goods that are available from other sources in competitive markets. Factors affecting the competitive position of suppliers of these commodities, including exchange rates, could materially adversely affect the demand for goods supplied by the sources served by the Company and, therefore, the Company's volumes, revenues and profit margins.

In addition to trucking competition, and to a greater degree than other rail carriers, the Company's subsidiary, Illinois Central Railroad Company (ICRR), is vulnerable to barge competition because its main routes are parallel to the Mississippi River system. The use of barges for some commodities, particularly coal and grain, often represents a lower cost mode of transportation. Barge competition and barge rates are affected by navigational interruptions from ice, floods and droughts, which can cause widely fluctuating barge rates. The ability of ICRR to maintain its market share of the available freight has traditionally been affected by the navigational conditions on the river.

The significant consolidation of rail systems in the United States has resulted in larger rail systems that are able to offer seamless services in larger market areas and accordingly, compete effectively with the Company in certain markets. This requires the Company to consider transactions that would similarly enhance its own service. There can be no assurance that the Company will be able to compete effectively against current and future competitors in the railroad industry and that further consolidation within the railroad industry will not adversely affect the Company's competitive position. No assurance can be given that competitive pressures will not lead to reduced revenues, profit margins or both.

Environmental matters

The Company's operations are subject to numerous federal, provincial, state, municipal and local environmental laws and regulations in Canada and the United States concerning, among other things, emissions into the air; discharges into waters; the generation, handling, storage, transportation, treatment and disposal of waste, hazardous substances and other materials; decommissioning of underground and aboveground storage tanks; and soil and groundwater contamination. A risk of environmental liability is inherent in railroad and related transportation operations; real estate ownership, operation or control; and other commercial activities of the Company with respect to both current and past operations. As a result, the Company incurs significant compliance and capital costs, on an ongoing basis, associated with environmental regulatory compliance and clean-up requirements in its railroad operations and relating to its past and present ownership, operation or control of real property.

While the Company believes that it has identified the costs likely to be incurred in the next several years, based on known information, for environmental matters, the Company's ongoing efforts to identify potential environmental concerns that may be associated with its properties may lead to future environmental investigations, which may result in the identification of additional environmental costs and liabilities.

In railroad and related transportation operations, it is possible that derailments, explosions or other accidents may occur that could cause harm to human health or to the environment. In addition, the Company is also exposed to liability risk, faced by the railroad industry generally, in connection with the transportation of toxic-by-inhalation hazardous materials such as chlorine and anhydrous ammonia, commodities that are essential to the public health and welfare and that, as a common carrier, the Company has a duty to transport. As a result, the Company may incur costs in the future, which may be material, to address any such harm, including costs relating to the performance of clean-ups, natural resource damages and compensatory or punitive damages relating to harm to individuals or property.

The ultimate cost of known contaminated sites cannot be definitively established, and the estimated environmental liability for any given site may vary depending on the nature and extent of the contamination, the available clean-up techniques, the Company's share of the costs and evolving regulatory standards governing environmental liability. Also, additional contaminated sites yet unknown may be discovered or future operations may result in accidental releases. For these reasons, there can be no assurance that material liabilities or costs related to environmental matters will not be incurred in the future, or will not have a material adverse effect on the Company's financial position or results of operations in a particular quarter or fiscal year, or that the Company's liquidity will not be adversely impacted by such environmental liabilities or costs.

Personal injury and other claims

In the normal course of its operations, the Company becomes involved in various legal actions, including claims relating to personal injuries, occupational disease and damage to property. The Company maintains provisions for such items, which it considers to be adequate for all of its outstanding or pending claims. The final outcome with respect to actions outstanding or pending at December 31, 2006, or with respect to future claims, cannot be predicted with certainty, and therefore there can be no assurance that their resolution will not have a material adverse effect on the Company's financial position or results of operations in a particular quarter or fiscal year.

Labor negotiations

Canadian workforce

As at December 31, 2006, CN employed a total of 15,232 employees in Canada, of which 12,183 were unionized employees.

