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Transcript

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Participants

Keith Creel, President & COO Canadian Pacific

Christian Wetherbee, CITI

Christian Wetherbee

So I guess I'll probably kick off, Keith. If you could just sort of give us an update on maybe where we are, the current business environment, how the railroad is running. It's been an interesting quarter, I think, across the industry from a volume standpoint. So if you can just give us a sense of where CP is, and then we can kind of take it from there.

Keith E. Creel

All right. Thanks, Chris. First, let me qualify this. In the spirit of Canadian railroads, don't let my southern Canadian accent confuse you. I'm actually from further south in Ontario.

With that said, overall, this has been, obviously like a lot of businesses, been a challenging quarter. We always have thought from the very beginning or at least at the end of the first quarter, given what was happening in the economy, the headwinds that we were facing in the world marketplace, we knew that second quarter was going to be tough, number one, from an advanced standpoint; number two, from a comparable standpoint because we had a very strong second quarter last year.

And then sequentially, I think it's important to understand, especially being a Canadian railroad, we essentially had no winter this year, which I'm not complaining about, but at the same time, sometimes the difference you see in the cost and the performance first quarter to second quarter is dramatically different. You don't see that this year. So while it wasn't a challenge in the first quarter, it helps explain some of the natural jump you get in the second quarter that we won't see this year. So with those 2 things said, except for 2 areas in the second quarter, pretty much demand is as light as it's been in line with what we thought. And those 2 areas that have sort of surprised us that we could see, obviously, was Canadian grain side and also crude.

I'll explain a little bit about both so you understand why we believe it's an isolated situation. So on the Canadian grain side, typically you have carryover from the previous year's crop. Now you're coming off 2 very strong record shipping years for CP, record Canadian grain shipped. We had a record crop in 2014. It was compounded by an abysmal winter in 2014, so the carryover in 2015 was dramatic. We had double what was a normal carryover. So instead of seeing things tail off in May to June, July -- a lot in June and July, some in May, last year, we had a strong 12-month shipping season. So from a comparable standpoint, this year, coming into the shipping season, we had half the carryover, which you would see a typical drop-off in June and July. And what surprised us is we moved so much grain. Because we had such a good mild winter, we moved a lot of grain ahead of time, and what we assume would be a drop-off in June and July, we saw in May. So June is happening the way we expected. What surprised us a bit is the drop-off that we had in May. So that's sort of an explanation on the revenue side when it comes to grain. So that's part of the underperformance from a revenue side. We're about -- on an RTM basis, we're about 12% quarter-to-date versus last year, les, and we had assumed around 6-7%, 7%.

The other area is this thing around crude. Obviously, Canadian crude, heavy crude, Alberta crude had a very horrific fire up in the Alberta, Fort McMurray area in Northern Alberta. Now we do not directly serve Northern Alberta, but the oil is moved out of a pipeline to all facilities, where it's transferred to a railcar, either in Edmonton or in Hardisty. Edmonton obviously is dual served by my competitor and myself. Hardisty is just CP-served. So what's been moving crude, heavy Alberta crude has been actually pipeline takeaway capacity. So right now, there's about -- when things are running normal, and it's moving back toward normal, not there yet, about 4 million barrels a day of production, and that's against about 3.8 million of pipeline takeaway capacity. So if the price doesn't move it up there, there's nowhere to move it, the pipeline is full, it goes by rail. And that's what was happening, and that's what we assume given the low price of crude.

Now when this fire occurred and they shut down production, they took about 1 million barrels a day out, which left a lot of capacity for the existing oil to move in. So naturally, it's not going to move by rail. So that's what's been going on this quarter since the fire. That surprised us as well. Obviously, we couldn't predict that.

Now does that adjust and correct itself? Yes, but it's more instead of -- now instead of third quarter. Some of that crude is still a big question mark. But we think, to the best of our ability, that will start moving in the fourth quarter as opposed to now and some in the third quarter. So those are the big surprises.

The other areas that we've done fair in: forest products has been an area that's got a little bit of upside in it, Canadian coal as much as we were all concerned about it 6 months ago. Certainly, Teck has had their challenges. World supply, price has been down, but we've -- that's bottomed out. Teck is a strong player on the world market. I think they picked up a little bit of market share which has offset some of the reduced overall demand in the marketplace. And I think we'll finish this year, based on what they're telling us and based on what we see, flat if not up a little bit. But again, that's second half strength as opposed to first half strength because we're slightly down now on Canadian coal.

