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# Transcript

## Q2 2016 Earnings Call

## July 20, 2016

**Corporate Participants:**

E. Hunter Harrison, CEO Canadian Pacific
Keith Creel, President & COO Canadian Pacific
Mark Erceg, EVP & CFO Canadian Pacific
Nadeem Velani, VP Investor Relations Canadian Pacific

# MANAGEMENT DISCUSSION SECTION

## Operator

Good morning. My name is Chris and I'll be your conference operator today. At this time, I'd like to welcome everyone to Canadian Pacific's Second Quarter 2016 Conference Call. The slides accompanying today's call are available at www.cpr.ca. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I would now like to introduce Nadeem Velani, VP, Investor Relations, to begin the conference.

## Nadeem Velani

*Vice President Investor Relations, Canadian Pacific*

Thanks, Chris. Good morning and thanks for joining us. I'm proud to have with me here today Hunter Harrison, Chief Executive Officer; Keith Creel, President and Chief Operating Officer; Mark Erceg, our Executive Vice President and Chief Financial Officer.

Before we begin, I want to remind you this presentation contains forward-looking information. Actual results may differ materially. The risks, uncertainties and other factors that could influence actual results are described on slide two, in the press release and in the MD&A filed with Canadian and U.S. regulators. This presentation also contains non-GAAP measures outlined on slide three.

The formal remarks will be followed by Q&A. In the interest of time, we would appreciate if you limit your questions to two. It is now my pleasure to introduce our CEO, Mr. Hunter Harrison.

## E. Hunter Harrison

*Chief Executive Officer, Canadian Pacific*

Thanks, Nadeem, and good morning to everyone. Thanks for joining us. I'm going to cover a few topics today. I trust you've seen our press release, and I'm not hopefully redundant. And Mark and Keith are going to cover the details of their performance in the second quarter, which I think we all recognize has been quite challenging. In fact, this whole first year has been quite challenging, and we've had much dialogue about that.

The thing that's exciting to me is – I've been doing this a long time – it's not my first rodeo, and I've never seen, I don't think, an operating group that reacted as quick as this operating group, led by Keith and Robert Johnson, to fix some of the processes internally that needed improvement that might have been broken that are very, very exciting going forward, which certainly speak to the second half of this year as well as, maybe more importantly, speak to next year's performance.

Let me just give you one example to start with. This group has come up with a different way to haul crews, and net, net, net, it's effectively, on an annualized basis, it's $40 million in savings. Now, that's not all going to kick in this year. We're going to get the benefit of 50%, 55% of the year there, but that shows you some of the hard work, grinding it out, we'll talk about some of the headcount initiatives that are a result of different operating plans with our trains.

The market has turned much more positive. Grain looks much better than we expected earlier in the year. In fact, if you listen to the experts in Canada, this will probably be a record year of all time of production of grain in Canada. The bulk of that has pretty well squared itself away. I think we'll see improvements second half, everywhere but probably crude, and we know the question marks that are there. And then throughout this presentation, I will be speaking to some of the initiatives that are taking place -- that speak more to the future than the past, and I think that's the point that this group that's with us this morning is to paint more about the future.

We've seen the first half of the year. We've taken our licks. We've had the fires. We've overcome some adversity. And we're still – we're going full speed. And at that reaction, as quick as it came about, was very refreshing and just gave me more confidence as I ride off in the sunset that this organization is in good hands to produce results that will, I think, will be very impressive to this group in the future.

So with those comments, let me call on Mr. Creel to give his perspective on the quarter.

## Keith Creel

*President & Chief Operating Officer, Canadian Pacific*

Okay. Thanks, Hunter, for those very kind comments. I want to echo and emphasize the point that Hunter made about this environment we've been in this first half, this second quarter. Obviously, not a runaway on the volume front, very challenging headwinds. But from an operating performance perspective, what gives me confidence in what we've done and the numbers that we produce is the foundation that we're setting for future success. And if I had to take in my career, as well, and match up any operating performance, I would argue this is, if not, one of the best operating performance quarters I've ever experienced.

From a leadership standpoint, from a bench standpoint, we told our investors back after our AGM at the first quarter result that we were going to realign our regions – which we've done. Robert Johnson, who I've worked with now for almost two decades of railroading, is leading the operating group, reporting to me, working together, in concert with me and the other team members here in Calgary; Guido's in the West, Tony's in the East, Scott Macdonald, and then, of course, Mike Foran running the operation centers. That combination, that bench, is second to none in this industry. And that's what's producing, with the people that we lead, these remarkable operating results.

We've had quantum leaps over the past several years that even in the face of negative volume, as Hunter taught me a long time ago, this operating plan is a gift that keeps on giving. It works as good, if not better, in the downtimes as it does the uptimes. But as we look forward to the second half and as we look forward to 2017 and 2018 with this reset base, that's where we drive operating leverage, that's how we continue to provide best-in-class service because you do it by executing the operating model, and that's how you continue to drive margin improvement. And that's what gives me confidence to be able to produce the kind of earnings that we're talking about producing this year, second half.

And then on the base of that, we talk about – and Hunter taught me this a long time as well – my number one challenge, as an operating guy, is a safe and efficient movement of goods from point A to point B. So on the safety front, which is all very topical in this industry, topical with our responsibility to communities we operate in and through – although that scenario that you never get there, it's a journey, it's not a destination – we continue to drive dramatic improvement in that area as well, which is good for business from a societal cost to people cost. It's the right thing to do. And it's not about being the best-in-class or the best-in-the-industry, it's all about day-in and day-out being the best that we can be ourselves.

We hold our own self to a high standard, and that's something we'll never forget about. And because of that, we're driving culture, process change into the people. We're producing some significant progress there that makes all of this possible.

I'll give you, for instance – we talked about this a little bit in the past – the power of just taking switches out of our main line. The number I looked at this morning is, to be precise, 843 switches we've identified. About half of those in the main line, the balance in our yards that are backtracks were redundant switches. What does that mean? That means less capital cost. What does that mean? That means you take them out of track and you get a more fluid railroad and more productive railroad, a faster railroad relative to turning asset.

So I don't have slow orders. I don't have a potential for derailment. I don't have an additional switch that I may not need or don't need to replace in my capital budgets. And as we go forward and grow this company, I now have an inventory of switches and track that I can cascade forward and lower my overall capital cost as we grow on the future. So just that one simple initiative, the power of this team to be able to do that and to repurpose this network, work-in-progress but certainly something that's instrumental for us as we go forward.

So let's spend a little time on the revenue side. Obviously, not a runaway – 12% down for the quarter. Not a very pretty picture obviously. I'm looking to the future. I'm looking to the second half. The quarter was much worse than we anticipated. We did expect to bottom. It was worse than what we had anticipated. But as I've said before, I never anticipated the fires in Alberta. I didn't anticipate the fact that we would move so much grain -- record amounts of grain in the supply chain. That we would run out of grain to move in May instead of June and July, which is what we had forecasted.

With that said, again, the worst of that is behind us. I'm looking forward. We still got a little bit of headwind – Canadian dollar. The strengthening dollar hit us some in the quarter; it's still going to hit us a little bit in the second half. But the second half of the year was optimistic. Today's rates, even with a little bit of offset, headwind was the currency. The back half of the year earnings potential is substantial.

Fuel surcharges hurt us about 3% during this transition time. We tracked out on OHD levels. So we're paying a higher OHD cost ourselves. The surcharge didn't kick in until the last part of June. So that was a headwind for us in the quarter, which will neutralize

in the third quarter and become a slight tailwind for us in the fourth quarter.

Price, very positive story with the service, excluding regulated grain, was 3%. That was slightly offset by a small negative mix impact, when you see the 2% price/mix, we want to cover on that. And then, finally, I think it's important that I point out the 2% reduction in [other] freight revenues, I don't want that to be misconstrued as price or misconstrued as rates, that's all about our business changing since last year. We sold the D&H. There are some haulage revenues that we enjoyed last year's second quarter from the NS, who bought it, that we don't enjoy this year. And also on a positive note, we've got less accessorial charge revenues. And what that tells me is that our customers, too, are working with us to turn assets. We don't have assets sitting around. Those valuable assets, be it the customer owns it or be it we own them, we're able to turn those at a lower incremental cost to drive additional volume at a lower cost, which is all good and fits well into our operating model.

