Press Release

North America's Railroad

# CN reports Q2-2016 net income of C$858 million, or C$1.10 per diluted share

### *Adjusted diluted earnings per share (EPS) [1] decreased by three per cent to C$1.11*

### *Record second-quarter operating ratio of 54.5 per cent*

**MONTREAL, July 25, 2016** — CN (TSX: CNR) (NYSE: CNI) today reported its financial and operating results for the second quarter and six-month period ended June 30, 2016.

**Second-quarter 2016 financial highlights**

- Net income was C$858 million, compared with net income of C$886 million for second-quarter 2015. Q2-2016 diluted EPS remained flat at C$1.10. The decrease in net income was mainly due to lower operating income and other income, and higher interest expense; net of related income taxes.
- Adjusted diluted EPS [1] of C$1.11 declined three per cent from year-earlier adjusted diluted EPS of C$1.15. The adjusted figures exclude the impact of deferred income tax adjustments resulting from higher provincial corporate income tax rates in both years.
- Operating income declined five per cent to C$1,293 million.
- Revenues decreased by nine per cent to C$2,842 million. Carloadings declined 12 per cent and revenue ton-miles declined 11 per cent.
- Operating expenses declined 12 per cent to C$1,549 million.
- Operating ratio of 54.5 per cent was a second-quarter record and an improvement of 1.9-points over the prior-year quarter.
- Free cash flow [1] for the first six months of 2016 was C$1,169 million, compared with C$1,051 million for the year-earlier period.

Luc Jobin, president and chief executive officer, said: "CN continued to face a very challenging volume environment in the second quarter and maintained strong discipline in realigning resources to keep them in line with reduced freight demand. Service remained solid, key operating metrics advanced, and we continued to improve our safety record. An important product of our cost-management and productivity focus was a record second-quarter operating ratio of 54.5 per cent.

"We expect the second quarter to be the volume trough for the year. For the balance of 2016, we continue to expect some markets to remain strong, including lumber and panels, automotive, and refined petroleum products, and we anticipate a bumper grain crop in Canada. At the same time, international intermodal volumes are expected to remain challenging while shipments of commodities related to oil and gas development, such as crude oil, frac sand and drilling pipe, are expected to decrease relative to last year.

"Given these expectations, we reiterate our April 25, 2016, financial outlook of aiming to deliver 2016 EPS in line with last year's adjusted diluted EPS [1] of C$4.44." [2]

## Foreign currency impact on results

Although CN reports its earnings in Canadian dollars, a large portion of its revenues and expenses is denominated in U.S. dollars. The fluctuation of the Canadian dollar relative to the U.S. dollar affects the conversion of the Company's U.S.-dollar-denominated revenues and expenses. On a constant currency basis, [(1)] CN's net income for the second quarter of 2016 would have been lower by C$23 million, or C$0.03 per diluted share.

## Second-quarter 2016 revenues, traffic volumes and expenses

Revenues for the second quarter of 2016 were C$2,842 million, a decrease of nine per cent, when compared to the same period in 2015. Revenues increased for forest products (four per cent), but were more than offset by revenue declines for coal (36 per cent), metals and minerals (17 per cent), petroleum and chemicals (16 per cent), grain and fertilizers (12 per cent), intermodal (four per cent), and automotive (one per cent).

The revenue decline was mainly attributable to decreased shipments of energy-related commodities including crude oil, frac sand, drilling pipe and semi-finished steel products as a result of declining energy markets; reduced shipments of coal due to weaker North American and global demand; lower volumes of Canadian grain to North American and export markets due to lower available supply; and lower applicable fuel surcharge rates. These factors were partly offset by the positive translation impact of the weaker Canadian dollar on U.S.-dollar-denominated revenues; freight rate increases; as well as increased shipments of lumber and panels to U.S. markets, and increased domestic retail intermodal shipments.

Carloadings for the quarter declined by 12 per cent to 1,249 thousand.

Revenue ton-miles (RTMs), measuring the relative weight and distance of rail freight transported by CN, declined by 11 per cent from the year-earlier quarter. Rail freight revenue per RTM, a measurement of yield defined as revenue earned on the movement of a ton of freight over one mile, increased by one per cent over the year-earlier period, driven by the positive translation impact of the weaker Canadian dollar and freight rate increases, partly offset by a significant increase in the average length of haul and lower applicable fuel surcharge rates.

Operating expenses for the second quarter decreased by 12 per cent to C$1,549 million, mainly due to lower costs resulting from decreased volumes of traffic, lower fuel prices, lower pension expense and cost-management initiatives, partly offset by the negative translation impact of a weaker Canadian dollar on U.S.-dollar-denominated expenses.

## Forward-Looking Statements

Certain statements included in this news release constitute "forward-looking statements" within the meaning of the United States Private Securities Litigation Reform Act of 1995 and under Canadian securities laws. By their nature, forward-looking statements involve risks, uncertainties and assumptions. The Company cautions that its assumptions may not materialize and that current economic conditions render such assumptions, although reasonable at the time they were made, subject to greater uncertainty. Forward-looking statements may be identified by the use of terminology such as "believes," "expects," anticipates," "assumes," "outlook," "plans," "targets," or other similar words. To the extent that CN has provided non-GAAP financial measures in its outlook, the Company may not be able to provide a reconciliation to the GAAP measures, due to unknown variables and uncertainty related to future results.

***2016 key assumptions***

*CN has made a number of economic and market assumptions in preparing its 2016 outlook. The Company now assumes that North American industrial production for the year will be slightly negative (compared with its April 25, 2016, assumption that North American industrial production would increase by less than one per cent) and assumes U.S. housing starts in the range of 1.2 million units and U.S. motor vehicle sales of approximately 17.5 million units. For the 2015/2016 crop year, the Canadian grain crop was in line with the five-year average and the U.S. grain crop was above the five-year average. The Company now assumes 2016/2017 grain crops in both Canada and the U.S. will be above their respective five-year averages (compared with its April 25, 2016, assumption that both the Canadian and U.S. 2016/2017 grain crops would be in line with their respective five-year averages). With these assumptions, CN now*

*expects total carloads for 2016 will decrease in the mid-single-digit range (compared with its April 25, 2016, assumption that total carloadings for the year would decline four to five per cent versus 2015). CN expects continued pricing improvement above inflation. CN assumes that in 2016 the value of the Canadian dollar in U.S. currency will be in the range of $0.75 to $0.80, and that the average price of crude oil (West Texas Intermediate) will be in the range of US$35 to US$45 per barrel. CN plans to invest approximately C$2.75 billion in its capital program, of which C$1.5 billion is targeted toward track infrastructure.*

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 to be materially different from the outlook or any future results or performance implied by such statements. Accordingly, readers are advised not to place undue reliance on forward-looking statements. Important risk factors that could affect the forward-looking statements include, but are not limited to, the effects of general economic and business conditions; industry competition; inflation, currency and interest rate fluctuations; changes in fuel prices; legislative and/or regulatory developments; compliance with environmental laws and regulations; actions by regulators; security threats; reliance on technology; transportation of hazardous materials; various events which could disrupt operations, including natural events such as severe weather, droughts, floods and earthquakes; effects of climate change; labor negotiations and disruptions; environmental claims; uncertainties of investigations, proceedings or other types of claims and litigation; risks and liabilities arising from derailments; and other risks detailed from time to time in reports filed by CN with securities regulators in Canada and the United States. Reference should be made to Management's Discussion and Analysis (MD&A) in CN's annual and interim reports, Annual Information Form and Form 40-F, filed with Canadian and U.S. securities regulators and available on CN's website, for a description of major risk factors.

Forward-looking statements reflect information as of the date on which they are made. CN assumes no obligation to update or revise forward-looking statements to reflect future events, changes in circumstances, or changes in beliefs, unless required by applicable securities laws. In the event CN does update any forward-looking statement, no inference should be made that CN will make additional updates with respect to that statement, related matters, or any other forward-looking statement.

1) See discussion and reconciliation of non-GAAP measures in the attached supplementary schedule, Non-GAAP Measures.

2) See Forward-Looking Statements for a summary of the key assumptions and risks regarding CN's 2016 outlook.

This earnings news release, as well as additional information, including the Financial Statements, Notes thereto and MD&A, is contained in CN's Quarterly Review available on the Company's website at www.cn.ca/quarterly-releases and on SEDAR at www.sedar.com as well as on EDGAR at www.sec.gov.

CN is a true backbone of the economy, transporting more than C$250 billion worth of goods annually for a wide range of business sectors, ranging from resource products to manufactured products to consumer goods, across a rail network of approximately 20,000 route-miles spanning Canada and mid-America. CN – Canadian National Railway Company, along with its operating railway subsidiaries – serves the cities and ports of Vancouver, Prince Rupert, B.C., Montreal, Halifax, New Orleans, and Mobile, Ala., and the metropolitan areas of Toronto, Edmonton, Winnipeg, Calgary, Chicago, Memphis, Detroit, Duluth, Minn./Superior, Wis., and Jackson, Miss., with connections to all points in North America. For more information about CN, visit the Company's website at www.cn.ca.

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## Selected Railroad Statistics – unaudited

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2016** | 2015 | **2016** | 2015 |
| **Financial measures** | | | | |
| ***Key financial performance indicators*** [(1)] | | | | |
| Total revenues *($ millions)* | **2,842** | 3,125 | **5,806** | 6,223 |
| Rail freight revenues *($ millions)* | **2,646** | 2,927 | **5,491** | 5,907 |
| Operating income *($ millions)* | **1,293** | 1,362 | **2,510** | 2,425 |
| Net income *($ millions)* | **858** | 886 | **1,650** | 1,590 |
| Diluted earnings per share *($)* | **1.10** | 1.10 | **2.10** | 1.96 |
| Adjusted diluted earnings per share *($)* [(2)] | **1.11** | 1.15 | **2.11** | 2.01 |
| Free cash flow *($ millions)* [(2)] | **585** | 530 | **1,169** | 1,051 |
| Gross property additions *($ millions)* | **670** | 659 | **1,139** | 1,127 |
| Share repurchases *($ millions)* | **533** | 404 | **1,053** | 833 |
| Dividends per share *($)* | **0.3750** | 0.3125 | **0.7500** | 0.6250 |
| ***Financial position*** [(1)] | | | | |
| Total assets *($ millions)* [(3)] | **36,094** | 33,498 | **36,094** | 33,498 |
| Total liabilities *($ millions)* [(3)] | **21,281** | 19,544 | **21,281** | 19,544 |
| Shareholders' equity *($ millions)* | **14,813** | 13,954 | **14,813** | 13,954 |
| ***Financial ratio*** | | | | |
| Operating ratio *(%)* | **54.5** | 56.4 | **56.8** | 61.0 |
| **Operational measures** [(4)] | | | | |
| ***Statistical operating data*** | | | | |
| Gross ton miles (GTMs) *(millions)* | **99,999** | 110,709 | **203,467** | 222,099 |
| Revenue ton miles (RTMs) *(millions)* | **49,717** | 55,713 | **101,973** | 112,842 |
| Carloads *(thousands)* | **1,249** | 1,414 | **2,504** | 2,767 |
| Route miles *(includes Canada and the U.S.)* | **19,600** | 19,500 | **19,600** | 19,500 |
| Employees *(end of period)* | **22,162** | 24,529 | **22,162** | 24,529 |
| Employees *(average for the period)* | **22,230** | 24,897 | **22,462** | 24,981 |
| ***Key operating measures*** | | | | |
| Rail freight revenue per RTM *(cents)* | **5.32** | 5.25 | **5.38** | 5.23 |
| Rail freight revenue per carload *($)* | **2,118** | 2,070 | **2,193** | 2,135 |
| GTMs per average number of employees *(thousands)* | **4,498** | 4,447 | **9,058** | 8,891 |
| Operating expenses per GTM *(cents)* | **1.55** | 1.59 | **1.62** | 1.71 |
| Labor and fringe benefits expense per GTM *(cents)* | **0.47** | 0.49 | **0.52** | 0.54 |
| Diesel fuel consumed *(US gallons in millions)* | **93.6** | 106.0 | **197.3** | 220.3 |
| Average fuel price *($/US gallon)* | **2.30** | 2.73 | **2.18** | 2.79 |
| GTMs per US gallon of fuel consumed | **1,068** | 1,044 | **1,031** | 1,008 |
| Terminal dwell *(hours)* | **13.6** | 14.6 | **14.0** | 15.7 |
| Train velocity *(miles per hour)* | **27.6** | 26.2 | **27.5** | 25.5 |
| ***Safety indicators*** [(5)] | | | | |
| Injury frequency rate *(per 200,000 person hours)* | **1.48** | 1.46 | **1.57** | 1.55 |
| Accident rate *(per million train miles)* | **1.57** | 2.49 | **1.33** | 2.48 |

*(1) Amounts expressed in Canadian dollars and prepared in accordance with United States generally accepted accounting principles, unless otherwise noted.*

*(2) See supplementary schedule entitled Non-GAAP Measures for an explanation of this non-GAAP measure.*

*(3) As a result of the retrospective adoption of new accounting standards in the fourth quarter of 2015, certain 2015 balances have been restated. See Note 2 – Recent accounting pronouncements to the Company's 2015 Annual Consolidated Financial Statements for additional information.*

*(4) Statistical operating data, key operating measures and safety indicators are based on estimated data available at such time and are subject to change as more complete information becomes available, as such, certain of the comparative data have been restated. Definitions of these indicators are provided on our website, www.cn.ca/glossary.*

*(5) Based on Federal Railroad Administration (FRA) reporting criteria.*

## Supplementary Information – unaudited

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | **2016** | 2015 | % Change Fav (Unfav) | % Change at constant currency Fav (Unfav) [2] | **2016** | 2015 | % Change Fav (Unfav) | % Change at constant currency Fav (Unfav) [2] |
| **Revenues *($ millions)*** [1] | | | | | | | | |
| Petroleum and chemicals | **492** | 586 | (16%) | (19%) | **1,070** | 1,229 | (13%) | (17%) |
| Metals and minerals | **292** | 351 | (17%) | (19%) | **602** | 728 | (17%) | (22%) |
| Forest products | **439** | 424 | 4% | - | **901** | 842 | 7% | 1% |
| Coal | **95** | 148 | (36%) | (38%) | **188** | 307 | (39%) | (42%) |
| Grain and fertilizers | **432** | 489 | (12%) | (14%) | **954** | 1,024 | (7%) | (11%) |
| Intermodal | **697** | 728 | (4%) | (6%) | **1,390** | 1,417 | (2%) | (5%) |
| Automotive | **199** | 201 | (1%) | (4%) | **386** | 360 | 7% | 1% |
| *Total rail freight revenues* | **2,646** | 2,927 | (10%) | (12%) | **5,491** | 5,907 | (7%) | (11%) |
| Other revenues | **196** | 198 | (1%) | (4%) | **315** | 316 | - | (4%) |
| *Total revenues* | **2,842** | 3,125 | (9%) | (12%) | **5,806** | 6,223 | (7%) | (11%) |
| **Revenue ton miles (RTMs) *(millions)*** | | | | | | | | |
| Petroleum and chemicals | **9,575** | 12,425 | (23%) | (23%) | **20,881** | 26,042 | (20%) | (20%) |
| Metals and minerals | **4,751** | 5,430 | (13%) | (13%) | **9,454** | 11,141 | (15%) | (15%) |
| Forest products | **7,807** | 7,605 | 3% | 3% | **15,736** | 14,847 | 6% | 6% |
| Coal | **2,686** | 3,916 | (31%) | (31%) | **4,934** | 8,126 | (39%) | (39%) |
| Grain and fertilizers | **10,353** | 11,783 | (12%) | (12%) | **22,883** | 24,727 | (7%) | (7%) |
| Intermodal | **13,519** | 13,493 | - | - | **26,182** | 26,086 | - | - |
| Automotive | **1,026** | 1,061 | (3%) | (3%) | **1,903** | 1,873 | 2% | 2% |
| *Total RTMs* | **49,717** | 55,713 | (11%) | (11%) | **101,973** | 112,842 | (10%) | (10%) |
| **Rail freight revenue / RTM *(cents)*** | | | | | | | | |
| Petroleum and chemicals | **5.14** | 4.72 | 9% | 5% | **5.12** | 4.72 | 8% | 3% |
| Metals and minerals | **6.15** | 6.46 | (5%) | (8%) | **6.37** | 6.53 | (2%) | (8%) |
| Forest products | **5.62** | 5.58 | 1% | (3%) | **5.73** | 5.67 | 1% | (5%) |
| Coal | **3.54** | 3.78 | (6%) | (9%) | **3.81** | 3.78 | 1% | (4%) |
| Grain and fertilizers | **4.17** | 4.15 | - | (2%) | **4.17** | 4.14 | 1% | (3%) |
| Intermodal | **5.16** | 5.40 | (4%) | (6%) | **5.31** | 5.43 | (2%) | (5%) |
| Automotive | **19.40** | 18.94 | 2% | (1%) | **20.28** | 19.22 | 6% | - |
| *Total rail freight revenue per RTM* | **5.32** | 5.25 | 1% | (1%) | **5.38** | 5.23 | 3% | (2%) |
| **Carloads *(thousands)*** | | | | | | | | |
| Petroleum and chemicals | **141** | 158 | (11%) | (11%) | **294** | 322 | (9%) | (9%) |
| Metals and minerals | **186** | 243 | (23%) | (23%) | **364** | 480 | (24%) | (24%) |
| Forest products | **110** | 112 | (2%) | (2%) | **223** | 221 | 1% | 1% |
| Coal | **73** | 105 | (30%) | (30%) | **152** | 220 | (31%) | (31%) |
| Grain and fertilizers | **129** | 147 | (12%) | (12%) | **275** | 301 | (9%) | (9%) |
| Intermodal | **542** | 581 | (7%) | (7%) | **1,065** | 1,103 | (3%) | (3%) |
| Automotive | **68** | 68 | - | - | **131** | 120 | 9% | 9% |
| *Total carloads* | **1,249** | 1,414 | (12%) | (12%) | **2,504** | 2,767 | (10%) | (10%) |
| **Rail freight revenue / carload *($)*** | | | | | | | | |
| Petroleum and chemicals | **3,489** | 3,709 | (6%) | (9%) | **3,639** | 3,817 | (5%) | (10%) |
| Metals and minerals | **1,570** | 1,444 | 9% | 5% | **1,654** | 1,517 | 9% | 3% |
| Forest products | **3,991** | 3,786 | 5% | 2% | **4,040** | 3,810 | 6% | - |
| Coal | **1,301** | 1,410 | (8%) | (11%) | **1,237** | 1,395 | (11%) | (16%) |
| Grain and fertilizers | **3,349** | 3,327 | 1% | (2%) | **3,469** | 3,402 | 2% | (2%) |
| Intermodal | **1,286** | 1,253 | 3% | 1% | **1,305** | 1,285 | 2% | (1%) |
| Automotive | **2,926** | 2,956 | (1%) | (4%) | **2,947** | 3,000 | (2%) | (7%) |
| *Total rail freight revenue per carload* | **2,118** | 2,070 | 2% | - | **2,193** | 2,135 | 3% | (2%) |