Looking forward -- everything else has been pretty much in line. Looking forward, we've got some optimism. Second half -- I'll explain that. But before I do, let me talk about the operational -- some of the stuff I'm really happy about that has exceeded expectations, and that's controlling cost. In a market like this, I learned a long time ago from Mr. Harrison that you control what you can control. You don't

make excuses. You focus on the things that you can do something about. And that's how we operate railroad day in and day out, and that's how we manage our expenses versus what our demand is. So this operating model, and Hunter said this a million times and you'll hear me say it for the next 20 years, too, it works as good, if not better, on the down cycles as it does on the up cycles because it's all about discipline, it's all about measuring processes and rightsizing your assets, be it locomotive, be it people, be it cars, against the level of business that you have. And that's exactly what we've been doing, and it's given us an opportunity, myself as well as Hunter, to teach and to train this team of railroaders that we have. You don't build Rome overnight. We haven't taught and created that complete culture and evolved everything and educated everyone the way we did in our previous lives. It takes some time.

We've been at this for 3.5 years. So as good as we've done and as much as we've accomplished, there's still so much left to do. So it's given me a chance to take their education level and their focus level to a whole another level. And you've seen us still improve margins in this down market as a result. And the beauty of that and the power of that as an investor is it's almost like a springboard. So when the top line comes back, you think about our margin improvement, you think about controlling our cost, you think about levels of productivity that, in the absence of this, we're sort of buried and may have taken longer to get to, we're going to get a benefit from them.

Short term, now, it's helping us get through this better than others, and long term, as the business comes back, it's going to help us rebound better than others. And at the same time, it allows you to get really good at providing service to your customers because you have to be much more precise to be able to protect keeping their business because they have options, be it truck capacity, be it another rail capacity. So overall, as much as I don't like down cycles, it gives us chance to become a stronger company, better railroaders, and it puts us in a position for a lot of success when the market comes back.

Christian Wetherbee

That's great. That's very helpful. In terms of just overall operations and sort of resources to what have been maybe surprisingly weaker volumes in the second quarter, how has that trended? Any update from a headcount perspective you can provide and sort of equipment? As far as -- you guys are, by far and away, the leader in terms of managing the resources and having stored locomotive fleet and being able to kind of get the most out of what you have on the field, but can you give us an update as where you stand there?

Keith E. Creel

Yes, Chris. From a headcount standpoint, if I go back to the beginning of the year, based on what we thought would be the demand, we sort of guided to a number of around 1,000 people that would come out year-over-year. So we're going to become better railroaders, more productive. We're going to right size assets, and we need about 1,000 less people.

So we got into this in the first quarter, and we were seeing what was going on around us. We said "You know what? That's not enough. We have an ability to go around 1,300."

Now since then, given what I've said, business has been a little bit less than what we thought it would be. We've changed that number more closer to somewhere between 1,400 and 1,500. I can get into the detail of how we do it, but it's all about, again, understanding processes and rightsizing not just in transportation, but in engineering, in mechanical, all the things that -- and the people. When you have resources and assets, if you got cars, if you got locomotives, you got to have people to maintain them. So if you've got too many and you've got too many people, not only do you have the operating expense and the field expense and the repair expense and the maintenance expense, I've got headcount expense, too. So it's through that process that we're able to look at the business and continue to right size. And it works the same way.

To your point, we've got 600 -- I think yesterday, it was 662-horsepower locomotives tied out -- tied up. I'm running the railroad with 822 or 823 on today's level of business. A year ago, it was a remarkably different number. That number would have been 400 more. So as business comes back, we're better railroaders. Again, productivity is at a level it wasn't before. I'm not going to have to bring back one from one.

Now I can't take a 20% increase in business and not bring back some people because I'm going to need more locomotives and I'm going to do it smart. But given that we've reset what our productivity expectations are, I don't need the same number that I would have needed before. So again, this down cycle allows us to get better at doing those kinds of things.

Christian Wetherbee

When you think about that 1,400 to 1,500, just so I'm clear, do you feel like that's a position you're at now that's sort of a full year target of how you get towards the end of the year? Is that the right way to think about it?

Keith E. Creel

Well, that's -- yes, we'll definitely be there at the end of the year. But our mandate and our objective is not to wait full year benefits. So we're working hard at that, and my intent is to be very close to that, if not there, at the end of the first half. Maybe there's a little bit of overflow into July, but it won't be much beyond July, and we'll see a second half benefit from it.