As of February 2007, the Company had in place labor agreements covering its entire Canadian unionized workforce. In September 2006, the Company began bargaining with the two unions whose agreements were to expire on December 31, 2006; namely the United Transportation Union (UTU), which represents conductors and yard coordinators, and the National Automobile Aerospace Transportation and General Workers Union of Canada (Canadian Auto Workers or CAW), which represents clerical and intermodal employees in one bargaining unit, shopcraft employees in a separate bargaining unit, as well as owner-operator truck drivers in a third bargaining unit. On January 14, 2007, the Company and the CAW reached tentative agreements covering all three bargaining units. The CAW completed its ratification process on January 29, 2007, and as a result, the collective agreements have been renewed for a four-year period ending December 31, 2010.

With respect to the UTU negotiations, on November 20, 2006, the Minister of Labour (Canada) appointed two conciliation officers to assist with negotiations pursuant to a request from the UTU, which CN had opposed as being premature. Following a conciliation process and the completion of required legislated processes, the union claimed it was in a legal strike position, and the Company would

have been legally permitted to lockout the members of the UTU bargaining unit or promulgate work rule changes unilaterally on February 9, 2007. On February 6, 2007, the UTU served a 72-hour advance strike notice to the Company and they commenced work stoppage on February 10, 2007. The Company is seeking to have the UTU work stoppage declared illegal. The UTU had also advised the Company that because the UTU-represented employees of the former BC Rail were legally members of its CN bargaining unit, it intended to bargain terms and conditions for those employees in conciliation along with its demands covering all its other members at CN. The Company intends to maintain its operations notwithstanding the work stoppage by the UTU-represented employees. Although there can be no assurance to such effect, the Company remains optimistic that a resolution can be reached quickly and that its operations will return to normal with minimal adverse effects on the Company's financial position or results of operations. The Company also has an agreement with the UTU for its Northern Quebec line, which is set to expire on December 15, 2007.

Following the acquisition of BC Rail, the Company reached implementing agreements in December 2004 for former BC Rail employees with the Council of Trade Unions and its members, representing all unions, regarding the integration of the various collective agreements. In March 2005, under Section 18 of the Canada Labour Code, the Company had filed a request with the Canada Industrial Relations Board (CIRB) to amend the current bargaining agent certificates at BC Rail to correspond with those agents representing the same employee groups at CN. On March 9, 2006, the CIRB issued its final decision and granted the Company's request to integrate the former BC Rail employees into CN's bargaining unit structures. Subsequently, the CAW union requested that the CIRB reconsider its decision. On April 20, 2006, the CIRB rejected the CAW's application and advised that its decision was final.

In 2007, CN will begin bargaining with two other national unions whose agreements expire December 31, 2007. These agreements will remain in effect until bargaining and legal processes have been concluded.

There can be no assurance that the Company will be able to renew and have ratified its collective agreements without any strikes or lockouts or that the resolution of these collective bargaining negotiations will not have a material adverse effect on the Company's financial position or results of operations.

U.S. workforce

As at December 31, 2006, CN employed a total of 6,579 employees in the United States, of which 5,732 were unionized employees.

As of February 2007, the Company had in place agreements with bargaining units representing the entire unionized workforce at Grand Trunk Western Railroad Incorporated (GTW); Duluth, Winnipeg and Pacific (DWP); ICRR; CCP Holdings, Inc. (CCP); Duluth, Missabe & Iron Range Railroad (DMIR); Bessemer & Lake Erie (BLE); and Pittsburgh & Conneaut Dock Company (PCD); and 98% of the unionized workforce at Wisconsin Central Transportation Corporation (WC). Agreements in place have various moratorium provisions, ranging from 2004 to 2011, which preserve the status quo in respect of given areas during the terms of such moratoriums. Several of these agreements are currently under renegotiation.

The general approach to labor negotiations by U.S. Class I railroads is to bargain on a collective national basis. GTW, DWP, ICRR, CCP, WC, DMIR, BLE and PCD have bargained on a local basis rather than holding national, industry-wide negotiations because they believe it results in agreements that better address both the employees' concerns and preferences, and the railways' actual operating environment. However, local negotiations may not generate federal intervention in a strike or lockout situation, since a dispute may be localized. The Company believes the potential mutual benefits of local bargaining outweigh the risks.