*Statistical operating data and related key operating measures are based on estimated data available at such time and are subject to change as more complete information becomes available.*

*(1) Amounts expressed in Canadian dollars.*

*(2) See supplementary schedule entitled Non-GAAP Measures for an explanation of this non-GAAP measure.*

## Non-GAAP Measures – unaudited

This supplementary schedule includes non-GAAP measures that do not have any standardized meaning prescribed by GAAP and therefore, may not be comparable to similar measures presented by other companies. From management's perspective, these non-GAAP measures are useful measures of performance and provide investors with supplementary information to assess the Company's results of operations and liquidity. These non-GAAP measures should not be considered in isolation or as a substitute for financial measures prepared in accordance with GAAP.

All financial information included in this supplementary schedule is expressed in Canadian dollars, unless otherwise noted.

## Adjusted performance measures

Management believes that adjusted net income and adjusted earnings per share are useful measures of performance that can facilitate period-to-period comparisons, as they exclude items that do not necessarily arise as part of the normal day-to-day operations of Canadian National Railway Company, together with its wholly-owned subsidiaries, collectively the "Company", and could distort the analysis of trends in business performance. The exclusion of such items in adjusted net income and adjusted earnings per share does not, however, imply that such items are necessarily non-recurring. These adjusted measures do not have any standardized meaning prescribed by GAAP and therefore, may not be comparable to similar measures presented by other companies.

For the three and six months ended June 30, 2016, the Company reported adjusted net income of $865 million, or $1.11 per diluted share, and $1,657 million, or $2.11 per diluted share, respectively. The adjusted figures for the three and six months ended June 30, 2016 exclude a deferred income tax expense of $7 million ($0.01 per diluted share) resulting from the enactment of a higher provincial corporate income tax rate.

For the three and six months ended June 30, 2015, the Company reported adjusted net income of $928 million, or $1.15 per diluted share, and $1,632 million, or $2.01 per diluted share, respectively. The adjusted figures for the three and six months ended June 30, 2015 exclude a deferred income tax expense of $42 million ($0.05 per diluted share) resulting from the enactment of a higher provincial corporate income tax rate.

The following table provides a reconciliation of net income and earnings per share, as reported for the three and six months ended June 30, 2016 and 2015, to the adjusted performance measures presented herein:

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *In millions, except per share data* | **2016** | 2015 | **2016** | 2015 |
| Net income as reported | **$ 858** | $ 886 | **$ 1,650** | $ 1,590 |
| *Adjustment:* Income tax expense | **7** | 42 | **7** | 42 |
| *Adjusted net income* | **$ 865** | $ 928 | **$ 1,657** | $ 1,632 |
| Basic earnings per share as reported | **$ 1.10** | $ 1.10 | **$ 2.11** | $ 1.97 |
| *Impact of adjustment, per share* | **0.01** | 0.05 | **0.01** | 0.05 |
| *Adjusted basic earnings per share* | **$ 1.11** | $ 1.15 | **$ 2.12** | $ 2.02 |
| Diluted earnings per share as reported | **$ 1.10** | $ 1.10 | **$ 2.10** | $ 1.96 |
| *Impact of adjustment, per share* | **0.01** | 0.05 | **0.01** | 0.05 |
| *Adjusted diluted earnings per share* | **$ 1.11** | $ 1.15 | **$ 2.11** | $ 2.01 |

## Constant currency

Financial results at constant currency allow results to be viewed without the impact of fluctuations in foreign currency exchange rates, thereby facilitating period-to-period comparisons in the analysis of trends in business performance. Measures at constant currency are considered non-GAAP measures and do not have any standardized meaning prescribed by GAAP and therefore, may not be comparable to similar measures presented by other companies. Financial results at constant currency are obtained by translating the current period results denominated in US dollars at the foreign exchange rates of the comparable period of the prior year. The average foreign exchange rates were $1.29 and $1.33 per US$1.00, respectively, for the three and six months ended June 30, 2016, and $1.23 per US$1.00, for both the three and six months ended June 30, 2015.

On a constant currency basis, the Company's net income for the three and six months ended June 30, 2016 would have been lower by $23 million ($0.03 per diluted share) and $80 million ($0.10 per diluted share), respectively.

# Non-GAAP Measures – unaudited

## Free cash flow

Management believes that free cash flow is a useful measure of performance as it demonstrates the Company's ability to generate cash for debt obligations and for discretionary uses such as payment of dividends, share repurchases, and strategic opportunities. The Company defines its free cash flow measure as the difference between net cash provided by operating activities and net cash used in investing activities; adjusted for changes in restricted cash and cash equivalents and the impact of major acquisitions, if any. Free cash flow does not have any standardized meaning prescribed by GAAP and therefore, may not be comparable to similar measures presented by other companies.

The following table provides a reconciliation of net cash provided by operating activities as reported for the three and six months ended June 30, 2016 and 2015, to free cash flow:

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *In millions* | **2016** | 2015 | **2016** | 2015 |
| Net cash provided by operating activities | **$ 1,271** | $ 1,203 | **$ 2,336** | $ 2,195 |
| Net cash used in investing activities | **(674)** | (662) | **(1,154)** | (1,143) |
| *Net cash provided before financing activities* | **597** | 541 | **1,182** | 1,052 |
| *Adjustment:* Change in restricted cash and cash equivalents | **(12)** | (11) | **(13)** | (1) |
| *Free cash flow* | **$ 585** | $ 530 | **$ 1,169** | $ 1,051 |

## Adjusted debt-to-adjusted EBITDA multiple

Management believes that the adjusted debt-to-adjusted earnings before interest, income taxes, depreciation and amortization (EBITDA) multiple is a useful credit measure because it reflects the Company's ability to service its debt. The Company calculates the adjusted debt-to-adjusted EBITDA multiple as adjusted debt divided by adjusted EBITDA. These measures do not have any standardized meaning prescribed by GAAP and therefore, may not be comparable to similar measures presented by other companies.

The following table provides a reconciliation of debt and net income to the adjusted measures presented below, which have been used to calculate the adjusted debt-to-adjusted EBITDA multiple:

| *In millions, unless otherwise indicated*    *As at and for the twelve months ended June 30,* | **2016** | 2015 |
|---|---|---|
| Debt [(1)] | **$ 10,322** | $ 9,308 |
| *Adjustment:* Present value of operating lease commitments [(2)] | **561** | 647 |
| *Adjusted debt* | **$ 10,883** | $ 9,955 |
| Net income | **$ 3,598** | $ 3,287 |
| Interest expense | **469** | 397 |
| Income tax expense | **1,315** | 1,318 |
| Depreciation and amortization | **1,180** | 1,118 |
| *EBITDA* | **6,562** | 6,120 |
| *Adjustments:* | | |
| Other income | **(31)** | (31) |
| Deemed interest on operating leases | **27** | 30 |
| *Adjusted EBITDA* | **$ 6,558** | $ 6,119 |
| Adjusted debt-to-adjusted EBITDA multiple *(times)* | **1.66** | 1.63 |

*(1) As a result of the retrospective adoption of a new accounting standard in the fourth quarter of 2015, the prior period debt balance has been adjusted. There was no impact to the related financial ratio. See Note 2 - Recent accounting pronouncements to the Company's 2015 Annual Consolidated Financial Statements for additional information.*

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

The increase in the Company's adjusted debt-to-adjusted EBITDA multiple at June 30, 2016, as compared to the same period in 2015, was mainly due to an increased debt level as at June 30, 2016, resulting from the net issuance of debt and a weaker Canadian-to-US dollar foreign exchange rate, partly offset by a higher net income earned during the twelve months ended June 30, 2016, as compared to the twelve months ended June 30, 2015.

## Consolidated Statements of Income – unaudited

| *In millions, except per share data* | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2016** | 2015 | **2016** | 2015 |
| **Revenues** | **$ 2,842** | $ 3,125 | **$ 5,806** | $ 6,223 |
| **Operating expenses** | | | | |
| Labor and fringe benefits | **469** | 542 | **1,059** | 1,210 |
| Purchased services and material | **377** | 434 | **785** | 891 |
| Fuel | **243** | 327 | **478** | 688 |
| Depreciation and amortization | **296** | 285 | **603** | 581 |
| Equipment rents | **92** | 83 | **187** | 177 |
| Casualty and other | **72** | 92 | **184** | 251 |
| *Total operating expenses* | **1,549** | 1,763 | **3,296** | 3,798 |
| *Operating income* | **1,293** | 1,362 | **2,510** | 2,425 |
| Interest expense | **(116)** | (105) | **(239)** | (209) |
| Other income (loss) | **(1)** | 16 | **4** | 20 |
| *Income before income taxes* | **1,176** | 1,273 | **2,275** | 2,236 |
| Income tax expense *(Note 3)* | **(318)** | (387) | **(625)** | (646) |
| ***Net income*** | **$ 858** | $ 886 | **$ 1,650** | $ 1,590 |
| **Earnings per share** *(Note 4)* | | | | |
| Basic | **$ 1.10** | $ 1.10 | **$ 2.11** | $ 1.97 |
| Diluted | **$ 1.10** | $ 1.10 | **$ 2.10** | $ 1.96 |
| **Weighted-average number of shares** *(Note 4)* | | | | |
| Basic | **778.9** | 803.5 | **782.5** | 806.4 |
| Diluted | **782.0** | 808.0 | **785.6** | 811.1 |
| **Dividends declared per share** | **$ 0.3750** | $ 0.3125 | **$ 0.7500** | $ 0.6250 |

*See accompanying notes to unaudited consolidated financial statements.*

## Consolidated Statements of Comprehensive Income – unaudited

| *In millions* | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2016** | 2015 | **2016** | 2015 |
| Net income | **$ 858** | $ 886 | **$ 1,650** | $ 1,590 |
| **Other comprehensive income (loss)** *(Note 8)* | | | | |
| Net gain (loss) on foreign currency translation | **(10)** | (18) | **(135)** | 78 |
| Net change in pension and other postretirement benefit plans | **39** | 54 | **88** | 115 |
| *Other comprehensive income (loss) before income taxes* | **29** | 36 | **(47)** | 193 |
| Income tax recovery (expense) | **(17)** | (27) | **(99)** | 42 |
| *Other comprehensive income (loss)* | **12** | 9 | **(146)** | 235 |
| ***Comprehensive income*** | **$ 870** | $ 895 | **$ 1,504** | $ 1,825 |

*See accompanying notes to unaudited consolidated financial statements.*

## Consolidated Balance Sheets – unaudited

| *In millions* | | **June 30 2016** | | December 31 2015 |
|---|---|---|---|---|
| **Assets** | | | | |
| ***Current assets*** | | | | |
| Cash and cash equivalents | **$** | **160** | $ | 153 |
| Restricted cash and cash equivalents *(Note 5)* | | **510** | | 523 |
| Accounts receivable | | **799** | | 878 |
| Material and supplies | | **451** | | 355 |
| Other | | **202** | | 244 |
| *Total current assets* | | **2,122** | | 2,153 |
| Properties | | **32,120** | | 32,624 |
| Pension asset | | **1,559** | | 1,305 |
| Intangible and other assets | | **293** | | 320 |
| ***Total assets*** | **$** | **36,094** | $ | 36,402 |
| **Liabilities and shareholders' equity** | | | | |
| ***Current liabilities*** | | | | |
| Accounts payable and other | **$** | **1,488** | $ | 1,556 |
| Current portion of long-term debt | | **1,238** | | 1,442 |
| *Total current liabilities* | | **2,726** | | 2,998 |
| Deferred income taxes | | **8,166** | | 8,105 |
| Other liabilities and deferred credits | | **602** | | 644 |
| Pension and other postretirement benefits | | **703** | | 720 |
| Long-term debt | | **9,084** | | 8,985 |
| ***Shareholders' equity*** | | | | |
| Common shares | | **3,722** | | 3,705 |
| Common shares in Share Trusts *(Note 5)* | | **(77)** | | (100) |
| Additional paid-in capital | | **365** | | 475 |
| Accumulated other comprehensive loss *(Note 8)* | | **(1,913)** | | (1,767) |
| Retained earnings | | **12,716** | | 12,637 |
| *Total shareholders' equity* | | **14,813** | | 14,950 |
| ***Total liabilities and shareholders' equity*** | **$** | **36,094** | $ | 36,402 |

*See accompanying notes to unaudited consolidated financial statements.*

## Consolidated Statements of Changes in Shareholders' Equity – unaudited

| In millions | Number of common shares Outstanding | Number of common shares Share Trusts | Common shares | Common shares in Share Trusts | Additional paid-in capital | Accumulated other comprehensive loss | Retained earnings | Total shareholders' equity |
|---|---|---|---|---|---|---|---|---|
| *Balance at December 31, 2015* | 787.2 | 1.4 | $ 3,705 | $ (100) | $ 475 | $ (1,767) | $ 12,637 | $ 14,950 |
| Net income | | | | | | | 1,650 | 1,650 |
| Stock options exercised | 0.4 | | 18 | | (3) | | | 15 |
| Settlement of other equity settled awards | | | 68 | | (114) | | | (46) |
| Stock-based compensation expense and other | | | | | 30 | | (3) | 27 |
| Share repurchase program *(Note 5)* | (14.6) | | (69) | | | | (984) | (1,053) |
| Disbursed from Share Trusts *(Note 5)* | 0.3 | (0.3) | | 23 | (23) | | | - |
| Other comprehensive loss *(Note 8)* | | | | | | (146) | | (146) |
| Dividends | | | | | | | (584) | (584) |
| ***Balance at June 30, 2016*** | **773.3** | **1.1** | **$ 3,722** | **$ (77)** | **$ 365** | **$ (1,913)** | **$ 12,716** | **$ 14,813** |

| In millions | Number of common shares Outstanding | Number of common shares Share Trusts | Common shares | Common shares in Share Trusts | Additional paid-in capital | Accumulated other comprehensive loss | Retained earnings | Total shareholders' equity |
|---|---|---|---|---|---|---|---|---|
| *Balance at December 31, 2014* | 809.4 | - | $ 3,718 | $ - | $ 439 | $ (2,427) | $ 11,740 | $ 13,470 |
| Net income | | | | | | | 1,590 | 1,590 |
| Stock options exercised | 0.4 | | 17 | | (3) | | | 14 |
| Settlement of other equity settled awards | | | 1 | | (3) | | | (2) |
| Stock-based compensation expense and other | | | | | 28 | | (2) | 26 |
| Share repurchase program *(Note 5)* | (10.7) | | (49) | | | | (784) | (833) |
| Share purchases by Share Trusts *(Note 5)* | (0.6) | 0.6 | | (44) | | | | (44) |
| Other comprehensive income *(Note 8)* | | | | | | 235 | | 235 |
| Dividends | | | | | | | (502) | (502) |
| *Balance at June 30, 2015* | 798.5 | 0.6 | $ 3,687 | $ (44) | $ 461 | $ (2,192) | $ 12,042 | $ 13,954 |