So, again, as we mentioned in April, the second quarter was the bottom. Perhaps the bottom was a little bit deeper than what we expected. But the second half, we're extremely optimistic given the potential, to Hunter's point, for strong volumes and improving rates despite some continuous uncertainty in crude and in intermodal. Q3, you can expect to see RTMs down in the mid-single digits given we've got very difficult crude compares last year. I'll point out that back in September, October are two strongest-ever crude months last year when the spreads inflected. We obviously don't have that this year.

But this team is out selling the strength of this franchise in a very disciplined manner. We're continually improving our service, and we're setting the foundation, as I said, for the rest of 2016 and in 2017 and 2018. It's exciting now. The value creation is pretty compelling, but it's inspiring as we go into 2017 and 2018 as we transition from Hunter and he turns the baton over to myself and this great team that we've assembled here at CP to produce continual earnings growth for our shareholders and service for our customers.

Over to Mark to provide a little more color.

## Mark Erceg

*Executive Vice President & Chief Financial Officer, Canadian Pacific*

Thanks, Keith.

As Keith mentioned, we did face a very challenging demand environment during the second quarter, which was further exacerbated by the Northern Alberta wildfires, which we believe negatively impacted shipments by about $20 million during the quarter. And the wildfire has also increased fuel expense by $9 million, which unfortunately couldn't be offset through our fuel surcharge program because we source a meaningful percentage of our fuel from the local Edmonton market where fuel was in short supply for several weeks following the crisis.

So while the team worked exceedingly hard take costs out as quickly as possible, while of course maintaining safe railroad operations, the speed and magnitude of the revenue decline during the second quarter made it difficult to offset the full impact. Which is why, despite bringing operating expenses down by 11% and finishing the quarter with over 2,000 fewer employees than we had last year at the same time, adjusted income came in below a year ago at $312 million or $2.05 per share.

Now, within that, comp and benefits was down 8% versus last year, driven by lower headcount and positive pension income. Fuel expense was down 29% due to lower volumes and improvement in fuel efficiency and lower fuel prices. And purchased services declined 13% due to lower locomotive overhauls and maintenance cost, fewer contractors, and a $17 million gain from the sale of some surplus freight cars.

Land sales were only $2 million in the quarter, but we do expect an additional $20 million of land sales throughout the balance of the year, with most of that expected to occur in the fourth quarter. All in, that would bring total land sales for the year to about $75 million – which is unchanged versus our last update.

Below the line, other income and charges as reported was a $9 million credit during the quarter due to an $18 million foreign exchange benefit on our non-U.S. dollar-denominated debt portfolio. If we were to exclude this non-operational impact, other income and charges would have been $9 million – $6 million of which related to one-time fees associated with our proposed offer to acquire another Class I rail.

Interest expense was up 37% to $115 million due to the additional debt we issued in 2015 to repurchased shares, and a weaker Canadian dollar versus the U.S. dollar. And then our effective tax rate, excluding the FX translation on our U.S. dollar-denominated debt, also came down this quarter, which was consistent with our expectations.

Currently, our year-to-date effective tax rate is 27.25%. And I'm pleased to report that we're actively pursuing a number of promising tax initiatives which may lower our full year all-in 2016 effective tax rate another 50 basis points to 100 basis points before the dust settles.

Finally, from a capital allocation standpoint, we remain committed to returning capital to our owners within the confines of our current credit rating. Consistent with this, you'll recall we announced a 5% NCIB share buyback program and a 40% increase in our dividend in conjunction with our Q1 earnings release.

As of today, we have purchased 5.3 million of the 6.9 million share authorization at an average price of just over $169 per share. And our key leverage metric, which is adjusted net-debt-to-EBITDA, currently sits at 2.9 times. At this point, we don't have any plans to issue an incremental long-term debt so we should see some natural deleveraging and expect to end the year with around 2.7 turns of adjusted net-debt-to-EBITDA.

So admittedly, after a challenging first half, we have our work cut out for us in the second half of the year, but the team is digging deep to manage cost and improve service, and we're confident that both OR and EPS will strengthen sequentially during both the third and the fourth quarters.

And with that, I'll hand the call back to Hunter to close our prepared remarks.

### E. Hunter Harrison

*Chief Executive Officer, Canadian Pacific*

Thanks, Mark and Keith, for those remarks.

Chris, we will be happy now to receive questions from the group if there are any.

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## QUESTION & ANSWER

### Operator

Thank you. [Operator Instructions] The first question is from Scott Group with Wolfe Research. Your line is open.

**<Q - Scott Group>**: Hey. Thanks. Morning, guys. So, wanted to ask you about the outlook. I'm not sure if you guys still see a path to double-digit earnings growth. I know most of us don't think that that's realistic, but maybe share, if you do think that that's possible, kind of -- what's some of the assumptions for maybe RTMs and then operating ratios are in the third and fourth quarter that gets you there?

**<A - E. Hunter Harrison>**: Well, I mean, clearly, Scott, I think that we certainly see a path there or we would have informed you otherwise sooner. Now, clearly, this is not a slam dunk. It's going to be a challenge. But if you look at the net-net-net effect of what we've discussed so far this morning with Mark and Keith about revenues, grain much more positive, cost initiatives that people hadn't dreamed of. And you put the net-net-net effect of that all together, you can come up with $100 million.

Now, I mean, you can do the math. If you look at the first half and you're trying to look at the full year – and most of the questions I've had lately have not been on the full year, but been on next year, that the focus is – there's certainly a path to get there.

Now if we see -- if something happens to the Canadian dollar, if something happens "beyond our control," and this gets to the point where we see that we can get there, and it's a material difference that as I've said to you earlier and before, we have an obligation and we'll report that to you and say look, for the following reasons, here's where we think we'll be. But if I didn't think that was realistic, we've all -- I spent, I don't know if it was last weekend or the weekend before, but the basic weekend going through all these various assumptions. The puts-and-takes, the plusses and the minuses, there's a lot of moving parts and anybody that said they can tell you exactly where we're going to be, come see me, because I got a job for them.

**<A - Keith Creel>**: Scott, the only thing I would add, from an RTM perspective right now, we're around year-to-date 7%, 7.5% down. We see the line of sight with the strength in – be it grain, be it the fundamentals that have changed on potash, coal, all those things setting, hitting the bottom so to speak and inflecting positively line of sight. We expected to see at the beginning of the year around

4% RTM down year-over-year. And from the operating performance, the leverage we're creating from a cost standpoint, the cost takeout which we'll see the benefit from more so the second half than the first half, mid-50s type operating ratio performance the second half.

**<Q - Scott Group>**: And Keith, just so I'm clear, you're saying down 7% for first half, you think RTMs sort of full year down 4%, and then are you saying mid-50s operating ratio is kind of what you think is possible in the third and fourth quarter?

**<A - Keith Creel>**: That is exactly correct. Which is what gives me -- I mean, you work the numbers. It gets us to a sub-59% operating ratio and it gets us knocking on the door right at that 10% double-digit earnings growth.

**<Q - Scott Group>**: Okay. And then just...

**<A - Keith Creel>**: I want to beat a dead horse here. I'm going to talk a bit about grain. This is what gets me excited and I got into this a lot yesterday. We're assuming an average grain harvest, I'm going to give this to you, and it's something that's fundamentally different this year than last time. So the key to -- you can have a record grain harvest, but the supply chain has got to be able to handle it, to be able to move it. So you've got to be able to load it on, what, move it, unload it, cycle the cars back.

So back in 2013, 2014, that was a 73 million metric ton, best-ever record harvest. We're looking at the potential now to exceed that. The last numbers we've gotten as recently as yesterday says it has the potential right now to be 70 million metric tons and more. Our numbers assume like a 68 million metric tons. Last year, it was a 64 million metric tons. So we have marginal upside. Now, the key again is I've got to be able to turn those cars. But what gives me confidence and ability to do better than we've ever done before is the investment that's been made.

