



2018

**Management's Discussion and Analysis
of Results of Operations and Financial
Condition**

February 15, 2019

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1. HIGHLIGHTS

The financial and operating highlights for Air Canada for the periods indicated are as follows:

(Canadian dollars in millions, except where indicated)	Fourth Quarter			Full Year		
	2018	2017 ⁽¹⁾	\$ Change	2018	2017 ⁽¹⁾	\$ Change
Financial Performance Metrics						
Operating revenues	4,246	3,820	426	18,065	16,252	1,813
Operating income	122	133	(11)	1,174	1,371	(197)
Income (loss) before income taxes	(216)	20	(236)	405	1,286	(881)
Net income (loss)	(231)	8	(239)	167	2,029	(1,862)
Adjusted pre-tax income ⁽²⁾	68	77	(9)	952	1,165	(213)
Adjusted net income ⁽²⁾	54	60	(6)	677	1,145	(468)
Operating margin %	2.9%	3.5%	(0.6) pp	6.5%	8.4%	(1.9) pp
EBITDAR (excluding special items) ⁽²⁾	543	521	22	2,851	2,928	(77)
EBITDAR margin (excluding special items) % ⁽²⁾	12.8%	13.6%	(0.8) pp	15.8%	18.0%	(2.2) pp
Unrestricted liquidity ⁽³⁾	5,725	4,181	1,544	5,725	4,181	1,544
Net cash flows from operating activities	360	389	(29)	2,695	2,738	(43)
Free cash flow ⁽²⁾	141	(43)	184	791	1,056	(265)
Adjusted net debt ⁽²⁾	5,858	6,116	(258)	5,858	6,116	(258)
Return on invested capital ("ROIC") % ⁽²⁾	12.6%	15.3%	(2.7) pp	12.6%	15.3%	(2.7) pp
Leverage ratio ⁽²⁾	2.1	2.1	-	2.1	2.1	-
Diluted earnings per share	\$ (0.85)	\$ 0.02	\$ (0.87)	\$ 0.60	\$ 7.31	\$ (6.71)
Adjusted earnings per share – diluted ⁽²⁾	\$ 0.20	\$ 0.22	\$ (0.02)	\$ 2.45	\$ 4.11	\$ (1.66)
Operating Statistics ⁽⁴⁾			% Change			% Change
Revenue passenger miles ("RPM") (millions)	20,801	19,396	7.2	92,360	85,137	8.5
Available seat miles ("ASM") (millions)	25,598	24,191	5.8	110,866	103,492	7.1
Passenger load factor %	81.3%	80.2%	1.1 pp	83.3%	82.3%	1.0 pp
Passenger revenue per RPM ("Yield") (cents)	18.2	17.6	3.8	17.6	17.1	2.5
Passenger revenue per ASM ("PRASM") (cents)	14.8	14.1	5.2	14.6	14.1	3.8
Operating revenue per ASM (cents)	16.6	15.8	5.1	16.3	15.7	3.8
Operating expense per ASM ("CASM") (cents)	16.1	15.2	5.7	15.2	14.4	6.0
Adjusted CASM (cents) ⁽²⁾	11.4	11.3	0.5	10.6	10.6	0.3
Average number of full-time equivalent ("FTE") employees (thousands) ⁽⁵⁾	30.5	28.3	7.6	29.9	27.8	7.4
Aircraft in operating fleet at period-end	400	395	1.3	400	395	1.3
Average fleet utilization (hours per day)	9.7	9.7	(0.1)	10.4	10.4	0.1
Seats dispatched (thousands)	15,185	14,522	4.6	63,800	60,820	4.9
Aircraft frequencies (thousands)	137.7	138.4	(0.5)	578.9	569.6	1.6
Average stage length (miles) ⁽⁶⁾	1,686	1,666	1.2	1,738	1,702	2.1
Fuel cost per litre (cents)	84.3	67.5	24.8	80.4	62.6	28.4
Fuel litres (thousands)	1,293,063	1,254,111	3.1	5,597,232	5,331,888	5.0
Revenue passengers carried (thousands) ⁽⁷⁾	11,909	11,314	5.3	50,904	48,126	5.8

- (1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.
- (2) Adjusted pre-tax income, adjusted net income, adjusted earnings per share - diluted, EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent), EBITDAR margin, leverage ratio, free cash flow, ROIC and adjusted CASM are each non-GAAP financial measures and adjusted net debt is an additional GAAP measure. Refer to sections 8 and 20 of this MD&A for descriptions of Air Canada's non-GAAP financial measures and additional GAAP measures. As referenced in the table above, special items are excluded from Air Canada's reported EBITDAR calculations. Refer to section 6 of this MD&A for information on the special items.
- (3) Unrestricted liquidity refers to the sum of cash, cash equivalents and short-term investments and the amount of available credit under Air Canada's revolving credit facilities. At December 31, 2018, unrestricted liquidity was comprised of cash, cash equivalents and short-term investments of \$4,707 million and undrawn lines of credit of \$1,018 million. At December 31, 2017, unrestricted liquidity was comprised of cash, cash equivalents and short-term investments of \$3,804 million and undrawn lines of credit of \$377 million.
- (4) Except for the reference to average number of FTE employees, operating statistics in this table include third party carriers (such as Jazz Aviation LP ("Jazz"), Sky Regional Airlines Inc. ("Sky Regional"), Air Georgian Limited ("Air Georgian") and Exploits Valley Air Services Ltd. ("EVAS")) operating under capacity purchase agreements with Air Canada.
- (5) Reflects FTE employees at Air Canada. Excludes FTE employees at third party carriers (such as Jazz, Sky Regional, Air Georgian and EVAS) operating under capacity purchase agreements with Air Canada.
- (6) Average stage length is calculated by dividing the total number of available seat miles by the total number of seats dispatched.
- (7) Revenue passengers are counted on a flight number basis (rather than by journey/itinerary or by leg) which is consistent with the IATA definition of revenue passengers carried.

2. INTRODUCTION AND KEY ASSUMPTIONS

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers, as the context may require, to Air Canada and/or one or more of Air Canada's subsidiaries, including its wholly-owned operating subsidiaries, Touram Limited Partnership, doing business as Air Canada Vacations® ("Air Canada Vacations") and Air Canada rouge LP, doing business as Air Canada Rouge® ("Air Canada Rouge"). This MD&A provides the reader with a review and analysis, from the perspective of management, of Air Canada's financial results for the fourth quarter and full year of 2018. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2018. All financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the CPA Canada Handbook – Accounting ("CPA Handbook"), which incorporates International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board ("IASB"), except for any non-GAAP measures and any financial information specifically denoted otherwise.

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 21 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of February 14, 2019.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of this MD&A. Air Canada issued a news release dated February 15, 2019 reporting on its results for the fourth quarter and the full year of 2018. This news release is available on Air Canada's website at aircanada.com and on SEDAR's website at www.sedar.com. For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult SEDAR at www.sedar.com.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

Air Canada's public communications may include forward-looking statements within the meaning of applicable securities laws. Such forward-looking statements are included in this MD&A and may be included in other communications, including filings with regulatory authorities and securities regulators. Forward-looking statements may be based on forecasts of future results and estimates of amounts not yet determinable. These statements may involve, but are not limited to, comments relating to strategies, expectations, planned operations or future actions. Forward-looking statements are identified using terms and phrases such as "anticipate", "believe", "could", "estimate", "expect", "intend", "may", "plan", "predict", "project", "will", "would", and similar terms and phrases, including references to assumptions.

Forward-looking statements, by their nature, are based on assumptions, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, our ability to successfully achieve or sustain positive net profitability or to realize our initiatives and objectives, industry, market, credit, economic and geopolitical conditions, energy prices, currency exchange, competition, our dependence on technology, cybersecurity risks, our ability to successfully implement appropriate strategic initiatives or reduce operating costs, our ability to successfully integrate and operate the Aeroplan loyalty business following its acquisition from Aimia Inc. and to successfully launch our new loyalty program, our ability to preserve and grow our brand, airport user and related fees, high levels of fixed costs, our dependence on key suppliers including regional carriers, employee and labour relations and costs, our dependence on Star Alliance and joint ventures, interruptions of service, environmental factors (including weather systems and other natural phenomena and factors arising from man-made sources), our ability to pay our indebtedness and maintain liquidity, pension issues, limitations due to restrictive covenants, pending and future litigation and actions by third parties, our ability to attract and retain required personnel, war, terrorist acts, casualty losses, changes in laws, regulatory developments or proceedings, epidemic diseases, insurance issues and costs, as well as the factors identified in Air Canada's public disclosure file available at www.sedar.com and, in particular, those identified in section 18 "Risk Factors" of this

MD&A. The forward-looking statements contained or incorporated by reference in this MD&A represent Air Canada's expectations as of the date of this MD&A (or as of the date they are otherwise stated to be made) and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether because of new information, future events or otherwise, except as required under applicable securities regulations.

KEY ASSUMPTIONS

Assumptions were made by Air Canada in preparing and making forward-looking statements. As part of its assumptions, Air Canada assumes continued relatively modest Canadian GDP growth for the first quarter and full year 2019. Air Canada also expects that the Canadian dollar will trade, on average, at C\$1.32 per U.S. dollar in the first quarter and for the full year 2019 and that the price of jet fuel will average 77 CAD cents per litre in the first quarter and 82 CAD cents per litre for the full year 2019.

INTELLECTUAL PROPERTY

Air Canada owns or has rights to trademarks, service marks or trade names used in connection with the operation of its business. In addition, Air Canada's names, logos and website names and addresses are owned or licensed by Air Canada. Air Canada also owns or has the rights to copyrights that also protect the content of its products and/or services. Solely for convenience, the trademarks, service marks, trade names and copyrights referred to in this MD&A may be listed without the ©, ® and TM symbols, but Air Canada reserves all rights to assert, to the fullest extent under applicable law, its rights or the rights of the applicable licensors to these trademarks, service marks, trade names and copyrights.

This MD&A may also include trademarks, service marks or trade names of other parties. Air Canada's use or display of other parties' trademarks, service marks, trade names or products is not intended to, and does not imply a relationship with, or endorsement or sponsorship of Air Canada by, the trademark, service mark or trade name owners or licensees.

3. ABOUT AIR CANADA

Air Canada is the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market and in the international market to and from Canada. In 2018, Air Canada, together with Jazz Aviation LP ("Jazz"), Sky Regional Airlines Inc. ("Sky Regional") and other regional airlines operating flights on behalf of Air Canada under capacity purchase agreements, operated, on average, 1,613 daily scheduled flights to 222 direct destinations on six continents, comprised of 64 Canadian cities, 60 destinations in the United States and a total of 98 cities in Europe, Africa, the Middle East, Asia, Australia, the Caribbean, Mexico and South America. In 2018, Air Canada carried a record of 50.9 million passengers, an increase of 5.8% from 2017.

At December 31, 2018, Air Canada mainline operated a fleet of 184 aircraft, comprised of 91 Boeing and Airbus narrow-body aircraft, 74 Boeing and Airbus wide-body aircraft, and 19 Embraer 190 regional jets, while Air Canada Rouge operated a fleet of 53 aircraft, comprised of 22 Airbus A319 aircraft, six Airbus A321 aircraft and 25 Boeing 767-300 aircraft.

Air Canada enhances its domestic and transborder network through capacity purchase agreements ("CPAs") with regional airlines, namely Jazz, Sky Regional Airlines Inc. ("Sky Regional"), Air Georgian Limited ("Air Georgian") and Exploits Valley Air Services Limited ("EVAS"), each of which operates flights on behalf of Air Canada. These carriers form an integral part of the airline's international network strategy, providing valuable traffic feed to Air Canada and Air Canada Rouge routes. At December 31, 2018, the Air Canada Express fleet was comprised of 45 Bombardier regional jets, 84 Bombardier Dash-8 turboprop aircraft and 25 Embraer 175 aircraft for a total of 154 aircraft. Air Georgian and EVAS also operated a total of nine 18-passenger Beech 1900 aircraft on behalf of Air Canada.

Air Canada is a founding member of the Star Alliance® network. Through the 28-member airline network, Air Canada offers its customers access to 1,317 destinations in 193 countries, as well as reciprocal participation in frequent flyer programs and the use of airport lounges and other common airport facilities.

Air Canada is able to build customer loyalty through Air Canada Altitude®, its frequent flyer program and through the Aeroplan® loyalty program. Air Canada Altitude recognizes and rewards Aeroplan members with a range of premium travel privileges and benefits corresponding to their travel activity, such as priority check-in, complimentary checked baggage and upgrades to Business Class, as well as opportunities to earn Aeroplan Miles on Air Canada flights and those of the other 27 Star Alliance member airlines. Aeroplan members also have opportunities to redeem their Aeroplan Miles for travel with Star Alliance member airlines.

Air Canada has been pursuing a comprehensive strategy to improve profitability and competitiveness in leisure markets. This strategy leverages the strengths of Air Canada, Air Canada Rouge, the airline's lower-cost airline, and Air Canada Vacations. Through Air Canada Rouge, Air Canada is pursuing opportunities in leisure markets made viable by Air Canada Rouge's more competitive cost structure. Air Canada Vacations is a leading Canadian tour operator, developing, marketing and distributing vacation travel packages, operating in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, Central and South America, South Pacific, Australia and Asia), and the inbound leisure travel market to destinations within Canada, and also offering cruise packages in North America, Europe and the Caribbean.

Air Canada Cargo, Canada's largest provider of air cargo services as measured by cargo capacity, provides direct cargo services to over 150 Canadian, U.S. transborder and international destinations and has sales representation in over 50 countries. Air cargo services are provided across the Air Canada network.