*See accompanying notes to unaudited consolidated financial statements.*

## Consolidated Statements of Cash Flows – unaudited

| In millions | Three months ended June 30 2016 | 2015 | Six months ended June 30 2016 | 2015 |
|---|---|---|---|---|
| **Operating activities** | | | | |
| Net income | **$ 858** | $ 886 | **$ 1,650** | $ 1,590 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization | **296** | 285 | **603** | 581 |
| Deferred income taxes | **171** | 147 | **326** | 217 |
| Changes in operating assets and liabilities: | | | | |
| Accounts receivable | **66** | 5 | **39** | 76 |
| Material and supplies | **(6)** | (35) | **(92)** | (119) |
| Accounts payable and other | **(73)** | (91) | **(81)** | (70) |
| Other current assets | **24** | 10 | **18** | (7) |
| Pensions and other, net | **(65)** | (4) | **(127)** | (73) |
| *Net cash provided by operating activities* | **1,271** | 1,203 | **2,336** | 2,195 |
| **Investing activities** | | | | |
| Property additions | **(670)** | (659) | **(1,139)** | (1,127) |
| Change in restricted cash and cash equivalents | **12** | 11 | **13** | 1 |
| Other, net | **(16)** | (14) | **(28)** | (17) |
| *Net cash used in investing activities* | **(674)** | (662) | **(1,154)** | (1,143) |
| **Financing activities** | | | | |
| Issuance of debt *(Note 5)* | **-** | - | **677** | - |
| Repayment of debt | **(387)** | (9) | **(498)** | (56) |
| Net issuance of commercial paper | **622** | 69 | **322** | 379 |
| Settlement of foreign exchange forward contracts on long-term debt | **(23)** | - | **(24)** | - |
| Common shares issued for stock options exercised and other | **3** | 4 | **15** | 15 |
| Withholding taxes remitted on the net settlement of equity settled awards *(Note 7)* | **(11)** | - | **(36)** | - |
| Repurchase of common shares *(Note 5)* | **(532)** | (402) | **(1,044)** | (812) |
| Purchase of common shares for settlement of other equity settled awards | **(9)** | (1) | **(10)** | (2) |
| Purchase of common shares by Share Trusts *(Note 5)* | **-** | (44) | **-** | (44) |
| Dividends paid | **(291)** | (250) | **(584)** | (502) |
| *Net cash used in financing activities* | **(628)** | (633) | **(1,182)** | (1,022) |
| Effect of foreign exchange fluctuations on US dollar-denominated cash and cash equivalents | **3** | - | **7** | 4 |
| *Net increase (decrease) in cash and cash equivalents* | **(28)** | (92) | **7** | 34 |
| Cash and cash equivalents, beginning of period | **188** | 178 | **153** | 52 |
| ***Cash and cash equivalents, end of period*** | **$ 160** | $ 86 | **$ 160** | $ 86 |
| **Supplemental cash flow information** | | | | |
| Interest paid | **$ (119)** | $ (111) | **$ (236)** | $ (202) |
| Income taxes paid | **(162)** | (186) | **(398)** | (414) |

*See accompanying notes to unaudited consolidated financial statements.*

# Notes to Unaudited Consolidated Financial Statements

## 1 – Basis of presentation

The accompanying unaudited Interim Consolidated Financial Statements, expressed in Canadian dollars, have been prepared in accordance with United States generally accepted accounting principles (GAAP) for interim financial statements. Accordingly, they do not include all of the disclosures required by GAAP for complete financial statements. In management's opinion, all adjustments (consisting of normal recurring accruals) considered necessary for fair presentation have been included.

These unaudited Interim Consolidated Financial Statements have been prepared using accounting policies consistent with those used in preparing Canadian National Railway Company's ("CN" or the "Company") 2015 Annual Consolidated Financial Statements and should be read in conjunction with such statements and Notes thereto.

## 2 – Recent accounting pronouncements

The following recent Accounting Standards Updates (ASUs) issued by the Financial Accounting Standards Board (FASB) were adopted by the Company during the current period:

| Standard | Description | Impact |
|---|---|---|
| **ASU 2016-09 Compensation – Stock Compensation** | Simplifies several aspects of the accounting for share-based payments, including the income tax consequences, classification of awards as either equity or liabilities, and classification in the Statement of Cash Flows. The new guidance includes multiple amendments with differing application methods. | The Company adopted this standard during the second quarter of 2016 with an effective date of January 1, 2016. The adoption of this standard did not have a significant impact on the Consolidated Financial Statements of the Company. |

The following recent ASUs issued by FASB have an effective date after June 30, 2016 and have not been adopted by the Company:

| Standard | Description | Impact | Effective date (1) |
|---|---|---|---|
| **ASU 2016-13 Financial Instruments – Credit Losses** | Requires financial assets measured at amortized cost to be presented at the net amount expected to be collected. The amendments replace the current incurred loss impairment methodology with one that reflects expected credit losses and considers a broader range of reasonable and supportable information to determine the expected credit loss estimates. | The Company is evaluating the effects that the adoption of the ASU will have on its Consolidated Financial Statements, if any; however, no significant impact is expected. | December 15, 2019. Early adoption is permitted. |
| **ASU 2016-02 Leases** | Requires the recognition of lease assets and lease liabilities on the Balance Sheet by lessees for most leases. The accounting treatment applied by a lessor is largely unchanged. Lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. | The Company is evaluating the effects that the adoption of the ASU will have on its Consolidated Financial Statements. | December 15, 2018. Early adoption is permitted. |
| **ASU 2016-01 Financial Instruments – Overall** | Addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments require equity investments (except those accounted for under the equity method of accounting or those resulting in consolidation) to be measured at fair value with changes in fair value recognized in net income. The new guidance can be applied by means of a cumulative effect adjustment to the Balance Sheet at the beginning of the year of adoption. | The adoption of the ASU will not have a significant impact on the Company's Consolidated Financial Statements. | December 15, 2017. |
| **ASU 2014-09 Revenue from Contracts with Customers** | Establishes principles for reporting the nature, amount, timing and uncertainty of revenues and cash flows arising from an entity's contracts with customers. The basis of the new standard is that an entity recognizes revenue to represent the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The new guidance can be applied using a retrospective or the cumulative effect transition method. | The Company is evaluating the effects that the adoption of the ASU will have on its Consolidated Financial Statements, if any; however, no significant impact is expected. | December 15, 2017. Early adoption is permitted. |

*(1) Effective for annual and interim reporting periods beginning after the stated date.*

## 3 – Income taxes

The Company recorded income tax expense of $318 million and $625 million for the three and six months ended June 30, 2016, respectively, compared to $387 million and $646 million, respectively, for the same periods in 2015.

Included in the 2016 figures was a deferred income tax expense of $7 million resulting from the enactment of a higher provincial corporate income tax rate, which was recorded in the second quarter.

Included in the 2015 figures was a deferred income tax expense of $42 million resulting from the enactment of a higher provincial corporate income tax rate, which was recorded in the second quarter.

## 4 – Earnings per share

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *In millions, except per share data* | **2016** | 2015 | **2016** | 2015 |
| Net income | **$ 858** | $ 886 | **$ 1,650** | $ 1,590 |
| Weighted-average basic shares outstanding | **778.9** | 803.5 | **782.5** | 806.4 |
| Dilutive effect of stock-based compensation | **3.1** | 4.5 | **3.1** | 4.7 |
| *Weighted-average diluted shares outstanding* | **782.0** | 808.0 | **785.6** | 811.1 |
| Basic earnings per share | **$ 1.10** | $ 1.10 | **$ 2.11** | $ 1.97 |
| Diluted earnings per share | **$ 1.10** | $ 1.10 | **$ 2.10** | $ 1.96 |
| Units excluded from the calculation as their inclusion would not have a dilutive effect: | | | | |
| Stock options | **1.6** | 0.8 | **1.6** | 0.8 |
| Performance share units | **0.4** | 0.1 | **0.4** | - |

## 5 – Financing activities

**Shelf prospectus and registration statement**

On February 23, 2016, under its current shelf prospectus and registration statement, the Company issued US$500 million ($686 million) 2.75% Notes due 2026 in the United States (U.S.) capital markets, which resulted in net proceeds of $677 million, intended for general corporate purposes, including the redemption and refinancing of outstanding indebtedness, and share repurchases. The Company has remaining capacity of $5,314 million under its current shelf prospectus and registration statement. Access to the Canadian and U.S. capital markets under the shelf prospectus and registration statement is dependent on market conditions.

**Revolving credit facility**

The Company has a revolving credit facility agreement with a consortium of lenders. On March 11, 2016, the agreement was amended, which increased the credit facility from $800 million to $1.3 billion, effective May 5, 2016. The increase in capacity provides the Company with additional financial flexibility. The amended credit facility of $1.3 billion consists of a tranche for $420 million maturing on May 5, 2019 and a tranche for $880 million maturing on May 5, 2021. The agreement allows for an increase in the credit facility amount, up to a maximum of $1.8 billion, as well as the option to extend the term by an additional year at each anniversary date, subject to the consent of individual lenders. The agreement contains customary terms and conditions, which were substantially unchanged by the amendment. The credit facility is available for general corporate purposes, including backstopping the Company's commercial paper programs, 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 Offered Rate (LIBOR), plus applicable margins. The credit facility agreement has one financial covenant, which limits debt as a percentage of total capitalization, and with which the Company is in compliance.

As at June 30, 2016 and December 31, 2015, the Company had no outstanding borrowings under its revolving credit facility and there were no draws during the six months ended June 30, 2016.

### Commercial paper

The Company has a commercial paper program in Canada and the U.S. Both programs are backstopped by the Company's revolving credit facility. During the second quarter of 2016, the maximum aggregate principal amount of commercial paper that could be issued increased from $800 million to $1.3 billion, or the US dollar equivalent on a combined basis.

As at June 30, 2016 and December 31, 2015, the Company had total commercial paper borrowings of US$600 million ($775 million) and US$331 million ($458 million), respectively, at a weighted-average interest rate of 0.48% and 0.41%, respectively, presented in Current portion of long-term debt on the Consolidated Balance Sheets.

### Accounts receivable securitization program

The Company has an agreement, expiring on February 1, 2018, to sell an undivided co-ownership interest in a revolving pool of accounts receivable to unrelated trusts for maximum cash proceeds of $450 million. As at June 30, 2016 and December 31, 2015, the Company had no proceeds received under the accounts receivable securitization program.

### Bilateral letter of credit facilities

The Company has a series of bilateral letter of credit facility agreements, expiring on April 28, 2018, with various banks to support its requirements to post letters of credit in the ordinary course of business. Under these agreements, the Company has the option from time to time to pledge collateral in the form of cash or cash equivalents, for a minimum term of one month, equal to at least the face value of the letters of credit issued. As at June 30, 2016, the Company had letters of credit drawn of $532 million ($551 million as at December 31, 2015) from a total committed amount of $567 million ($575 million as at December 31, 2015) by the various banks.

As at June 30, 2016, cash and cash equivalents of $510 million ($523 million as at December 31, 2015) were pledged as collateral and recorded as Restricted cash and cash equivalents on the Consolidated Balance Sheets.

### Share repurchase programs

The Company may repurchase shares pursuant to a Normal Course Issuer Bid (NCIB) at prevailing market prices plus brokerage fees, or such other prices as may be permitted by the Toronto Stock Exchange. Under its current NCIB, the Company may repurchase up to 33.0 million common shares between October 30, 2015 and October 29, 2016. As at June 30, 2016, the Company had repurchased 20.4 million common shares for $1,463 million under its current program.

The following table provides the information related to the share repurchase programs for the three and six months ended June 30, 2016 and 2015:

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *In millions, except per share data* | **2016** | 2015 | **2016** | 2015 |
| Number of common shares repurchased (1) | **7.2** | 5.3 | **14.6** | 10.7 |
| Weighted-average price per share (2) | **$ 73.80** | $ 77.14 | **$ 72.20** | $ 78.17 |
| Amount of repurchase (3) | **$ 533** | $ 404 | **$ 1,053** | $ 833 |

*(1) Includes repurchases of common shares in the first and second quarters of 2016 and the first quarter of 2015 pursuant to private agreements between the Company and arm's length third-party sellers.*

*(2) Includes brokerage fees where applicable.*

*(3) Includes settlements in subsequent periods.*

### Share Trusts

The Company's Employee Benefit Plan Trusts ("Share Trusts") purchase common shares on the open market, which are used to deliver common shares under the Share Units Plan (see *Note 7 - Stock-based compensation*). For the six months ended June 30, 2016, the Share Trusts disbursed 0.3 million common shares, which had a historical cost of $23 million, representing a weighted-average price per share of $73.31, for settlement under the Share Units Plan. For the three and six months ended June 30, 2015, the Share Trusts purchased 0.6 million common shares for $44 million at a weighted-average price per share of $74.39, including brokerage fees. Additional information relating to the share purchases by Share Trusts is provided in *Note 13 – Share capital* to the Company's 2015 Annual Consolidated Financial Statements.

## 6 – Pensions and other postretirement benefits

The Company has various retirement benefit plans under which substantially all of its employees are entitled to benefits at retirement age, generally based on compensation and length of service and/or contributions. Additional information relating to the retirement benefit plans is provided in *Note 12 - Pensions and other postretirement benefits* to the Company's 2015 Annual Consolidated Financial Statements.

The following table provides the components of net periodic benefit cost (income) for defined benefit pension and other postretirement benefit (OPEB) plans for the three and six months ended June 30, 2016 and 2015:

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | Pensions | | OPEB | | Pensions | | OPEB | |
| *In millions* | **2016** | 2015 | **2016** | 2015 | **2016** | 2015 | **2016** | 2015 |
| Current service cost | **$ 30** | $ 35 | **$ -** | $ - | **$ 65** | $ 78 | **$ 1** | $ 1 |
| Interest cost | **136** | 162 | **2** | 2 | **272** | 325 | **4** | 5 |
| Expected return on plan assets | **(255)** | (251) | **-** | - | **(509)** | (502) | **-** | - |
| Amortization of prior service cost | **1** | 1 | **1** | 1 | **2** | 2 | **1** | 1 |
| Amortization of net actuarial loss (gain) | **39** | 53 | **(2)** | (1) | **88** | 114 | **(3)** | (2) |
| *Net periodic benefit cost (income)* [(1)] | **$ (49)** | $ - | **$ 1** | $ 2 | **$ (82)** | $ 17 | **$ 3** | $ 5 |

*(1) In the second quarter of 2016 and 2015, the Company revised its estimate of full year Net periodic benefit cost (income) for pensions to reflect updated plan demographic information.*

**Pension contributions**

Pension contributions for the six months ended June 30, 2016 and 2015 of $88 million and $92 million, respectively, primarily represent contributions to the Company's main pension plan, the CN Pension Plan, for the current service cost as determined under the Company's current actuarial valuations for funding purposes. In 2016, the Company expects to make total cash contributions of approximately $130 million for all of the Company's pension plans.

**Adoption of the spot rate approach**

In the first quarter of 2016, the Company adopted the spot rate approach to measure current service cost and interest cost for all defined benefit pension and other postretirement benefit plans on a prospective basis as a change in accounting estimate. In prior periods, these costs were determined using the discount rate used to measure the projected benefit obligation at the beginning of the period.

The spot rate approach enhances the precision to which current service cost and interest cost are measured by increasing the correlation between projected cash flows and spot discount rates corresponding to their maturity. Under the spot rate approach, individual spot discount rates along the same yield curve used in the determination of the projected benefit obligation are applied to the relevant projected cash flows at the relevant maturity. More specifically, current service cost is measured using the projected cash flows related to benefits expected to be accrued in the following year by active members of a plan and interest cost is measured using the projected cash flows making up the projected benefit obligation multiplied by the corresponding spot discount rate at each maturity. Use of the spot rate approach does not affect the measurement of the projected benefit obligation.

Based on bond yields prevailing at December 31, 2015, the single equivalent discount rates to determine current service cost and interest cost under the spot rate approach in 2016 are 4.24% and 3.27%, respectively, compared to 3.99%, for both costs, under the approach applied in prior periods. For the three and six months ended June 30, 2016, the adoption of the spot rate approach increased net periodic benefit income by approximately $35 million and $65 million, respectively, compared to the approach applied in prior periods.

## 7 – Stock-based compensation

The Company has various stock-based compensation plans for eligible employees. A description of the major plans is provided in *Note 14 – Stock-based compensation* to the Company's 2015 Annual Consolidated Financial Statements.