Christian Wetherbee

Okay. No, that's helpful. So I want to pick up a little bit on your comments that you made about the atypical seasonality, I think, of the first quarter and how that compares to the second quarter. At least the way that we've been sort of looking at the business, we assumed relatively flattish type of progression from 1Q to 2Q because of some of those benefits. And I think you saw, as you mentioned, no winter.

Nothing to complain about, but it makes the comparison pretty hard on a sequential basis. Is that still the right way to think about it? Or has the volume dynamic in the second quarter been a little bit more negative to be able to reach those types of levels?

Keith E. Creel

Yes. Let me say this. Number one, we've -- I know that investors focus quarter-to-quarter, but we try to take a more -- a little bit longer-term approach.

But specific to the second quarter, in a normal market, had the revenue been what we assumed, then I would have agreed with you. You should see the same, if not a little bit of sequential improvement. If not for these improvements we've made, given-- we've had much less revenue than what we expected, it'd be a lot worse than it is.

But we still see, not improvement, but it's closer to, in my mind -- we still got a couple of weeks left -- but it'll be closer to a60 number as opposed to a sub-58.9 number.

But with that said, again, and I can talk as much detail as you want to talk to -- I can talk about the markets and why -- with second half benefit from the synergies, the operating synergies, the reductions we've made, the productivity levels, when you start to add more demand, because our expectation is more demand and I can talk about it by line segment, business segment second half, we're going to recover that.

And that's why, as much as it's not easy, we're not about to give up and change our guidance because we still think it's achievable. We've got to work our tails off. We've got to execute what we said we're going to do -- both top line and bottom line. But if it happensas we predict it and as we start to see it happening now, we feel that we're going to make our guidancefor the year.

Christian Wetherbee

And just to be clear, that's the double-digit earnings growth guidance?

Keith E. Creel

Yes. Double-digit and a sub-59% operating ratio. That's correct.

Christian Wetherbee

Okay, got it. I just want to make sure we're clear. So let's talk about some of those volume environments, particularly for the second half. What do you see, when you go sort of line-by-line through the business, where there is some opportunity? You've talked about a couple of the areas where you're surprised by a little bit of the downside, and they seem to be somewhat transitory in nature, at least to some extent. Where does the upside come from in the back half of theyear?

Keith E. Creel

Okay. Let's -- if I can, let me reverse that question. I'm going to start with what I don't know and what's questionable, and that's crude. I mean, obviously, I don't think anybody in this room knows what'sgoing to happen. I'd like to say that it goes to $60 a barrel and stays there. But if I understand economics -- I went to class that day -- as long as there's more supply than demand, I don't know that that's going to happen. So we think that dynamic happens in 2017.

We think, right now, crude still remains a question mark. Again, once pipeline capacity fills up and that additional product comes online, we're going tostart to see more movement. But it's a question mark. I'm making my best estimate on timing. I don't control it.

So if you set crude aside and you look at the areas that we have some visibility to, Canadian grain, we assumed in the second half an average year. We're getting information now that, number one, Iknew that the plantings were earlier, so there's a potential for product to start coming in from harvestearlier than normal. So maybe some of that crop year starts to move in July as opposed to moving in August and ramping up. So that's one possibility.

But for sure what we're seeing, based on what I've been told as of late, the moisture content is great. The estimations from all the grain companies -- they're more bullish than an average crop. So instead of a 60 million to 64 million metric ton crop year, they're suggesting it's going to be 65 million to 69 million.

So that area alone represents a meaningful revenueopportunity for this company on the Canadian grain side. Because assume you get half of that, do the math, it's substantial.

The other strength is U.S. grain. U.S. grain has been a very challenging story in 2015. We didn't move barley at all. Historically, we were down. Farmers, the price was down, the U.S. dollar was up, they weren't motivated to move it. They created a whole lot of storage as a result of the winter of 2014, which exceeded normal storage count, so they were able to sit on more grain. Now this year, CP is in a very good position because of our franchise. The area that we pull grain from, ag product fromis expecting about a 9% higher than average harvest. S

o that -- again, if you talk about what's pent up and what hasn't moved, if you talk about what's coming in and they had to make space for, you talk about the U.S. dollar is moderating, the competitive option, Brazil, is not as strong, the price is going up over the past 5 to 6 weeks, the things that we thought were happening are starting to happen. So U.S. grain is an opportunity for us in the second half. So we see that as a bright spot.