Negotiations are ongoing with the bargaining units with which the Company does not have agreements or settlements. Until new agreements are reached or the processes of the Railway Labor Act have been exhausted, the terms and conditions of existing agreements generally continue to apply. On July 19, 2006, one of the unions representing 250 GTW employees took a one-day strike action during the mediation process. However, a U.S. District Court subsequently determined that the strike action was improper and enjoined employees from further action. The employees returned to work and the Company continues to be in mediation with that union. There can be no assurance that there will not be any work action by any of the bargaining units with which the Company is currently in negotiations or that the resolution of these negotiations will not have a material adverse effect on the Company's financial position or results of operations.

Regulation

The Company's rail operations in Canada are subject to (i) regulation as to rate setting, level of service and network rationalization by the Canadian Transportation Agency (the Agency) under the Canada Transportation Act (the CTA), and (ii) safety regulation by the federal Minister of Transport under the Railway Safety Act and certain other statutes. The Company's U.S. rail operations are subject to (i) economic regulation by the Surface Transportation Board (STB) and (ii) safety regulation by the Federal Railroad Administration (FRA). As such, various Company business transactions must gain prior regulatory approval, with attendant risks and uncertainties, and the Company is subject to government oversight with respect to rate and service issues. In particular, the STB completed a proceeding on January 26, 2007 in which it reviewed the practice of rail carriers, including the Company and the majority of other large railroads operating within the U.S., of assessing a fuel surcharge computed as a percentage of the base rate for service. Following its review, the STB directed carriers to change that practice and adjust their fuel surcharge programs within 90 days on a basis more closely related to the amount of fuel consumed on individual movements. The Company is evaluating the impact of the STB's decision. The Company is also subject to a variety of health, safety, security, labor, environmental and other regulations, all of which can affect its competitive position and profitability.

The Company's ownership of the former Great Lakes Transportation vessels is subject to regulation by the U.S. Coast Guard and the Department of Transportation, Maritime Administration, which regulate the ownership and operation of vessels operating on the Great Lakes and in U.S. coastal waters. While recent Congressional legislation and Coast Guard rulemakings have not adversely affected CN's ownership of these vessels, no assurance can be given that any future legislative or regulatory initiatives by the U.S. federal government will not materially adversely affect the Company's operations or its competitive and financial position.

With respect to safety, rail safety regulation in Canada is the responsibility of Transport Canada, which administers the Canadian Railway Safety Act, as well as the rail portions of other safety-related statutes. In the U.S., rail safety regulation is the responsibility of the FRA, which administers the Federal Rail Safety Act, as well as the rail portions of other safety statutes. In addition, safety matters related to security are overseen by the Transportation Security Administration (TSA), which is part of the U.S. Department of Homeland Security and the Pipeline and Hazardous Materials Safety Administration (PHMSA), which, like the FRA, is part of the U.S. Department of Transportation.

The federal government carries out a review of Canadian transportation legislation periodically. The latest review resulted in a report to the Minister of Transport, released to the public on July 18, 2001, which contains numerous recommendations for legislative changes affecting all modes of transportation, including rail. On February 25, 2003, the Canadian Minister of Transport released the policy document *Straight Ahead - A Vision for Transportation in Canada*. On March 24, 2005, the Minister of Transport tabled Bill C-44 entitled *An Act to Amend the Canada Transportation Act and the Railway Safety Act, to enact the VIA Rail Canada Act and to make consequential amendments to other Acts*. Bill C-44 was terminated when Parliament was dissolved on November 29, 2005 and has since been replaced by two separate pieces of legislation: Bill C-3 entitled *International Bridges and Tunnels Act*, tabled on April 24, 2006 and Bill C-11 entitled *Transportation Amendment Act*, tabled on May 4, 2006, relating to passenger service providers, noise, mergers and other issues. Also, the federal government is currently engaged in a consultative process relating to shipper-railway relationships. On December 14, 2006, the federal government announced a full review of the Railway Safety Act. Members of the panel to conduct the review are expected to be appointed in early 2007 and are expected to submit their report in the fall of 2007. No assurance can be given that any future legislative action by the federal government or other future government initiatives will not materially adversely affect the Company's financial position or results of operations.