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *In millions* | **2016** | 2015 | **2016** | 2015 |
| **Share Units Plan** [1] | | | | |
| Equity settled awards | **$ 9** | $ 9 | **$ 20** | $ 17 |
| Cash settled awards | **1** | (7) | **4** | 2 |
| *Total Share Units Plan expense* | **$ 10** | $ 2 | **$ 24** | $ 19 |
| **Voluntary Incentive Deferral Plan (VIDP)** [2] | | | | |
| Cash settled awards | **$ (2)** | $ (5) | **$ 1** | $ (4) |
| *Total VIDP expense (recovery)* | **$ (2)** | $ (5) | **$ 1** | $ (4) |
| **Stock option awards** | **$ 2** | $ 2 | **$ 5** | $ 5 |
| *Total stock-based compensation expense (recovery)* | **$ 10** | $ (1) | **$ 30** | $ 20 |
| Tax benefit recognized in income | **$ 3** | $ - | **$ 7** | $ 5 |
| Excess tax benefit recognized in income | **$ 2** | $ - | **$ 2** | $ - |

*(1) Performance share unit (PSU) awards are granted under the Share Units Plan.*

*(2) Deferred share unit (DSU) awards are granted under the Voluntary Incentive Deferral Plan.*

### Share Units Plan

| | Equity settled | | | | Cash settled |
|---|---|---|---|---|---|
| | PSUs-ROIC [1] | | PSUs-TSR [2] | | PSUs-ROIC [3] |
| | Units | Weighted-average grant date fair value | Units | Weighted-average grant date fair value | Units |
| | *In millions* | | *In millions* | | *In millions* |
| Outstanding at December 31, 2015 | 1.3 | $ 64.36 | 0.1 | $ 114.86 | 0.7 |
| Granted | 0.5 | $ 33.73 | 0.2 | $ 95.16 | - |
| Settled [4] [5] | (0.5) | $ 75.15 | - | N/A | (0.3) |
| *Outstanding at June 30, 2016* | **1.3** | **$ 49.23** | **0.3** | **$ 103.87** | **0.4** |

*(1) The grant date fair value of equity settled PSUs-ROIC granted in 2016 of $18 million is calculated using a lattice-based valuation model. As at June 30, 2016, total unrecognized compensation cost related to nonvested equity settled PSUs-ROIC outstanding was $23 million and is expected to be recognized over a weighted-average period of 1.6 years.*

*(2) The grant date fair value of equity settled PSUs-TSR granted in 2016 of $16 million is calculated using a Monte Carlo simulation model. As at June 30, 2016, total unrecognized compensation cost related to nonvested equity settled PSUs-TSR outstanding was $16 million and is expected to be recognized over a weighted-average period of 1.8 years.*

*(3) The fair value as at June 30, 2016 of cash settled PSUs-ROIC outstanding is calculated using a lattice-based valuation model. As at June 30, 2016, total unrecognized compensation cost related to nonvested cash settled PSUs-ROIC outstanding was $4 million and is expected to be recognized over a weighted-average period of 0.5 years. As at June 30, 2016, the liability for cash settled PSUs-ROIC was $32 million ($66 million as at December 31, 2015).*

*(4) Equity settled PSUs-ROIC granted in 2013 met the minimum share price condition for settlement and attained a performance vesting factor of 150%. In the first quarter of 2016, these awards were settled, net of the remittance of the participants' minimum statutory withholding tax obligation of $25 million, by way of disbursement from the Share Trusts of 0.3 million common shares.*

*(5) Cash settled PSUs-ROIC granted in 2013 met the minimum share price condition for payout and attained a performance vesting factor of 150%. In the first quarter of 2016, the Company paid out $37 million for these awards.*

### Voluntary Incentive Deferral Plan

| | Equity settled DSUs [1] | | Cash settled DSUs [2] |
|---|---|---|---|
| | Units | Weighted-average grant date fair value | Units |
| | *In millions* | | *In millions* |
| Outstanding at December 31, 2015 | 1.8 | $ 76.44 | 0.4 |
| Granted | - | $ 73.63 | - |
| Settled [3] | (0.2) | $ 76.34 | - |
| *Outstanding at June 30, 2016* [4] | **1.6** | **$ 76.43** | **0.4** |

*(1) The grant date fair value of equity settled DSUs granted in 2016 of $2 million is calculated using the Company's stock price on the grant date. As at June 30, 2016, the aggregate intrinsic value of equity settled DSUs outstanding amounted to $119 million.*

*(2) The fair value as at June 30, 2016 of cash settled DSUs is based on the intrinsic value. As at June 30, 2016, the liability for cash settled DSUs was $33 million ($36 million as at December 31, 2015). The closing stock price used to determine the liability was $76.29.*

*(3) In the first half of 2016, the Company purchased 0.1 million common shares for the settlement of equity settled DSUs, net of the remittance of the participants' minimum statutory withholding tax obligation of $11 million.*

*(4) The number of units outstanding that were nonvested, unrecognized compensation cost and the remaining recognition period for cash and equity settled DSUs have not been quantified as they relate to a minimal number of units.*

### Stock option awards

| | Options outstanding | |
|---|---|---|
| | Number of options | Weighted-average exercise price |
| | *In millions* | |
| Outstanding at December 31, 2015 [1] | 5.9 | $ 53.43 |
| Granted [2] | 1.1 | $ 74.28 |
| Exercised | (0.4) | $ 36.48 |
| *Outstanding at June 30, 2016* [1] [2] [3] | **6.6** | **$ 55.28** |
| Exercisable at June 30, 2016 [1] [3] | **4.1** | **$ 45.41** |

*(1) Stock options with a US dollar exercise price have been translated into Canadian dollars using the foreign exchange rate in effect at the balance sheet date.*

*(2) The grant date fair value of options granted in 2016 of $12 million ($10.41 per unit) is calculated using the Black-Scholes option-pricing model. As at June 30, 2016, total unrecognized compensation cost related to nonvested options outstanding was $13 million and is expected to be recognized over a weighted-average period of 1.9 years.*

*(3) As at June 30, 2016, the vast majority of stock options were in-the-money. The weighted-average term to expiration of options outstanding was 6.4 years and the weighted-average term to expiration of exercisable stock options was 5.0 years. As at June 30, 2016, the aggregate intrinsic value of in-the-money stock options outstanding amounted to $145 million and the aggregate intrinsic value of stock options exercisable amounted to $128 million.*

## 8 – Accumulated other comprehensive loss

| *In millions* | Foreign currency translation adjustments | Pension and other postretirement benefit plans | Derivative instruments | Total before tax | Income tax recovery (expense) | Total net of tax |
|---|---|---|---|---|---|---|
| Balance at March 31, 2016 | $ (334) | $ (2,155) | $ 7 | $ (2,482) | $ 557 | $ (1,925) |
| Other comprehensive income (loss) before reclassifications: | | | | | | |
| Foreign exchange loss on translation of net investment in foreign operations | (53) | | | (53) | - | (53) |
| Foreign exchange gain on translation of US dollar-denominated debt designated as a hedge of the net investment in U.S. subsidiaries (1) | 43 | | | 43 | (6) | 37 |
| Amounts reclassified from Accumulated other comprehensive loss: | | | | | | |
| Amortization of net actuarial loss | | 37 | | 37 (2) | (10) (3) | 27 |
| Amortization of prior service cost | | 2 | | 2 (2) | (1) (3) | 1 |
| *Other comprehensive income (loss)* | (10) | 39 | - | 29 | (17) | 12 |
| *Balance at June 30, 2016* | **$ (344)** | **$ (2,116)** | **$ 7** | **$ (2,453)** | **$ 540** | **$ (1,913)** |

| *In millions* | Foreign currency translation adjustments | Pension and other postretirement benefit plans | Derivative instruments | Total before tax | Income tax recovery (expense) | Total net of tax |
|---|---|---|---|---|---|---|
| Balance at December 31, 2015 | $ (209) | $ (2,204) | $ 7 | $ (2,406) | $ 639 | $ (1,767) |
| Other comprehensive income (loss) before reclassifications: | | | | | | |
| Foreign exchange loss on translation of net investment in foreign operations | (693) | | | (693) | - | (693) |
| Foreign exchange gain on translation of US dollar-denominated debt designated as a hedge of the net investment in U.S. subsidiaries (1) | 558 | | | 558 | (75) | 483 |
| Amounts reclassified from Accumulated other comprehensive loss: | | | | | | |
| Amortization of net actuarial loss | | 85 | | 85 (2) | (23) (3) | 62 |
| Amortization of prior service cost | | 3 | | 3 (2) | (1) (3) | 2 |
| *Other comprehensive income (loss)* | (135) | 88 | - | (47) | (99) | (146) |
| *Balance at June 30, 2016* | **$ (344)** | **$ (2,116)** | **$ 7** | **$ (2,453)** | **$ 540** | **$ (1,913)** |

*(1) The Company designates US dollar-denominated debt of the parent company as a foreign currency hedge of its net investment in U.S. subsidiaries. As a result, from the dates of designation, foreign exchange gains and losses on translation of the Company's US dollar-denominated debt are recorded in Accumulated other comprehensive loss, which minimizes volatility of earnings resulting from the conversion of US dollar-denominated debt into Canadian dollars.*

*(2) Reclassified to Labor and fringe benefits in the Consolidated Statements of Income and included in components of net periodic benefit cost. See Note 6 - Pensions and other postretirement benefits.*

*(3) Included in Income tax expense in the Consolidated Statements of Income.*

| *In millions* | | Foreign currency translation adjustments | | Pension and other postretirement benefit plans | | Derivative instruments | | Total before tax | | Income tax recovery (expense) | | Total net of tax |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Balance at March 31, 2015 | $ | (362) | $ | (2,449) | $ | 7 | $ | (2,804) | $ | 603 | $ | (2,201) |
| Other comprehensive income (loss) before reclassifications: | | | | | | | | | | | | |
| Foreign exchange loss on translation of net investment in foreign operations | | (120) | | | | | | (120) | | - | | (120) |
| Foreign exchange gain on translation of US dollar-denominated debt designated as a hedge of the net investment in U.S. subsidiaries (1) | | 102 | | | | | | 102 | | (13) | | 89 |
| Amounts reclassified from Accumulated other comprehensive loss: | | | | | | | | | | | | |
| Amortization of net actuarial loss | | | | 52 | | | | 52 (2) | | (13) (3) | | 39 |
| Amortization of prior service cost | | | | 2 | | | | 2 (2) | | (1) (3) | | 1 |
| *Other comprehensive income (loss)* | | (18) | | 54 | | - | | 36 | | (27) | | 9 |
| *Balance at June 30, 2015* | $ | (380) | $ | (2,395) | $ | 7 | $ | (2,768) | $ | 576 | $ | (2,192) |

| *In millions* | | Foreign currency translation adjustments | | Pension and other postretirement benefit plans | | Derivative instruments | | Total before tax | | Income tax recovery (expense) | | Total net of tax |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2014 | $ | (458) | $ | (2,510) | $ | 7 | $ | (2,961) | $ | 534 | $ | (2,427) |
| Other comprehensive income (loss) before reclassifications: | | | | | | | | | | | | |
| Foreign exchange gain on translation of net investment in foreign operations | | 622 | | | | | | 622 | | - | | 622 |
| Foreign exchange loss on translation of US dollar-denominated debt designated as a hedge of the net investment in U.S. subsidiaries (1) | | (544) | | | | | | (544) | | 72 | | (472) |
| Amounts reclassified from Accumulated other comprehensive loss: | | | | | | | | | | | | |
| Amortization of net actuarial loss | | | | 112 | | | | 112 (2) | | (29) (3) | | 83 |
| Amortization of prior service cost | | | | 3 | | | | 3 (2) | | (1) (3) | | 2 |
| *Other comprehensive income* | | 78 | | 115 | | - | | 193 | | 42 | | 235 |
| *Balance at June 30, 2015* | $ | (380) | $ | (2,395) | $ | 7 | $ | (2,768) | $ | 576 | $ | (2,192) |

*(1) The Company designates US dollar-denominated debt of the parent company as a foreign currency hedge of its net investment in U.S. subsidiaries. As a result, from the dates of designation, foreign exchange gains and losses on translation of the Company's US dollar-denominated debt are recorded in Accumulated other comprehensive loss, which minimizes volatility of earnings resulting from the conversion of US dollar-denominated debt into Canadian dollars.*

*(2) Reclassified to Labor and fringe benefits in the Consolidated Statements of Income and included in components of net periodic benefit cost. See Note 6 - Pensions and other postretirement benefits.*

*(3) Included in Income tax expense in the Consolidated Statements of Income.*

## 9 – Major commitments and contingencies

**Commitments**

As at June 30, 2016, the Company had commitments to acquire railroad ties, rail, locomotives, and other equipment and services, as well as outstanding information technology service contracts and licenses, at an aggregate cost of $1,056 million. In addition, the Company has estimated remaining commitments, through to December 31, 2017, of approximately $13 million (US$10 million), in relation to the acquisition of the principal lines of the former Elgin, Joliet and Eastern Railway Company, for grade separation projects.

**Contingencies**

In the normal course of business, the Company becomes involved in various legal actions seeking compensatory and occasionally punitive damages, including actions brought on behalf of various purported classes of claimants and claims relating to employee and third-party personal injuries, occupational disease and property damage, arising out of harm to individuals or property allegedly caused by, but not limited to, derailments or other accidents.

As at June 30, 2016, the Company had aggregate reserves for personal injury and other claims of $290 million, of which $57 million was recorded as a current liability ($296 million as at December 31, 2015, of which $51 million was recorded as a current liability).

Although the Company considers such provisions to be adequate for all its outstanding and pending claims, the final outcome with respect to actions outstanding or pending as at June 30, 2016, or with respect to future claims, cannot be reasonably determined. When establishing provisions for contingent liabilities the Company considers, where a probable loss estimate cannot be made with reasonable certainty, a range of potential probable losses for each such matter, and records the amount it considers the most reasonable estimate within the range. However, when no amount within the range is a better estimate than any other amount, the minimum amount in the range is accrued. For matters where a loss is reasonably possible but not probable, a range of potential losses cannot be estimated due to various factors which may include the limited availability of facts, the lack of demand for specific damages and the fact that proceedings were at an early stage. Based on information currently available, the Company believes that the eventual outcome of the actions against the Company will not, individually or in the aggregate, have a material adverse effect on the Company’s financial position. However, due to the inherent inability to predict with certainty unforeseeable future developments, there can be no assurance that the ultimate resolution of these actions will not have a material adverse effect on the Company’s results of operations, financial position or liquidity.

**Environmental matters**

The Company’s operations are subject to numerous federal, provincial, state, municipal and local environmental laws and regulations in Canada and the U.S. 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.

The Company has identified approximately 205 sites at which it is or may be liable for remediation costs, in some cases along with other potentially responsible parties, associated with alleged contamination and is subject to environmental clean-up and enforcement actions, including those imposed by the United States Federal *Comprehensive Environmental Response, Compensation and Liability Act* of 1980 (CERCLA), also known as the Superfund law, or analogous state laws. CERCLA and similar state laws, in addition to other similar Canadian and U.S. laws, generally impose joint and several liability for clean-up and enforcement costs on current and former owners and operators of a site, as well as those whose waste is disposed of at the 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 6 sites governed by the Superfund law (and analogous 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 addressing these known contaminated sites cannot be definitively established given that the estimated environmental liability for any given site may vary depending on the nature and extent of the contamination; the nature of anticipated response actions, taking into account the available clean-up techniques; evolving regulatory standards governing environmental liability; and the number of potentially responsible parties and their financial viability. As a result, liabilities are recorded based on the results of a four-phase assessment conducted on a site-by-site basis. A liability is initially recorded when environmental assessments occur, remedial efforts are probable, and when the 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. The Company estimates the costs related to a particular site using cost scenarios established by external consultants based on the extent of contamination and expected costs for remedial efforts. In the case of multiple parties, the Company accrues its allocable share of liability taking into account the Company’s alleged responsibility, the number of potentially responsible parties and their ability to pay their respective share of the liability. Adjustments to initial estimates are recorded as additional information becomes available.

The Company's provision for specific environmental sites is undiscounted and includes costs for remediation and restoration of sites, as well as monitoring costs. Costs related to any unknown existing or future contamination will be accrued in the period in which they become probable and reasonably estimable.

As at June 30, 2016, the Company had aggregate accruals for environmental costs of $100 million, of which $47 million was recorded as a current liability ($110 million as at December 31, 2015, of which $51 million was recorded as a current liability). The Company anticipates that the majority of the liability at June 30, 2016 will be paid out over the next five years. Based on the information currently available, the Company considers its accruals to be adequate.

**Guarantees and indemnifications**

A description of the Company's guarantees and indemnifications is provided in *Note 16 – Major commitments and contingencies* to the Company's 2015 Annual Consolidated Financial Statements.

***Guarantees***

*Guarantee of residual values of operating leases*

The Company has guaranteed a portion of the residual values of certain of its assets under operating leases with expiry dates between 2016 and 2022, for the benefit of the lessor. If the fair value of the assets at the end of their respective lease term is less than the fair value, as estimated at the inception of the lease, then the Company must, under certain conditions, compensate the lessor for the shortfall. As at June 30, 2016, the maximum exposure in respect of these guarantees was $175 million ($200 million as at December 31, 2015). There are no recourse provisions to recover any amounts from third parties.

*Other guarantees*

As at June 30, 2016, the Company, including certain of its subsidiaries, had granted $532 million ($551 million as at December 31, 2015) of irrevocable standby letters of credit and $121 million ($120 million as at December 31, 2015) of surety and other bonds, issued by highly rated financial institutions, to third parties to indemnify them in the event the Company does not perform its contractual obligations. As at June 30, 2016, the maximum potential liability under these guarantee instruments was $653 million ($671 million as at December 31, 2015), of which $582 million ($589 million as at December 31, 2015) related to workers' compensation and other employee benefit liabilities and $71 million ($82 million as at December 31, 2015) related to other liabilities. The letters of credit were drawn on the Company's bilateral letter of credit facilities. The guarantee instruments expire at various dates between 2016 and 2018.

As at June 30, 2016, the Company has not recorded a liability with respect to guarantees and indemnifications as the Company did not expect to make any payments under its guarantees and indemnifications.