The other area that's meaningful piece of our revenue is potash, export potash, Canpotex specifically. Typically, we would have moved more of the tonnage -- the annual tonnage. At this point of the year, we have not, and we have not because the contract between Asia and Canpotex has not been settled yet. I'm sure that the customers in Asia are no different than the customers in North America. In a down market, you're going to try to get all the leverage you can and get the best rates you can. So they're in the middle of that process, theybeing Canpotex and their customers in Asia, and that has not been resolved. Now Canpotex has voiced tome and their guidance to me and their advice to me is it is what it is. We're not going to make a bad business decision. We're going to stick to our guidance, and we're going to move the same amount of potash that we moved last year. It's just more back-half loaded. And it's possible, even in the middle of a harvest, number one, because we got a lot of assets; and number two, a lot of the potash that moved last year was moved first half not second half. So the comparables are much larger second half.

So those are two very, very bright spots for us, I think that are coming -- or three, I guess, that are coming to fruition that give us our confidence in second half being much better than -- meaningful amount better than first half as far as demand standpoint.

And then the other area that I think is unique to CP outside of what normal GDP gives you -- well, there's two areas. We've talked about this a long time, and we said our first obligation is to fix this railroad. We're going to get service because without service you don't stay in business.

But if you get service and you have low cost, best service, you can compete in any marketplace. So the market sets the rate. The competition sets the mark. So be it rail, be it truck, I don't care what you're talking about, if I don't have the service to go to my customer and say "You can trust your shipment with me," then I'm not going to be their choice of transportation. We've got that now.

We've got a team ofmarketing folks that are being held accountable to what they produce day in and day out. And that's why part of what I'm doing is spending a tremendous amount of my time with them to develop them, to teach them how to sell service, to help them explain service, to go to the customer and say, "Listen, Mr. Customer, it's not just about the rate." If you're a car owner -- and I've talked about this and this is what -- I use that a lot because it sort of -- it exemplifies the power of this operating model and this franchise.

There's a particular part of business that's on our competitor that we can better serve. And when I say better serve, my route is shorter and faster. And I'm one that believes that if you have the best route and you optimize and convert that, then you can have the lowest cost and the best service. Because you got the shorter transit time, you can use pure assets and move the same amount of

product, oversimplified. So we went in this negotiation with this customer that I would consider as a merchandise customer because this is like a 20-, 25-car movement a day, part of their assembly line where service matters. If they don't have it, they'll shut down, and then the guy that gives you the business loses his job. That doesn't help you a lot. But in this negotiation, rates were talked about. And I said, "I'm not going to cut my rate. I'm not going to match the competitor just to get the business because I've got a better network. And I can show you, and we did, that I can make your transportation cost less because instead of owning 20 cars a day to move this level of business, I'm half a day faster to your facility, you don't need 20, you need 15. So what capital cost, what maintenance cost, what ownership cost those 5 cars represent at $100,000 apiece and I can give you the same rate or even a little more and you're still saving money by shipping on my railroad." So those stories are starting to unfold.

So the merchandise now, that's an opportunity for us as we go forward. And that's why, organically, there are a lot of chapters left in this story. We're just now starting to do those things as those pieces of business, those -- they're not triples, they're singles and doubles. But you add them up and you can win a baseball game, right? So we're getting the credibility to be able to have those discussions, and we're starting to win some of those arguments. The other piece is Intermodal, Domestic Intermodal specifically. We should be, in the markets that we serve, truck-competitive. And my network, at the end of the day, if I do my job and run it properly, it's shorter.

It should be able to meet -- beat my competitor on the rail into these major markets on the domestic side, and that's what we're focused on. And we're changing the strategy as well a little bit on thedomestic side. CP historically, number one, originally, when we first came there, they triggered their service off of International Intermodal.

Now I like international business but the margins are not very great, andit's not as service-sensitive from a time standpoint. When I say service-sensitive, domestic can be hours. When you miss getting on the store shelf, then you could miss a market. So the people that are shipping domestic needs to be their own time or they lose business. These people that are shipping international, when it's coming across the steamship line and it's stacked five high in Vancouver and it goes -- and sits on our facility for 4 or 5 days before they come get and take it to the distribution center, it's not a matter of hours. It's a matter of days.

So if you get into the service market, you've got a shorternetwork, you've got a product out there and you have reliability and you've got people that put business on your railroad. And that's what we've benefited from for the last 2 years. Well, you can't go into a down market. Well, a lot of our customer base, probably two-thirds, were more big-box retailer type.