The U.S. Congress has had under consideration for several years various pieces of legislation that would increase federal economic regulation of the railroad industry, and additional legislation was introduced in 2006. In addition, the STB is authorized by statute to commence regulatory proceedings if it deems them to be appropriate. No assurance can be given that any future regulatory initiatives by the U.S. federal government will not materially adversely affect the Company's operations, or its competitive and financial position.

The Company is subject to statutory and regulatory directives in the United States addressing homeland security concerns. These include border security arrangements, pursuant to an agreement the Company and CP entered into with U.S. Customs and Border Protection (CBP) and the Canada Border Services Agency (CBSA). These requirements include advance electronic transmission of cargo information for U.S.-bound traffic and cargo screening (including gamma ray and radiation screening), as well as U.S. government-imposed restrictions on the transportation into the United States of certain commodities. These also include participation in CBP's Customs-Trade Partnership Against Terrorism (C-TPAT) program and designation as a low-risk carrier under CBSA's Customs Self-Assessment (CSA) program. In the fourth quarter of 2003, the CBP issued regulations to extend advance notification requirements to all modes of transportation and the U.S. Food and Drug Administration promulgated interim final rules requiring advance notification by all modes for certain food imports into the United States. CBSA is also working on implementation of advance notification requirements for

Canadian-bound traffic. Recently, the U.S. Department of Agriculture (USDA) issued a proposed interim rule, which would remove the current exemption from inspection for imported fruits and vegetables grown in Canada and the exemptions for all transport modes from the agricultural quarantine and inspection (AQI) user fee for traffic entering the U.S. from Canada. The rule was originally scheduled to take effect on November 24, 2006, but the USDA deferred implementation for surface modes until March 1, 2007.

The Company has also worked with the Association of American Railroads to develop and put in place an extensive industry-wide security plan to address terrorism and security-driven efforts by state and local governments seeking to restrict the routings of certain hazardous materials. If such state and local routing restrictions were to go into force, they would be likely to add to security concerns by foreclosing the Company's most optimal and secure transportation routes, leading to increased yard handling, longer hauls, and the transfer of traffic to lines less suitable for moving hazardous materials, while also infringing upon the exclusive and uniform federal oversight over railroad security matters. In addition to recommended security action items for the rail transportation of toxic inhalation hazard (TIH) materials jointly announced by the TSA and the FRA on June 23, 2006 and November 21, 2006, the TSA and the PHMSA also separately issued, on December 21, 2006, related notices of proposed rulemakings. Among other things, the TSA's regulations would require rail carriers operating within the U.S. to provide upon request, within one hour, location and shipping information on cars on their networks containing TIH materials and certain radioactive or explosive materials, and ensure the secure, attended transfer of all such cars to and from shippers, receivers and other carriers. The PHMSA's regulations would require carriers to report annually the volume and route-specific data for cars containing these commodities; conduct a safety and security risk analysis for each used route; identify a commercially practicable alternative route for each used route; and select for use the practical route posing the least safety and security risk.

While the Company will continue to work closely with the CBSA, CBP, and other Canadian and U.S. agencies, as described above, no assurance can be given that these and future decisions by the U.S., Canadian, provincial, state, or local governments on homeland security matters, legislation on security matters enacted by the U.S. Congress, or joint decisions by the industry in response to threats to the North American rail network, will not materially adversely affect the Company's operations, or its competitive and financial position.

Business prospects and other risks

In any given year, the Company, like other railroads, is susceptible to changes in the economic conditions of the industries and geographic areas that produce and consume the freight it transports or the supplies it requires to operate. In addition, many of the goods and commodities carried by the Company experience cyclicity in demand. Many of the bulk commodities the Company transports move offshore and are affected more by global rather than North American economic conditions. The Company's results of operations can be expected to reflect these conditions because of the significant fixed costs inherent in railroad operations.