We introduced dedicated trains in this marketplace two years ago. We're sold out, Scott. They want more; they being the grain companies in Canada, they being the grain companies in the U.S. They're speaking with their pocket votes because when they commit to those dedicated trains, it's a 12-month commitment. They've got known resources, known assets. They can go out and make sales and they could depend upon this railroad to move those sets faster than they ever have to the marketplace.

They've invested hundreds of millions of dollars on the West Coast, be it in Viterra -- Viterra investment, North Shore investment, South Shore investment. Richardson has invested tons of money. So suffice it to say if they've invested hundreds of millions of dollars, they know how to unload grain and how to load it into ships, I would expect their capacity has got to be increased.

So, I mean, I can talk about this all day long. Another margin issue that I think is critically important for people to understand, the day of the 112-car grain train of CP is done. We're moving to 134 cars. Why are we doing that? Takes the same amount of locomotive. There's a 17% or 18% pick-up in cars per train which means at the end of the day, same amount of grain is lower cost, lower locomotives, lower train starts. It's an immediate margin opportunity for us, as well as an additional opportunity for the farmer and for us to work in concert with the grain companies to move more grain. That's a powerful, powerful thing especially when you're facing what might be a huge opportunity for us both in 2016 to make up some of what we've lost the first half, but the true power is going to be in 2017 in those lull months which we've experienced this year. But this is all a very positive story for us.

**<Q - Scott Group>**: That's good color. Just one – just real quick one for you, Mark. What's the run rate on your diluted share count right now? Just because we saw this, the big buyback in the quarter, but it didn't show up much in 2Q.

**<A - Mark Erceg>**: As far as – I'm sorry, I'm trying to make sure I understand the question. We repurchased about 75% of the program that was initially authorized. Obviously as we get into the quarter-end, we go into a blackout period so we've been out of the market for the last couple of weeks. In the materials that I posted, we have the June 30 share count which I'll refer you to.

**<Q – Scott Group>**: Okay. And are there any thoughts about upsizing the buyback given that you've done most of it already?

**<A - Mark Erceg>**: I think what we would say that our thinking on the matter hasn't changed at this point. As always, our first call on cash is the needs of the operation and whatever is required to support the free and efficient movement of cars and provide our customers with excellent service. And once those needs are satisfied, we look to returning the excess cash to our owners through either dividend increases or share repurchase and of course, we want to do that within the confines of our existing credit metrics. So as we sit here today, given where our leverage ratios are, it is our expectation that we'll complete the existing program and then as we committed to, we will pay debt down a little bit, we'd like to end the year around 2.7 times, debt deleverage effectively.

**<Q - Scott Group>**: Okay. Thanks a lot for the time, guys.

**<A - E. Hunter Harrison>**: Thanks, Scott.

## Operator

The next question is from Ravi Shanker with Morgan Stanley. Your line is open.

**<Q - Ravi Shanker>**: Thanks. Good morning, everyone. Thanks for all the color on these specific steps you're taking to kind of, as in boost operating efficiency. It almost seems like you kind of sent a message that there's a lot more room to kind of get that OR down over time. Is that the right takeaway or are you just kind of giving examples of the blocking and tackling that you guys do on a daily basis that we may not be appreciating here?

**<A - E. Hunter Harrison>**: No, I think the first takeaway is the right way to look at it. And look, in the interest of full disclosure I'm not – I don't have a teleprompter here, okay? But look, this is different than what we're doing and I think given Keith's remark, you will see the bar being raised over time and us stepping over the bar even in better shape than we've been in the past.

**<Q - Ravi Shanker>**: Great. And Hunter, you're now entering, or you will enter next year a three-year consulting agreement with CP. Almost sounds like you still have unfinished business here even if you're not doing the day-to-day stuff. Any particular new focus areas that you have, or that you're going to have in your time as consultant or what kind of role do you see as playing in the next four years?

**<A - E. Hunter Harrison>**: Well, I'm going to do what Keith says.

**<A - Keith Creel>**: That would be a huge change.

**<A - E. Hunter Harrison>**: No. I mean, seriously. Look, I think I wouldn't necessarily privy to all the dialogue with this, but I think the board said, look, we've got an opportunity to have two pretty good railroaders during a transition period, and that's not the worst thing in the world. Look, I don't know how much I'll be called on. I think it's to be determined. And I'm a hired hand, and as Keith and the board sort out what they would like me to do or work on, that's where I'll spend my time and energy.

And, I mean, Keith and I, this is not a new relationship. We've been doing this 20-some-odd years, so it's not like we don't understand each other. We talk the same language. Philosophically, we're pretty closely aligned. I don't like his style and dress, but we're working on that. And he doesn't like my style. But, look, I think this is kind of a work-in-progress.

**<A - Keith Creel>**: Yes. If I could add a comment, Hunter and I have been skating together and putting pucks in the net – three railroads over two decades. It's nice of the board to support me and the fact that I know that I've got him as a strategic advisor if I need him. And if nothing else from a coaching standpoint, he's got 50-plus years of experience; I've got half that. I've seen a lot with him – I mean, a lot with him, but there's still a lot I haven't seen.

So to know that he's there if I need him during this three-year period, he's part of this family, I'm thrilled that we have him to call on if we need him.

**<Q - Ravi Shanker>**: Great. Congratulations, Keith. A quick housekeeping question if I may. You gave us the revenue impact from the fires. Do you have an EBIT or an EPS impact as well, I'm sorry, to get the conversion on that revenue?

**<A - Mark Erceg>**: I think what I would do is I would just take the $20 million of revenue and I'll just take out the volume variable element from that, which is probably, call it 30%, the rough math. And then, of course, with the additional $9 million expense from the fuel side, so that that can back into it pretty quick.

**<Q - Ravi Shanker>**: Thank you very much.

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## Operator

The next question is from Steve Hansen with Raymond James. Your line is open.

**<Q - Steve Hansen>**: Yeah. Good morning, guys. Just a quick one on, one, the revenue silos and potash in particular. The back half comps look pretty easy and we're starting to get some visibility emerging on international contracts. Just trying to get some color around any timing visibility you have on the ramp up of those volumes. And I guess just a secondary to that is, what direction is it going to be heading? Is it all heading west, or are we starting to get some eastbound volumes this year as well?

**<A - Keith Creel>**: Yeah, the preponderance – I'll start with the last – it's westbound export stuff. The domestic markets are not that strong, so this is driven by export demand. Russia settled their contracts last week, I believe it is, and Canpotex is sort of in the final stages of handling their stuff. They've got stuff booked next month, you'll see a ramp up. From a run rate standpoint, tonnage is all

back half, to your point. Third quarter, fourth quarter should be about 20% more on an RTM basis than what we saw in the second quarter. So it's coming.

The beautiful thing is, from a competing resource standpoint, we've got a lot of capacity on this railroad, so I've got no qualms and no concerns about maintaining a fluid network of running grain as well as running potash at the same time. We obviously don't have any crude out there, no pun intended. It's not in the mix. So grain and potash, we're looking forward to moving it to a much higher degree than we did in the first half.

**<Q - Steve Hansen>**: Okay. Great. That's helpful. And then just, the Canadian coal has actually been quite impressive here at least for the last four weeks, five weeks after a relatively tough second quarter as well, and do you have any visibility on the back half for the year as well?

**<A - Keith Creel>**: Yeah. Actually, that's something that is pretty encouraging. To your point, the prices have stabilized, the price for the third quarter is higher than the price for the second quarter, so I would suggest that that's inflected as well. From a run rate standpoint, we're tracking well with Teck. We got 17 sets out there that are running 90 hour cycle times which are unheard of. The service is great, we're controlling our cost, and I see line of sight to a little upside there. We finished last year just under 24 million metric tons. The run rates right now, I see is coming closer to 25 million metric tons, 25.5 million metric tons in 2016.

**<Q - Steve Hansen>**: That's great. Very helpful, guys. Thanks.

**<A - E. Hunter Harrison>**: Steve, let me add to that. This is a little bit of the challenge we have on the forecasting side. If you look at what we were expecting and what we were hearing, anecdotally, out of Teck, our largest customer, in the first of the year was whether they were going to stay in business, and they bounced back and now things are going very well. There's been a matter of, effectively, six months or seven months, the whole apple cart has totally changed and so that's some of the things that maybe we see or hear that the market is not as up to date on.