So it's nice when there's a lot of demand, a lot of business for us, but in the down markets, if their sales are down, then, guess what, your freight is down. So we decided to diversify. Number one, I don't want to lock this company into a down economic cycle long term. I want to be a good partner with my customers, but I'm not going to do a 5-year deal and lock myself in today's economics based on the demand and artificially suppress my freight rates for the next 5 years. I'm not doing that.

So number one, those customers that are big- box type, we will do short deals, and I'll maintain their business and protect their business. BecauseI got a better route, I'm going to give them better service. I don't have to do it with a guaranteed rate for 5 years. The market sets the rate. I'm going to be in the market real time not 5 years from now. And then the other way that we're protecting ourselves is starting to diversify. So instead of two-thirds being domestic, big chunk business, that's going to be a percentage that always matters, but I'm also going to diversify and I'm going to go after two other lanes that we really haven't pursued at CP in the past.

And that's cross-border domestic. So that's more specifically truck-competitive. It's traffic that's moving between Montreal, Toronto and Chicago that might be going by road, that's in line at Port Huron or in line at Windsor taking a whole lot of time to get across that border and maybe they got more assets than they need because of all that variability, if I can give them a consistent service and put it on rail and be competitive, I can take trucks off the road and put them on my railroad. And a lot of times, from an equipment standpoint, I'm using empty cube that belongs to a steamship line so I don't have the equipment cost. And the near benefit is they don't have the empty deadhead cost. So it's a win-win for all parties. So that specific area, we've got 1 train we put in service about 1 year ago, 1.5 years ago. And again, what doesn't kill you makes you stronger. It got to the point -- about 4 months ago, I said, "Listen, international business is down. We've got this train set. It's a fixed cost." We did a deal withCSX to run over their railroad to Buffalo, to CP, and then we take it into Toronto and we take it into Montreal. Number one, from a service standpoint, we've got a great transit time, comparable to the competition. I'm competing, again, with truck, so it makes a lot of sense from an economic standpoint on an international. I've got double-stack capacity now, which I didn't have on the normal CP route.So it helps us on the international side. But that service -- given we haven't focused on this domestic cross- border, that train running probably 4,000 feet and it costs me the same -- whether it's 10,000 feet or 4,000 feet. So I said, "Guys, listen, I know why it's there. It's so that we can have a competitive option and compete in international, but I'm not paying for that privilege right now. It's a downtime. We got to control cost. So you need to grow it or it goes away, and it comes back when we need it."

So that's when we gotengaged in cross-border domestic. We've done a partnership with a company, Hub Group, in the States. So their sales force becomes CP sales force. We've got a partnership, and we literally, over the past 3 months, have taken that train from what it was to about 200% growth. So it's not completely full, but it's making money, which is what this whole game is about, right? So -- and it sets us in position to diversify, as I've explained, on the domestic side. So we're not so suspect to the economy because we're partnering with truck as well. And it also sets us up to compete on a level playing field with our competitor from

service options, when we play for international business. So it's really -- the strategy is playing outextremely well. So that's another area that we're just now starting to see the benefit from that makes me feel good about the second half. That's why you see CP's domestic business not quite as bad as everybody else's, and that's why I'm so excited about growth as we go into2017.

Christian Wetherbee

Yes, okay. That certainly makes sense. And you mentioned the international piece, and certainly, historically margins have been a little bit more challenged in that piece of the business relative to the domestic side. But I think we're starting to see some of those early international contracts that sort of maybe switched sides shortly after the management transition at CP coming back for renewal. Are those big opportunities, good opportunities? And were those the sort of singles and doubles? Are those kinds of things that maybe you don't necessarily want to get too competitive on?

Keith E. Creel

Well, listen, I -- again, remember this, market sets the rate. And if we can make money, then I'm going to play in it, right? So I'm not we're not going to make a bad business decision. We understand ourcosts. We understand strengths of our services. We understand cost of capital. We manage both sides of the ledger sheet very responsibly.

So again, if the market's there, we've got a very much improved network. Back then, if I go back to when we walked away from those contracts, our cost structure, our margins were, I don't know, probably 2,000 points higher or if not somewhere in that neighborhood. So again, the market sets the rate. Very capable competitor, a different cost structure, we can play and make a buck. And if it didn't sink, let's -- it's a triple. It's a grand slam. It's a big chunk of business. And this was a particular customer, 1 of the 3, a significant one that CP had been in business with for more than 3 decades, so there is -- definitely was a relationship of business. We knew -- if you're with a railroad that long, your customers -- or sort of our customers and all these intermodal facilities are similar to where their customer base is. If you understand the markets -- they made a tough decision.