## 10 – Financial instruments

### Derivative financial instruments

The Company uses derivative financial instruments from time to time in the management of its foreign currency and interest rate exposures. The Company has limited involvement with derivative financial instruments in the management of its risks and does not hold or issue them for trading or speculative purposes. As at June 30, 2016, the Company had outstanding foreign exchange forward contracts with a notional value of US$967 million (US$361 million as at December 31, 2015). Changes in the fair value of foreign exchange forward contracts, resulting from changes in foreign exchange rates, are recognized in Other income in the Consolidated Statement of Income as they occur.

For the three and six months ended June 30, 2016, the Company recorded a loss of $2 million and $47 million, respectively, related to foreign exchange forward contracts, compared to a loss of $7 million and a gain of $29 million, respectively, for the same periods in 2015. These gains and losses were largely offset by the re-measurement of US dollar-denominated monetary assets and liabilities recorded in Other income.

As at June 30, 2016, Other current assets included an unrealized gain of $6 million ($4 million as at December 31, 2015) and Accounts payable and other included an unrealized loss of $21 million ($2 million as at December 31, 2015), related to the fair value of outstanding foreign exchange forward contracts.

### Fair value of financial instruments

The following table provides the valuation methods and assumptions used by the Company to estimate the fair value of financial instruments and their associated level within the fair value hierarchy:

| Level | Valuation methods and assumptions |
|---|---|
| **Level 1**<br>**Quoted prices for identical instruments in active markets** | The carrying amounts of Cash and cash equivalents and Restricted cash and cash equivalents approximate fair value. These financial instruments include highly liquid investments purchased three months or less from maturity, for which the fair value is determined by reference to quoted prices in active markets. |
| **Level 2**<br>**Significant inputs (other than quoted prices included in Level 1) are observable** | The carrying amounts of Accounts receivable, Other current assets, and Accounts payable and other approximate fair value. The fair value of these financial instruments is not determined using quoted prices, but rather from market observable information. The fair value of derivative financial instruments used to manage the Company's exposure to foreign currency risk and included in Other current assets and Accounts payable and other is measured by discounting future cash flows using a discount rate derived from market data for financial instruments subject to similar risks and maturities.<br><br>The carrying amount of the Company's debt does not approximate fair value. The fair value is estimated based on quoted market prices for the same or similar debt instruments, as well as discounted cash flows using current interest rates for debt with similar terms, company rating, and remaining maturity. As at June 30, 2016, the Company's debt had a carrying amount of $10,322 million ($10,427 million as at December 31, 2015) and a fair value of $12,077 million ($11,720 million as at December 31, 2015). |
| **Level 3**<br>**Significant inputs are unobservable** | The carrying amounts of investments included in Intangible and other assets approximate fair value, with the exception of certain cost investments for which significant inputs are unobservable and fair value is estimated based on the Company's proportionate share of the underlying net assets. As at June 30, 2016, the Company's investments had a carrying amount of $64 million ($69 million as at December 31, 2015) and a fair value of $207 million ($220 million as at December 31, 2015). |

# Management's Discussion and Analysis

This Management's Discussion and Analysis (MD&A) dated July 25, 2016, relates to the consolidated financial position and results of operations of Canadian National Railway Company, together with its wholly-owned subsidiaries, collectively "CN" or the "Company," and should be read in conjunction with the Company's 2016 unaudited Interim Consolidated Financial Statements and Notes thereto. It should also be read in conjunction with the Company's 2015 audited Annual Consolidated Financial Statements and Notes thereto, and the 2015 Annual MD&A. All financial information reflected herein is expressed in Canadian dollars and prepared in accordance with United States generally accepted accounting principles (GAAP), unless otherwise noted.

CN's common shares are listed on the Toronto and New York stock exchanges. Additional information about CN filed with Canadian securities regulatory authorities and the United States Securities and Exchange Commission (SEC), including the Company's 2015 Annual Information Form and Form 40-F, may be found online at www.sedar.com, www.sec.gov, and on the Company's website at www.cn.ca/regulatory-filings. The Company's Notice of Intention to Make a Normal Course Issuer Bid may be found online at www.sedar.com and www.sec.gov. Copies of such documents may be obtained by contacting the Corporate Secretary's office.

## Business profile

CN is engaged in the rail and related transportation business. CN's network of approximately 20,000 route miles of track spans Canada and mid-America, uniquely connecting three coasts: the Atlantic, the Pacific and the Gulf of Mexico. CN's extensive network and efficient connections to all Class I railroads provide CN customers access to all three North American Free Trade Agreement (NAFTA) nations. A true backbone of the economy, CN handles over $250 billion worth of goods annually and carries more than 300 million tons of cargo, serving exporters, importers, retailers, farmers and manufacturers.

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 better positions the Company to face economic fluctuations and enhances its potential for growth opportunities. For the six months ended June 30, 2016, no individual commodity group accounted for more than 24% of total revenues. From a geographic standpoint, 17% of revenues relate to United States (U.S.) domestic traffic, 35% transborder traffic, 18% Canadian domestic traffic and 30% overseas traffic. The Company is the originating carrier for approximately 85% of traffic moving along its network, which allows it both to capitalize on service advantages and build on opportunities to efficiently use assets.

## Strategy overview

A description of the Company's Strategy is provided in the section entitled *Strategy overview* of the Company's 2015 Annual MD&A.

**2016 second quarter highlights**

- The Company attained a record second quarter operating ratio of 54.5%.
- The Company paid quarterly dividends of $0.3750 per share, representing an increase of 20% when compared to 2015, amounting to $291 million.
- The Company repurchased 7.2 million common shares, returning $533 million to its shareholders.

**2016 business outlook and assumptions**

In 2016, the Company sees growth in lumber and panels, finished vehicles and parts, as well as refined petroleum products, while shipments of commodities related to oil and gas development such as crude oil, frac sand and drilling pipe are expected to decrease relative to 2015. The Company sees unfavorable global demand-supply dynamics impacting coal shipments. A moderate decline in short-haul iron ore shipments and weaker international intermodal volumes are also expected.

Underpinning the 2016 business outlook, the Company now assumes that North American industrial production will be slightly negative. For the 2015/2016 crop year, the Canadian grain crop was in line with the five-year average and the U.S. grain crop was above the five-year average. The Company now assumes that the 2016/2017 grain crops in both Canada and the U.S. will be above their respective five-year averages.

The forward-looking statements discussed in this 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. In addition to the assumptions and expectations discussed in this section, reference should be made to the section of this MD&A entitled *Forward-looking statements* for assumptions and risk factors affecting such statements.

## Forward-looking statements

Certain statements included in this MD&A are “forward-looking statements” within the meaning of the *United States Private Securities Litigation Reform Act of 1995* and under Canadian securities laws. By their nature, forward-looking statements involve risks, uncertainties and assumptions. The Company cautions that its assumptions may not materialize and that current economic conditions render such assumptions, although reasonable at the time they were made, subject to greater uncertainty. Forward-looking statements may be identified by the use of terminology such as “believes,” “expects,” “anticipates,” “assumes,” “outlook,” ”plans,” “targets” or other similar words.

Forward-looking statements include, but are not limited to, those set forth in the table below, which also presents key assumptions used in determining these forward-looking statements. See also the section of this MD&A entitled *Strategy overview – 2016 business outlook and assumptions*.

| Forward-looking statements | Key assumptions |
|---|---|
| Statements relating to revenue growth opportunities, including those referring to general economic and business conditions | • North American and global economic growth<br>• Long-term growth opportunities being less affected by current economic conditions |
| Statements relating to the Company’s ability to meet debt repayments and future obligations in the foreseeable future, including income tax payments, and capital spending | • North American and global economic growth<br>• Adequate credit ratios<br>• Investment-grade credit ratings<br>• Access to capital markets<br>• Adequate cash generated from operations and other sources of financing |
| Statements relating to pension contributions | • Adequate cash generated from operations and other sources of financing<br>• Adequate long-term return on investment on pension plan assets<br>• Level of funding as determined by actuarial valuations, particularly influenced by discount rates for funding purposes |

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 to be materially different from the outlook or any future results or performance implied by such statements. Accordingly, readers are advised not to place undue reliance on forward-looking statements. Important risk factors that could affect the forward-looking statements include, but are not limited to, the effects of general economic and business conditions; industry competition; inflation, currency and interest rate fluctuations; changes in fuel prices; legislative and/or regulatory developments; compliance with environmental laws and regulations; actions by regulators; security threats; reliance on technology; transportation of hazardous materials; various events which could disrupt operations, including natural events such as severe weather, droughts, floods and earthquakes; effects of climate change; labor negotiations and disruptions; environmental claims; uncertainties of investigations, proceedings or other types of claims and litigation; risks and liabilities arising from derailments; and other risks detailed from time to time in reports filed by CN with securities regulators in Canada and the U.S., including its Annual Information Form and Form 40-F. See the section entitled *Business risks* of this MD&A and the Company’s 2015 Annual MD&A for a description of major risk factors.

Forward-looking statements reflect information as of the date on which they are made. CN assumes no obligation to update or revise forward-looking statements to reflect future events, changes in circumstances, or changes in beliefs, unless required by applicable securities laws. In the event CN does update any forward-looking statement, no inference should be made that CN will make additional updates with respect to that statement, related matters, or any other forward-looking statement.

## Financial highlights

| *In millions, except percentage and per share data* | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| | **2016** | 2015 | **2016** | 2015 |
| Revenues | **$ 2,842** | $ 3,125 | **$ 5,806** | $ 6,223 |
| Operating income | **$ 1,293** | $ 1,362 | **$ 2,510** | $ 2,425 |
| Net income | **$ 858** | $ 886 | **$ 1,650** | $ 1,590 |
| Adjusted net income (1) | **$ 865** | $ 928 | **$ 1,657** | $ 1,632 |
| Basic earnings per share | **$ 1.10** | $ 1.10 | **$ 2.11** | $ 1.97 |
| Adjusted basic earnings per share (1) | **$ 1.11** | $ 1.15 | **$ 2.12** | $ 2.02 |
| Diluted earnings per share | **$ 1.10** | $ 1.10 | **$ 2.10** | $ 1.96 |
| Adjusted diluted earnings per share (1) | **$ 1.11** | $ 1.15 | **$ 2.11** | $ 2.01 |
| Dividends declared per share | **$ 0.3750** | $ 0.3125 | **$ 0.7500** | $ 0.6250 |
| Total assets (2) | **$ 36,094** | $ 33,498 | **$ 36,094** | $ 33,498 |
| Total long-term liabilities (2) | **$ 18,555** | $ 16,446 | **$ 18,555** | $ 16,446 |
| Operating ratio | **54.5%** | 56.4% | **56.8%** | 61.0% |
| Free cash flow (3) | **$ 585** | $ 530 | **$ 1,169** | $ 1,051 |

*(1) See the section of this MD&A entitled Adjusted performance measures for an explanation of this non-GAAP measure.*

*(2) As a result of the retrospective adoption of new accounting standards in the fourth quarter of 2015, certain 2015 balances have been adjusted. See the section of the Company's 2015 Annual MD&A entitled Recent accounting pronouncements for additional information.*

*(3) See the section of this MD&A entitled Liquidity and capital resources - Free cash flow for an explanation of this non-GAAP measure.*

## Second quarter and first half of 2016 compared to corresponding periods in 2015

Net income for the second quarter of 2016 was $858 million, a decrease of $28 million, or 3%, when compared to the same period in 2015, with diluted earnings per share remaining flat at $1.10. The $28 million decrease was mainly due to lower operating income and other income, and higher interest expense; net of the related income taxes. Net income for the six months ended June 30, 2016 was $1,650 million, an increase of $60 million, or 4%, when compared to the same period in 2015, with diluted earnings per share rising 7% to $2.10. The $60 million increase was mainly due to higher operating income net of the related income taxes, partly offset by an increase in interest expense.

Operating income for the quarter ended June 30, 2016 decreased by $69 million, or 5%, to $1,293 million. Operating income for the six months ended June 30, 2016 increased by $85 million, or 4%, to $2,510 million. The operating ratio, defined as operating expenses as a percentage of revenues, was 54.5% in 2016, compared to 56.4% in 2015, a 1.9-point improvement. The six-month operating ratio was 56.8% in 2016, compared to 61.0% in 2015, a 4.2-point improvement.

Revenues for the quarter ended June 30, 2016 decreased by $283 million, or 9%, to $2,842 million, and $417 million, or 7%, to $5,806 million for the first six months, mainly attributable to decreased shipments of energy-related commodities including crude oil, frac sand, drilling pipe and semi-finished steel products as a result of declining energy markets; reduced shipments of coal due to weaker North American and global demand; lower volumes of Canadian grain to North American and export markets due to lower available supply; and lower applicable fuel surcharge rates. These factors were partly offset by the positive translation impact of the weaker Canadian dollar on US dollar-denominated revenues; freight rate increases; as well as increased shipments of lumber and panels to U.S. markets, increased domestic retail intermodal shipments, and higher volumes of finished vehicle traffic in the first quarter.

Operating expenses for the quarter ended June 30, 2016 decreased by $214 million, or 12%, to $1,549 million, and $502 million, or 13%, to $3,296 million for the first six months, mainly due to lower costs resulting from decreased volumes of traffic, lower fuel prices, lower pension expense and cost-management initiatives, partly offset by the negative translation impact of a weaker Canadian dollar on US dollar-denominated expenses.

## Non-GAAP measures

This MD&A makes reference to non-GAAP measures including adjusted net income, adjusted earnings per share, constant currency, free cash flow, and adjusted debt-to-adjusted EBITDA multiple, that do not have any standardized meaning prescribed by GAAP and therefore, may not be comparable to similar measures presented by other companies. From management's perspective, these non-GAAP measures are useful measures of performance and provide investors with supplementary information to assess the Company's results of operations and liquidity. These non-GAAP measures should not be considered in isolation or as a substitute for financial measures prepared in accordance with GAAP.

For further details of these non-GAAP measures, including a reconciliation to the most directly comparable GAAP financial measures, refer to the sections entitled *Adjusted performance measures, Constant currency* and *Liquidity and capital resources.*

## Adjusted performance measures

Management believes that adjusted net income and adjusted earnings per share are useful measures of performance that can facilitate period-to-period comparisons, as they exclude items that do not necessarily arise as part of the normal day-to-day operations of the Company and could distort the analysis of trends in business performance. The exclusion of such items in adjusted net income and adjusted earnings per share does not, however, imply that such items are necessarily non-recurring. These adjusted measures do not have any standardized meaning prescribed by GAAP and therefore, may not be comparable to similar measures presented by other companies.

For the three and six months ended June 30, 2016, the Company reported adjusted net income of $865 million, or $1.11 per diluted share, and $1,657 million, or $2.11 per diluted share, respectively. The adjusted figures for the three and six months ended June 30, 2016 exclude a deferred income tax expense of $7 million ($0.01 per diluted share) resulting from the enactment of a higher provincial corporate income tax rate.

For the three and six months ended June 30, 2015, the Company reported adjusted net income of $928 million, or $1.15 per diluted share, and $1,632 million, or $2.01 per diluted share, respectively. The adjusted figures for the three and six months ended June 30, 2015 exclude a deferred income tax expense of $42 million ($0.05 per diluted share) resulting from the enactment of a higher provincial corporate income tax rate.

The following table provides a reconciliation of net income and earnings per share, as reported for the three and six months ended June 30, 2016 and 2015, to the adjusted performance measures presented herein:

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *In millions, except per share data* | **2016** | 2015 | **2016** | 2015 |
| Net income as reported | **$ 858** | $ 886 | **$ 1,650** | $ 1,590 |
| *Adjustment:* Income tax expense | **7** | 42 | **7** | 42 |
| *Adjusted net income* | **$ 865** | $ 928 | **$ 1,657** | $ 1,632 |
| Basic earnings per share as reported | **$ 1.10** | $ 1.10 | **$ 2.11** | $ 1.97 |
| *Impact of adjustment, per share* | **0.01** | 0.05 | **0.01** | 0.05 |
| *Adjusted basic earnings per share* | **$ 1.11** | $ 1.15 | **$ 2.12** | $ 2.02 |
| Diluted earnings per share as reported | **$ 1.10** | $ 1.10 | **$ 2.10** | $ 1.96 |
| *Impact of adjustment, per share* | **0.01** | 0.05 | **0.01** | 0.05 |
| *Adjusted diluted earnings per share* | **$ 1.11** | $ 1.15 | **$ 2.11** | $ 2.01 |

## Constant currency

Financial results at constant currency allow results to be viewed without the impact of fluctuations in foreign currency exchange rates, thereby facilitating period-to-period comparisons in the analysis of trends in business performance. Measures at constant currency are considered non-GAAP measures and do not have any standardized meaning prescribed by GAAP and therefore, may not be comparable to similar measures presented by other companies. Financial results at constant currency are obtained by translating the current period results denominated in US dollars at the foreign exchange rates of the comparable period of the prior year. The average foreign exchange rates were $1.29 and $1.33 per US$1.00, respectively, for the three and six months ended June 30, 2016, and $1.23 per US$1.00, for both the three and six months ended June 30, 2015.

On a constant currency basis, the Company's net income for the three and six months ended June 30, 2016 would have been lower by $23 million ($0.03 per diluted share) and $80 million ($0.10 per diluted share), respectively.