**<Q - Steve Hansen>**: Much appreciated. Thanks.

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## Operator

The next question is from Fadi Chamoun with BMO. Your line is open.

**<Q - Fadi Chamoun>**: Good morning.

**<A - E. Hunter Harrison>**: Good morning, Fadi.

**<Q - Fadi Chamoun>**: Maybe just a quick clarification first. Keith, I think you mentioned that you saw the third quarter RTM would be down mid-single digit. And then in the second question, you thought that the operating ratio in the third quarter could be in the mid-50%s. Is that – did I get that right?

**<A - Keith Creel>**: That's correct. That's correct.

**<Q - Fadi Chamoun>**: Okay.

**<A - Keith Creel>**: So now we're getting less worse every week as this product starts to move. So to continue to improve -- so that's 4% end the year.

**<Q - Fadi Chamoun>**: Okay. And the second question I wanted to ask if sort of, you've clearly taken this cost curve down quite a bit in the last few years and you continue to do so, and you seem like you have a good setup going through the second half. But you've also been demonstrating a lot of improvement in reliability and service and so on. And sort of the biggest payout have always been that you're going to be able to convert some of that improvement in service and reliability into acceleration in some of that top line.

So my question is how does the conversation with the customer sound like now that you sort of have two years, three years under your belt of improvement, how do you feel going about that opportunity to improve revenue growth going into 2017, and if you have sort of some thought about where you think the opportunities are from a markets point of view?

**<A - Keith Creel>**: Yes. To your point, we're there where we're starting to have credible conversations and winning business as a result of the service. We're getting to a point where our marketing team can go out and, from a dollars and cents standpoint, explain to a customer what service means to them. Now, we can help them take money out of their transportation costs, give them reliability.

Be it ownership – think about equipment – people that own equipment, now they're worried about costs just like everyone else is. If I can give them service that will help them to reduce their ownership cost, owning a smaller fleet, or their maintenance costs owning that smaller fleet – it's getting compelling.

So as these contracts, and these are lumpy, they're not huge. You know were not talking about, $100 million, $150 million, $200 million contracts, there are not a lot of those out there. We're talking 50-car shipments everyday, 25-car shipments, $50 million, $30 million, those kind of conversations. Because we now have service with the strength of this franchise where we do have franchise strength, and I'm talking about length-of-haul and reliability, very different conversations today than they were in the past.

So over the next two years to three years, that's part of the growth. I say it all the time, probably $200 million to $300 million on an annual basis of incremental opportunity. If we repatriate the business that should naturally be on this railroad, be it in truck or be it with our competitors, it's a compelling revenue organic growth opportunity for us. Now it's muted right now because of the economy. When I look at domestic intermodal, that's a compelling service. And if you look at the numbers, we're down year-over-year but you've got to keep in mind how much we've grown it previous to that, and you also got to keep in mind what the market's giving to you.

So we're not feeling great, but we're doing a whole better than what others are doing given the strength of that service offering. So there's more to come, Fadi. This is really going to pay for itself and start producing that earnings growth and that service over 2017 and 2018 and 2019, as opposed to this year in a very muted demand year.

**<Q - Fadi Chamoun>**: Okay. So this $200 million, $300 million of business that you've talked about, I guess, you see that sort of incremental to whatever the economy gives you, whether it's 1% GDP or 2%. This is sort of incremental to that that you should be able to...

**<A - Keith Creel>**: That's the correct assumption. Obviously, won't get it all overnight but over the next two year to three years. My full intent for this team to take this powerful operating team, this marketing team, our staff, our corporate office team and convert this revenue back to this railroad at a very low incremental cost, be it the service we get to the customer through transactions, through interactions, and through day-to-day just movement of their freight from point A to point B.

**<Q - Fadi Chamoun>**: Okay.

**<A - Keith Creel>**: Something they've never been able to experience at CP, and it tastes pretty good.

**<Q - Fadi Chamoun>**: Okay. And maybe one follow-up on that. So the domestic intermodal, can you talk a little bit about the progression of that market sequentially in the quarter, like how did it look like in April, how did you exit in June?

**<A - Keith Creel>**: It's getting stronger. Obviously, what I expect, intermodal overall and of course domestic is a piece to this. I think we'll close the gap and inflect a positive year-over-year growth. I would have said six months ago that it would have been strong single-digit growth. Now maybe it's low-single-digit growth. I'm not sure. That's the uncertainty that I speak of.

But as truck capacity, as fuel price goes up, which is of late it's going back down. So, I mean, that's the uncertainty in the whole thing.

The service is compelling. The lanes are shorter out versus our competitors, single truck driver, competitive, and we're doing it faster than we ever have and we're being reliable. That's what it takes to win market share.

Some of what has underperformed is just the organic growth that we have seen with our existing customers. That's obviously – they're facing the same headwinds everybody else is facing, but through our initiatives selling in growing cross-border domestic, through our initiatives picking up additional wholesale customers, or our initiatives picking out customers we never enjoyed because we got service, we're doing a little bit better than everyone else, but overall, obviously, the market is what the market is.

**<Q - Fadi Chamoun>**: Okay. Thank you, Keith.

**<A - Keith Creel>**: Thank you, Fadi.

## Operator

The next question is from Brandon Oglenski with Barclays. Your line is open.

**<Q - Eric Morgan>**: Good morning. This is Eric Morgan on for Brandon. Thanks for taking my question. I wanted to ask one on CapEx, came in a little bit higher than the run rate to get to your guidance for the year. I'm just wondering if you could comment on the uptick sequentially, and if $1.1 billion for the full year still the right number, and maybe any initial thoughts for 2017?

**<A - Mark Erceg>**: Yeah. We're still very confident that the CapEx will be down significantly from prior years. We're targeting somewhere in the $300 million to $400 million range. We obviously continue to use the dynamic process to make sure that we're investing in the infrastructure and improving service. And as both Keith and Hunter have alluded, we have identified a number of additional cost take-out opportunities as we want to spend and invest behind those. So it's halfway through the year. It's hard to pin it down, but I can assure you that it will be down substantively year-over-year.

And because we have done a lot of work over the years to build the North line and build out the sidings and other things. And because we had done such a great job on locomotive management, I would expect that our spend in 2017 will look very similar probably to our spend in 2016, probably even slightly down.

**<Q - Eric Morgan>**: Okay. That's helpful. Thanks. And just a quick one on interest expense. Is the $115 million a good run rate from here, or do you think it could come back up to your – I think you had been saying $125 million to $130 million per quarter?

**<A - Mark Erceg>**: Yeah. I think even where we sit right now, we don't have any plans to issue any additional long-term debt. That's a good proxy to use. I should have clarified earlier, I wasn't as clear as I would have liked to have been on an earlier question. The actual share count we ended at as of June 30 was 148.4 million shares. So I do want to make sure I clarify that for both.

**<Q - Eric Morgan>**: Okay. Appreciate it.

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## Operator

The next question is from Turan Quettawala. Your line is open – with Scotiabank – my apologies. Your line is open.

**<Q - Turan Quettawala>**: Yes. Good morning. Keith, just maybe talking a little bit more about the revenue potential here. I think last quarter, you talked about 3,000 cold sales calls, and the focus at CP obviously is pacing on selling the new service. Can you talk maybe a little bit about the conversion rates on that selling activity? Is it in line with your expectation and maybe even just the $200 million or $300 million kind of you talked about in terms of growth, how much of that is sort of already in the bag?

**<A - Keith Creel>**: Well, I would start with the second first. That $200 million to $300 million, I'd say there's probably $50 million that we picked up this year, so there's still more to come over the next two to three years. As far as the cold call sales, well, the conversion rate's not great, but you don't expect it to be with cold call sales.