And I think in all honesty, and I've learned this since I joined CP, because they were a house account, sometimes that sets people up to think that you can take business for granted and you don't have to produce and you don't have to provide service and you get them locked into a long-term deal and they're sort of in bed with you whether they want to be or not. And I think that's what caught up with CP.

Now for me and for Hunter, when we looked at it, I could make money at it. But I've got involved since. We've improved the service. I know that -- the history. I know that they respect this railroad. I've met with their senior team myself and, again, making room for me to be part of this marketing team, in line with what I said earlier. I've gone to Hong Kong. I met with this customer. I know two things. I know I've got to give them a value proposition that helps them grow their business. And if I do, I'm going to grow it as well. And I've got to reestablish trust and respect. And I've got to show them that the CP they knew four years ago is not the CP of today. And it's the CP that not only do we run it better and more disciplined and understand we have to earn your service every day, it's also a CP that's invested $4 billion more. And I'm not running my railroad at17 miles an hour, I'm running my railroad at 25 miles an hour. And I don't have the same length throughout the key markets. My routes are 225 miles shorter. So think about the power of, either from an asset story or from a revenue story, if I can run 225 miles shorter and I can do it 20% faster, it's compelling from a service standpoint, it's compelling from a cost standpoint and it's compelling from a competitive option standpoint.

So long answer to your question. Those decisions will be made next year. That particular contract -- if I were them, I'm not going to suggest or assume I get all the business. But I'm going to make it tougher than that to give me a substantial part of thebusiness.

Unidentified Participant

How many potential clients or lost clients have you gotten back, Keith?

Keith E. Creel

There were three contracts specific to International Intermodal. In the quantum of the three, about $300 million, then, annually. So it's substantial, it's a lot of money.

Unidentified Participant

So you said earlier that given yours and Hunter's experience, you've got a lot of work still to do at CP. If you look at your model, how far towards 100% are you?

Keith E. Creel

You know what, I would say we're 30% there from a revenue standpoint and even from an operating standpoint. I mean the things that we've done so far, we've made quantum leaps, and you do thatinitially. And you can't just keep repeating those quantum leaps, but it takes time.

This operating model is about using fewer trains, longer trains, more fuel-efficient trains, which require fewer people, fewer assets, and you turn them fast. Well, to do that, you've got to change the physical layout of the railroad. So you can't have what's a traditional railroad, which is a siding every 10 miles that's 6,000 feet long, I need them every 15 miles that are 10,000 feet long. So it takes time to get all that done because you're having to run the business every day while you're doing it. So we've gotten a lot of the core route done. But where the growth is coming in the future, and I'm talking about grain growth, I'm talking about crude growth, sort of the north line of our railroad, which was underinvested in and underutilized, which, in some cases, is the shortest route to the markets. Those are the things that we sort of backed off of because we don't need it yet. But as business comes back, we'll convert that and lockstep with the business. Because I know capital costs, it's easy, I could spend $100 million and put it into the ground, but that means Igot to depreciate it, too, right? So my depreciation expense -- if I'm needlessly spending capital and I don't need it, it's going to cost my shareholders for years until that business comes. So we're mindful of all those things.

So this process to me, if -- maybe I'm in the third inning of a 9-inning game. And when Iget there, I'm going to tell you I'm playing extra innings. That's just the way I work and I understand from two decades of doing this. And I'm oversimplifying it, but if I've got my 10 top issues that cost me either velocity, money, challenges from an operating standpoint or service, whatever they are, once you fix them, there's going to be 10 more. And if you ever think that you've arrived, that's when the slack is going to run in -- that's the way we've explained it in our business -- and you're going to lose it. You'regoing to lose service. You're going to lose your cost advantage. You're going to lose your service product you can give to the customer. And the bottom line is you're not going to be first in the industry, you're going to be last in the industry.

Unidentified Participant

You've set aside rolling stock and track. How much are you spending on capital expenditures, primarily technology?

Keith E. Creel

Well, not a lot, in all honesty. We've got -- our total capital spend this year is $1.1 billion, and this is -- a lot of people missed this. We cut capital $400 million.