4. STRATEGY

Air Canada's principal objective is to become a sustainably profitable global champion. In pursuing this goal, Air Canada seeks to continually improve customer experience and employee engagement and create value for shareholders by focusing on four core priorities:

- Identify and implement cost reduction and revenue enhancing initiatives;
- Pursue profitable international growth opportunities and leverage its competitive attributes to expand margins, in large part by increasing connecting traffic through its strategic international gateways in Toronto, Vancouver and Montreal, and grow and compete effectively in both the business and leisure market to and from Canada;
- Engage customers by continually enhancing their travel experience and by consistently achieving customer service excellence; and
- Foster positive culture change. This includes making meaningful investments in training and other tools that promote improved collaboration to enable Air Canada and its employees to better work together in a supportive and enriching environment.

Revenue Enhancement and Cost Transformation

Margin improvement through the implementation of sustainable cost transformation and profitable revenue-generating initiatives is a key priority at Air Canada. Air Canada continues to seek and implement measures to reduce unit costs and expand margins, including through fleet modernization and greater fleet productivity. Additionally, Air Canada seeks to improve its ability to generate incremental passenger and ancillary revenue, including through its expanded suite of branded fare products and investments in technology.

Key achievements in 2018

- Record operating revenue of \$18,065 million, \$1,813 million or 11% above 2017.
- Carried record 50.9 million passengers, an increase of 5.8% from 2017.
- EBITDAR margin of 15.8%, consistent with the 2018 EBITDAR margin of approximately 16% forecast in Air Canada's news release dated October 31, 2018. Operating income of \$1,174 million in 2018 reflected a decrease of \$197 million from 2017. EBITDAR is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.
- ROIC of 12.6%, consistent with the 2018 ROIC of approximately 12% forecast in Air Canada's news release dated October 31, 2018. ROIC is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Realized or identified savings of \$220 million under the new Cost Transformation Program intended to secure \$250 million in savings. Air Canada expects to achieve the remaining savings of \$30 million by the end of 2019.
- Adjusted CASM increased 0.3% from 2017, in line with the range of no increase to an increase of 0.75% projected in Air Canada's news release dated October 31, 2018. CASM increased 6.0% from 2017. Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Added one Airbus A321, two Airbus A319 and one Boeing 767 aircraft to the Air Canada Rouge fleet and five Boeing 787-9 and 16 Boeing 737 MAX 8 aircraft to the mainline fleet.

- Sold and leased back 25 Embraer 190 aircraft, of which six were returned to the lessor in late 2018.
- Record unrestricted liquidity of \$5,725 million.
- Finalized, in November 2018, definitive agreements to acquire Aimia Inc's Aeroplan loyalty business as well as commercial agreements related to and in support of this acquisition with TD, CIBC, and Visa. The acquisition was completed on January 10, 2019.

Air Canada is taking tangible steps to pursue its strategy for sustained value creation and profitability through the execution of new and on-going strategic initiatives. These include:

Air Canada Rouge

Since its first flight in July 2013, Air Canada Rouge, Air Canada's low-cost carrier, has been deployed to a growing number of Caribbean destinations and select leisure destinations in the U.S. and Canada, as well as in international leisure markets where demand is highly elastic and responds positively to competitively priced, non-stop capacity. At December 31, 2018, Air Canada Rouge operated 53 aircraft (25 Boeing 767, 22 Airbus A319 and six Airbus A321 aircraft). Air Canada plans to add 10 narrow-body aircraft to Air Canada Rouge's fleet in 2019. Refer to section 8 "Fleet" of this MD&A for additional information.

Air Canada Rouge provides Air Canada with the flexibility to shift capacity between markets as well as between seasons. It also provides Air Canada with the ability to compete against lower-cost carriers as well as emerging North American ultra-low-cost carriers. Air Canada Rouge offers competitive fares while leveraging the strengths of Air Canada mainline, including its powerful brand, award-winning products and services, extensive network with enhanced connection options, distribution capability and operational expertise.

Boeing 787 Aircraft

To date, Air Canada has taken delivery of 35 Boeing 787 Dreamliner aircraft of its firm order of 37 (comprised of 8 787-8 and 29 787-9 aircraft). Air Canada plans to take delivery of the remaining two Boeing 787-9 aircraft on firm order by the summer of 2019. The Boeing 787 Dreamliner is driving new opportunities for profitable growth by opening new international destinations made viable by its lower operating costs, mid-size capacity and longer range.

Narrow-body Fleet Renewal Program

To date, Air Canada has taken delivery of 20 Boeing 737 MAX 8 aircraft of its firm order of 61 737 MAX aircraft (comprised of 50 Boeing 737 MAX 8 and 11 Boeing 737 MAX 9 aircraft). The Boeing 737 MAX aircraft are replacing the Airbus narrow-body aircraft in Air Canada's mainline fleet. Air Canada plans to add 18 737 Max 8 aircraft to the mainline narrow-body fleet in 2019.

Air Canada estimates that the Boeing 737 MAX 8 aircraft is delivering an 11% lower CASM when compared to the mainline Airbus A320 aircraft, mainly driven by greater maintenance and fuel efficiencies. This aircraft also offers greater deployment opportunities in the domestic, U.S. transborder and certain Atlantic markets.

Air Canada has a firm order for 45 Airbus A220-300 aircraft, the first of which Air Canada plans to take delivery of in late 2019. The first 25 aircraft on delivery will replace the Embraer 190 aircraft in Air Canada's mainline fleet, with the incremental aircraft supporting Air Canada's hub and network growth. Air Canada estimates that the Airbus A220-300 aircraft will deliver a 12% lower CASM when compared to the Embraer 190 aircraft, mainly driven by greater maintenance and fuel efficiencies. This aircraft, with its longer range, will also offer greater deployment opportunities, enabling Air Canada to serve new markets not as well suited to Air Canada's larger Boeing 737 MAX or Airbus A321 aircraft. Refer to section 8 "Fleet" of this MD&A for additional information.

Improvements to Commercial Agreement with Jazz and Equity Investment in Chorus

In February 2019, Air Canada concluded an agreement to amend and extend its capacity purchase agreement ("CPA") with Jazz, a wholly-owned subsidiary of Chorus Aviation Inc. The amendments will provide long term stability for Chorus, reaffirming Jazz as Air Canada's most significant Air Canada Express carrier well into the future. The amendments will bolster the strength and competitiveness of the Air Canada Express brand and its coast-to-coast regional network, and provide significant CPA savings for Air Canada, while optimizing network and fleet flexibility when compared to the current agreement.

Highlights of the CPA amendments are as follows:

- An extension of the CPA term by ten years from January 1, 2026 to December 31, 2035.
- Simplification and modernization of the Jazz fleet with growth through more, larger gauge aircraft. The amendments include various minimum levels of covered aircraft at different points in time, providing Air Canada the flexibility to optimize its fleet within its network strategy.
- The continuance of a fixed fee structure, including new terms mitigating risk and market-oriented compensation to make the CPA more competitive, for Air Canada, given new competitors entering the market.
- In support of Air Canada's cost transformation program, projected annual savings to Air Canada of approximately \$50 million in 2019 and 2020, and cumulative savings of approximately \$53 million between 2021 and 2025, both as compared to the 2015 CPA framework (from both fixed fee and performance incentive reductions). Beyond 2025, the CPA provides for a market competitive fixed fee. These projected savings are in addition to the significant benefits expected from improved network efficiencies relating to this transaction.
- The continuation of a highly successful pilot mobility agreement that provides Air Canada Express pilots with access to pilot careers at Air Canada on a planned basis.
- The consolidation of more of Air Canada's overall regional capacity into Jazz' footprint, thereby lowering Air Canada's overall regional costs in the future.

The amendments became effective retroactively as at January 1, 2019.

Concurrent with the CPA amendments, Air Canada made a \$97.26 million equity investment in Chorus, subscribing for 15,561,600 Class B voting shares in the capital of Chorus, representing, at time of issuance, approximately 9.99% of the issued and outstanding Class A variable voting shares and Class B voting shares of Chorus on a combined basis. Chorus shares were issued to Air Canada at a price of \$6.25 per share, representing a 5% premium to their five-day volume weighted average price as of the close of trading on January 10, 2019. Concurrently with the closing of the equity investment, Air Canada and Chorus entered into an investor rights agreement under which, among other things, Air Canada will hold the investment shares for a period of at least 60 months, subject to certain limited exceptions. Deputy Chief Executive Officer and Chief Financial Officer of Air Canada, Michael Rousseau, was also appointed to the board of directors of Chorus.

Other Revenue Optimization and Cost Reduction Initiatives

Air Canada has created a culture of continuous cost transformation and revenue improvement across the organization, continually seeking productivity, process and other improvements. Initiatives may entail revising business and operational processes, including supply chain and maintenance operations, improving employee productivity and asset utilization, and promoting workplace policies to add revenue and lower costs.

Air Canada updated its suite of branded fare products to allow it to further segment its customer base and offer a variety of fare options and a customized on-board experience. These new re-bundled fares provide a wider range of choices and stimulate sales based on specific attributes, driving incremental

revenue. Air Canada continues to increase its ancillary revenue from its "à la carte" services, such as those related to baggage, ticket changes, seat selection, preferred seating and upgrades, and from its onboard offerings, including food, beverage, duty-free shopping and onboard Wi-Fi Internet. Air Canada is also realizing incremental revenue through investments in web and mobile platforms and, in 2018, saw a significant acceleration in direct channel share and core ancillary revenue sales.

Investments in technology will also play an important role in enhancing margins, including the implementation of a new passenger service system ("PSS") in late 2019 which is further described below. This new system is expected to provide annual incremental benefits of over \$100 million.

Leveraging International Network

Air Canada is focused on leveraging its international network and its competitive attributes to appropriately expand margins, in large part by increasing international connecting traffic through its strategic international gateways in Toronto, Vancouver and Montreal, and competing effectively in the leisure market to and from Canada. Air Canada also continues to develop commercial alliances with major international carriers to broaden its network offerings.

Key developments in 2018

- Introduced non-stop Air Canada mainline service from Vancouver to Paris and Zurich; from Montreal to Dublin and Tokyo-Narita; and from Toronto to Shannon.
- Launched non-stop Air Canada Rouge service from Montreal to Bucharest, Lisbon, Phoenix and Victoria; from Toronto to Bucharest, Kamloops, Nanaimo, Porto and Zagreb; and from Edmonton to Las Vegas.
- Started non-stop Air Canada Express service from Toronto to Omaha and Providence; from Montreal to Baltimore, London (ON), Pittsburgh, and Windsor; from Vancouver to Sacramento; from Edmonton to Kelowna, San Francisco and Victoria; and from Calgary to Comox.
- Converted Air Canada Rouge service between Montreal and Casablanca to mainline service using an Airbus A330 aircraft.
- Concluded a revenue-sharing joint venture agreement with Air China, the first joint venture agreement between a Chinese and North American airline. The agreement, which is in respect of all flights between mainline China and Canada, allows for cooperation in various commercial and operational areas, including network planning, revenue management, sales and distribution, and airport operations. The joint venture agreement provides customers more flight choices, seamless travel experiences, optimized flight schedules, harmonized fare products, as well as reciprocal participation in frequent flyer programs and use of airport lounges. Air Canada and Air China also enhanced their codeshare agreement to include Zhengzhou, Xiamen, Shenzhen and Nanjing in domestic China and Victoria, Kelowna, Saskatoon, and Regina in domestic Canada. Furthermore, the codeshare agreement now includes flights between Montreal and Havana, and Montreal and Shanghai.
- Expanded the codeshare agreement with Cathay Pacific, further widening the network by connecting Air Canada's services to Hong Kong to many Southeast Asian destinations, including the Philippines, Malaysia, Vietnam and Thailand. As a result, Air Canada now offers codeshare services to destinations such as Manila, Cebu, Kuala Lumpur, Ho Chi Minh City, Hanoi, Bangkok, Phuket and Chiang Mai.
- Implemented a new codeshare agreement with Adria Airways, connecting Air Canada's services to Germany and Belgium (Frankfurt, Munich and Brussels) to Ljubljana, Slovenia.
- Expanded the codeshare agreement with All Nippon Airways (ANA) with the addition of ANA's code on Air Canada's new Montreal-Narita service, providing customers with additional travel options to cities within Japan and other Asian destinations.

- Increased sixth freedom traffic (international-to-international, including U.S.) connecting through Air Canada's major Canadian hubs by 15% when compared to 2017.

Air Canada has competitive strengths which allows it to profitably pursue international route opportunities. It has the ability to appreciably increase international-to-international traffic through its strategic international gateways in Toronto, Vancouver and Montreal, and is broadening its network appeal through its membership in Star Alliance, its revenue-sharing joint venture with Air China on routes between Canada and China, and its A++ trans-Atlantic revenue-sharing joint venture with United Airlines and Deutsche Lufthansa AG, which the parties are focused on enhancing to increase competitiveness, create operating efficiencies and improve customer experience. Air Canada's network is also enhanced through numerous codeshare and interline agreements. Furthermore, Air Canada has access to Canada's wide portfolio of international route rights, and Canada's multi-ethnic demographic profile provides the airline with further opportunities to profitably capture demand for international travel. These attributes, combined with Air Canada's powerful brand and industry-leading products and services, allow it to leverage its network and benefit from the higher margins generally available in international markets.