We're literally knocking on people's doors, talking to people that, frankly, didn't know who CP is or maybe we've had sentiment that they didn't recognize or think that CP cared about the small shipper. We're the bulk railroad, if it's not 100 cars, we didn't want to move it. Well, operationally, my philosophy is if it's 10 cars, there's more margin in it, and that's how you sell service, and I can become part of their assembly line moving products from point A to point B from one facility to the other, and that's what we're going to get better at.

So this is all new to the team. I would say, on an annualized basis, it's probably netted us $3 million, $4 million. But it's not what we've got, it's what's still to come. And as we get out and get credibility and our name gets out in the street, and they know us as the railroad that'll move all your business, and we can do it reliably and efficiently, and you could afford to take your transportation costs down and rely on our network as opposed to paying a premium for a truck, then it's going to give those transportation decision-makers the confidence they need to be able to shift share to us off the highway and allow us to haul them in our railroad.

**<Q - Turan Quettawala>**: Perfect. Thank you very much. I'll just stick to one.

**<A - Keith Creel>**: Thank you.

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## Operator

The next question is from Walter Spracklin with RBC. Your line is open.

**<Q - Walter Spracklin>**: Yeah. Thanks very much. Good morning, everyone.

**<A - Keith Creel>**: Hey, Walter.

**<A - E. Hunter Harrison>**: Hi, Walter.

**<Q - Walter Spracklin>**: So if I heard you correctly, I think what you're saying is you guys have achieved some pretty impressive operating performance here with lower volumes, and that even if whether the full year guidance gets met or not, if it's 8% or 10%, the key here is that you've set the ground work for some tremendous opportunity going into 2017.

So if I'm reading that right, I mean, some of the impact really is going to be felt in 2017, particularly with grain where I think it's the first quarter and second quarter of each year is where you get the real upside. If that's the case and we're coming off a particularly low volume year this year, and we have, as a result, a very easy comp into 2017, I know we're going into some 2017 discussion here now, but what level of volume lift, given that easier comp and given that very substantial potential grain haul, could we be looking at in terms – in 2017?

**<A - Keith Creel>**: I haven't run the numbers, Walter, but it's compelling. You took great notes because you just said exactly what's happening. I mean, that's what's going on. We're going to see tailwinds from grain next year. We're going to see tailwinds potentially from potash next year. I see an opportunity for intermodal growth. I see an opportunity for merchandise growth. 2017 to me is pretty exciting. Now, where the pin's going to fall, I don't know exactly where to put it yet. I've got to see what the economy does second half, but all I can say is it's exciting.

**<Q - Walter Spracklin>**: Yeah. That's great. And I guess my second question is on that kind of volume growth, given the base you've set with the lower volume in the first half of the year and the operating conditions that you've created at CP, I mean, isn't the operating leverage therefore quite compelling off that higher volume growth, and again, I'm [ph] asking a twice ending (45:00) question, but could we see mid-50%s through the year in 2017?

**<A - Keith Creel>**: Well, I would aspire and I think the potential is there to be best-in-class is what I would say.

**<A - E. Hunter Harrison>**: You got it, Walter.

**<Q - Walter Spracklin>**: Okay. All right, those are my two. Thanks very much.

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## Operator

The next question is from Chris Wetherbee with Citi. Your line is open.

**<Q - Chris Wetherbee>**: Hey. Thanks. Good morning.

**<A - E. Hunter Harrison>**: Good morning, Chris.

**<Q - Chris Wetherbee>**: Good morning. I wanted to touch on the resources as we move into the back half of the year. So I think you kind of outlined the story in terms of the volumes coming back here. Can you talk a little bit about headcount? Can you talk a little bit about sort of locomotives? What do you need as you go back and kind of bring some of this business back on line?

**<A - Keith Creel>**: Well, right now we're down about – I think we reported 900 heads. After June, we're now 1,000 heads less versus last year. Looking at our efficiencies, looking at our initiatives that I've talked about, the grain piece is 20% pickup per train. That's pretty compelling. We expect, with this reset base, to be able to absorb most of this growth, and we'll finish the year pretty much the number we're at now, which is around 11,900 heads, plus or minus. Now if we have a banner year, and as the supply chain handles more grain than I think it will, because we haven't yet tested it yet. To that point, we've got resources on the sideline. I've got almost 700 locomotives that are parked. I've got 4,000 grain hoppers that are parked.

So if the supply chain can demonstrate it will sustain more volume and do it fluidly, then the resources are there. So, I mean, it's compelling and in that case, will I have to add a few more running trades employees? Yes. But I'll tell you, there's a lot of room for productivity on our existing trains to absorb this, which is exactly what we're getting after the second half.

**<Q - Chris Wetherbee>**: Okay. Okay. That's very helpful. And then when you think in that context, Hunter, I think you called out $100 million opportunity in the back half of the year. I'm guessing it's probably a little bit more fourth quarter weighted because that's when I think the majority of some of this volume pickup begins to happen in a bigger way. But just any way we can kind of slice out how that might be playing out, progressing over the back half of the year will be helpful.

**<A - E. Hunter Harrison>**: Yeah. We have a little debate, but typically in the fourth quarter, you get in the holidays and supply chain issues with not unloading, more than you do third quarter. So if the grain comes in and starts, pretty soon now as we've been led that it's going to, then third quarter's going to have a big jump and it will be better than -- could be better than fourth quarter.

If it flip flops the other way with the supply chain, then it could turn the other way, but it's going to move third quarter or fourth quarter or via carryover into a big start for next year. So I think the leverage is there. I think the resources, as Keith has described, are there to handle the business. And the one thing that we need to continue to press on is to be sure that the rest of the supply chain reacts as we're reacting.

And so, we, in the past, the rail sector has taken some criticism, if you go back to 2013, 2014, about number of resources and so forth. So if need be, we're going to put a scorecard of who's doing what and where. Here's what rail's doing. Here's what the unloaders are doing. Here's what the loaders are going. And we're going to call a spade a spade.

And I think, to Keith's point earlier, you're going to face a supply chain pickup. They've made investment. We have produced results and they have confidence in us. We've developed confidence in them and effectively have no service issue there that I'm aware of, and usually I'm aware of them if they're significant. So, yeah, to Keith's point, it's pretty exciting going into next year.

**<Q - Chris Wetherbee>**: Okay. It sounds like grain is kind of the trigger.

**<A - Keith Creel>**: Grain is king. Grain is king right now.

**<Q - Chris Wetherbee>**: That's right.

**<A - Keith Creel>**: We're happy about it.

**<Q - Chris Wetherbee>**: Thanks very much for the time, guys. I appreciate it.

**<A - E. Hunter Harrison>**: We also – I mean, everything is turning for grain. If you look, first of all, we get the rate action, which the increase was I think 4...

**<A - Keith Creel>**: 4.6%.

**<A - E. Hunter Harrison>**: ...4.6% or 4.8%, okay? That's number one. Number two, I think I read that it's the more acres planted than in the past. The yield is better with new technology and so forth. So, if you believe what you read, the only thing that's holding grain back is the supply chain coordination. And we want to be a player and a leader to help Canada, and we have the same issues in the U.S., just on a smaller scale, become a world leader in the movement of grain.

**<A - Keith Creel>**: And I would say this. Listen, we all learned a lot in the supply chain, be it the grain companies or be it the railroads in 2013, 2014. We work closely with our grain customers, which are the grain companies. And I can tell you now their leadership understands this. We all have to execute. They understand they're part of a team. We're out collaborating on the ground this week. We're out meeting with elevators in Vancouver. So if we work together, there's a lot of potential here for something that this country has never been able to produce in the past, which is going to help it short term and long term from reliability and a world respect standpoint from being a supplier of wheat.

**<Q - Chris Wetherbee>**: That's great color. Thanks for the time, guys. Appreciate it.

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## Operator

The next question is from Ken Hoexter with Merrill Lynch. Your line is open.

**<Q - Ken Hoexter>**: Great. Good morning.

**<A - Keith Creel>**: Good morning, Ken.

**<Q - Ken Hoexter>**: Keith, I guess your peer has talked a little bit about doing what needs to be done to retain market share. What

are your thoughts on the state of price competition on the rail side. You talked about going in and winning some business from truck. Can you talk a little about your thoughts on the pricing side?