My basic capital, I didn't cut. I adjusted a little bit because I'm expecting to be more productive, but that wasn't the focus of the cut, and that's about keeping the railroad safe with ties, steels and ballasts. So the balance between the $750 million andthe $1.1 billion, some of it's exchange. It fluctuates a little bit. But in reality, it's PTC. That's somethingwe're having to deal with now. That's about a $45 million expense that goes away in 2015.

Rolling stock-wise, I would say we're doing some smart stuff, stuff we had a long-term lease that, from probably financial weakness, our predecessors leased. It makes more sense to buy, so we're buying out some leases on some equipment, returning back what we don't need. That's probably -- I don't know, $25 million, $30 million is a guesstimate without looking at it.

And then $60 million, $70 million on IT-type stuff. Andit's not we're building new systems, we're sort of replenishing. We're tweaking. We're adjusting. We're getting more productive. We're retiring some legacy systems. We're -- ironically, like some companies, we have systems that when they implemented, instead of making the change management work and teaching people how to really use the benefits that drive the synergies of the system, they cut it off. And then you get a system that's sort of sub-optimized because you didn't manage the change. And then you go back -- well, that won't do what I need, so I got to maintain another one on the side to do what I cut off on that one. Well, some of that discipline -- our IT guy, Mike Redeker, is like, "You know what, I'mnot spending any money unless it's justified." You've got to earn your capital that you get. And if there's a system out there that we've sub-optimized because we haven't managed the change, guess what,you're going to manage the change. And we're going to quit maintaining two when one will do the work because I got to pay for two, I got to have people for two, cost for two. We're going to go to the one, and we're going to have the discipline to execute it. So it's sort of taking the same mindset we do on operations. We're getting good at operations. I've got a solid bench. They're getting better every day. They're notdone.

They never will be done. I'm 25 years in this and almost all that with Hunter, and he tells me every day I'm not done. I may disagree a little bit. I'm probably better than he thinks he is, if he's done his job. But I'll never finish. I learn every day.

But on the other side, the marketing team, this is all new to them. Their entire careers, the people that are still with us that were part of the old CP never had service to sell. They answered the phone. They stayed in the office. They made promises that the operating team could never keep, and then they apologize two weeks later because we didn't do it. Now they're part of the process. Operating-centric company, they help us define the product. When we do that together, we all own it together and we deliver it together. But it still takes time to teach them how to sell it. It's -- you think I wouldn't have to have the discussion I have with that customer about the rate on the cars that I shared with you. I had to get involved in that. They wanted me, "Keith, can you call your counterpart at that particular large customer and tell them that's the best we can do?" And I said, "Guys, if you talked about what value cycle times give them. If you explain that to him, you can quantify all that and the ownership cost, to give them a dollar incentive, that transportation decision-maker can decide. And if you have, yes I'll call them. But if you haven't -- if you ask me again and you haven't, you won't ask me again a second time because you're not doing your job." But it takes time to teach people those kind of things. So...

Unknown Analyst

In your model, what do you -- when you get the track sort of rationalized, what do you think the railroad's average speed can be?

Keith E. Creel

Well, we're 25 miles an hour now. That's all in. That's terminal time. That's -- so you got to be careful with that number when you compare to what's good and what's bad. Because I believe that assets sit in yards -- I believe assets move on trains and not the road. The AAR standard is just between terminals. Some of the crew change time, and the time in terminals is taken out. To me, you're on the clock all the time. So that 25 miles an hour is an all-in number.

I would have guessed part of our multi-year plan in 2014 was get to 23 miles an hour. So we've blown by that. But again, it's part of you don't know what you don't know. I haven't been on this network for 10 years; I've been on it for three.

So every time I go out on the property, the folks that are there think they're doing a great job, and they are, but when you point things out to them, they're like, "Well, we never thought of that." And like, right now, I talked about these switches. We're taking out over 600 switches, mainline and yard switches. Well, all those switches, as long as they're on track, require, by regulations, expense to inspect them and expense to maintain them to make sure you run a safe railroad. And unfortunately, as good as we are, we're not any more close to getting there yet. I'm sure that a lot of those switches were taken out that we've identified a surplus. Because we've exceeded our speed expectations, they probably had, in the capital plan, to be replaced.