Air Canada plans to continue to selectively and profitably expand its international services by leveraging its new aircraft and improved cost structure, and by exploiting the following competitive advantages:

- A widely recognized brand and a strong position in the market for trans-Atlantic and trans-Pacific travel to and from Canada and to and from North and South America via Canada.
- An extensive and expanding global network, enhanced by the airline's membership in Star Alliance and by numerous commercial arrangements.
- A flexible fleet mix, enabling the airline to redeploy or otherwise manage capacity to match changes in demand.
- Air Canada Altitude, Air Canada's frequent flyer program, which recognizes the airline's most frequent flyers by offering them a range of exclusive travel privileges, including the benefits derived from Air Canada's Aeroplan program, which allows all customers to earn and redeem Aeroplan Miles.
- Competitive products and services, including lie-flat suites in the Signature Class cabin, concierge services, Maple Leaf® lounges and, at its Toronto global hub, an exclusive Air Canada Signature Suite offering eligible Signature Class customers exclusive amenities, including "à la carte" meal service in the Suite's complimentary restaurant.
- Geographically well-positioned hubs (Toronto, Montreal and Vancouver) with efficient in-transit facilities, accentuating the advantages of flying Air Canada for customers travelling between the U.S. and Asia or Europe.
- Favourable slot times at busy airports, including Beijing, Shanghai, Hong Kong, Tokyo-Narita, Tokyo-Haneda, Paris-Charles de Gaulle, Frankfurt, London-Heathrow, New York-LaGuardia, and Washington-Ronald Reagan National Airport.

In 2019, Air Canada plans to launch additional international services, including non-stop Air Canada year-round flights from Toronto to Vienna. The flights to Austria's capital will be operated in cooperation with Star Alliance joint venture partner Austrian Airlines. Air Canada also plans to launch non-stop summer seasonal service from Montreal to Bordeaux and increase weekly frequencies from Vancouver to Delhi, Melbourne and Zurich.

Air Canada enhances its domestic and transborder network through capacity purchase agreements with Jazz, Sky Regional and other airlines (operating under the Air Canada Express banner). Air Canada Express provides a network of local traffic, as well as high volumes of feeder traffic that flow into Air Canada's long-haul network and support its strategy to grow international transit traffic to and from the U.S. In 2019, Air Canada plans to enhance services to North Carolina, including with the launch of a new, non-stop daily flight between Montreal and Raleigh. The airline will also deploy larger aircraft on flights

between Toronto and Raleigh and Charlotte to increase capacity on these routes and introduce Business Class service.

Air Canada continues to increase sixth freedom traffic, particularly from the U.S., with its award-winning products and services, geographically well-positioned Canadian hubs, extensive network and other competitive advantages.

Lester B. Pearson International Airport ("Toronto Pearson") offers a strategic advantage due to its proximity to densely populated major U.S. markets and serves a large number of business and leisure travelers flying to and from Toronto, Canada's largest city. Air Canada's and its Star Alliance partners' operations are consolidated in one terminal at Toronto Pearson, which also has efficient in-transit facilities that allow passengers and their bags to move seamlessly between Canadian and U.S. Customs and Immigration. For several years, Air Canada has worked closely with the Greater Toronto Airports Authority ("GTAA") to transform Toronto Pearson into the leading North American airport and gain a greater share of the global sixth freedom market.

Air Canada has also been growing its Vancouver hub into a premier gateway to Asia-Pacific markets and developing Montreal into a complementary trans-Atlantic hub. With convenient connections between Vancouver and cities across North America, Air Canada offers some of the shortest elapsed travel time between continental North America and Pacific Asia, providing a better travel experience. The airline's Montreal hub not only links North America with key markets in France, but also positions Montreal as a premier gateway to the Atlantic. Given the improvements that are being made in Toronto, Vancouver and Montreal, the airline is able to build its network from the U.S. to provide increased connection flows to its international flights.

Since its inception in 1997, the Star Alliance network has grown to include the following 28 airlines: Adria Airways, Aegean Airlines, Air Canada, Air China, Air India, Air New Zealand, ANA, Asiana Airlines, Austrian Airlines, Avianca, Avianca Brasil, Brussels Airlines, Copa Airlines, Croatia Airlines, EGYPTAIR, Ethiopian Airlines, EVA Air, LOT Polish Airlines, Lufthansa, Scandinavian Airlines, Shenzhen Airlines, Singapore Airlines, South African Airways, Swiss International Air Lines AG, TAP Portugal, THAI, Turkish Airlines and United Airlines.

In addition to its membership in Star Alliance and its joint venture agreements, Air Canada's numerous codeshare and interline agreements allow it to achieve greater critical mass and network scope. Air Canada has 36 codeshare partners, of which 26 are Star Alliance members and 10 are non-members (Aer Lingus, Central Mountain Air, Etihad, Eurowings, GOL Linhas Aéreas Inteligentes, Jet Airways, Middle East Airlines, SriLankan Airlines, Cathay Pacific and Virgin Australia).

Air Canada continues to assess new strategic partnerships in support of its business plan and international growth strategy.

Customer Engagement

Providing a consistently high level of customer service and growing the airline's premium customer base are important aspects of Air Canada's business strategy. Air Canada continually strives to improve customer loyalty and generate positive referrals to attract new customers. The airline recognizes that its ongoing success is dependent on consistently delivering superior value and innovative products, providing the highest levels of customer service and anticipating the changing needs of customers.

Acquisition of Aimia's Aeroplan Loyalty Business

Air Canada Altitude is designed to recognize and reward its most frequent travelers with exclusive perks and privileges based on the number of miles or segments customers fly combined with their total spend. These privileges, including priority airport services, lounge access, and eUpgrade credits, are designed to enhance the Air Canada experience and encourage loyalty from frequent flyers. Altitude members also benefit from Air Canada's Aeroplan program, which provides a wide range of ways to earn and redeem Aeroplan Miles, including flights and upgrades to over 1,200 destinations worldwide.

On January 10, 2019, Air Canada completed the closing of its purchase of Aimia Canada Inc., owner and operator of the Aeroplan loyalty business, from Aimia Inc. The aggregate purchase price for the acquisition consisted of \$450 million in cash plus \$47 million in cash for pre-closing adjustments. The purchase price is subject to post-closing adjustments and the acquisition also includes the assumption of the Aeroplan Miles liability. Air Canada received payments from The Toronto-Dominion Bank ("TD") and Canadian Imperial Bank of Commerce ("CIBC") in the aggregate amount of \$822 million. Visa Canada Corporation ("Visa") also made a payment to Air Canada and, assuming completion of the Amex Bank of Canada ("AMEX") agreement referred to below, AMEX will do likewise.

Concurrently with the conclusion of the Aeroplan purchase, Air Canada, TD, CIBC, and Visa finalized various commercial agreements relating to and in support of the acquisition, including credit card loyalty program and network agreements for future participation in Air Canada's new loyalty program. In addition, TD and CIBC made payments to Aimia Canada Inc., now Air Canada's subsidiary, in the aggregate amount of \$400 million as prepayments to be applied towards future monthly payments in respect of Aeroplan Miles. Air Canada also has entered into an agreement in principle with AMEX, which also issues Aeroplan co-branded products, to secure its continued participation in Air Canada's loyalty program after 2020. Following the closing of the acquisition, Aimia Canada Inc. changed its name to Aeroplan Inc.

Consistent with its promise of continued investments in the customer experience, Air Canada plans to launch its new loyalty program in mid-2020. Air Canada believes that the new program will allow it to further strengthen customer relationships, offer members more flexible rewards, and deliver a more consistent end-to-end customer experience. The new program will offer broad earning and redemption opportunities, more personalized service and a better digital experience for Air Canada customers.

Passenger Service System

Air Canada concluded an agreement with Amadeus for the full Amadeus Altéa Suite passenger service system (PSS) including reservations, inventory and departure control solutions. The new reservation system, scheduled to be implemented in late 2019, will allow Air Canada to optimize its flight schedule by providing the ability to more easily manage inventory between any given origin and destination and automate rebookings during flight disruptions, such as those caused by extreme weather. It will also support Air Canada's international network through more seamless booking and customer handling with Star Alliance and interline partners.

Products and Services

Investing in products and services remains pivotal to Air Canada's commitment to customer engagement. To this end, the airline has partnered with leading brands and continues to invest in premium products that enhance the customer's journey.

In 2018, Air Canada launched Air Canada Signature Service, rebranding the lie-flat Business Class product available on most international mainline flights, as well as select key transcontinental markets. Air Canada Signature Service provides eligible customers with an end-to-end premium experience, including access to priority ground products, including select concierge services, as well an exclusive on-board experience in Air Canada Signature Class.

Air Canada Signature Class was also introduced in North America, replacing Business Class – Transcontinental, and for the first time showcasing a product specification aligned to international standards in North America. Air Canada Signature Class is available on select transcontinental routes, including daily overnight flights from Los Angeles, San Francisco and Vancouver to Toronto. Air Canada Signature Class is also available on flights between Toronto and Honolulu.

Air Canada provides concierge assistance at 47 airports globally. In 2019, the airline plans to expand this service to include Dubai and Vienna. The premium agent program, with specially-trained customer sales and service agents accredited specifically to work at Priority Check-in and inside the Maple Leaf Lounges, is now available at 10 Canadian airports, with plans to expand to key locations in the U.S. throughout 2019.

Throughout 2018, Air Canada also expanded the use of a fleet of BMW vehicles, operating as part of the Air Canada Valet Service at Toronto Pearson. At the end of 2018, Air Canada operated a fleet of 20 BMW 7-series limousines, providing select customers connecting from a domestic to an international Air Canada Signature Class with a personalized airside drive between the gate areas. By 2019, this will make Air Canada the first airline in North America to provide this type of service to Business Class customers, subject to certain restrictions.

The Maple Leaf Lounge portfolio has expanded to Saskatoon, with the opening of Air Canada's 23rd lounge worldwide. Air Canada also opened a new 7,400 square feet Maple Leaf Lounge located inside the new gate area at New York La Guardia, as well as a new 3,600 square feet Maple Leaf Lounge at St-John's International Airport. The lounges at La Guardia and St-John's International are each replacing existing facilities, providing a significantly improved ground product. In 2019, Air Canada expects to open a new Maple Leaf Lounge at San Francisco International Airport, as well as starting a comprehensive refurbishment program of existing facilities at key hubs.

The Air Canada Signature Suite, a premium "à la carte" dining facility available at Toronto Pearson open for select customers departing in Air Canada Signature Class, opened in late 2017 and has been well received by customers throughout 2018. Plans are underway to review and possibly expand the concept to Vancouver International Airport in 2019.

Seamless means of transiting through Air Canada's hubs at Toronto Pearson, Vancouver and Montreal Trudeau and enhancements to facilities and processes supporting Air Canada's sixth freedom traffic strategy now allow customers connecting from Japan to a domestic destination to not have to claim their bags at the connecting point, unless otherwise advised by customs. This is in addition to customers connecting from the U.S., Europe or Australia to a Canadian airport through these hubs. By summer 2019, Air Canada expects to have all international to domestic connections included in the International to Domestic program. Supporting new flights to Asia, during 2018, Air Canada also expanded the China Transit Program to include Montreal Trudeau, providing eligible citizens of the People's Republic of China the opportunity to connect through Montreal on select eligible flights without the need for a Canadian visa.

Starting with the Boeing 787 Dreamliner, and then followed by the Boeing 777, Air Canada has been progressively upgrading its wide-body aircraft with next generation cabin, and in-flight entertainment products. They have been enthusiastically received by customers and, in 2019, Air Canada will extend these improvements to its fleet of Airbus A330 aircraft. Air Canada also received its first 18 new Boeing 737 MAX (two in 2017 and 16 in 2018) and, in late 2019, will take its first delivery of the new Airbus A220 aircraft. These aircraft bring market-leading cabins and entertainment products to Air Canada's narrow-body fleet.

Air Canada and Air Canada Rouge have expanded Wi-Fi connectivity to additional aircraft and expect to have all aircraft connected by the end of 2019. Air Canada introduced complimentary global streaming Wi-Fi service as a reward option for Altitude Elite 75K and Super Elite 100K members, making Air Canada the first airline in North America to offer complimentary Wi-Fi to its most frequent flyers.

Air Canada received a number of awards recognizing its industry-leading products and services in 2018, including being named *Best Airline in North America* in the 2018 Skytrax World Airline Awards, as well as *Best Business Class in North America*. Skytrax also revalidated Air Canada's ranking as North America's only four-star International network carrier as part of a quality audit which assessed more than 1,000 touch-points on the ground and in the air. As part of the four-star re-certification, Air Canada was awarded high marks for the Air Canada Signature Class service on select North American transcontinental markets, the new Business Class seat offered on the Boeing 737 MAX aircraft, the state-of-the-art entertainment system on the Boeing fleet, as well as the service offered in Premium Economy Class, all reflective of the significant investment in product and service undertaken over the previous years. In addition, the Air Canada Signature Suite was considered amongst the best, if not the best in the world for business class pre-flight dining.

In late 2018, the Ipsos Reid 2018 Canadian Business Traveller Survey confirmed Air Canada as the preferred airline for domestic travel for 92% of frequent business travellers. The national study determined that Air Canada is the only Canadian airline to see a consistent increase in preference and in usage over the past five years. Additionally, readers of leading frequent business traveller magazine, Business

Traveler, have named Air Canada *Best North American Airline for International Travel*, as well as *Best North American Airline for Inflight Experience*. Among other things, the survey of frequent business travellers found:

- Overall satisfaction with Air Canada's service continues to increase, contrasting that of domestic competitors, climbing six percentage points over 2017 for in-flight and four percentage points for airports. Air Canada's highest scores in the last five years were driven by satisfaction in its schedule, loyalty program, customer service and perception as a dynamic organization.
- Air Canada is the only Canadian airline that has seen an increase in its Net Promoter Score (NPS) for 2018.
- 96% intend to use Air Canada for domestic business travel in the coming year, significantly more than those who intended to use other Canadian carriers.
- Air Canada is the preferred airline for travel between Canada and the U.S., increasing by 11 percentage points over the last five years.
- Business travel increased the most internationally to Europe, Asia and other global destinations, growing by five percentage points over last year.