**<A - Keith Creel>**: My thoughts, Ken, are sell the strength of this franchise. Take a disciplined approach, we're not going to be commoditized. If I can get out, again, with a customer and explain to them how moving freight on my railroad saves them money and helps them make more money -- it's not about cutting rates, it's about selling service.

So doing what it takes is making sure we control the low cost. So I can go out the marketplace, the market sets the rates. I could still earn cost of capital. We're going to make good business decisions, but I'm not going to go out and slice and cut and destroy and give leverage away and create a bad business decision for this company that we're going to live with for the next five years or three years. That's why we don't believe...

**<Q - Ken Hoexter>**: No, no, I understand, from your perspective. I'm wondering they've been talking maybe a bit about being more proactive. I just want to know if you've seen that in the market in their attempt to retain share.

**<A - Keith Creel>**: It's not affecting us. I mean, my volumes are what they are. You'd have to talk with them. And I tend to believe that they're smarter railroaders than that, in all honestly, I really do. They got a good network, they've got a good product as well. There's enough space for both railroads to do a great job and I think they're going to be fine. I respect their leadership. I can't criticize too much, we got a lot of sweat equity over there. You got two of the best railroads in North America right here in Canada. There's enough space for us all to operate in a disciplined fashion and make money and provide great service for our customers.

**<Q - Ken Hoexter>**: Okay. And then, just following up on the leverage questions before. I just want to understand, when you were talking – kind of, I get the mid-50s target in the back half of the year as volumes return. But when do those – when do you need to start bringing back some of the costs? I guess, when you talk about having plenty of capacity but yet you're seeing volumes or expect volumes to ramp up, can you kind of help us think about when that leverage peaks and you need to start bringing the costs back on line?

**<A - Keith Creel>**: Well, that's going to be minimal, number one, because we're absorbing more than half of it through existing networks. So, I mean, I don't see it until the peak, and it's going to be, again, incremental, and it's going to be minimal, and I'm not bringing it back until I see the white of their eyes. We've got enough capacity with our existing network now to absorb, which is what we're doing. Again, I keep talking about it, but it's pretty darn exciting to me.

In the past, we've resisted running big grain trains. What we look at, I got three locomotives in every one of those 112-car trains and there's enough horsepower to pull 134 cars. And this incremental cost is fuel. The crew cost me the same. The meet costs me the same. I'm going to pick up capacity by doing it. I could run fewer trains. So there's a lot we can do with what we're doing now.

We're developing a plan with Robert and his team to move some grain also on manifest trains. So, again, it's more to that incremental cars to a fixed cost, it's pretty much margins going right to the bottom line. So that's taking the existing network and making it more robust, adding more cars to existing trains, which is what we're going to be doing until we get into the peak of this thing. And then we'll be adding incremental costs that we'll be making a lot more revenue and a lot more money when we do it.

**<Q - Ken Hoexter>**: Thanks, Keith. And just a quick numbers question. Mark, did you mention a $17 million gain in the quarter? I just want to make sure I heard that right.

**<A - Mark Erceg>**: Correct.

**<Q - Ken Hoexter>**: And that was on car sales?

**<A - Mark Erceg>**: Yes.

**<Q - Ken Hoexter>**: Okay.

**<A - Mark Erceg>**: Came through purchased services.

**<Q - Ken Hoexter>**: Purchasing, right. Thank you very much for the time. Appreciate the thoughts and the time.

## Operator

The next question is from Tom Wadewitz with UBS. Your line is open.

**<Q - Thomas Wadewitz>**: Yeah. Great. Thanks. So, Hunter, you had a brief comment on the consulting arrangement looking to July of 2017. I'm wondering if that precludes you from interacting with other railroads. So if you're doing consulting with CP, does that mean you can't consult with other North American railroads?

**<A - E. Hunter Harrison>**: I think I have a non-compete in the arrangement and the reason why I don't know is because I hadn't focused a lot on the agreement. I've been trying to focus on running the railroad. But I think it's typical kind of boilerplate language that would, subject to other arrangements, that would be I'm restricted for two years or three years or whatever the restrictions might be. That's the issue.

**<Q - Thomas Wadewitz>**: Right, right. Okay. All right. Thanks.

**<A - E. Hunter Harrison>**: I can't do multiple consulting, okay?

**<Q - Thomas Wadewitz>**: Right, right. Well, I figured that would be the case, but that was worth asking. I think, Keith, you've talked about some of the impact of running better service and the opportunity in intermodal, so what you control, but what do you think might drive an improvement in intermodal market, the piece that you don't control? Do you think -- is there an inventory issue which has kind of come in and so that could support improvement in domestic intermodal, international intermodal? Just what kind of visibility do you have to the market and is it appropriate to be optimistic on international intermodal in fourth quarter that you could see it flat or do you think we'll still stay down in intermodal if you look at the kind of third quarter, fourth quarter?

**<A - Keith Creel>**: Well, I mean at the end of the day, consumer consumption drives intermodal. I'm not going to suggest that it doesn't, Tom. So I see the same things that you see. I see what's different and unique for this franchise is an ability to compete with truck, the strength of our network. Again, we've got to get that reliability there which we have so that helps us. But as far as incremental large growth coming back, again, it's got to be driven by consumption. And I do think obviously, inventory levels are up. Again, I can't ignore that. But at the same time, I still see a lot of trucks out on the highway that I can make a compelling value proposition should be on the rail and that's exactly what we're going after. I think there's an opportunity to convert that. And I think as fuel prices go up, and they will, they're not going to stay here forever.

At some point, they have to, the price is going to be shorter than what the demand is and you're going to see an inflection and you're going to see truck rates go up. And you're going to see some additional capacity be consumed. And you're going to see more share come back to the railroads. So, we're poised for that growth. In the meantime, we're going to do better than what the economy is doing or what they had otherwise, given the strength of our service as demonstrated in – although weak, not as weak as some others' numbers. I think that's a pretty compelling proposition. That's really all I can do in this place until the demand comes back.

**<A - E. Hunter Harrison>**: Can I just add one thing and I've said this before, the service issue is also driven by interest rates and the inventory. If interest rates are zero, then you got one issue with carrying costs and inventories. And if the interest rates go to – I remember when prime was knocked down 20%, the value of service goes to something else. So we have to be sensitive to – it's hard to put a bunch of customers on an intermodal train when one wants overnight service, one likes to store on your lot and they all own different products, and I'm going to talk about that in a minute in my closing remarks, so stay tuned.

**<Q - Thomas Wadewitz>**: Okay. So, but – I guess going back to Keith's comment though, it sounds like, look at the macro numbers and you might need improvement in consumption and economic activity to get the intermodal volumes, at least international volumes, ticking up from where they are.

**<A - Keith Creel>**: Well, the only other story in international obviously is the contract we're competing for. It's not a secret. I think we've got a very much improved network than we had. Our cost base is much lower. Service is compelling. To me, you put those two together, it's a pretty compelling value proposition. So we're going to compete for the business. At the end of the da,y if it's a good business decision, on the strength of this network there's no reason to believe that we shouldn't enjoy that business. So more to come on that. That's a next-year decision, not this year.

**<Q - Thomas Wadewitz>**: Right, right. Okay. Thank you for the perspective on that. Appreciate it.

**<A - Keith Creel>**: Thanks, Tom.

**<A - E. Hunter Harrison>**: Okay.

## Operator

The next question is from David Vernon with Bernstein. Your line is open.

**<Q - David Vernon>**: Hey, guys. Thanks for taking the question. I guess, Keith, you had mentioned the moving from 112 to 134 length grain car trains. How much of that improvement is ahead of us, is it a full 20%, or are you guys kind of already on your way towards moving there, I mean, in that direction?

**<A - Keith Creel>**: It's ahead of us. We've picked up some on empties, we've been running 160 some-odd car, empty trains, to save some train starts. We put some grain so far on manifest trains, but the real benefit of this is going to be when we start running. You're talking, order magnitude, during the harvest, you're running in Canada for export grain between Thunder Bay and Vancouver about 45 trains a week at previous run rates.