So you get it across the entire ledger sheet. I think, once we finish, though -- we're getting close to a number of that. You got to get to a conversation, "Does it make a whole lot of sense to go a whole lot faster? Because the next quantum change is your next collective agreement." So if I had an ability -- the equipment can go 70 miles an hour. If I had the right collective agreement and I can invest the money and pay for it and I could run trains twice as fast as I run them today safely, then, you know what, there's a whole another quantum leap of opportunity. But right now, I don't have that benefit, and I'm not economically incented to spend the millions it would take to be able to put a railroad and put the locomotives on it and need all that expense without giving the return to my shareholders.

So that's where we're at. I think there's still more room. We'll see incremental improvements over the next few years. But to get quantum changes, it takes quantum investment, and it's going to take a quantum change and a collective agreement, which I fully believe eventually will happen. It makes too much sense not to happen. We're just not there yet today.

Christian Wetherbee

Scott, I think you have a question.

Unidentified Participant

Keith, post ending the acquisition attempts, I would have expected you guys -- while I'm on the fixed income side, I expect you to step up the pace of share repurchases. You didn't do that. I guess the question now is, what is your target leverage at this point? And are more aggressive share repurchase -- would you want to go to mid triple BBB over the near term?

Keith E. Creel

Well, where we're at now, we worked hard to get our credit ratings improved. And obviously, when you got a better credit rating, your cost of capital is going to be less. I personally was involved in explaining our operating model, our business model, the balance sheet, with our previous CFO, with all the rating agencies. And we said, "This is what we're going to do. 2.5x is our objective. We get to 2.5x, and we're going to protect it." We want to be a solid -- not the best, but a solid investment-grade company. And that's what we did, and they rewarded us. And we all know that if we lose that credibility, it's a whole lot harder to get it back than it was to get it initially.

So I want to keep my powder dry. The board feels the same. We want to keep that turn to maintain that respectable credit rating. And that's why we did not leverage out, so to speak, and buy more shares back. We clearly understand that our share is at a suppressed value right now. We know what the intrinsic value of that share is. So second half -- we said this when we did it, and I'll reiterate. It's a board decision. But my recommendation would be if we have a strong second half, we create more cash flow than we expect because we got more top line and the stock remains suppressed, then we'll have this discussion, should we change it? But again, it won't be taken lightly. It would be an exception.

So what to assume? I would assume 5% to 6% of what we're doing, as long as you see our leverage is 2.5x. Unless there's some great bargain out there and it makes a whole lot of sense, we're going to do what's right for the shareholders and we'll make the exception, but it'sonly going to be in those kind of cases we do.

Unidentified Participant

That's on a net basis or that's gross?

Keith E. Creel

2.5x, yes, net basis.

Christian Wetherbee

So I have one more question before I wrap up. I just want to touch real briefly on price, just get asense as to how you're thinking about the price dynamic and sort of where that should be in the second half of the year.

Keith E. Creel

Okay. Well, we said all along, as a Canadian railroad, there's a bit different dynamic. Many of you likely understand the regulatory -- the levers they could pull in Canada are quite different than in the U.S. And so we've said, as a Canadian railroad, 3% to 4%. It's consistent, and it works in the down times, it works in the up times. And it keeps you out of FOAs, and it keeps you out of court, which is what happens in Canada. It's a 60-day challenge, and we're sitting there playing baseball arbitration. And I've got a customer saying, "We're having tough times too, and your rate should be cut 5%." And I'm trying to tell them the rates should be up 5%, and that's a 10% swing. And there's a whole lot on the table.

So where we're at now, it's closer to the 3% than the 4% and up. Markets -- as the GDP improves and demand improves, then you can assume closer to the 4% versus the 3%. People ask how we do that. Number one, we're conservative in nature from the very beginning. And number two, I don't have a problem going to the customer and saying, "Listen, right now, no times are tough. My times are tough, too, but I've got a contract signed with employees to deliver your service. And if you don't have to have a strike, I got to pay them. I'm going to do what I said I was going to do, and I got to give them a 3% rate increase, if my costs are going up 3%.

As long as I'm giving you service, I can help you save money. You can give me more business, to my point earlier, and I can help you save money. But I got to -- I've got to raise the rates. I can't cut rates and stay in business and keep investing in physical plant, keep giving you the service that helps you win in your marketplace. You win, I win." So that's pretty much where we're at this year, closer to 3% as opposed to 4%. But as things change, it will be the reverse.

Christian Wetherbee

Okay. That's very helpful. Thank you, Keith and Nadeem, for joining us. Really appreciate it.

Keith E. Creel

Thank you.