## Revenues

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| *In millions, unless otherwise indicated* | **2016** | 2015 | % Change | % Change at constant currency | **2016** | 2015 | % Change | % Change at constant currency |
| Rail freight revenues | **$ 2,646** | $ 2,927 | (10%) | (12%) | **$ 5,491** | $ 5,907 | (7%) | (11%) |
| Other revenues | **196** | 198 | (1%) | (4%) | **315** | 316 | - | (4%) |
| *Total revenues* | **$ 2,842** | $ 3,125 | (9%) | (12%) | **$ 5,806** | $ 6,223 | (7%) | (11%) |
| **Rail freight revenues** | | | | | | | | |
| Petroleum and chemicals | **$ 492** | $ 586 | (16%) | (19%) | **$ 1,070** | $ 1,229 | (13%) | (17%) |
| Metals and minerals | **292** | 351 | (17%) | (19%) | **602** | 728 | (17%) | (22%) |
| Forest products | **439** | 424 | 4% | - | **901** | 842 | 7% | 1% |
| Coal | **95** | 148 | (36%) | (38%) | **188** | 307 | (39%) | (42%) |
| Grain and fertilizers | **432** | 489 | (12%) | (14%) | **954** | 1,024 | (7%) | (11%) |
| Intermodal | **697** | 728 | (4%) | (6%) | **1,390** | 1,417 | (2%) | (5%) |
| Automotive | **199** | 201 | (1%) | (4%) | **386** | 360 | 7% | 1% |
| *Total rail freight revenues* | **$ 2,646** | $ 2,927 | (10%) | (12%) | **$ 5,491** | $ 5,907 | (7%) | (11%) |
| Revenue ton miles (RTMs) *(millions)* | **49,717** | 55,713 | (11%) | (11%) | **101,973** | 112,842 | (10%) | (10%) |
| Rail freight revenue/RTM *(cents)* | **5.32** | 5.25 | 1% | (1%) | **5.38** | 5.23 | 3% | (2%) |

Revenues for the quarter ended June 30, 2016 totaled $2,842 million compared to $3,125 million in the same period in 2015, a decrease of $283 million, or 9%. Revenues for the first half of 2016 were $5,806 million, a decrease of $417 million, or 7%, when compared to the same period in 2015. The decreases were mainly attributable to decreased shipments of energy-related commodities including crude oil, frac sand, drilling pipe and semi-finished steel products as a result of declining energy markets; reduced shipments of coal due to weaker North American and global demand; lower volumes of Canadian grain to North American and export markets due to lower available supply; and lower applicable fuel surcharge rates. These factors were partly offset by the positive translation impact of the weaker Canadian dollar on US dollar-denominated revenues; freight rate increases; as well as increased shipments of lumber and panels to U.S. markets, increased domestic retail intermodal shipments, and higher volumes of finished vehicle traffic in the first quarter.

Fuel surcharge revenues decreased by $92 million in the second quarter and $230 million in the first half of 2016 when compared to the same periods in 2015 as a result of lower applicable fuel surcharge rates.

Revenue ton miles (RTMs), measuring the relative weight and distance of rail freight transported by the Company, declined by 11% in the second quarter and 10% in the first half of 2016 relative to the same periods in 2015.

Rail freight revenue per RTM, a measurement of yield defined as revenue earned on the movement of a ton of freight over one mile, increased by 1% in the second quarter and 3% in the first half of 2016, when compared to the same periods in 2015, driven by the positive translation impact of the weaker Canadian dollar and freight rate increases, partly offset by a significant increase in the average length of haul and lower applicable fuel surcharge rates.

### Petroleum and chemicals

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | **2016** | 2015 | % Change | % Change at constant currency | **2016** | 2015 | % Change | % Change at constant currency |
| Revenues *(millions)* | **$ 492** | $ 586 | (16%) | (19%) | **$ 1,070** | $ 1,229 | (13%) | (17%) |
| RTMs *(millions)* | **9,575** | 12,425 | (23%) | (23%) | **20,881** | 26,042 | (20%) | (20%) |
| Revenue/RTM *(cents)* | **5.14** | 4.72 | 9% | 5% | **5.12** | 4.72 | 8% | 3% |

Revenues for this commodity group decreased by $94 million, or 16%, in the second quarter and $159 million, or 13%, in the first half of 2016 when compared to the same periods in 2015. The decreases were mainly due to lower shipments of crude oil due to increased pipeline capacity and the effects of the Alberta wildfires in the second quarter of 2016, which also adversely impacted volumes of sulfur; as well as lower applicable fuel surcharge rates. These factors were partly offset by the positive translation impact of a weaker Canadian dollar; higher volumes of refined petroleum products including gasoline and diesel, and propane; as well as freight rate increases.

Revenue per RTM increased by 9% in the second quarter and 8% in the first half of 2016 when compared to the same periods in 2015, mainly due to a significant decrease in the average length of haul, the positive translation impact of a weaker Canadian dollar and freight rate increases, partly offset by lower applicable fuel surcharge rates.

### Metals and minerals

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | **2016** | 2015 | % Change | % Change at constant currency | **2016** | 2015 | % Change | % Change at constant currency |
| Revenues *(millions)* | **$ 292** | $ 351 | (17%) | (19%) | **$ 602** | $ 728 | (17%) | (22%) |
| RTMs *(millions)* | **4,751** | 5,430 | (13%) | (13%) | **9,454** | 11,141 | (15%) | (15%) |
| Revenue/RTM *(cents)* | **6.15** | 6.46 | (5%) | (8%) | **6.37** | 6.53 | (2%) | (8%) |

Revenues for this commodity group decreased by $59 million, or 17%, in the second quarter and $126 million, or 17%, in the first half of 2016 when compared to the same periods in 2015. The decreases were mainly due to decreased shipments of energy-related commodities including frac sand, drilling pipe, and semi-finished steel products as a result of declining energy markets; and lower applicable fuel surcharge rates. These factors were partly offset by the positive translation impact of a weaker Canadian dollar.

Revenue per RTM decreased by 5% in the second quarter and 2% in the first half of 2016 when compared to the same periods in 2015, mainly due to a significant increase in the average length of haul and lower applicable fuel surcharge rates, offset by the positive translation impact of a weaker Canadian dollar.

### Forest products

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | **2016** | 2015 | % Change | % Change at constant currency | **2016** | 2015 | % Change | % Change at constant currency |
| Revenues *(millions)* | **$ 439** | $ 424 | 4% | - | **$ 901** | $ 842 | 7% | 1% |
| RTMs *(millions)* | **7,807** | 7,605 | 3% | 3% | **15,736** | 14,847 | 6% | 6% |
| Revenue/RTM *(cents)* | **5.62** | 5.58 | 1% | (3%) | **5.73** | 5.67 | 1% | (5%) |

Revenues for this commodity group increased by $15 million, or 4%, in the second quarter and $59 million, or 7%, in the first half of 2016 when compared to the same periods in 2015. The increases were mainly due to the positive translation impact of a weaker Canadian dollar; increased shipments of lumber and panels to the U.S. due to an improved U.S. housing market; and freight rate increases. These factors were partly offset by lower applicable fuel surcharge rates and decreased shipments of paper products amidst weak market conditions.

Revenue per RTM increased by 1% in both the second quarter and first half of 2016 when compared to the same periods in 2015, mainly due to the positive translation impact of a weaker Canadian dollar and freight rate increases, offset by lower applicable fuel surcharge rates and an increase in the average length of haul.

**Coal**

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | **2016** | 2015 | % Change | % Change at constant currency | **2016** | 2015 | % Change | % Change at constant currency |
| Revenues *(millions)* | **$ 95** | $ 148 | (36%) | (38%) | **$ 188** | $ 307 | (39%) | (42%) |
| RTMs *(millions)* | **2,686** | 3,916 | (31%) | (31%) | **4,934** | 8,126 | (39%) | (39%) |
| Revenue/RTM *(cents)* | **3.54** | 3.78 | (6%) | (9%) | **3.81** | 3.78 | 1% | (4%) |

Revenues for this commodity group decreased by $53 million, or 36%, in the second quarter and $119 million, or 39%, in the first half of 2016 when compared to the same periods in 2015. The decreases were mainly due to lower volumes of thermal coal to U.S. coal-fired utilities, and continued global oversupply impacting export shipments of thermal coal via the U.S. Gulf Coast and metallurgical coal via west coast ports; as well as lower applicable fuel surcharge rates. These factors were partly offset by the positive translation impact of a weaker Canadian dollar and freight rate increases.

Revenue per RTM decreased by 6% in the second quarter and increased by 1% in the first half of 2016 when compared to the same periods in 2015. The decrease in the second quarter was mainly due to lower applicable fuel surcharge rates, partly offset by the positive translation impact of a weaker Canadian dollar and freight rate increases. The increase in the first half was mainly due to a significant decrease in the average length of haul, the positive translation impact of a weaker Canadian dollar and freight rate increases, partly offset by lower applicable fuel surcharge rates.

**Grain and fertilizers**

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | **2016** | 2015 | % Change | % Change at constant currency | **2016** | 2015 | % Change | % Change at constant currency |
| Revenues *(millions)* | **$ 432** | $ 489 | (12%) | (14%) | **$ 954** | $ 1,024 | (7%) | (11%) |
| RTMs *(millions)* | **10,353** | 11,783 | (12%) | (12%) | **22,883** | 24,727 | (7%) | (7%) |
| Revenue/RTM *(cents)* | **4.17** | 4.15 | - | (2%) | **4.17** | 4.14 | 1% | (3%) |

Revenues for this commodity group decreased by $57 million, or 12%, in the second quarter and $70 million, or 7%, in the first half of 2016 when compared to the same periods in 2015. The decreases were mainly due to lower volumes of Canadian wheat to North American and export markets, lower export volumes of barley and lentils, decreased volumes of oats to U.S. markets, and reduced volumes of U.S. corn and soybean meal exports via the Gulf of Mexico mainly in the first quarter; as well as lower applicable fuel surcharge rates. These factors were partly offset by the positive translation impact of a weaker Canadian dollar; increased volumes of Canadian canola meal and oil, and increased offshore exports of Canadian canola and soybeans mainly in the first quarter; as well as freight rate increases.

Revenue per RTM remained flat in the second quarter and increased by 1% in the first half of 2016 when compared to the same periods in 2015, mainly due to the positive translation impact of a weaker Canadian dollar and freight rate increases, almost entirely offset by lower applicable fuel surcharge rates.

**Intermodal**

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | **2016** | 2015 | % Change | % Change at constant currency | **2016** | 2015 | % Change | % Change at constant currency |
| Revenues *(millions)* | **$ 697** | $ 728 | (4%) | (6%) | **$ 1,390** | $ 1,417 | (2%) | (5%) |
| RTMs *(millions)* | **13,519** | 13,493 | - | - | **26,182** | 26,086 | - | - |
| Revenue/RTM *(cents)* | **5.16** | 5.40 | (4%) | (6%) | **5.31** | 5.43 | (2%) | (5%) |

Revenues for this commodity group decreased by $31 million, or 4%, in the second quarter and $27 million, or 2%, in the first half of 2016 when compared to the same periods in 2015. The decreases were mainly due to lower applicable fuel surcharge rates and decreased international volumes via the Port of Vancouver. These factors were partly offset by the positive translation impact of a weaker Canadian dollar; increased international volumes via the Port of Halifax, and higher domestic retail volumes in the industrial and consumer products segments; as well as freight rate increases.

Revenue per RTM decreased by 4% in the second quarter and 2% in the first half of 2016 when compared to the same periods in 2015, mainly due to lower applicable fuel surcharge rates and an increase in the average length of haul, partly offset by the positive translation impact of a weaker Canadian dollar and freight rate increases.

**Automotive**

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | **2016** | 2015 | % Change | % Change at constant currency | **2016** | 2015 | % Change | % Change at constant currency |
| Revenues *(millions)* | **$ 199** | $ 201 | (1%) | (4%) | **$ 386** | $ 360 | 7% | 1% |
| RTMs *(millions)* | **1,026** | 1,061 | (3%) | (3%) | **1,903** | 1,873 | 2% | 2% |
| Revenue/RTM *(cents)* | **19.40** | 18.94 | 2% | (1%) | **20.28** | 19.22 | 6% | - |

Revenues for this commodity group decreased by $2 million, or 1%, in the second quarter and increased by $26 million, or 7%, in the first half of 2016 when compared to the same periods in 2015. The decrease in the second quarter was mainly due to lower applicable fuel surcharge rates, partly offset by the positive translation impact of a weaker Canadian dollar and freight rate increases. The increase in the first half was mainly due to higher volumes of domestic finished vehicle and parts traffic, and increased finished vehicle imports via the Port of Halifax mainly in the first quarter; the positive translation impact of a weaker Canadian dollar; and freight rate increases, partly offset by lower applicable fuel surcharge rates.

Revenue per RTM increased by 2% in the second quarter and 6% in the first half of 2016 when compared to the same periods in 2015, mainly due to a decrease in the average length of haul, the positive translation impact of a weaker Canadian dollar and freight rate increases, partly offset by lower applicable fuel surcharge rates.

**Other revenues**

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| | **2016** | 2015 | % Change | % Change at constant currency | **2016** | 2015 | % Change | % Change at constant currency |
| Revenues *(millions)* | **$ 196** | $ 198 | (1%) | (4%) | **$ 315** | $ 316 | - | (4%) |

Other revenues are largely derived from non-rail services that support CN's rail business including vessels and docks, warehousing and distribution, automotive logistic services, freight forwarding and transportation management; as well as other revenues including commuter train revenues.

Other revenues decreased by $2 million, or 1%, in the second quarter and $1 million, remaining flat, in the first half of 2016 when compared to the same periods in 2015, mainly due to lower revenues from freight forwarding and vessels, partly offset by the positive translation impact of a weaker Canadian dollar and higher revenues from automotive logistic services.

## Operating expenses

Operating expenses for the second quarter of 2016 amounted to $1,549 million compared to $1,763 million in the same quarter of 2015. Operating expenses for the first half of 2016 amounted to $3,296 million compared to $3,798 million in the same period of 2015. The decreases of $214 million, or 12%, and $502 million, or 13%, respectively, in the second quarter and the first half of 2016 were mainly due to lower costs resulting from decreased volumes of traffic, lower fuel prices, lower pension expense and cost-management initiatives, partly offset by the negative translation impact of a weaker Canadian dollar on US dollar-denominated expenses.

| | Three months ended June 30 | | | | Six months ended June 30 | | | |
|---|---|---|---|---|---|---|---|---|
| *In millions* | **2016** | 2015 | % Change | % Change at constant currency | **2016** | 2015 | % Change | % Change at constant currency |
| Labor and fringe benefits | **$ 469** | $ 542 | 13% | 15% | **$ 1,059** | $ 1,210 | 12% | 16% |
| Purchased services and material | **377** | 434 | 13% | 15% | **785** | 891 | 12% | 15% |
| Fuel | **243** | 327 | 26% | 29% | **478** | 688 | 31% | 35% |
| Depreciation and amortization | **296** | 285 | (4%) | (2%) | **603** | 581 | (4%) | (1%) |
| Equipment rents | **92** | 83 | (11%) | (6%) | **187** | 177 | (6%) | 1% |
| Casualty and other | **72** | 92 | 22% | 25% | **184** | 251 | 27% | 31% |
| *Total operating expenses* | **$ 1,549** | $ 1,763 | 12% | 15% | **$ 3,296** | $ 3,798 | 13% | 17% |

**Labor and fringe benefits**

Labor and fringe benefits expense decreased by $73 million, or 13%, in the second quarter of 2016 and $151 million, or 12%, in the first half of 2016 when compared to the same periods in 2015. The decreases were primarily a result of a lower average headcount due to lower volumes of traffic and increased productivity, and lower pension expense, partly offset by higher incentive-based compensation expense and the negative translation impact of the weaker Canadian dollar.

**Purchased services and material**

Purchased services and material expense decreased by $57 million, or 13%, in the second quarter of 2016 and $106 million, or 12%, in the first half of 2016 when compared to the same periods in 2015. The decreases were mainly due to lower repairs and maintenance costs resulting from lower volumes of traffic and cost-management initiatives, as well as favorable winter conditions in the first quarter, and lower accident costs, partly offset by the negative translation impact of the weaker Canadian dollar.

**Fuel**

Fuel expense decreased by $84 million, or 26%, in the second quarter of 2016 and $210 million, or 31%, in the first half of 2016 when compared to the same periods in 2015. The decreases were primarily due to lower fuel prices and lower volumes of traffic, partly offset by the negative translation impact of the weaker Canadian dollar.

**Depreciation and amortization**

Depreciation and amortization expense increased by $11 million, or 4%, in the second quarter of 2016 and $22 million, or 4%, in the first half of 2016 when compared to the same periods in 2015. The increases were mainly due to net capital additions and the negative translation impact of the weaker Canadian dollar, partly offset by the favorable impact of depreciation studies.

**Equipment rents**

Equipment rents expense increased by $9 million, or 11%, in the second quarter of 2016 and $10 million, or 6%, in the first half of 2016 when compared to the same periods in 2015. The increases were primarily due to lower rental income from the use of the Company's locomotives and cars, and the negative translation impact of the weaker Canadian dollar, partly offset by lower rental and car hire expense.

**Casualty and other**

Casualty and other expense decreased by $20 million, or 22%, in the second quarter of 2016 and $67 million, or 27%, in the first half of 2016 when compared to the same periods in 2015. The decreases were mainly due to lower accident costs partly offset by the negative translation impact of the weaker Canadian dollar.