Culture Change

Air Canada continues to evolve its culture, transforming from a transportation company to a customer service excellence company which treats its employees and its customers with care and class. In 2018, Air Canada launched a new employee engagement survey which provided stronger analytics and a deeper understanding of where additional focus is required. With a 30% response rate, the survey yielded meaningful data to determine an employee net promoter score (eNPS). A total of 78% of employees surveyed were identified as “promoters” (the truly engaged) or “passives” (those leaning towards positive or are more easily influenced to become promoters with small incremental actions). Work environment, support and learning opportunities were identified as key takeaways. The survey also further reinforced the link between customer perceptions and employee behaviours, while providing meaningful direction for the development of 2018 and 2019 initiatives.

Air Canada also regularly validates the organizational pulse through focus groups and Yammer, its internal social media platform. The airline also connects with employees through weekly executive messages and multiple communications channels, including a daily newsletter. Over 5,000 employees participated in town halls held in hangars across the system which allowed for open Q&A sessions between employees and executives.

To equip managers to excel at critical face-to-face communications, Air Canada's management development programs focus on coaching for soft skills that include relationship building and making authentic connections. In 2019, Air Canada will focus on the evolution of manager 'soft skills' - an essential ingredient in leadership competency development.

It is expected that Millennials will make up 75% of Air Canada's workforce within the next 15 years. Air Canada's development programs are customized, taking into account different learning and engagement styles. The airline's succession strategy is now driven by a Talent Board comprised of executives working closely with Human Resources to identify and prepare new leadership - both young and seasoned.

Air Canada is also leveraging artificial intelligence and virtual interviews to enhance its hiring practices and ensure it is attracting the best candidates in the field.

The importance of diversity and inclusion at work is a direct reflection of Air Canada's broad customer base and a key element in Air Canada's hiring strategy. In 2019, a senior leader diversity counsel and company-wide employee business groups will identify programs and opportunities to promote diversity, including “Women in Aviation” learning events, scholarships and internships for under-represented groups, such as people with disability and spectrum limitations.

Air Canada's achievements can be measured in several ways, including through external recognition such as:

- One of Canada's Best Diversity Employers – 2018 – Mediacorp Canada
- One of Canada's Top 100 Employers – 2019 – Mediacorp Canada
- One of Montréal's Top Employers – 2019 – Mediacorp Canada
- One of Canada's Most Attractive Employers – 2018 – Universum Global
- One of 50 Most Engaged Workplaces™ – 2018 – Achievers
- One of 2018 North American Candidate Experience Awards winners – Talent Board
- Fifth in the Top 20 Employer Brands in Canada – 2018 – Randstad

Labour

Starting in 2014, Air Canada entered into multiple long-term labour agreements with unions representing its unionized workforce. These agreements provide additional stability and flexibility, as well as demonstrate a collaborative partnership supporting its transformation into a global champion. These agreements include the following:

- ACPA (Pilots) – In 2014, Air Canada and ACPA, representing pilots, ratified a new contract providing collective agreement terms for 10 years, ending September 29, 2024, subject to certain renegotiation provisions and benchmarks over this period. In 2017, Air Canada ratified amendments to its existing long-term labour agreement with ACPA. The amendments to the 10-year agreement provide additional commercial opportunities as well as increased operational flexibility.
- IAMAW (Maintenance, Operations and Baggage) – In 2016, Air Canada and the IAMAW, representing technical maintenance, operational support and airport baggage handlers, concluded a new contract providing collective agreement terms for 10 years, ending March 31, 2026, subject to certain renegotiation provisions over this period.
- CALDA (Dispatchers) – In 2016, Air Canada and CALDA, representing flight dispatchers, concluded a new contract providing collective agreement terms for 12 years, ending February 29, 2028, subject to certain renegotiation provisions over this period.
- CUPE (Flight Attendants) – In 2015, Air Canada and CUPE, representing flight attendants, concluded a new contract providing collective agreement terms for 10 years, ending March 31, 2025, subject to certain renegotiation provisions over this period.
- Unifor (Customer Service and Sales Agents) – In 2015, Air Canada and Unifor, representing the airline's customer service and sales agents concluded a new contract providing collective agreement terms for five years, ending February 28, 2020.

5. OVERVIEW

Full year 2018 Financial Summary

The following is an overview of Air Canada's results of operations and financial position for the full year 2018 compared to the full year 2017.

- Record operating revenues of \$18,065 million in 2018 compared to operating revenues of \$16,252 million in 2017, an increase of \$1,813 million or 11%. On capacity growth of 7.1%, record passenger revenues of \$16,223 million increased \$1,630 million or 11.2% from 2017.
- Operating expenses of \$16,891 million in 2018 versus operating expenses of \$14,881 million in 2017, an increase of \$2,010 million or 14%. CASM increased 6.0% from 2017. Adjusted CASM increased 0.3% from 2017.
- Operating income of \$1,174 million in 2018 compared to operating income of \$1,371 million in 2017, a decrease of \$197 million.
- EBITDAR of \$2,851 in 2018 compared to EBITDAR of \$2,928 million in 2017, a decrease of \$77 million. The airline reported a 2018 EBITDAR margin (EBITDAR as a percentage of operating revenue) of 15.8%. This compared to an EBITDAR margin of 18.0% in 2017. Special items are excluded from all of Air Canada's reported EBITDAR calculations. Refer to section 6 of this MD&A for information on special items.
- Net income of \$167 million or \$0.60 per diluted share in 2018 versus net income of \$2,029 million or \$7.31 per diluted share in 2017. In 2018, Air Canada recorded foreign exchange losses of \$317 million and a loss on disposal of assets of \$188 million. In 2017, Air Canada recorded a deferred income tax recovery of \$759 million and foreign exchange gains of \$120 million.
- Adjusted net income of \$677 million or \$2.45 per diluted share in 2018 versus adjusted net income of \$1,145 million or \$4.11 per diluted share in 2017. Refer to section 20 "Non-GAAP Financial Measures of this MD&A for additional information.
- Adjusted net debt of \$5,858 million at December 31, 2018 versus adjusted net debt of \$6,116 million at December 31, 2017, a decrease of \$258 million. In 2018, increases in long-term debt and finance lease balances of \$533 million and capitalized operating lease balances of \$112 million were more than offset by an increase in cash, cash equivalents and short-term investment balances of \$903 million. Adjusted net debt is an additional GAAP measure. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for additional information.
- Air Canada's leverage ratio (adjusted net debt to trailing 12-month EBITDAR) was 2.1 at December 31, 2018, unchanged from December 31, 2017. Leverage ratio is a non-GAAP financial measure. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for additional information.
- Net cash flows from operating activities of \$2,695 million in 2018 versus net cash flows from operating activities of \$2,738 million in 2017. In 2018, free cash flow of \$791 million decreased \$265 million from 2017 and exceeded the \$500 million to \$600 million range projected in Air Canada's news release dated October 31, 2018. The better than expected free cash flow can be attributed to a combination of lower than projected capital expenditures, better than expected cash from working capital and stronger than anticipated income from operations. Refer to section 0 "Consolidated Cash Flow Movements" of this MD&A for additional information.
- Return on invested capital ("ROIC") for the 12 months ended December 31, 2018 of 12.6%, in line with the ROIC of approximately 12% projected in Air Canada's news release dated October 31, 2018. This compared to ROIC of 15.3% for the 12 months ended December 31, 2017. The decrease in ROIC versus 2017 was mainly driven by lower adjusted net income, an increase in average shareholders' equity net of excess cash and an increase in aircraft rent expense year-over-year.

Fourth Quarter 2018 Financial Summary

The following is an overview of Air Canada's results of operations for the fourth quarter of 2018 compared to the fourth quarter of 2017.

- Record operating revenues of \$4,246 million in the fourth quarter of 2018 compared to operating revenues of \$3,820 million in the fourth quarter of 2017, an increase of \$426 million or 11%. On capacity growth of 5.8%, record passenger revenues of \$3,795 million increased \$386 million or 11.3% from the fourth quarter of 2017.
- Operating expenses of \$4,124 million in the fourth quarter of 2018 versus operating expenses of \$3,687 million in the fourth quarter of 2017, an increase of \$437 million or 12%. CASM increased 5.7% from the fourth quarter of 2017. Adjusted CASM increased 0.5% from the fourth quarter of 2017, better than the 1.5% to 2.5% increase projected in Air Canada's news release dated October 31, 2018. Air Canada's better than expected adjusted CASM performance was largely due to lower aircraft maintenance expense, driven by a favourable annual adjustment related to end-of-lease maintenance provisions, as well as the timing of certain engine maintenance events.
- Operating income of \$122 million in the fourth quarter of 2018 compared to operating income of \$133 million in the fourth quarter of 2017, a decrease of \$11 million.
- Record EBITDAR of \$543 million in the fourth quarter of 2018 compared to the previous record EBITDAR of \$521 million in the fourth quarter of 2017, an increase of \$22 million. The airline reported a fourth quarter 2018 EBITDAR margin of 12.8% compared to an EBITDAR margin of 13.6% in the fourth quarter of 2017.
- A net loss of \$231 million or \$0.85 per diluted share in the fourth quarter of 2018 versus net income of \$8 million or \$0.02 per diluted share in the fourth quarter of 2017.
- Adjusted net income of \$54 million or \$0.20 per diluted share in the fourth quarter of 2018 versus adjusted net income of \$60 million or \$0.22 per diluted share in the fourth quarter of 2017.
- Net cash flows from operating activities of \$360 million in the fourth quarter of 2018 versus net cash flows from operating activities of \$389 million in the fourth quarter of 2017. Free cash flow of \$141 million in the fourth quarter of 2018 represented an improvement of \$184 million from the fourth quarter of 2017.

6. RESULTS OF OPERATIONS – FULL YEAR 2018 VERSUS FULL YEAR 2017

The following table and discussion provide and compare results of Air Canada for 2018 and 2017:

(Canadian dollars in millions, except per share figures)	Full Year			
	2018	2017 ⁽¹⁾	Change	
			\$	%
Operating revenues				
Passenger	\$ 16,223	\$ 14,593	\$ 1,630	11
Cargo	803	708	95	13
Other	1,039	951	88	9
Total revenues	18,065	16,252	1,813	11
Operating expenses				
Aircraft fuel	3,969	2,927	1,042	36
Regional airlines expense				
Aircraft fuel	531	412	119	29
Other	2,311	2,205	106	5
Wages, salaries and benefits	2,873	2,671	202	8
Airport and navigation fees	964	905	59	7
Aircraft maintenance	1,003	938	65	7
Depreciation, amortization and impairment	1,080	956	124	13
Sales and distribution costs	807	770	37	5
Ground package costs	602	538	64	12
Aircraft rent	518	503	15	3
Catering and onboard services	433	383	50	13
Communications and information technology	294	254	40	16
Special items	-	30	(30)	(100)
Other	1,506	1,389	117	8
Total operating expenses	16,891	14,881	2,010	14
Operating income	1,174	1,371	(197)	
Non-operating income (expense)				
Foreign exchange gain (loss)	(317)	120	(437)	
Interest income	108	60	48	
Interest expense	(331)	(311)	(20)	
Interest capitalized	35	36	(1)	
Net financing expense relating to employee benefits	(50)	(65)	15	
Gain (loss) on financial instruments recorded at fair value	(1)	23	(24)	
Gain on sale and leaseback of assets	-	52	(52)	
Gain on debt settlements and modifications	9	21	(12)	
Loss on disposal of assets	(188)	-	(188)	
Other	(34)	(21)	(13)	
Total non-operating expense	(769)	(85)	(684)	
Income before income taxes	405	1,286	(881)	
Income tax (expense) recovery	(238)	743	(981)	
Net income	\$ 167	\$ 2,029	\$ (1,862)	
Diluted earnings per share	\$ 0.60	\$ 7.31	\$ (6.71)	
EBITDAR ⁽²⁾	\$ 2,851	\$ 2,928	\$ (77)	
Adjusted pre-tax income ⁽²⁾	\$ 952	\$ 1,165	\$ (213)	
Adjusted net income ⁽²⁾	\$ 677	\$ 1,145	\$ (468)	
Adjusted earnings per share – diluted ⁽²⁾	\$ 2.45	\$ 4.11	\$ (1.66)	

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

(2) EBITDAR, adjusted pre-tax income, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

System Passenger Revenues

With the adoption of *IFRS 15 – Revenue from Contracts with Customers* effective January 1, 2018, certain passenger and cargo related fees were reclassified from Other revenue to Passenger revenue and Cargo revenue on Air Canada's consolidated statement of operations, with restatement of 2017 amounts. This reclassification has no impact on total operating revenue. Concurrent with this change in presentation, Air Canada has revised the methodology used to calculate yield and PRASM. These measures are now based on total passenger revenues, with restatement of 2017 amounts on the same basis.

In 2018, system passenger revenues of \$16,223 million increased \$1,630 million or 11.2% from 2017 on traffic growth of 8.5% and a yield improvement of 2.5%. On a stage length adjusted basis, yield increased 3.7% when compared to 2017. Business cabin revenues, on a system-basis, increased \$376 million or 13.2% from 2017 on traffic and yield growth of 9.4% and 3.5%, respectively.

The table below provides passenger revenue by geographic region for the full year 2018 and the full year 2017.

Passenger Revenue (Canadian dollars in millions)	Full Year		Change	
	2018	2017 ⁽¹⁾	\$	%
Canada	\$ 4,894	\$ 4,637	\$ 257	5.5
U.S. transborder	3,504	3,195	309	9.7
Atlantic	4,237	3,539	698	19.7
Pacific	2,430	2,195	235	10.7
Other	1,158	1,027	131	12.7
System	\$ 16,223	\$ 14,593	\$ 1,630	11.2

(1) Air Canada adopted accounting standard *IFRS 15 – Revenue from Contracts with Customers* effective January 1, 2018 with restatement of 2017 amounts.

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the full year 2018 versus the full year 2017.