So you can do the math, 18% improvement on per train, we've got 18% fewer trains out there which is going to drive margin improvement, where I'm moving 18% more business and creating 18% more revenue with the same fixed cost.

**<Q - David Vernon>**: Yeah, I mean, that was going to be kind of my follow-up question. If you think about that, that 20% slot improvement in availability, is that going to be something that you guys are going to look to market aggressively, or is that something that you're going to be looking more to put in the pocket, or is there going to be a mix depending on the market?

**<A - Keith Creel>**: Well, it's given us the ability to market dedicated trains, so obviously, the faster we turn cars, if they're moving on the train, they're not yet linked to the next hundred cars to add to it, I'm going to get velocity improved to my existing fleet which means from a margin standpoint, I can control cost by reducing the fleet, or I can add cars and keep them turning to make more revenue. I can work it either way. It's pretty compelling.

**<Q - David MARK ERCEGVernon>**: Okay. And then maybe just as a quick follow-up. I think Hunter you've mentioned some efforts you guys were making to change how you guys are doing crewing. It was going to lead to some additional savings. Is there any more color you can provide on that, initiative?

**<A - E. Hunter Harrison>**: Yeah. Look, I might as well give it to you now and then we'll have time for maybe a couple more questions. What really pulls all of this together is pretty exciting initiatives that we've been working on for some time here that's taken the whole team, from IR to the operating group, to everyone. And in the third quarter, we'll be rolling out with those of you that have maybe followed this team in the past, what has been referred to as trip plans.

So we're going to have the ability shortly, just a couple of little kinks are being worked out. That every car, non-bulk, will have a trip plan that some of you are familiar with before. Each individual car from door-to-door. Not train service, not car service for that individual car. Everyone. Which is going to pull a lot of intelligence together that will allow these operating initiatives to go forward. It will do a lot for the customer in seeing the reliability of our service and the value of it. And hopefully, they will have a better understanding and appreciation. We will have a very quick dynamic analytical tool that within eight hours or nine hours, if there is a problem and somebody doesn't do what they're supposed to do, will recognize and know it.

And somebody wrote a book about this, I don't think others are spending a lot of time here, but that's for them to decide what they want to do. This is our addition to the plan and probably the final major initiative that I'll be working on as CEO. And if we get that going, that's going to pull all these opportunities that Keith talked about with train starts, the size of trains, the leverage, the controlling cost, the value of the service to the customer, which will help us across the board, and we think set us apart from others, and will really keep the door open for further initiatives.

Now, I've learned the hard way every time you think you've figured it all out, there's more. And you think we can't get any better than that train size, and there's more. So, I don't know what more is coming out of this team, but it's not going to be over if it's an issue. So, just don't miss this train.

So, Chris, we've got time for a couple of questions.

## Operator

Certainly. The next question is from Allison Landry with Credit Suisse. Your line is open.

**<Q - Allison Landry>**: Thanks. I just wanted to ask a question on price and how we should be thinking about it for the back half of the year considering the step-up in the Canadian regulated grain cap and maybe do you see any potential for some stronger pricing on some of the other bulk businesses?

**<A - Keith Creel>**: I still think you should model, we said 3% to 4% in this environment. Given what we don't know about crude, given what we don't know with some of the other markets, I'd still say around 3% is what I would expect.

**<Q - Allison Landry>**: Okay. I'll stick with one. Thanks.

**<A - Keith Creel>**: Thank you.

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## Operator

The next question is from Justin Long with Stephens. Your line is open.

**<Q - Justin Long>**: Thanks for fitting me in, and I'll stick it to one as well. I wanted to follow up on the headcount question and ask about headcount beyond this year. If we want to assume that volume growth returns in 2017 and beyond, do you think headcount grows at a rate that's half of volume growth, or is there more leverage than that? I just want to get a general sense for the ramp and headcount you'd expect in a normal volume environment.

**<A - Keith Creel>**: Well, it's not going to be one-for-one. There's going to be some productivity in it, I don't know if it's 50% or 30% or 20%, but we're obviously going to do better with less resources. I don't know. I'm not going to guess the number. It's going to be double-digit improvement. It's going to be compelling, but I'm not going to suggest it's 50%. If I got it right now, I got it real wrong if I give you 50% next year, that's for sure. But I need a little bit of time to digest these new initiatives we've got the second half before I can even give a little more color on it myself.

**<Q - Justin Long>**: Okay. That's fair enough. I'll leave it at that. Thanks for the time.

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## Operator

The next question is from Jason Seidl with Cowen & Co. Your line is open.

**<Q - Jason Seidl>**: Thanks, operator. Hey, everyone. A couple of quick ones here. Number one, Keith, you've mentioned obviously the fire has caught everyone by surprise. I know it was a pretty big tragedy for Western Canada. Is there going to be any rebuilding benefit in terms of stuff being shipped back out there?

**<A - Keith Creel>**: Not anything that's material. I mean, I'm sure there's going to be some stuff that moves, but we don't – with our network not reaching there, we don't see any material impact to us at all.

**<Q - Jason Seidl>**: Okay. And the other one, you talked a little bit about international intermodal. On the domestic side, it's obviously been a tough year to compete with the trucks given where diesel prices went to and where some of the truck pricing went. Do you guys see that market tightening up and being a more level playing field for the rails to compete?

**<A - Keith Creel>**: I guess a lot of it has to do with fuel price. So if you see fuel price going up, I do see that market tightening up. And then the others are going to be driven by demand, the consumer. If you see increased demand and consumption, then you're going to see increased demand to bring more product to the rail. And the third variable is how well we do sell in our service and marketing these new lanes across.

Domestic intermodal product's growing great for us, it's gaining traction all the time. John and his team are doing a great job with it. How much more potential we have on that one train, obviously I've got to be careful, I don't want to get to a point we'll add a second train start. We're not there yet, but that's something that we got to pay attention to. But, again, overall, whatever the economy gives us, we're going to be dealing with it better. That's probably the best way to say it.

**<Q – Jason Seidl>**: All right, Keith. Guys, appreciate the time, as always.

**<A - Keith Creel>**: Thank you.

**<A - E. Hunter Harrison>**: Thank you.

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## Operator

The next question is from Jeff Kauffman with Buckingham Research. Your line is open.

**<Q - Jeff Kauffman>**: Thank you very much. Hi, guys. A lot of my questions have been answered. So let me come back to this train length question. Keith, if you can take the grain franchise to the 134 car trains on average, that's about 25% of your RTMs.

You've done a tremendous job growing train length over the last three years to four years. We're about 7,200 feet, I guess. Where do you think this can go in one year to two years?

**<A - Keith Creel>**: It's going to get better. I mean, obviously, there's always going to be some longer ones. But ideally, I get this network, I'd love to have all 10,000-foot trains. Now, that's perfect world, but that sort of tells you where the potential is and what the franchise footprint would be able to handle. The key is on the receiving, in the origination, we've got a lot of grain trains.

So what we're doing now to work with customers is they build these new facilities and you read about the bricks-and-mortar that's been fitting out the ferries, they're matching the size of those facilities to match the capacity of the railroad. That's another compelling opportunity for incremental change.

Something else we haven't benefited from yet with investments from Canpotex and in partnership with UP, some of this potash we send to Portland. If you remember, Canpotex just announced they pulled out of Rupert. That means they've invested in Portland, they've invested in Vancouver, which are both markets we serve. And in the Portland market, a lot of people don't understand, those trains are 130-car trains versus the ones who go to Vancouver are 172. If they're going to grow their capacity out of Portland, which is where it's going to have to go, then there's an incremental opportunity to grow those train sizes.

So, I mean, I get pretty excited and you can sense I'm passionate about this. But there's a lot of fruit left out on the vine to be harvested by this company as we go forward the next two years to three years.

**<Q - Jeff Kauffman>**: All right. That's awesome. Let me – just one follow-up detail question. Capital spending's down, but you're still spending between $1.1 billion, $1.2 billion this year. I was a little surprised depreciation expense was flat sequentially because it has been growing over the last two years, three years. Is that a decent run rate or was there something that caused that to be flat and we shouldn't necessarily model it flat as we look out over the rest of the year next year?