Global as well as North American trade conditions, including trade barriers on certain commodities, may interfere with the free circulation of goods across Canada and the United States.

As part of the Security and Prosperity Partnership entered into in 2005 by the Presidents of the United States and Mexico and the Prime Minister of Canada, as a trilateral effort to increase security and enhance prosperity among Canada, the U.S. and Mexico, a North American Competitiveness Council has been created. The Council is intended to engage the private sector as partners with the governments of the three countries in finding solutions to North American trade and security issues in the context of the Security and Prosperity Partnership. The Prime Minister has designated the Company's President and Chief Executive Officer as a member of the Council, and CN will be active in the Council's activities.

The Company, like other railroads, is susceptible to the volatility of fuel prices due to changes in the economy or supply disruptions. Rising fuel prices could materially adversely affect the Company's expenses. As such, CN has implemented a fuel surcharge program to help mitigate the impact of rising fuel prices. No assurance can be given that continued increases in fuel prices or supply disruptions will not materially adversely affect the Company's operations or its financial position.

Overall return in the capital markets, and the level of interest rates, affect the funded status of the Company's pension plans as well as the Company's results of operations. Adverse changes with respect to pension plan returns and the level of interest rates from the date of the last actuarial valuation may increase future pension contributions and could have a material adverse effect on the Company's results of operations. The funding requirements, as well as the impact on the results of operations, will be determined following the completion of future actuarial valuations.

Potential terrorist actions can have a direct or indirect impact on the transportation infrastructure, including railway infrastructure in North America, and interfere with the free flow of goods. International conflicts can also have an impact on the Company's markets.

The Company conducts its business in both Canada and the U.S. and as a result, is affected by currency fluctuations. Based on the Company's current operations, the estimated annual impact on net income of a year-over-year one-cent change in the Canadian dollar

relative to the U.S. dollar is approximately \$11 million. Changes in the exchange rate between the Canadian dollar and other currencies (including the U.S. dollar) make the goods transported by the Company more or less competitive in the world marketplace and thereby further affect the Company's revenues and expenses.

Should a significant economic slowdown or recession occur in North America or other key markets, or should major industrial restructuring take place, the volume of rail shipments carried by the Company may be adversely affected.

In addition to the inherent risks of the business cycle, the Company's operations are occasionally susceptible to severe weather conditions, which can disrupt operations and service for the railroad as well as for the Company's customers. In recent years, severe drought conditions in western Canada, for instance, significantly reduced bulk commodity revenues, principally grain.

Generally accepted accounting principles require the use of historical cost as the basis of reporting in financial statements. As a result, the cumulative effect of inflation, which has significantly increased asset replacement costs for capital-intensive companies such as CN, is not reflected in operating expenses. Depreciation charges on an inflation-adjusted basis, assuming that all operating assets are replaced at current price levels, would be substantially greater than historically reported amounts.

Controls and procedures

The Company's Chief Executive Officer and its Chief Financial Officer, after evaluating the effectiveness of the Company's "disclosure controls and procedures" (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of December 31, 2006, have concluded that the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company and its consolidated subsidiaries would have been made known to them.

During the fourth quarter ending December 31, 2006, there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

During 2006, in the course of its evaluation, management had identified certain deficiencies in its internal control over financial reporting which the Company does not believe, either individually or in the aggregate, resulted in a material weakness to its internal control over financial reporting.

As of December 31, 2006, management has assessed the effectiveness of the Company's internal control over financial reporting using the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework. Based on this assessment, management has determined that the Company's internal control over financial reporting was effective as of December 31, 2006, and issued Management's Report on Internal Control over Financial Reporting dated February 12, 2007 to that effect.

Additional information, including the Company's 2006 Annual Information Form (AIF) and Form 40-F, may be found on SEDAR at www.sedar.com and on EDGAR at www.sec.gov, respectively.

Montreal, Canada
February 12, 2007