Full Year 2018 versus Full Year 2017 ⁽¹⁾	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	PRASM % Change
Canada	5.5	3.2	2.7	(0.4)	2.7	2.3
U.S. transborder	9.7	6.9	7.1	0.1	2.4	2.6
Atlantic	19.7	10.4	14.7	3.1	4.4	8.4
Pacific	10.7	4.0	5.7	1.4	4.7	6.4
Other	12.7	14.7	12.8	(1.4)	-	(1.7)
System	11.2	7.1	8.5	1.0	2.5	3.8

(1) Air Canada adopted accounting standard *IFRS 15 – Revenue from Contracts with Customers* effective January 1, 2018 with restatement of 2017 amounts which are reflected in the table above.

Components of the year-over-year change in full year system passenger revenues included:

- The 8.5% traffic increase which reflected traffic growth in all markets and included gains in the business and premium economy cabins. Consistent with the airline's objective of increasing global international-to-international connecting traffic through its major Canadian hubs (sixth freedom traffic), the traffic growth in 2018 reflected an increase in connecting traffic via Canada to international destinations.

- The 2.5% system yield increase which reflected:
 - increases in fares and carrier surcharges, growth in high-yielding local traffic and an improved overall fare mix;
 - greater proportional growth of high-yielding business and premium economy class passengers;
 - an increase in ancillary revenues, including through baggage fees, advance seat selection/preferred seating fees and airport paid upgrades; and
 - the introduction of an expanded suite of fare offerings on domestic, U.S. transborder and Atlantic services, resulting in growth in ancillary revenue and an improved fare mix.

These factors were partly offset by an increase in average stage length of 2.1%, due to long-haul international expansion, which had the effect of reducing system yield by 1.2 percentage points.

Domestic Passenger Revenues

In 2018, domestic passenger revenues of \$4,894 million increased \$257 million or 5.5% from 2017.

Components of the year-over-year change in full year domestic passenger revenues included:

- The 2.7% traffic increase which reflected traffic growth on all major domestic services as well as incremental connecting traffic within Canada to international destinations. The traffic growth in 2018 included gains in the business cabin.
- The 2.7% yield increase which reflected yield improvements on all major domestic services. The overall yield improvement versus 2017 reflected gains in the business cabin as well as the impact of new fare categories on domestic services, resulting in growth in ancillary revenue, including baggage fees, and an improved fare mix.

U.S. Transborder Passenger Revenues

In 2018, U.S. transborder passenger revenues of \$3,504 million increased \$309 million or 9.7% from 2017.

Components of the year-over-year change in full year U.S. transborder passenger revenues included:

- The 7.1% traffic increase which reflected traffic growth on all major U.S. transborder services. The traffic increase in 2018 reflected strong passenger demand between Canada and the U.S., gains in the business cabin and growth in international-to-international connecting passenger flows from the U.S.
- The 2.4% yield increase which reflected yield growth on all major U.S. transborder services with the exception of U.S. short-haul routes. The launch of new fare categories on U.S. transborder services, resulting in growth in ancillary revenue and an improved fare mix, contributed to the overall yield improvement year-over-year. An unfavourable currency impact of \$13 million was an offsetting factor.

Atlantic Passenger Revenues

In 2018, Atlantic passenger revenues of \$4,237 million increased \$698 million or 19.7% from 2017.

Components of the year-over-year change in full year Atlantic passenger revenues included:

- The 14.7% traffic increase which reflected traffic growth on all major Atlantic services and included gains in all cabins. The 10.4% capacity growth year-over-year was mainly due to the launch of new services from Vancouver to France and Switzerland; from Toronto to Ireland, Portugal, Romania and Croatia; and from Montreal to Ireland, Romania and Portugal, as well as to increased frequencies on existing routes.
- The 4.4% yield increase which reflected yield improvements on all major Atlantic services and included an increase in carrier surcharges year-over-year and a favourable currency impact of \$20 million. The launch of a new fare category on Atlantic services, resulting in growth in ancillary revenue, including baggage fees, and an improved fare mix, also contributed to the overall yield improvement year-over-year. An increase in average stage length of 1.5%, which had the effect of reducing Atlantic yield by 0.9 percentage points, was a partly offsetting factor.

Pacific Passenger Revenues

In 2018, Pacific passenger revenues of \$2,430 million increased \$235 million or 10.7% from 2017.

Components of the year-over-year change in full year Pacific passenger revenues included:

- The 5.7% traffic increase which reflected traffic growth on all major Pacific services with the exception of services to Hong Kong and Japan where capacity was reduced year-over-year. The traffic growth included gains in the business and premium economy cabins.
- The 4.7% yield increase which reflected yield growth on all major Pacific services with the exception of Australia which was slightly below 2017. The yield increase year-over-year included gains in the business and premium economy cabins. The lower yield on services to Australia reflected increased industry capacity when compared to 2017. The overall Pacific yield improvement versus 2017 included an increase in carrier surcharges year-over-year, particularly in Japan and Korea where surcharges are regulated.

Other Passenger Revenues

In 2018, Other passenger revenues (from routes to and from the Caribbean, Mexico and Central and South America) of \$1,158 million increased \$131 million or 12.7% from 2017.

Components of the year-over-year change in full year Other passenger revenues included:

- The 12.8% traffic increase which reflected traffic growth on services to South America and on routes to traditional sun destinations. The traffic growth in 2018 included gains in all cabins.
- No change in yield when compared to 2017 as yield growth on services to the Caribbean was offset by yield decreases on services to South America and Mexico. The yield decline on services to South America was mainly due to a significant increase in average stage length due to the removal of the short-haul tag between Santiago and Buenos Aires as Air Canada now serves both markets on a non-stop basis. The yield decline on services to Mexico was mainly driven by competitive pricing activities due to increased industry capacity. An increase in average stage length of 4.1% had the effect of reducing yield in the Other markets by 2.3 percentage points. On a stage length adjusted basis, yield increased 2.3% when compared to 2017.

Cargo Revenues

In 2018, cargo revenues of \$803 million increased \$95 million or 13.6% from 2017 on yield and traffic growth of 8.1% and 5.1%, respectively. In 2018, the Atlantic and Pacific markets experienced particularly strong performances.

The table below provides cargo revenue by geographic region for the full year 2018 and the full year 2017.

Cargo Revenue (Canadian dollars in millions)	Full Year		Change	
	2018	2017 ⁽¹⁾	\$	%
Canada	\$ 95	\$ 84	\$ 11	14.0
U.S. transborder	43	39	4	11.5
Atlantic	278	245	33	13.7
Pacific	325	280	45	16.0
Other	62	60	2	2.6
System	\$ 803	\$ 708	\$ 95	13.6

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

Other Revenues

In 2018, other revenues of \$1,039 million increased \$88 million or 9% when compared to 2017, mainly due to an increase in ground package revenue at Air Canada Vacations, driven by both higher passenger volumes and a higher price of ground packages when compared to 2017. An increase in passenger and airline-related fees versus 2017 was also a contributing factor.

CASM and Adjusted CASM

In 2018, CASM increased 6.0% and adjusted CASM increased 0.3% when compared to 2017.

The table below compares Air Canada's CASM and adjusted CASM for the full year 2018 to the full year 2017.

(cents per ASM)	Full Year		Change	
	2018	2017 ⁽¹⁾	cents	%
Aircraft fuel	¢ 3.58	¢ 2.83	¢ 0.75	26.6
Regional airlines expense			-	
Aircraft fuel	0.48	0.40	0.08	20.4
Other	2.08	2.13	(0.05)	(2.2)
Wages and salaries	1.96	1.99	(0.03)	(1.4)
Benefits	0.63	0.59	0.04	6.4
Airport and navigation fees	0.87	0.87	-	(0.6)
Aircraft maintenance	0.90	0.91	(0.01)	(0.3)
Depreciation, amortization and impairment	0.97	0.92	0.05	5.4
Sales and distribution costs	0.73	0.74	(0.01)	(2.2)
Ground package costs	0.54	0.52	0.02	4.4
Aircraft rent	0.47	0.49	(0.02)	(3.8)
Catering and onboard services	0.39	0.37	0.02	5.5
Communications and information technology	0.27	0.25	0.02	7.9
Special items	-	0.03	(0.03)	(100.0)
Other	1.37	1.34	0.03	1.3
CASM	¢ 15.24	¢ 14.38	¢ 0.86	6.0
Remove:				
Aircraft fuel expense ⁽²⁾ , ground package costs at Air Canada Vacations and special items	(4.61)	(3.78)	(0.83)	21.9
Adjusted CASM ⁽³⁾	¢ 10.63	¢ 10.60	¢ 0.03	0.3

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

(2) Includes aircraft fuel expense related to regional airline operations.

(3) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating Expenses

In 2018, operating expenses of \$16,891 million increased \$2,010 million or 14% from 2017 on capacity growth of 7.1%.

The more notable components of the year-over-year change in operating expenses are described below.

Aircraft Fuel Expense

In 2018, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to \$4,500 million, an increase of \$1,161 million or 35% from 2017. This increase reflected:

- higher jet fuel prices (before the impact of foreign exchange), which accounted for an increase of \$918 million;
- a higher volume of fuel liters consumed, which accounted for an increase of \$165 million;
- an unfavourable currency impact of \$44 million; and

- fuel hedging losses/expenses of \$36 million in 2018 versus fuel hedging losses/expenses of \$2 million in 2017, an increase of \$34 million.

Regional Airlines Expense

In 2018, regional airlines expense of \$2,842 million increased \$225 million or 9% when compared to 2017, reflecting, in large part, higher aircraft fuel expense year-over-year, as well as a growth in capacity purchase fees due to a higher volume of engine maintenance activity when compared to 2017. Higher CPA rates and the impact of increased flying were also contributing factors.

The table below provides a breakdown of regional airlines expense for the full year 2018 and the full year 2017.

(Canadian dollars in millions)	Full Year		Change	
	2018	2017	\$	%
Capacity purchase fees	\$ 1,333	\$ 1,267	\$ 66	5
Aircraft fuel	531	412	119	29
Airport and navigation fees	296	293	3	1
Sales and distribution costs	153	146	7	5
Depreciation, amortization and impairment	38	28	10	36
Aircraft rent	41	40	1	3
Other	450	431	19	4
Total regional airlines expense	\$ 2,842	\$ 2,617	\$ 225	9

Wages, Salaries and Benefits Expense

In 2018, wages and salaries expense of \$2,174 million increased \$115 million or 6% from 2017, largely due to a higher number of full-time equivalent ("FTE") employees, mainly in support of the airline's capacity growth and international expansion strategy

In 2018, employee benefits expense of \$699 million increased \$87 million or 14% from 2017, higher than the increase of \$75 million projected in Air Canada's news release dated October 31, 2018. The increase in employee benefits expenses versus 2017 was mainly due to the higher level of FTE employees and the impact of lower discount rates which increased the current service cost of defined benefit pension plans.

Airport and Navigation Fees

In 2018, airport and navigation fees of \$964 million increased \$59 million or 7% from 2017, largely due to growth in wide-body and international flying. In addition, in 2017, Air Canada received a \$15 million one-time refund from Nav Canada while no such refund was received in 2018. The favourable impact of Air Canada's agreement with the Greater Toronto Airports Authority, which is allowing the airline to increase international connecting traffic at Toronto Pearson International Airport on a more cost-effective basis, and a 3.9% Nav Canada rate reduction effective September 1, 2017 were offsetting factors.

Aircraft Maintenance Expense

In 2018, aircraft maintenance expense of \$1,003 million increased \$65 million or 7% from 2017, better than the increase of \$95 million projected in Air Canada's news release dated October 31, 2018. This better than anticipated performance was largely due to an annual adjustment related to end-of-lease maintenance provisions and to timing of engine maintenance events. The increase in aircraft maintenance expense versus 2017 was mainly driven by an increase in engine and components maintenance activity and the impact of having additional Boeing 787 aircraft in the fleet in 2018, which have engines under power-by-the-hour arrangements. These increases were largely offset by the

impact of having a greater number of aircraft leases being extended in 2018 and to more favourable end-of-lease conditions on aircraft lease extensions. The impact of a stronger Canadian dollar on U.S. denominated maintenance expenses was also an offsetting factor.

The table below provides a breakdown of the more significant items included in maintenance expense for the full year 2018 and the full year 2017.

(Canadian dollars in millions)	Full Year		Change	
	2018	2017	\$	%
Technical maintenance	\$ 923	\$ 824	\$ 99	12
Maintenance provisions ⁽¹⁾	51	100	(49)	(49)
Other	29	14	15	107
Total aircraft maintenance expense	\$ 1,003	\$ 938	\$ 65	7

(1) Maintenance provisions relate to return conditions on aircraft leases which are recorded over the term of the lease.

Depreciation, Amortization and Impairment Expense

In 2018, depreciation, amortization and impairment expense of \$1,080 increased \$124 million or 13% from 2017, in line with the increase of \$125 million projected in Air Canada's news release dated October 31, 2018. The increase in depreciation, amortization and impairment expense versus 2017 was largely due to the addition of Boeing 787 and 737 MAX aircraft into the mainline fleet. The sale of 25 Embraer 190 aircraft (which Air Canada leased back), in August 2018, was an offsetting factor.

Sales and Distribution Costs

In 2018, sales and distribution costs of \$807 million increased \$37 million or 5% from 2017, reflecting, in large part, the growth in passenger revenue. The favourable impact of new commission programs introduced in North America in April 2018 and growth in direct bookings when compared to 2017 were offsetting factors.

Ground Package Costs

In 2018, the cost of ground packages at Air Canada Vacations of \$602 million increased \$64 million or 12% when compared to 2017, mainly due to higher passenger volumes and a higher cost of ground packages (before the impact of foreign exchange) reflecting, in large part, a change in product mix. A favourable currency impact was an offsetting factor.

Aircraft Rent

In 2018, aircraft rent expense of \$518 million increased \$15 million or 3% from 2017, reflecting, in large part, the impact of a greater number of leased aircraft, including 25 Embraer 190 aircraft which Air Canada sold and leased back in August 2018, partly offset by the impact of lower rates on certain lease renewals.