**<A - Mark Erceg>**: I think the numbers that we're posting now should be fairly stable. Obviously, it's a very large depreciating pool. We do new studies from time to time where we look at large asset classes and sometimes that will make adjustments to the depreciation curve as it relates to the loco class as an example. But generally, the best proxy and predictor of next quarter's depreciation rate is the one that we just posted.

**<Q - Jeff Kauffman>**: Okay. Fair enough. Congratulations. Thank you.

**<A - Keith Creel>**: Thank you.

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## Operator

The next question is from Benoit Poirier with Desjardins Capital. Your line is open.

**<Q - Benoit Poirier>**: Yes. Good morning, and thank you for taking my question. Just on the automotive side very quickly, when we look at the carload, it's barely, it's up slightly year-to-date. I was just wondering when we look at the current trend whether we should see kind of an acceleration in the coming quarters.

**<A - Keith Creel>**: No. I would expect sort of flattish to what you're seeing, maybe slightly down.

**<Q - Benoit Poirier>**: Okay. And what about 2017, Keith?

**<A - Keith Creel>**: You know what, there's some upside that I didn't – I don't know even, I don't know what to believe anymore in that marketplace. Every time I read the paper, they say it's peaked, they say it hasn't peaked. I just don't know. So we're not assuming any incremental strong growth. We're going to take modest projections based on normal run rates, 2%, 3% growth next year I guess. There's no big contracts that are coming in play next year that I could speak to. So it's more about selling service, growing with the people that we're aligned with in partnership, more so with Toyota and Honda, those two key accounts for us.

**<Q - Benoit Poirier>**: Okay. Thank you very much for the time.

**<A - Keith Creel>**: Thanks, Benoit. Take care.

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## Operator

The next question is from Brian Ossenbeck with JPMorgan. Your line is open.

**<Q - Brian Ossenbeck>**: All right. Thanks for squeezing me in here at the end. Just real quick one, Mark, on the tax benefits. You mentioned 50 to 100 basis points. Can you just give us a little more detail on what's driving that, assuming it will be permanent reduction and what we should expect on the timing? That'd be helpful. Thanks.

**<A - Mark Erceg>**: Yes. Great question. With Q2, you did see a flow of the rate from 27.5% to 27.25%. That was largely the result of some work we did on an internal corporate restructuring project. As we think about what opportunities are in front of us, there's really a couple of things driving our thinking.

One is just mix of income between U.S. and Canada. That's a piece of it. But then there's also optimization work that we're doing on our affiliate lending and our transport pricing strategies. So I'm pretty confident that this should be a sustained reduction in our tax rate going forward. Whether or not the full amount will roll into 2017 and beyond, again, there's a little bit of mix and income at play here. But we're definitely getting a lot sharper on our tax planning strategy, and I think you're starting to see some of the benefits of that. I would...

**<Q - Brian Ossenbeck>**: Okay. Thanks.

**<A - Mark Erceg>**: ...as for your specifics on Q3, Q4. We have to say there's some additional work to do, but I would think that the rate that would be applied would be pretty equitable between those two quarters.

**<Q - Brian Ossenbeck>**: Okay. And the reduction is off of what base, full-year 2015?

**<A - Mark Erceg>**: Off the 27.25%, I think there's the opportunity for another 50 to 100 basis points.

**<Q - Brian Ossenbeck>**: Okay. All right. Thanks a lot.

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## Operator

The next question is from David Tyerman with Cormark Securities. Your line is open.

**<Q - David Tyerman>**: Yeah. So I just wanted to get a better sense of this OR reduction you're talking about for the second half. You're looking at 5% roughly from last year. If I've done my math right, your volumes are going to be roughly flat in the second half on RTM. So I'm wondering what is driving the big improvement that you see. Is it labor, is it purchased services, or what is it?

**<A - Keith Creel>**: Headcount's down a thousand people versus last year. It's all operational improvement. It's all productivity.

**<Q - David Tyerman>**: So would the headcount go down further in the second half from where we are now?

**<A - Keith Creel>**: No, no. Not if we're going to take this volume that we're saying is going to drive the top line. We're going to absorb a tremendous amount of the volume through productivity, through increased train length, through using what we have more. So no, don't expect a big inflection, but at the same time, if I'm going to have that many more RTMs – and we're talking about sequentially over two quarters about 17% or 18% more than I'm handling now – I'm going to absorb it through productivity.

**<A - Mark Erceg>**: The only thing I would add is we do things that obviously OR in the second half can be quite strong. I made the comment earlier that we do expect it to improve sequentially, and you guys will probably note that stock-based comp should be a fairly big headwind in Q3 as you're working your model. So we're very bullish on the second half. Obviously, it progresses through the second half.

**<Q - David Tyerman>**: Right. I guess I'm struggling with this though, because you're going to have roughly similar RTMs in the second half of last year yet you're saying you're going to be 5% better on OR and you're not changing your...

**<A - Keith Creel>**: Our cost base is a lot lower than it was, same time, same volume last year. I don't – maybe I'm missing something, I...

**<Q - David Tyerman>**: Well, I'm just looking at things like running employees through at current levels and it's not going to get you a 5% improvement.

**<A - Keith Creel>**: Well, I'm not going to debate the numbers with you. At the end of the day, we got fewer employees moving the same amount of tonnage. I don't know...

**<A - E. Hunter Harrison>**: Yeah. Well, look, let me give you a couple of examples we started with $40 million in crew hauling which is contractual, that's contractors, that's $40 million on an annualized basis. In the second half, you can argue, okay, but you only pick up X, half that, 60% of it, whatever the number is. The train starts will be down, hauling the same tonnage with fewer people, and less fuel and you add those numbers up, trimming your model and that's what you get.

**<A - Keith Creel>**: We've got 300 less locomotives running today than we had last year, which means less mechanics, which means less parts and it's all those moving parts, there's no one single silver bullet item, it's just the power of this operating model and the way it creates the leverage to drop -- to move a ton of freight at a much lower cost this year versus last year, because all of those fixed costs are less. I mean, I...

**<A - Nadeem Velani>**: David, it's Nadeem. I'll follow up with you after the call if that works for you.

**<Q - David Tyerman>**: Okay. That's fine. And just one last question. The other pricing change, revenue per revenue ton, that you had in the quarter, the negative 2% from the D&H South, demurrage, et cetera, is that likely to recur in future quarters?

**<A - Keith Creel>**: No, we'll lap -- it will be some in the third quarter, David. But we'll lap it in the fourth quarter which is when the D&H sale occurred in the third, so it disappears fourth quarter completely.

**<Q - David Tyerman>**: Okay. Great.

**<A - Keith Creel>**: Except for the accessorial. I hadn't looked at accessorial charges in the fourth quarter, we have to see if there's any impact.

**<A – Nadeem Velani>**: It won't be as pronounced in the – it won't be 2%, it might be maybe 1%, David, and that eases, dissipates in Q4.

**<Q - David Tyerman>**: Okay.  That's fine.

**<A - E. Hunter Harrison>**: One of the examples, one example here, okay? The grain this year, the margin is going to be much better; the price is going to be higher. There's going to be more of it, and there's more margin there. So, there's not one big glob, it's kind of across the board that we've – I shouldn't – I can still say we a little bit, but the operating group has just really produced some outstanding results and Nadeem will be happy to go through the details.

**<Q - David Tyerman>**: Okay. That's helpful. Thank you.

**<A - E. Hunter Harrison>**: Okay.

## Operator

Mr. Harrison, there are no further questions at this time. Please continue.

## E. Hunter Harrison

I don't know what else to say except I think that what we've tried to present to you today is this: tough first half of the year; it's behind us. There's good news in the second half with these various initiatives that we have spent most of the time with your Q&A. And I guess the most important thing, we're not dwelling on the number of whether we made the guidance exactly or that we're 0.1% under or over.

What we're focusing mostly on, and I really think you're focusing mostly on, is the future in 2017 and it looks brighter and brighter. And I think we all can say that here with a great deal of confidence. And we appreciate your participation, appreciate the confidence that you've shown in this team, and we look forward to impressing you even further in the future. Thanks.

## Keith Creel

Thank you.