## Other income and expenses

### Interest expense

Interest expense was $116 million and $239 million for the three and six months ended June 30, 2016, respectively, compared to $105 million and $209 million, respectively, for the same periods in 2015. The increases were mainly due to the negative translation impact of the weaker Canadian dollar on US dollar-denominated interest expense and a higher level of debt.

### Other income (loss)

In the second quarter and first half of 2016, the Company recorded other loss of $1 million and other income of $4 million, respectively, compared to other income of $16 million and $20 million, respectively, in the same periods in 2015, due to lower gains on disposal of land.

### Income tax expense

The Company recorded income tax expense of $318 million and $625 million for the three and six months ended June 30, 2016, respectively, compared to $387 million and $646 million, respectively, for the same periods in 2015.

Included in the 2016 figures was a deferred income tax expense of $7 million resulting from the enactment of a higher provincial corporate income tax rate, which was recorded in the second quarter.

Included in the 2015 figures was a deferred income tax expense of $42 million resulting from the enactment of a higher provincial corporate income tax rate, which was recorded in the second quarter.

The effective tax rates for the three and six months ended June 30, 2016 were 27.0% and 27.5%, respectively, and 30.4% and 28.9%, respectively, for the same periods in 2015. Excluding the net deferred income tax expense of $7 million in 2016 and $42 million in 2015, the effective tax rates for the three and six months ended June 30, 2016 were 26.4% and 27.2%, respectively, and 27.1% and 27.0%, respectively, for the same periods in 2015.

## Summary of quarterly financial data

| | **2016 Quarters** | | 2015 Quarters | | | | 2014 Quarters | |
|---|---|---|---|---|---|---|---|---|
| *In millions, except per share data* | **Second [1]** | First | Fourth | Third | Second [2] | First | Fourth | Third |
| Revenues | **$ 2,842** | $ 2,964 | $ 3,166 | $ 3,222 | $ 3,125 | $ 3,098 | $ 3,207 | $ 3,118 |
| Operating income | **$ 1,293** | $ 1,217 | $ 1,354 | $ 1,487 | $ 1,362 | $ 1,063 | $ 1,260 | $ 1,286 |
| Net income | **$ 858** | $ 792 | $ 941 | $ 1,007 | $ 886 | $ 704 | $ 844 | $ 853 |
| Basic earnings per share | **$ 1.10** | $ 1.01 | $ 1.19 | $ 1.26 | $ 1.10 | $ 0.87 | $ 1.04 | $ 1.04 |
| Diluted earnings per share | **$ 1.10** | $ 1.00 | $ 1.18 | $ 1.26 | $ 1.10 | $ 0.86 | $ 1.03 | $ 1.04 |
| Adjusted diluted earnings per share [3] | **$ 1.11** | $ 1.00 | $ 1.18 | $ 1.26 | $ 1.15 | $ 0.86 | $ 1.03 | $ 1.04 |
| Dividends per share | **$ 0.3750** | $ 0.3750 | $ 0.3125 | $ 0.3125 | $ 0.3125 | $ 0.3125 | $ 0.2500 | $ 0.2500 |

*(1) Included in net income in the second quarter of 2016 was an income tax expense of $7 million that resulted from the enactment of a higher corporate income tax rate.*

*(2) Included in net income in the second quarter of 2015 was an income tax expense of $42 million that resulted from the enactment of a higher corporate income tax rate.*

*(3) See the section of this MD&A entitled Adjusted performance measures for an explanation of this non-GAAP measure.*

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 (see the section entitled *Business risks* of the Company's 2015 Annual MD&A). Operating expenses reflect the impact of freight volumes, seasonal weather conditions, labor costs, fuel prices, and the Company's productivity initiatives. Fluctuations in the Canadian dollar relative to the US dollar have also affected the conversion of the Company's US dollar-denominated revenues and expenses and resulted in fluctuations in net income in the rolling eight quarters presented above.

## Liquidity and capital resources

An analysis of the Company's liquidity and capital resources is provided in the section entitled *Liquidity and capital resources* of the Company's 2015 Annual MD&A. There were no significant changes during the first half of 2016, except as noted below.

As at June 30, 2016 and December 31, 2015, the Company had Cash and cash equivalents of $160 million and $153 million, respectively; Restricted cash and cash equivalents of $510 million and $523 million, respectively; and a working capital deficit of $604 million and $845 million, respectively. The working capital deficit decreased by $241 million in the first half of 2016 primarily as a result of a decrease in Current portion of long-term debt. The cash and cash equivalents pledged as collateral for a minimum term of one month pursuant to the Company's bilateral letter of credit facilities are recorded as Restricted cash and cash equivalents. There are currently no specific requirements relating to working capital other than in the normal course of business as discussed herein.

The Company expects cash from operations and its various sources of financing to be sufficient to meet its ongoing obligations. The Company is not aware of any trends or expected fluctuations in its liquidity that would impact its ongoing operations or financial condition as at the date of this MD&A.

### Available financing sources

#### *Shelf prospectus and registration statement*

On February 23, 2016, under its current shelf prospectus and registration statement, the Company issued US$500 million ($686 million) 2.75% Notes due 2026 in the U.S. capital markets, which resulted in net proceeds of $677 million. The Company has remaining capacity available of $5,314 million under its current shelf prospectus and registration statement. Access to the Canadian and U.S. capital markets under the shelf prospectus and registration statement is dependent on market conditions.

#### *Revolving credit facility*

On March 11, 2016, the Company's revolving credit facility agreement was amended, which increased the credit facility from $800 million to $1.3 billion, effective May 5, 2016. The increase in capacity provides the Company with additional financial flexibility. The amended credit facility of $1.3 billion consists of a tranche for $420 million maturing on May 5, 2019 and a tranche for $880 million maturing on May 5, 2021. The accordion feature, which provides for an additional $500 million subject to the consent of individual lenders, remains unchanged. As at June 30, 2016 and December 31, 2015, the Company had no outstanding borrowings under its revolving credit facility and there were no draws during the six months ended June 30, 2016.

#### *Commercial paper*

The Company's commercial paper programs are backstopped by the Company's revolving credit facility agreement, which was amended March 11, 2016. During the second quarter of 2016, the maximum aggregate principal amount of commercial paper that could be issued increased from $800 million to $1.3 billion, or the US dollar equivalent on a combined basis. As at June 30, 2016 and December 31, 2015, the Company had total commercial paper borrowings of US$600 million ($775 million) and US$331 million ($458 million), respectively, presented in Current portion of long-term debt on the Consolidated Balance Sheets.

#### *Accounts receivable securitization program*

As at June 30, 2016 and December 31, 2015, the Company had no proceeds received under the accounts receivable securitization program, which provides the Company with access to up to $450 million of proceeds.

#### *Bilateral letter of credit facilities*

As at June 30, 2016, the Company had letters of credit drawn of $532 million ($551 million as at December 31, 2015) from a total committed amount of $567 million ($575 million as at December 31, 2015) by the various banks. As at June 30, 2016, cash and cash equivalents of $510 million ($523 million as at December 31, 2015) were pledged as collateral and recorded as Restricted cash and cash equivalents on the Consolidated Balance Sheets.

Additional information relating to these financing sources is provided in the section entitled *Liquidity and capital resources – Available financing sources* of the Company's 2015 Annual MD&A as well as *Note 5 - Financing activities* to the Company's unaudited Interim Consolidated Financial Statements.

### Credit ratings

The Company's long-term debt and commercial paper credit ratings remain unchanged from those described in the section entitled *Liquidity and capital resources – Credit ratings* of the Company's 2015 Annual MD&A.

**Cash flows**

| In millions | Three months ended June 30 | | | Six months ended June 30 | | |
|---|---|---|---|---|---|---|
| | **2016** | 2015 | Variance | **2016** | 2015 | Variance |
| Net cash provided by operating activities | **$ 1,271** | $ 1,203 | $ 68 | **$ 2,336** | $ 2,195 | $ 141 |
| Net cash used in investing activities | **(674)** | (662) | (12) | **(1,154)** | (1,143) | (11) |
| Net cash used in financing activities | **(628)** | (633) | 5 | **(1,182)** | (1,022) | (160) |
| Effect of foreign exchange fluctuations on US dollar-denominated cash and cash equivalents | **3** | - | 3 | **7** | 4 | 3 |
| *Net increase (decrease) in cash and cash equivalents* | **(28)** | (92) | 64 | **7** | 34 | (27) |
| Cash and cash equivalents, beginning of period | **188** | 178 | 10 | **153** | 52 | 101 |
| *Cash and cash equivalents, end of period* | **$ 160** | $ 86 | $ 74 | **$ 160** | $ 86 | $ 74 |

***Operating activities***

Net cash provided by operating activities increased by $68 million in the second quarter of 2016 when compared to the same period in 2015, mainly due to favorable changes in working capital. Net cash provided by operating activities increased by $141 million in the first half of 2016 when compared to the same period in 2015, due to improvements in cash earnings, partly offset by unfavorable changes in working capital.

*Pension contributions*

The Company's contributions to its various defined benefit pension plans are made in accordance with the applicable legislation in Canada and the U.S. and such contributions follow minimum and maximum thresholds as determined by actuarial valuations.

Actuarial valuations are generally required on an annual basis for all Canadian plans, or when deemed appropriate by the Office of the Superintendent of Financial Institutions (OSFI). Actuarial valuations are also required annually for the Company's U.S. qualified pension plans. For accounting purposes, the funded status is calculated under GAAP. For funding purposes, the funded status of the Company's Canadian registered defined benefit pension plans is calculated under going concern and solvency scenarios as prescribed under federal pension legislation and is subject to guidance issued by the Canadian Institute of Actuaries and OSFI. The federal pension legislation requires funding deficits to be paid over a number of years. Alternatively, a letter of credit can be subscribed to fulfill solvency deficit payments.

The Company's most recently filed actuarial valuations for funding purposes for its Canadian registered defined benefit pension plans conducted as at December 31, 2015 indicated a funding excess on a going concern basis of approximately $2.2 billion and a funding excess on a solvency basis of approximately $0.3 billion calculated using the three-year average of the plans' hypothetical wind-up ratio.

Pension contributions for the six months ended June 30, 2016 and 2015 of $88 million and $92 million, respectively, primarily represent contributions to the CN Pension Plan, for the current service cost as determined under the Company's current actuarial valuations for funding purposes. In 2016, the Company expects to make total cash contributions of approximately $130 million for all of the Company's pension plans.

Adverse changes to the assumptions used to calculate the Company's funding status, particularly the discount rate, as well as changes to existing federal pension legislation could significantly impact to the Company's future pension contributions.

Additional information relating to the pension plans is provided in *Note 12 – Pensions and other postretirement benefits* to the Company's 2015 Annual Consolidated Financial Statements.

*Income tax payments*

Net income tax payments decreased by $16 million in the first six months of 2016 when compared to the same period in 2015, mainly due to lower tax installments for the 2016 fiscal year. For the 2016 fiscal year, the Company's net income tax payments are expected to be approximately $800 million.

***Investing activities***

Net cash used in investing activities increased by $12 million in the second quarter of 2016 and $11 million first half of 2016 when compared to the same periods in 2015, mainly as a result of higher property additions.

*Property additions*

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *In millions* | **2016** | 2015 | **2016** | 2015 |
| Track and roadway | **$ 560** | $ 533 | **$ 838** | $ 770 |
| Rolling stock | **43** | 60 | **164** | 234 |
| Buildings | **13** | 12 | **21** | 19 |
| Information technology | **22** | 38 | **42** | 65 |
| Other | **32** | 16 | **74** | 39 |
| *Property additions* (1) | **$ 670** | $ 659 | **$ 1,139** | $ 1,127 |

*(1) Includes $64 million and $110 million associated with the U.S. federal government legislative Positive Train Control implementation in the three and six months ended June 30, 2016, respectively, ($25 million and $41 million in the three and six months ended June 30, 2015, respectively).*

*Capital expenditure program*

The Company reduced its budget for capital spending from approximately $2.9 billion to approximately $2.75 billion in the first quarter of 2016 as a result of updated foreign exchange assumptions. The details of the Company's 2016 capital program are provided in the section entitled *Liquidity and capital resources – Cash flows* of the Company's 2015 Annual MD&A.

***Financing activities***

Net cash used in financing activities decreased by $5 million in the second quarter of 2016 when compared to the same period in 2015, driven by a net issuance of commercial paper, partly offset by the repayment of notes and debt related to capital leases, and higher repurchases of common shares and dividend payments. Net cash used in financing activities increased by $160 million in the first half of 2016 when compared to the same period in 2015, driven by the repayment of notes and debt related to capital leases, higher repurchases of common shares and dividend payments, and a lower net issuance of commercial paper, partly offset by the issuance of notes.

*Debt financing activities*

Debt financing activities in the first half of 2016 included the following:

- On February 23, 2016, issuance of US$500 million ($686 million) 2.75% Notes due 2026 in the U.S. capital markets, which resulted in net proceeds of $677 million;
- On June 1, 2016, repayment of US$250 million ($328 million) 5.80% Notes due 2016 upon maturity;
- Repayment of debt related to capital leases of $59 million in the second quarter and $170 million in the first half; and
- Net issuance of commercial paper of $622 million in the second quarter and $322 million in the first half.

Debt financing activities in the first half of 2015 included a net issuance of commercial paper of $69 million in the second quarter and $379 million in the first half, and repayment of debt related to capital leases of $56 million in the first half.

Additional information relating to the Company's outstanding debt securities is provided in *Note 10 – Long-term debt* to the Company's 2015 Annual Consolidated Financial Statements.

*Share repurchase programs*

The Company may repurchase shares pursuant to a Normal Course Issuer Bid (NCIB) at prevailing market prices plus brokerage fees, or such other prices as may be permitted by the Toronto Stock Exchange. Under its current NCIB, the Company may repurchase up to 33.0 million common shares between October 30, 2015 and October 29, 2016. As at June 30, 2016, the Company had repurchased 20.4 million common shares for $1,463 million under its current program.

The following table provides the information related to the share repurchase programs for the three and six months ended June 30, 2016 and 2015:

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *In millions, except per share data* | **2016** | 2015 | **2016** | 2015 |
| Number of common shares repurchased (1) | **7.2** | 5.3 | **14.6** | 10.7 |
| Weighted-average price per share (2) | **$ 73.80** | $ 77.14 | **$ 72.20** | $ 78.17 |
| Amount of repurchase (3) | **$ 533** | $ 404 | **$ 1,053** | $ 833 |

*(1) Includes repurchases of common shares in the first and second quarters of 2016 and the first quarter 2015 pursuant to private agreements between the Company and arm's length third-party sellers.*

*(2) Includes brokerage fees where applicable.*

*(3) Includes settlements in subsequent periods.*

*Share Trusts*

The Company's Employee Benefit Plan Trusts ("Share Trusts") purchase common shares on the open market, which are used to deliver common shares under the Share Units Plan. For the six months ended June 30, 2016, the Share Trusts disbursed 0.3 million common shares, which had a historical cost of $23 million, representing a weighted-average price per share of $73.31, for settlement under the Share Units Plan. For the three and six months ended June 30, 2015, the Share Trusts purchased 0.6 million common shares for $44 million at a weighted-average price per share of $74.39, including brokerage fees.

*Dividends paid*

The Company paid quarterly dividends of $0.3750 per share amounting to $291 million and $584 million in the second quarter and first half of 2016, respectively, compared to $250 million and $502 million, at the rate of $0.3125 per share, for the same periods in 2015.

**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 June 30, 2016:

| *In millions* | **Total** | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 & thereafter |
|---|---|---|---|---|---|---|---|
| Debt obligations (1) | **$ 9,984** | $ 1,162 | $ 637 | $ 670 | $ 704 | $ - | $ 6,811 |
| Interest on debt obligations (2) | **6,526** | 217 | 429 | 395 | 347 | 327 | 4,811 |
| Capital lease obligations (3) | **442** | 60 | 177 | 16 | 16 | 22 | 151 |
| Operating lease obligations | **649** | 100 | 114 | 111 | 82 | 56 | 186 |
| Purchase obligations (4) | **1,056** | 647 | 237 | 42 | 35 | 30 | 65 |
| Other long-term liabilities (5) | **731** | 32 | 65 | 47 | 42 | 59 | 486 |
| *Total contractual obligations* | **$ 19,388** | **$ 2,218** | **$ 1,659** | **$ 1,281** | **$ 1,226** | **$ 494** | **$ 12,510** |

*(1) Presented net of unamortized discounts and debt issuance costs and excludes capital lease obligations.*

*(2) Interest payments on floating rate notes are calculated based on the three-month London Interbank Offered Rate effective as at June 30, 2016.*

*(3) Includes $338 million of minimum lease payments and $104 million of imputed interest at rates ranging from 0.7% to 7.3%.*

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

*(5) Includes expected payments for workers' compensation, postretirement benefits other than pensions, net unrecognized tax benefits, environmental liabilities and pension obligations that have been classified as contractual settlement agreements.*

### Free cash flow

Management believes that free cash flow is a useful measure of performance as it demonstrates the Company's ability to generate cash for debt obligations and for discretionary uses such as payment of dividends, share repurchases, and strategic opportunities. The Company defines its free cash flow measure as the difference between net cash provided by operating activities and net cash used in investing activities; adjusted for changes in restricted cash and cash equivalents and the impact of major acquisitions, if any. Free cash flow does not have any standardized meaning prescribed by GAAP and therefore, may not be comparable to similar measures presented by other companies.