Special Items

In the first quarter of 2017, Air Canada recorded a provision of \$30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations. Air Canada paid the fine in the second quarter of 2017. Air Canada has appealed the decision. While Air Canada cannot predict with certainty the outcome of its appeal or any related proceedings, Air Canada believes it has reasonable grounds to challenge the European Commission's ruling. Refer to "Current legal proceedings" under section 18 "Risk Factors" of this MD&A for additional information.

Other Expenses

In 2018, other expenses of \$1,506 million increased \$117 million or 8% from 2017, reflecting, in large part, the capacity growth and Air Canada's international expansion strategy, as well as an increase in customer service expense. The increase in customer service expense was partly due to the impact of operational disruptions caused by severe weather, particularly in the first half of 2018. In addition, the first quarter of 2018 included expenses of \$26 million related to new uniforms.

The table below provides a breakdown of the more significant items included in other expenses for the full year 2018 and the full year 2017.

(Canadian dollars in millions)	Full Year		Change	
	2018	2017	\$	%
Terminal handling	\$ 327	\$ 296	\$ 31	10
Crew cycle	212	197	15	8
Building rent and maintenance	176	167	9	5
Miscellaneous fees and services	173	164	9	5
Remaining other expenses	618	565	53	9
Total other expense	\$ 1,506	\$ 1,389	\$ 117	8

Non-operating Income (Expense)

In 2018, non-operating expense amounted to \$769 million versus non-operating expense of \$85 million in 2017.

Components of the year-over-year change in non-operating expense included:

- In 2018, losses on foreign exchange amounted to \$317 million compared to gains on foreign exchange of \$120 million in 2017. The December 31, 2018 closing exchange rate was US\$1=C\$1.3637 while the December 31, 2017 closing exchange rate was US\$1=C\$1.2571. Foreign exchange losses on long-term debt of \$501 million were partly offset by foreign exchange gains on foreign currency derivatives of \$245 million.
- In 2017, Air Canada recorded a gain of \$52 million on the sale and leaseback of four Boeing 787-9 aircraft. No such gains were recorded in 2018.
- In 2018, Air Canada recorded a gain of \$9 million on debt modifications, which included a gain of \$11 million related to the repricing of the airline's US\$1.2 billion senior secured credit facility. This compared to a gain on debt modifications of \$27 million in 2017, which was also related to the repricing of the senior secured credit facility.
- In 2018, Air Canada recorded a loss on disposal of assets of \$188 million related to the sale of 25 Embraer 190 aircraft. No such loss was recorded in 2017. Air Canada realized net proceeds of \$293 million from the sale of these aircraft in 2018.

7. RESULTS OF OPERATIONS – FOURTH QUARTER 2018 VERSUS FOURTH QUARTER 2017

The following table and discussion provide and compare results of Air Canada for the fourth quarter of 2018 and the fourth quarter of 2017:

(Canadian dollars in millions, except per share figures)	Fourth Quarter			
	2018	2017 ⁽¹⁾	Change	
			\$	%
Operating revenues				
Passenger	\$ 3,795	\$ 3,409	\$ 386	11
Cargo	217	198	19	10
Other	234	213	21	10
Total revenues	4,246	3,820	426	11
Operating expenses				
Aircraft fuel	958	735	223	30
Regional airlines expense				
Aircraft fuel	133	112	21	19
Other	575	563	12	2
Wages, salaries and benefits	719	674	45	7
Airport and navigation fees	225	201	24	12
Aircraft maintenance	250	243	7	3
Depreciation, amortization and impairment	267	245	22	9
Sales and distribution costs	182	169	13	8
Ground package costs	126	106	20	19
Aircraft rent	133	126	7	6
Catering and onboard services	104	89	15	17
Communications and information technology	69	62	7	11
Other	383	362	21	6
Total operating expenses	4,124	3,687	437	12
Operating income	122	133	(11)	
Non-operating income (expense)				
Foreign exchange loss	(269)	(62)	(207)	
Interest income	32	18	14	
Interest expense	(84)	(79)	(5)	
Interest capitalized	8	9	(1)	
Net financing expense relating to employee benefits	(12)	(18)	6	
Loss on financial instruments recorded at fair value	(3)	(1)	(2)	
Gain on debt settlements and modifications	-	24	(24)	
Other	(10)	(4)	(6)	
Total non-operating expense	(338)	(113)	(225)	
Income (loss) before income taxes	(216)	20	(236)	
Income tax expense	(15)	(12)	(3)	
Net income	\$ (231)	\$ 8	\$ (239)	
Diluted earnings (loss) per share	\$ (0.85)	\$ 0.02	\$ (0.87)	
EBITDAR ⁽²⁾	\$ 543	\$ 521	\$ 22	
Adjusted pre-tax income ⁽²⁾	\$ 68	\$ 77	\$ (9)	
Adjusted net income ⁽²⁾	\$ 54	\$ 60	\$ (6)	
Adjusted earnings per share – diluted ⁽²⁾	\$ 0.20	\$ 0.22	\$ (0.02)	

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

(2) EBITDAR, adjusted pre-tax income, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

System Passenger Revenues

In the fourth quarter of 2018, system passenger revenues of \$3,795 million increased \$386 million or 11.3% from the fourth quarter of 2017 on traffic growth of 7.2% and a yield improvement of 3.8%. On a stage length adjusted basis, yield increased 4.5% when compared to the same quarter in 2017. Business cabin revenues, on a system-basis, increased \$92 million or 12.5% from the fourth quarter of 2017 on traffic and yield growth of 9.3% and 2.9%, respectively.

The table below provides passenger revenue by geographic region for the fourth quarter of 2018 and the fourth quarter of 2017.

Passenger Revenue (Canadian dollars in millions)	Fourth Quarter		Change	
	2018	2017 ⁽¹⁾	\$	%
Canada	\$ 1,216	\$ 1,151	\$ 65	5.6
U.S. transborder	846	746	100	13.4
Atlantic	899	763	136	18.0
Pacific	550	501	49	9.7
Other	284	248	36	14.5
System	\$ 3,795	\$ 3,409	\$ 386	11.3

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the fourth quarter of 2018 versus the fourth quarter of 2017.

Fourth Quarter 2018 versus Fourth Quarter 2017 ⁽¹⁾	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	PRASM % Change
Canada	5.6	1.5	1.7	0.2	3.9	4.1
U.S. transborder	13.4	9.7	9.6	(0.1)	3.5	3.4
Atlantic	18.0	9.5	14.5	3.5	3.0	7.7
Pacific	9.7	(0.8)	0.3	0.9	9.3	10.6
Other	14.5	15.2	14.0	(0.9)	0.5	(0.6)
System	11.3	5.8	7.2	1.1	3.8	5.2

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts which are reflected in the table above.

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the fourth quarter of 2018 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q4'17 ⁽¹⁾	Q1'18	Q2'18	Q3'18	Q4'18
Passenger revenues	11.4	11.8	10.4	11.2	11.3
Capacity (ASMs)	9.5	8.6	7.5	6.7	5.8
Traffic (RPMs)	9.9	11.4	8.2	7.5	7.2
Passenger load factor (pp change)	0.3	2.1	0.5	0.6	1.1
Yield	1.4	0.4	2.0	3.4	3.8
PRASM	1.8	3.0	2.7	4.2	5.2

(1) To provide a more meaningful comparison, the year-over-year percentage changes for the fourth quarter 2017 versus the fourth quarter of 2016 are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in fourth quarter system passenger revenues included:

- The 7.2% traffic increase which reflected traffic growth in all markets and included gains in the business and premium economy cabins. Consistent with the airline's objective of increasing global international-to-international connecting traffic through its major Canadian hubs (sixth freedom traffic), the traffic growth in the fourth quarter of 2018 reflected an increase in connecting traffic via Canada to international destinations.
- The 3.8% system yield increase which reflected:
 - increases in fares and carrier surcharges, growth in high-yielding local traffic, and an improvement in the overall fare mix;
 - greater proportional growth of high-yielding business and premium economy class passengers;
 - an increase in ancillary revenues, including through baggage fees, advance seat selection/preferred seating fees and airport paid upgrades;
 - the introduction of an expanded suite of fare offerings on domestic, U.S. transborder and Atlantic services, resulting in growth in ancillary revenue and an improved fare mix; and
 - a favourable currency impact of \$35 million when compared to the fourth quarter of 2017.

These factors were partly offset by an increase in average stage length of 1.2%, due to long-haul international expansion, which had the effect of reducing system yield by 0.7 percentage points.

Domestic Passenger Revenues

In the fourth quarter of 2018, domestic passenger revenues of \$1,216 million increased \$65 million or 5.6% from the fourth quarter of 2017.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the fourth quarter of 2018 and each of the previous four quarters.

Canada	Year-over-Year by Quarter (% Change)				
	Q4'17 ⁽¹⁾	Q1'18	Q2'18	Q3'18	Q4'18
Passenger revenues	5.4	5.9	6.6	4.3	5.6
Capacity (ASMs)	1.4	3.4	3.2	4.3	1.5
Traffic (RPMs)	1.6	3.0	2.6	3.4	1.7
Passenger load factor (pp change)	0.2	(0.3)	(0.5)	(0.7)	0.2
Yield	3.5	2.8	3.9	0.9	3.9
PRASM	3.8	2.5	3.2	-	4.1

(1) To provide a more meaningful comparison, the year-over-year percentage changes for the fourth quarter 2017 versus the fourth quarter of 2016 are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in fourth quarter domestic passenger revenues included:

- The 1.7% traffic increase which reflected traffic growth on all major domestic services as well as incremental connecting traffic within Canada to international destinations. The traffic growth in the fourth quarter of 2018 included gains in the business cabin.
- The 3.9% yield increase which reflected yield improvements on all major domestic services. The overall yield improvement versus the fourth quarter of 2017 reflected gains in the business cabin as well as the impact of new fare categories on domestic services, resulting in growth in ancillary revenue and an improved fare mix.

U.S. Transborder Passenger Revenues

In the fourth quarter of 2018, U.S. transborder passenger revenues of \$846 million increased \$100 million or 13.4% from the fourth quarter of 2017.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the fourth quarter of 2018 and each of the previous four quarters.

U.S. transborder	Year-over-Year by Quarter (% Change)				
	Q4'17 ⁽¹⁾	Q1'18	Q2'18	Q3'18	Q4'18
Passenger revenues	6.3	6.9	8.9	9.7	13.4
Capacity (ASMs)	6.7	5.5	6.8	5.9	9.7
Traffic (RPMs)	7.1	6.7	6.6	5.6	9.6
Passenger load factor (pp change)	0.3	0.9	(0.1)	(0.3)	(0.1)
Yield	(0.7)	0.1	2.2	3.8	3.5
PRASM	(0.3)	1.3	2.0	3.5	3.4

(1) To provide a more meaningful comparison, the year-over-year percentage changes for the fourth quarter 2017 versus the fourth quarter of 2016 are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in fourth quarter U.S. transborder passenger revenues included:

- The 9.6% traffic increase which reflected traffic growth on all major U.S. transborder services. The traffic increase in the fourth quarter of 2018 reflected strong passenger demand between Canada and the U.S., gains in the business cabin, and growth in international-to-international connecting passenger flows from the U.S.
- The 3.5% yield increase which reflected yield growth on all major U.S. transborder services. The launch of new fare categories on U.S. transborder services, resulting in growth in ancillary revenue and an improved fare mix, and a favourable currency impact of \$10 million contributed to the overall yield improvement year-over-year. An increase in average stage length of 1.8%, which had the effect of reducing U.S. transborder yield by 1.0 percentage points, was a partly offsetting factor.

Atlantic Passenger Revenues

In the fourth quarter of 2018, Atlantic passenger revenues of \$899 million increased \$136 million or 18.0% from the fourth quarter of 2017.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the fourth quarter of 2018 and each of the previous four quarters.

Atlantic	Year-over-Year by Quarter (% Change)				
	Q4'17 ⁽¹⁾	Q1'18	Q2'18	Q3'18	Q4'18
Passenger revenues	22.2	23.9	17.8	20.3	18.0
Capacity (ASMs)	13.9	9.6	11.9	10.3	9.5
Traffic (RPMs)	14.4	17.5	15.5	13.1	14.5
Passenger load factor (pp change)	0.3	5.4	2.6	2.2	3.5
Yield	6.8	5.4	1.9	6.4	3.0
PRASM	7.3	13.0	5.3	9.1	7.7

(1) To provide a more meaningful comparison, the year-over-year percentage changes for the fourth quarter 2017 versus the fourth quarter of 2016 are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in fourth quarter Atlantic passenger revenues included:

- The 14.5% traffic increase which reflected traffic growth on all major Atlantic services and included gains in all cabins. The 9.5% capacity growth year-over-year was due to additional frequencies from Vancouver to India, an extension of seasonal mainline operations, including Toronto and Montreal to Italy and Montreal to Israel, and an extension of seasonal services on many markets operated by Air Canada Rouge.
- The 3.0% yield increase which reflected yield improvements on all major Atlantic services and included an increase in carrier surcharges year-over-year and a favourable currency impact of \$12 million. The launch of a new fare category on Atlantic services, resulting in growth in ancillary revenue, including baggage fees, and an improved fare mix, also contributed to the overall yield improvement year-over-year.

Pacific Passenger Revenues

In the fourth quarter of 2018, Pacific passenger revenues of \$550 million increased \$49 million or 9.7% from the fourth quarter of 2017.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the fourth quarter of 2018 and each of the previous four quarters.

Pacific	Year-over-Year by Quarter (% Change)				
	Q4'17 ⁽¹⁾	Q1'18	Q2'18	Q3'18	Q4'18
Passenger revenues	13.5	14.2	9.9	9.9	9.7
Capacity (ASMs)	12.2	12.0	5.2	1.1	(0.8)
Traffic (RPMs)	13.7	15.9	5.7	2.9	0.3
Passenger load factor (pp change)	1.0	2.8	0.4	1.5	0.9
Yield	(0.2)	(1.5)	4.0	6.8	9.3
PRASM	1.1	1.9	4.5	8.6	10.6

(1) To provide a more meaningful comparison, the year-over-year percentage changes for the fourth quarter 2017 versus the fourth quarter of 2016 are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in fourth quarter Pacific passenger revenues included:

- The 9.3% yield increase which reflected yield growth on all major Pacific services with the exception of Australia which was slightly below the fourth quarter of 2017. The lower yield on services to Australia reflected increased industry capacity when compared to the same quarter in 2017. The overall Pacific yield improvement versus the fourth quarter of 2017 included an increase in carrier surcharges year-over-year and a favourable currency impact of \$6 million.
- The 0.3% traffic increase which reflected traffic growth on services to Australia, Korea and China, offset by traffic decreases on services to Hong Kong, Japan and Taiwan where capacity was reduced year-over-year. The traffic growth included gains in the business and premium economy cabins.

Other Passenger Revenues

In the fourth quarter of 2018, Other passenger revenues (from routes to and from the Caribbean, Mexico and Central and South America) of \$284 million increased \$36 million or 14.5% from the fourth quarter of 2017.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the fourth quarter of 2018 and each of the previous four quarters.

Other	Year-over-Year by Quarter (% Change)				
	Q4'17 ⁽¹⁾	Q1'18	Q2'18	Q3'18	Q4'18
Passenger revenues	23.7	17.7	7.6	7.9	14.5
Capacity (ASMs)	18.7	15.0	11.7	16.8	15.2
Traffic (RPMs)	17.9	15.6	8.6	11.1	14.0
Passenger load factor (pp change)	(0.6)	0.4	(2.4)	(4.3)	(0.9)
Yield	4.8	1.9	(0.9)	(2.8)	0.5
PRASM	4.1	2.4	(3.7)	(7.6)	(0.6)

(1) To provide a more meaningful comparison, the year-over-year percentage changes for the fourth quarter 2017 versus the fourth quarter of 2016 are based on previously reported 2016 and 2017 amounts as 2016 amounts have not been restated for the adoption of IFRS 15.

Components of the year-over-year change in fourth quarter Other passenger revenues included:

- The 14.0% traffic increase which reflected traffic growth on services to South America and on routes to traditional sun destinations. The traffic growth in the fourth quarter of 2018 included gains in all cabins.
- The 0.5% yield increase which reflected yield growth on services to the Caribbean and Mexico, largely offset by a yield decrease on services to South America. The yield decline on services to South America was mainly due a significant increase in average stage length due to the removal of the short-haul tag between Santiago and Buenos Aires as Air Canada now serves both markets on a non-stop basis. An increase in average stage length of 6.1% had the effect of reducing yield in the Other markets by 3.4 percentage points. On a stage length adjusted basis, yield increased 3.9% when compared to the fourth quarter of 2017.

Cargo Revenues

In the fourth quarter of 2018, cargo revenues of \$217 million increased \$19 million or 10.0% from the same quarter in 2017 on yield and traffic growth of 6.8% and 2.9%, respectively. In the fourth quarter of 2018, the Atlantic and Pacific markets experienced particularly strong performances.

The table below provides cargo revenue by geographic region for the fourth quarter of 2018 and the fourth quarter of 2017.

Cargo Revenue (Canadian dollars in millions)	Fourth Quarter		Change	
	2018	2017 ⁽¹⁾	\$	%
Canada	\$ 27	\$ 23	\$ 4	21.3
U.S. transborder	12	10	2	23.2
Atlantic	72	66	6	8.5
Pacific	88	81	7	9.2
Other	18	18	-	(2.5)
System	\$ 217	\$ 198	\$ 19	10.0

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

Other Revenues

In the fourth quarter of 2018, other revenues of \$234 million increased \$21 million or 10% when compared to the fourth quarter of 2017, mainly due to an increase in ground package revenue at Air Canada Vacations. This increase was driven by higher passenger volumes and, to a lesser extent, a higher price of ground packages when compared to the fourth quarter of 2017. An increase in passenger and airline-related fees versus the fourth quarter of 2017 was also a contributing factor to the increase in other revenue.

CASM and Adjusted CASM

In the fourth quarter of 2018, CASM increased 5.7% and adjusted CASM increased 0.5% when compared to the fourth quarter of 2017.

The table below compares Air Canada's CASM and adjusted CASM for the fourth quarter of 2018 to the fourth quarter of 2017.

(cents per ASM)	Fourth Quarter		Change	
	2018	2017 ⁽¹⁾	cents	%
Aircraft fuel	¢ 3.74	¢ 3.04	¢ 0.70	23.1
Regional airlines expense			-	
Aircraft fuel	0.52	0.46	0.06	12.0
Other	2.25	2.33	(0.08)	(3.3)
Wages and salaries	2.18	2.26	(0.08)	(3.4)
Benefits	0.63	0.53	0.10	18.4
Airport and navigation fees	0.88	0.83	0.05	5.5
Aircraft maintenance	0.98	1.01	(0.03)	(3.1)
Depreciation, amortization and impairment	1.04	1.01	0.03	2.8
Sales and distribution costs	0.71	0.70	0.01	1.3
Ground package costs	0.49	0.44	0.05	11.6
Aircraft rent	0.52	0.52	-	0.4
Catering and onboard services	0.41	0.37	0.04	11.0
Communications and information technology	0.27	0.26	0.01	4.4
Other	1.49	1.48	0.01	0.8
CASM	¢ 16.11	¢ 15.24	¢ 0.87	5.7
Remove:				
Aircraft fuel expense ⁽²⁾ , ground package costs at Air Canada Vacations and special items	(4.75)	(3.94)	(0.81)	20.5
Adjusted CASM ⁽³⁾	¢ 11.36	¢ 11.30	¢ 0.06	0.5

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

(2) Includes aircraft fuel expense related to regional airline operations.

(3) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating Expenses

In the fourth quarter of 2018, operating expenses of \$4,124 million increased \$437 million or 12% from the fourth quarter of 2017 on capacity growth of 5.8%.

In the fourth quarter of 2018, the unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), compared to the same quarter in 2017, increased operating expenses by \$64 million (comprised of \$37 million related to aircraft fuel expense and an aggregate of \$27 million relating to non-fuel operating expenses).

The more notable components of the year-over-year change in operating expenses are described below.

Aircraft Fuel Expense

In the fourth quarter of 2018, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to \$1,091 million, an increase of \$244 million or 29% from the fourth quarter of 2017. This increase reflected:

- higher jet fuel prices (before the impact of foreign exchange), which accounted for an increase of \$151 million;
- an unfavourable currency impact of \$37 million;
- a higher volume of fuel litres consumed, which accounted for an increase of \$27 million; and
- fuel hedging losses/expenses of \$26 million in the fourth quarter of 2018 versus fuel hedging gains (net of expenses) of \$3 million in the fourth quarter of 2017, an increase of \$29 million.

Regional Airlines Expense

In the fourth quarter of 2018, regional airlines expense of \$708 million increased \$33 million or 5% when compared to the fourth quarter of 2017, reflecting, in large part, higher aircraft fuel expense year-over-year, as well as a growth in capacity purchase fees due to higher CPA rates year-over-year.

The table below provides a breakdown of regional airlines expense for the fourth quarter of 2018 and the fourth quarter of 2017.

(Canadian dollars in millions)	Fourth Quarter		Change	
	2018	2017	\$	%
Capacity purchase fees	\$ 336	\$ 330	\$ 6	2
Aircraft fuel	133	112	21	19
Airport and navigation fees	73	71	2	3
Sales and distribution costs	34	35	(1)	(3)
Depreciation, amortization and impairment	11	7	4	57
Aircraft rent	10	10	-	-
Other	111	110	1	1
Total regional airlines expense	\$ 708	\$ 675	\$ 33	5

Wages, Salaries and Benefits Expense

In the fourth quarter of 2018, wages and salaries expense of \$557 million increased \$11 million or 2% from the same quarter in 2017, largely due to a higher number of FTE employees mainly in support of the airline's capacity growth and international expansion strategy.

In the fourth quarter of 2018, employee benefits expense of \$162 million increased \$34 million or 27% from the fourth quarter of 2017, mainly due to the higher level of FTE employees and the impact of lower discount rates which increased the current service cost of defined benefit pension plans. In addition, the fourth quarter of 2017 reflected a favourable impact of \$9 million related to an annual valuation pertaining to workers' compensation versus an unfavourable impact of \$4 million in the fourth quarter of 2018.

Airport and Navigation Fees

In the fourth quarter of 2018, airport and navigation fees of \$225 million increased \$24 million or 12% from the fourth quarter of 2017, largely due to growth in wide-body and international flying. In addition, in the fourth quarter of 2017, Air Canada received a \$15 million one-time refund from Nav Canada while no such refund was received in the fourth quarter of 2018. The favourable impact of Air Canada's agreement with the Greater Toronto Airports Authority, which is allowing the airline to increase international connecting traffic at Toronto Pearson International Airport on a more cost-effective basis, was an offsetting factor.

Aircraft Maintenance Expense

In the fourth quarter of 2018, aircraft maintenance expense of \$250 million increased \$7 million or 3% from the fourth quarter of 2017.

The table below provides a breakdown of the more significant items included in maintenance expense for the fourth quarter of 2018 and the fourth quarter of 2017.

(Canadian dollars in millions)	Fourth Quarter		Change	
	2018	2017	\$	%
Technical maintenance	\$ 222	\$ 206	\$ 16	8
Maintenance provisions ⁽¹⁾	17	31	(14)	(45)
Other	11	6	5	83
Total aircraft maintenance expense	\$ 250	\$ 243	\$ 7	3

(1) Maintenance provisions relate to return conditions on aircraft leases which are recorded over the term of the lease.

Depreciation, Amortization and Impairment Expense

In the fourth quarter of 2018, depreciation, amortization and impairment expense of \$267 increased \$22 million or 9% from the fourth quarter of 2017, largely due to the addition of Boeing 787 and 737 MAX aircraft into the mainline fleet. The sale of 25 Embraer 190 aircraft (which Air Canada leased back) in August 2018 was an offsetting factor.

Sales and Distribution Costs

In the fourth quarter of 2018, sales and distribution costs of \$182 million increased \$13 million or 8% from the same quarter in 2017, reflecting, in large part, the growth in passenger revenue. The favourable impact of new commission programs introduced in North America in April 2018 and growth in direct bookings when compared to the fourth quarter of 2017 were offsetting factors.

Ground Package Costs

In the fourth quarter of 2018, the cost of ground packages at Air Canada Vacations of \$126 million increased \$20 million or 19% when compared to the same quarter in 2017 due to a higher cost of ground packages (before the impact of foreign exchange) reflecting, in large part, a change in product mix, and higher passenger volumes year-over-year.

Aircraft Rent

In the fourth quarter of 2018, aircraft rent expense of \$133 million increased \$7 million or 6% from fourth quarter of 2017, reflecting, in large part, the impact of a greater number of leased aircraft, including 25 Embraer 190 aircraft which Air Canada sold and leased back in August 2018, and an unfavourable currency impact when compared to the fourth quarter of 2017. The impact of lower rates on certain lease renewals was an offsetting factor.

Other Expenses

In the fourth quarter of 2018, other expenses of \$383 million increased \$21 million or 6% from the same quarter in 2017, reflecting, in large part, the capacity growth and Air Canada's international expansion strategy.

The table below provides a breakdown of the more significant items included in other expenses for the fourth quarter of 2018 and the fourth quarter of 2017.

(Canadian dollars in millions)	Fourth Quarter		Change	
	2018	2017	\$	%
Terminal handling	\$ 77	\$ 69	\$ 8	12
Crew cycle	52	51	1	2
Building rent and maintenance	47	41	6	15
Miscellaneous fees and services	50	45	5	11
Remaining other expenses	157	156	1	1
Total other expense	\$ 383	\$ 362	\$ 21	6

Non-operating Income (Expense)

In the fourth quarter of 2018, non-operating expense amounted to \$338 million versus non-operating expense of \$113 million in the fourth quarter of 2017.

Components of the year-over-year change in non-operating expense included:

- In the fourth quarter of 2018, losses on foreign exchange amounted to \$269 million compared to losses on foreign exchange of \$62 million in the fourth quarter of 2017. The December 31, 2018 closing exchange rate was US\$1=C\$1.3637 while the September 30, 2018 closing exchange rate was US\$1=C\$1.2908. Foreign exchange losses on long-term debt of \$333 million were partly offset by foreign exchange gains on foreign currency derivatives of \$75 million.
- In the fourth quarter of 2017, Air Canada recorded a gain of \$27 million on debt modifications related to the repricing of the airline's US\$1.2 billion senior secured credit facility. No such gains were recorded in the fourth quarter of 2018.

8. FLEET

Mainline and Air Canada Rouge

The following table provides Air Canada's and Air Canada Rouge's operating fleet as at December 31, 2018. Refer to the Air Canada Express section below for information on the fleet of aircraft operated by regional airlines operating flights on behalf of Air Canada under capacity purchase agreements with Air Canada.