The following table provides a reconciliation of net cash provided by operating activities as reported for the three and six months ended June 30, 2016 and 2015, to free cash flow:

| | Three months ended June 30 | | Six months ended June 30 | |
|---|---|---|---|---|
| *In millions* | **2016** | 2015 | **2016** | 2015 |
| Net cash provided by operating activities | **$ 1,271** | $ 1,203 | **$ 2,336** | $ 2,195 |
| Net cash used in investing activities | **(674)** | (662) | **(1,154)** | (1,143) |
| *Net cash provided before financing activities* | **597** | 541 | **1,182** | 1,052 |
| *Adjustment:* Change in restricted cash and cash equivalents | **(12)** | (11) | **(13)** | (1) |
| *Free cash flow* | **$ 585** | $ 530 | **$ 1,169** | $ 1,051 |

### Adjusted debt-to-adjusted EBITDA multiple

Management believes that the adjusted debt-to-adjusted earnings before interest, income taxes, depreciation and amortization (EBITDA) multiple is a useful credit measure because it reflects the Company's ability to service its debt. The Company calculates the adjusted debt-to-adjusted EBITDA multiple as adjusted debt divided by adjusted EBITDA. These measures do not have any standardized meaning prescribed by GAAP and therefore, may not be comparable to similar measures presented by other companies.

The following table provides a reconciliation of debt and net income to the adjusted measures presented below, which have been used to calculate the adjusted debt-to-adjusted EBITDA multiple:

| *In millions, unless otherwise indicated* — *As at and for the twelve months ended June 30,* | **2016** | 2015 |
|---|---|---|
| Debt [(1)] | **$ 10,322** | $ 9,308 |
| *Adjustment:* Present value of operating lease commitments [(2)] | **561** | 647 |
| *Adjusted debt* | **$ 10,883** | $ 9,955 |
| Net income | **$ 3,598** | $ 3,287 |
| Interest expense | **469** | 397 |
| Income tax expense | **1,315** | 1,318 |
| Depreciation and amortization | **1,180** | 1,118 |
| *EBITDA* | **6,562** | 6,120 |
| *Adjustments:* | | |
| Other income | **(31)** | (31) |
| Deemed interest on operating leases | **27** | 30 |
| *Adjusted EBITDA* | **$ 6,558** | $ 6,119 |
| Adjusted debt-to-adjusted EBITDA multiple *(times)* | **1.66** | 1.63 |

*(1) As a result of the retrospective adoption of a new accounting standard in the fourth quarter of 2015, the prior period debt balance has been adjusted. There was no impact to the related financial ratio. See the section of the Company's 2015 Annual MD&A entitled Recent accounting pronouncements for additional information.*

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

The increase in the Company's adjusted debt-to-adjusted EBITDA multiple at June 30, 2016, as compared to the same period in 2015, was mainly due to an increased debt level as at June 30, 2016, resulting from the net issuance of debt and a weaker Canadian-to-US dollar foreign exchange rate, partly offset by a higher net income earned during the twelve months ended June 30, 2016, as compared to the twelve months ended June 30, 2015.

All forward-looking statements discussed in this section are subject to risks and uncertainties and are 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 section of this MD&A entitled *Forward-looking statements* for a discussion of assumptions and risk factors affecting such forward-looking statements.

## Off balance sheet arrangements

**Guarantees and indemnifications**

In the normal course of business, the Company, including certain of its subsidiaries, enters into agreements that may involve providing guarantees or indemnifications to third parties and others, which may extend beyond the term of the agreements. These include, but are not limited to, residual value guarantees on operating leases, standby letters of credit, surety and other bonds, and indemnifications that are customary for the type of transaction or for the railway business. As at June 30, 2016, the Company has not recorded a liability with respect to guarantees and indemnifications. Additional information relating to guarantees and indemnifications is provided in *Note 9 – Major commitments and contingencies* to the Company's unaudited Interim Consolidated Financial Statements.

## Outstanding share data

As at July 25, 2016, the Company had 771.6 million common shares and 6.4 million stock options outstanding.

## Financial instruments

**Risk management**

In the normal course of business, the Company is exposed to various financial risks from its use of financial instruments, such as credit risk, liquidity risk, and market risks such as foreign currency risk, interest rate risk and commodity price risk. A description of these risks and how the Company manages them, is provided in the section entitled *Financial instruments* of the Company's 2015 Annual MD&A.

***Foreign currency risk***

The estimated annual impact on net income of a year-over-year one-cent change in the Canadian dollar relative to the US dollar is approximately $30 million.

**Derivative financial instruments**

As at June 30, 2016, the Company had outstanding foreign exchange forward contracts with a notional value of US$967 million (US$361 million as at December 31, 2015). For the three and six months ended June 30, 2016, the Company recorded a loss of $2 million and $47 million, respectively, related to foreign exchange forward contracts, compared to a loss of $7 million and a gain of $29 million, respectively, for the same periods in 2015. These gains and losses were largely offset by the re-measurement of US dollar-denominated monetary assets and liabilities recorded in Other income.

As at June 30, 2016, Other current assets included an unrealized gain of $6 million ($4 million as at December 31, 2015) and Accounts payable and other included an unrealized loss of $21 million ($2 million as at December 31, 2015), related to the fair value of outstanding foreign exchange forward contracts.

**Fair value of financial instruments**

As at June 30, 2016, the Company's investments had a carrying amount of $64 million ($69 million as at December 31, 2015) and a fair value of $207 million ($220 million as at December 31, 2015). As at June 30, 2016, the Company's debt had a carrying amount of $10,322 million ($10,427 million as at December 31, 2015) and a fair value of $12,077 million ($11,720 million as at December 31, 2015).

Additional information relating to financial instruments is provided in *Note 10 – Financial instruments* to the Company's unaudited Interim Consolidated Financial Statements.

## Recent accounting pronouncements

The following recent Accounting Standards Updates (ASUs) issued by the Financial Accounting Standards Board (FASB) were adopted by the Company during the current period:

| Standard | Description | Impact |
|---|---|---|
| **ASU 2016-09 Compensation – Stock Compensation** | Simplifies several aspects of the accounting for share-based payments, including the income tax consequences, classification of awards as either equity or liabilities, and classification in the Statement of Cash Flows. The new guidance includes multiple amendments with differing application methods. | The Company adopted this standard during the second quarter of 2016 with an effective date of January 1, 2016. The adoption of this standard did not have a significant impact on the Consolidated Financial Statements of the Company. |

The following recent ASUs issued by FASB have an effective date after June 30, 2016 and have not been adopted by the Company:

| Standard | Description | Impact | Effective date [1] |
|---|---|---|---|
| **ASU 2016-13 Financial Instruments – Credit Losses** | Requires financial assets measured at amortized cost to be presented at the net amount expected to be collected. The amendments replace the current incurred loss impairment methodology with one that reflects expected credit losses and considers a broader range of reasonable and supportable information to determine the expected credit loss estimates. | The Company is evaluating the effects that the adoption of the ASU will have on its Consolidated Financial Statements, if any; however, no significant impact is expected. | December 15, 2019. Early adoption is permitted. |
| **ASU 2016-02 Leases** | Requires the recognition of lease assets and lease liabilities on the Balance Sheet by lessees for most leases. The accounting treatment applied by a lessor is largely unchanged. Lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. | The Company is evaluating the effects that the adoption of the ASU will have on its Consolidated Financial Statements. | December 15, 2018. Early adoption is permitted. |
| **ASU 2016-01 Financial Instruments – Overall** | Addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments require equity investments (except those accounted for under the equity method of accounting or those resulting in consolidation) to be measured at fair value with changes in fair value recognized in net income. The new guidance can be applied by means of a cumulative effect adjustment to the Balance Sheet at the beginning of the year of adoption. | The adoption of the ASU will not have a significant impact on the Company's Consolidated Financial Statements. | December 15, 2017. |
| **ASU 2014-09 Revenue from Contracts with Customers** | Establishes principles for reporting the nature, amount, timing and uncertainty of revenues and cash flows arising from an entity's contracts with customers. The basis of the new standard is that an entity recognizes revenue to represent the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The new guidance can be applied using a retrospective or the cumulative effect transition method. | The Company is evaluating the effects that the adoption of the ASU will have on its Consolidated Financial Statements, if any; however, no significant impact is expected. | December 15, 2017. Early adoption is permitted. |

*(1) Effective for annual and interim reporting periods beginning after the stated date.*

## Critical accounting estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates, judgments and assumptions that affect the reported amounts of revenues, expenses, 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 available information. Actual results could differ from these estimates. The Company's policies for income taxes, depreciation, pensions and other postretirement benefits, personal injury and other claims and environmental matters, 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. Reference is made to the section entitled *Critical accounting estimates* of the Company's 2015 Annual MD&A for a detailed description of the Company's critical accounting estimates. There have not been any material changes to these estimates, except as noted below for pensions and other postretirement benefits.

**Adoption of the spot rate approach**

In the first quarter of 2016, the Company adopted the spot rate approach to measure current service cost and interest cost for all defined benefit pension and other postretirement benefit plans on a prospective basis as a change in accounting estimate. In prior periods, these costs were determined using the discount rate used to measure the projected benefit obligation at the beginning of the period.

The spot rate approach enhances the precision to which current service cost and interest cost are measured by increasing the correlation between projected cash flows and spot discount rates corresponding to their maturity. Under the spot rate approach, individual spot discount rates along the same yield curve used in the determination of the projected benefit obligation are applied to the relevant projected cash flows at the relevant maturity. More specifically, current service cost is measured using the projected cash flows related to benefits expected to be accrued in the following year by active members of a plan and interest cost is measured using the projected cash flows making up the projected benefit obligation multiplied by the corresponding spot discount rate at each maturity. Use of the spot rate approach does not affect the measurement of the projected benefit obligation.

Based on bond yields prevailing at December 31, 2015, the single equivalent discount rates to determine current service cost and interest cost under the spot rate approach in 2016 are 4.24% and 3.27%, respectively, compared to 3.99%, for both costs, under the approach applied in prior periods. For the three and six months ended June 30, 2016, the adoption of the spot rate approach increased net periodic benefit income by approximately $35 million and $65 million, respectively, compared to the approach applied in prior periods.

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

## Business risks

In the normal course of business, the Company is exposed to various business risks and uncertainties that can have an effect on the Company's results of operations, financial position, or liquidity. While some exposures may be reduced by the Company's risk management strategies, many risks are driven by external factors beyond the Company's control or are of a nature which cannot be eliminated.

Reference is made to the section entitled *Business risks* of the Company's 2015 Annual MD&A for a detailed description of such key areas of business risks and uncertainties with respect to: Competition, Environmental matters, Personal injury and other claims, Labor negotiations, Regulation, Transportation of hazardous materials, Economic conditions, Pension funding volatility, Reliance on technology, Trade restrictions, Terrorism and international conflicts, Customer credit risk, Liquidity, Supplier concentration, Availability of qualified personnel, Fuel costs, Foreign exchange, Interest rate, Transportation network disruptions, and Weather and climate change, which is incorporated herein by reference. Additional risks and uncertainties not currently known to management or that may currently not be considered material by management, could nevertheless also have an adverse effect on the Company's business.

There have been no material changes to the risks described in the Company's 2015 Annual MD&A. The following is an update on labor negotiations and regulatory matters.

**Labor negotiations**

As at June 30, 2016, CN employed a total of 15,258 employees in Canada, of which 10,989, or 72%, were unionized employees; and 6,904 employees in the U.S., of which 5,453, or 79% were unionized employees. The Company's relationships with its unionized workforce are governed by, amongst other items, collective agreements which are negotiated from time to time. Disputes relating to the renewal of collective agreements could potentially result in strikes, slowdowns and loss of business. Future labor agreements or renegotiated agreements could increase labor and fringe benefits expenses. There can be no assurance that the Company will be able to renew and have

its collective agreements ratified 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 results of operations or financial position.

***Canadian workforce***

On March 23, 2016, the Company served notice to commence bargaining for the renewal of the collective agreements with the Teamsters Canada Rail Conference governing approximately 2,500 train conductors and yard coordinators, which expired on July 22, 2016. On June 29, 2016, the Company filed a notice of dispute seeking conciliation assistance. On July 14, 2016, the Minister of Labour appointed two conciliation officers to assist the parties with their negotiations.

The Company's collective agreements remain in effect until the bargaining process outlined under the *Canada Labour Code* has been exhausted.

***U.S. workforce***

As of July 25, 2016, all collective agreements covering non-operating craft employees and six of sixteen collective agreements covering operating craft employees are under renegotiation.

Where negotiations are ongoing, the terms and conditions of existing collective bargaining agreements continue to apply until new agreements are reached or the processes of the *Railway Labor Act* have been exhausted.

**Regulation**

***Economic regulation – Canada***

On June 25, 2014, the Government of Canada launched a statutory review of the Canada Transportation Act. The review concluded on December 21, 2015 when a report was submitted to the Federal Minister of Transport by the Chair of the review panel. The report was tabled in Parliament on February 25, 2016 by the Federal Minister of Transport. It is unclear what actions will be taken by the Government after it has considered the findings of the report and consulted with interested groups, and the potential impact on CN, if any.

On June 15, 2016, the Government of Canada announced that the provisions introduced by Bill C-30, notably with respect to extended interswitching distances and minimum volumes of grain to be moved, which were set to expire on August 1, 2016, had been extended until August 2017.

On June 18, 2016, the liability and compensation regime for rail under the *Safe and Accountable Rail Act* came into force. Under the regime, railway companies are strictly liable for damages resulting from accidents involving crude oil and are required to maintain minimum liability insurance coverage in respect of losses incurred as a result of a railway accident involving crude oil. The Act also creates a fund, capitalized through levies payable by crude oil shippers, to compensate for losses exceeding the railway company's minimum insurance level. CN has provided the Canadian Transportation Agency with submissions respecting the adequacy of its insurance coverage and has started collecting the levy on crude shipments.

***Economic regulation – U.S.***

On March 28, 2016, the Surface Transportation Board issued a Notice of Proposed Rulemaking to revoke previously granted exemptions of five commodities from regulatory oversight: (1) crushed or broken stone, (2) hydraulic cement, (3) coke produced from coal, (4) primary iron or steel products, and (5) iron or steel scrap, wastes or tailings.

On April 29, 2016, the U.S. Court of Appeals for the District of Columbia Circuit ruled that the *Passenger Rail Investment and Improvement Act of 2008 (PRIIA)* violates the due process rights of freight railroads, and consequently, that the performance standards jointly promulgated by Amtrak and the Federal Railroad Administration (FRA) pursuant to PRIIA are unconstitutional. The case will likely be appealed to the U.S. Supreme Court later this year.

***Safety regulation – Canada***

On April 28, 2016, Transport Canada issued a Protective Direction under which railways are required to provide municipalities and first responders with data on dangerous goods to improve emergency planning, risk assessment, and training.

On June 1, 2016, the Minister of Transport proposed amendments to the *Transportation of Dangerous Goods Act* to improve reporting requirements by carriers respecting shipments of dangerous goods to enhance public safety and improve local emergency response.

On June 18, 2016, Transport Canada proposed Locomotive Emissions Regulations under the *Railway Safety Act* to limit air pollution and align Canadian standards with U.S. regulations.

***Safety regulation – U.S.***

On March 15, 2016, the FRA issued a Notice of Proposed Rulemaking establishing a requirement for a minimum of two crewmembers on most train movements, with the second crewmember needing to be physically located on the train, except in certain circumstances. The FRA will consider possible scenarios for use of a one person crew, but some element of a safety assessment will be involved with each scenario.

On July 13, 2016, in coordination with the FRA, the Pipeline and Hazardous Materials Safety Administration announced proposed regulations for oil spill response plans and information sharing for high-hazard flammable trains to improve oil spill response readiness and mitigate effects of oil-related rail incidents.

***Positive Train Control***

The Company filed its annual progress report with the FRA on March 31, 2016. In addition to the annual progress report, the FRA is now requesting that railroads submit a quarterly progress report, the first of which is due on July 31, 2016.

No assurance can be given that these and any other current or future regulatory or legislative initiatives by the Canadian and U.S. federal governments and agencies will not materially adversely affect the Company's results of operations or its competitive and financial position.

**Trade restrictions**

On October 12, 2015, the Softwood Lumber Agreement (SLA) between Canada and the U.S. expired. The SLA included a clause that prevents the U.S. from launching any trade action against Canadian producers for one year after the expiration date of the SLA. It is unlikely that a new agreement will be renegotiated before the moratorium period ends. After the moratorium period ends, there is a risk that Canadian softwood lumber shipments to the U.S. may be impacted by future trade disputes.

There can be no assurance that any trade action taken by the Canadian and U.S. federal governments and agencies will not have a material adverse effect on the volume of rail shipments and/or revenues from commodities carried by the Company, and thus materially and negatively impact earnings and/or cash flow.

## 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 June 30, 2016, have concluded that the Company's disclosure controls and procedures were effective.

During the second quarter ended June 30, 2016, 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.