Mainline	Total Seats	Number of Operating Aircraft	Average Age	Owned	Finance Lease	Operating Lease
<u>Wide-body aircraft</u>						
Boeing 787-8	255	8	4.2	8	-	-
Boeing 787-9	298	27	2.1	21	-	6
Boeing 777-300ER	450/400	19	8.5	10	1	8
Boeing 777-200LR	300	6	11.1	4	-	2
Boeing 767-300ER	211	6	29.5	3	-	3
Airbus A330-300	292	8	18.2	8	-	-
<u>Narrow-body aircraft</u>						
Boeing 737 MAX 8	169	18	0.8	18	-	-
Airbus A321	190	15	15.7	5	-	10
Airbus A320	146	42	25.2	1	-	41
Airbus A319	120	16	21.2	5	-	11
Embraer 190	97	19	11.3	-	-	19
Total Mainline		184	13.6	83	1	100
Air Canada Rouge						
<u>Wide-body aircraft</u>						
Boeing 767-300ER ⁽¹⁾	282	25	21.6	3	2	20
<u>Narrow-body aircraft</u>						
Airbus A321	200	6	3.7	-	-	6
Airbus A319 ⁽¹⁾	136	22	20.2	17	-	5
Total Air Canada Rouge		53	19.0	20	2	31
Total Mainline and Air Canada Rouge		237	14.8	103	3	131

(1) The Boeing 767 aircraft and the Airbus A319 aircraft reflected as owned in the table above are owned by Air Canada and leased to Air Canada Rouge.

The table below provides the number of aircraft in Air Canada's operating fleet as at December 31, 2018 as well as Air Canada's planned operating fleet, including aircraft operating and expected to be operated by Air Canada Rouge, as at December 31, 2019 and December 31, 2020.

	Actual		Planned		
	December 31, 2018	2019 Fleet Changes	December 31, 2019	2020 Fleet Changes	December 31, 2020
Mainline					
<u>Wide-body aircraft</u>					
Boeing 787-8	8	-	8	-	8
Boeing 787-9	27	2	29	-	29
Boeing 777-300ER	19	-	19	-	19
Boeing 777-200LR	6	-	6	-	6
Boeing 767-300ER	6	(6)	-	-	-
Airbus A330-300	8	4	12	1	13
<u>Narrow-body aircraft</u>					
Boeing 737 MAX 8	18	18	36	14	50
Airbus A321	15	-	15	-	15
Airbus A320	42	(13)	29	(13)	16
Airbus A319	16	-	16	-	16
Airbus A220-300	-	1	1	14	15
Embraer 190	19	(5)	14	(14)	-
Total Mainline	184	1	185	2	187
Air Canada Rouge					
<u>Wide-body aircraft</u>					
Boeing 767-300ER	25	-	25	-	25
<u>Narrow-body aircraft</u>					
Airbus A321	6	4	10	-	10
Airbus A320	-	6	6	1	7
Airbus A319	22	-	22	-	22
Total Air Canada Rouge	53	10	63	1	64
Total wide-body aircraft	99	-	99	1	100
Total narrow-body aircraft	138	11	149	2	151
Total Mainline and Air Canada Rouge	237	11	248	3	251

Sale of Embraer 190 Aircraft

In August 2018, Air Canada finalized the sale and leaseback of 25 Embraer 190 aircraft. Six of these aircraft were returned to the lessor in 2018. Air Canada will continue to operate the remaining 19 until they gradually exit the fleet in 2019 and 2020.

Air Canada Express

The table below provides the number of aircraft operated, as at December 31, 2018, and planned, as at December 31, 2019 and December 31, 2020, on behalf of Air Canada, by Jazz, Sky Regional and other airlines operating flights under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada.

	Actual		Planned		
	December 31, 2018	2019 Fleet Changes	December 31, 2019	2020 Fleet Changes	December 31, 2020
Embraer 175	25	-	25	-	25
Bombardier CRJ-100/200	24	(2)	22	(7)	15
Bombardier CRJ-900	21	5	26	9	35
Bombardier Dash 8-100	15	(15)	-	-	-
Bombardier Dash 8-300	25	(2)	23	(4)	19
Bombardier Dash 8-Q400	44	-	44	(8)	36
Total Air Canada Express	154	(14)	140	(10)	130

Other Aircraft with CPA Carriers

A total of nine 18-passenger Beech 1900 aircraft are also operated by CPA carriers on behalf of Air Canada.

9. FINANCIAL AND CAPITAL MANAGEMENT

9.1. Liquidity

Air Canada manages its liquidity needs through a variety of strategies, including by seeking to sustain and improve cash from operations and free cash flow, sourcing committed financing, as necessary, for new and existing aircraft, and through other financing activities.

Liquidity needs are primarily related to meeting obligations associated with financial liabilities, capital commitments, ongoing operations, contractual and other obligations, which are further discussed in sections 9.6, 9.7 and 9.8 of this MD&A. Air Canada monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available for use as well as those assets being used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. At December 31, 2018, unrestricted liquidity amounted to \$5,725 million (comprised of cash, cash equivalents and short-term investments of \$4,707 million and undrawn lines of credit of \$1,018 million). This compared to unrestricted liquidity of \$4,181 million at December 31, 2017 (comprised of cash, cash equivalents and short-term investments of \$3,804 million and undrawn lines of credit of \$377 million). In addition, Air Canada monitors its financial leverage as measured by the adjusted net debt to EBITDAR ratio, as further described in section 9.3 of this MD&A.

9.2. Financial Position

The following table provides a condensed consolidated statement of financial position of Air Canada as at December 31, 2018 and as at December 31, 2017.

(Canadian dollars in millions)	December 31, 2018	December 31, 2017 ⁽¹⁾	\$ Change
Assets			
Cash, cash equivalents and short-term investments	\$ 4,707	\$ 3,804	\$ 903
Other current assets	1,594	1,593	1
Current assets	\$ 6,301	\$ 5,397	\$ 904
Deposits and other assets	444	465	(21)
Property and equipment	9,729	9,252	477
Pension assets	1,969	1,583	386
Deferred income tax	39	456	(417)
Intangible assets	404	318	86
Goodwill	311	311	-
Total assets	\$ 19,197	\$ 17,782	\$ 1,415
Liabilities			
Current liabilities	\$ 5,099	\$ 5,101	\$ (2)
Long-term debt and finance leases	6,197	5,448	749
Pension and other benefit liabilities	2,547	2,592	(45)
Maintenance provisions	1,118	1,003	115
Other long-term liabilities	151	167	(16)
Deferred income tax	52	49	3
Total liabilities	\$ 15,164	\$ 14,360	\$ 804
Total shareholders' equity	\$ 4,033	\$ 3,422	\$ 611
Total liabilities and shareholders' equity	\$ 19,197	\$ 17,782	\$ 1,415

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

Movements in current assets and current liabilities are described in section 9.4 "Working Capital" of this MD&A. Long-term debt and finance leases are discussed in sections 9.3 "Adjusted Net Debt" and 9 "Consolidated Cash Flow Movements" of this MD&A.

At December 31, 2018, property and equipment amounted to \$9,729 million, an increase of \$477 million from December 31, 2017. This increase was mainly due to additions to property and equipment of \$2,039 million, offset by the impact of depreciation expense of \$1,066 million and the impact of the sale of 25 Embraer 190 aircraft in 2018.

In 2018, additions to property and equipment included five Boeing 787-9 aircraft and 16 Boeing 737 MAX 8 aircraft. Four Boeing 787 and nine Boeing 737 MAX aircraft were financed with proceeds from the sale of enhanced equipment trust certificates (EETCs) issued through a U.S. dollar private offering in 2017, one Boeing 787 and four Boeing 737 MAX aircraft were financed with proceeds from the sale of EETCs issued through a Canadian dollar private offering in 2018, and three Boeing 737 MAX aircraft were purchased with cash. Additional information on these EETC private offerings can be found in section 9.8 "Contractual Obligations" of this MD&A. In 2018, additions to property and equipment also included progress payments on future aircraft deliveries and capitalized maintenance costs.

The net long-term pension and other benefit liabilities of \$578 million (comprised of pension and other benefit liabilities of \$2,547 million net of pension assets of \$1,969 million) decreased \$431 million from December 31, 2017. This decrease was mainly due to a 21-basis point increase in the discount rate used to value the liabilities and the impact of revised demographic assumptions, resulting in a net gain on remeasurements on employee liabilities of \$688 million for the year ended December 31, 2018 (\$503 million, net of tax) recorded on Air Canada's consolidated statement of comprehensive income. The revised demographic assumptions relate mainly to updated actuarial assumptions regarding retirement rates, which resulted in a decrease to the actuarial liability of \$277 million.

9.3. Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at December 31, 2018 and as at December 31, 2017.

(Canadian dollars in millions, except where indicated)	December 31, 2018	December 31, 2017	\$ Change
Total long-term debt and finance leases	\$ 6,197	\$ 5,448	\$ 749
Current portion of long-term debt and finance leases	455	671	(216)
Total long-term debt and finance leases (including current portion)	\$ 6,652	\$ 6,119	\$ 533
Less cash, cash equivalents and short-term investments	(4,707)	(3,804)	(903)
Net debt	\$ 1,945	\$ 2,315	\$ (370)
Capitalized operating leases ⁽¹⁾	3,913	3,801	112
Adjusted net debt ⁽¹⁾	\$ 5,858	\$ 6,116	\$ (258)
EBITDAR (trailing 12 months)	\$ 2,851	\$ 2,928	\$ (77)
Adjusted net debt to EBITDAR ratio ⁽²⁾	2.1	2.1	-

(1) Adjusted net debt is an additional GAAP financial measure and a key component of the capital managed by Air Canada and provides management with a measure of its net indebtedness. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7. This definition of capitalized operating leases is used by Air Canada and may not be comparable to similar measures presented by other public companies. Aircraft rent (including aircraft rent expense related to regional airline operations) was \$559 million for the 12 months ended December 31, 2018 and \$543 million for the 12 months ended December 31, 2017.

(2) Adjusted net debt to trailing 12-month EBITDAR ratio (also referred to as "leverage ratio" in this MD&A) is a non-GAAP financial measure and is used by Air Canada as a means to measure financial leverage. Leverage ratio is calculated by dividing adjusted net debt by trailing 12-month EBITDAR. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

At December 31, 2018, total long-term debt and finance leases (including current portion) of \$6,652 million increased \$533 million from December 31, 2017. The unfavourable impact of a weaker Canadian dollar, as at December 31, 2018 compared to December 31, 2017, increased foreign currency denominated debt (mainly U.S. dollars) by \$501 million. In 2018, new aircraft-related borrowings of \$1,210 million were largely offset by debt repayments of \$1,167 million.

At December 31, 2018, adjusted net debt of \$5,858 million decreased \$258 million from December 31, 2017 as increases in long-term debt and finance lease balances of \$533 million and capitalized operating lease balances of \$112 million were more than offset by an increase in cash, cash equivalents and short-term investment balances of \$903 million. At December 31, 2018, Air Canada's leverage ratio (adjusted net debt to trailing 12-month EBITDAR ratio) was 2.1, unchanged from December 31, 2017.

At December 31, 2018, Air Canada's weighted average cost of capital ("WACC"), on a pre-tax basis, was 7.2% (compared to 7.6% at December 31, 2017). WACC is based on an estimate by management and consists of an estimated cost of equity of 20.0% and an average cost of debt and finance leases of 4.4% (compared to an estimated cost of equity of 20.0% and an average cost of debt and finance leases of 4.5% at December 31, 2017).

9.4. Working Capital

The table below provides information on Air Canada's working capital balances as at December 31, 2018 and as at December 31, 2017.

(Canadian dollars in millions)	December 31, 2018	December 31, 2017 ⁽¹⁾	\$ Change
Cash, cash equivalents and short-term investments	\$ 4,707	\$ 3,804	\$ 903
Accounts receivable	796	814	(18)
Other current assets	798	779	19
Total current assets	\$ 6,301	\$ 5,397	\$ 904
Accounts payable and accrued liabilities	1,927	1,961	(34)
Advance ticket sales	2,717	2,469	248
Current portion of long-term debt and finance leases	455	671	(216)
Total current liabilities	\$ 5,099	\$ 5,101	\$ (2)
Net working capital	\$ 1,202	\$ 296	\$ 906

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

The net working capital of \$1,202 million at December 31, 2018 represented an improvement of \$906 million from December 31, 2017.

The net cash flow benefit of positive operating results in 2018 more than offset the impact of net capital expenditures. Net cash outflow relating to capital expenditures was \$838 million (after deducting proceeds drawn on the delivery of five Boeing 787 and 13 Boeing 737 MAX aircraft of \$1,210 million, and proceeds on the sale of 25 Embraer 190 aircraft of \$293 million less the repayment of the associated debt of \$144 million). In 2018, Air Canada also made an additional debt repayment of \$268 million in conjunction with the amendment of the 2016 Credit Facility (refer to section 9.3 "Adjusted Net Debt" of this MD&A for additional information) and purchased three Boeing 737 MAX aircraft using cash.

9.5. Consolidated Cash Flow Movements

The table below provides the cash flow movements for Air Canada for the periods indicated.

(Canadian dollars in millions)	Fourth Quarter			Full Year		
	2018	2017	\$ Change	2018	2017	\$ Change
Net cash flows from operating activities	\$ 360	\$ 389	\$ (29)	\$ 2,695	\$ 2,738	\$ (43)
Proceeds from borrowings	-	-	-	1,210	733	477
Reduction of long-term debt and finance lease obligations	(361)	(240)	(121)	(1,170)	(814)	(356)
Shares purchased for cancellation	(50)	(35)	(15)	(73)	(71)	(2)
Issue of shares	-	2	(2)	5	9	(4)
Financing fees	(4)	(11)	7	(12)	(26)	14
Net cash flows used in financing activities	\$ (415)	\$ (284)	\$ (131)	\$ (40)	\$ (169)	\$ 129
Short-term investments	36	(167)	203	(848)	(998)	150
Additions to property, equipment and intangible assets	(219)	(432)	213	(2,197)	(2,422)	225
Proceeds from sale of assets	1	2	(1)	11	5	6
Proceeds from sale-leaseback of assets	-	-	-	293	740	(447)
Other	(1)	(24)	23	47	(16)	63
Net cash flows used in investing activities	\$ (183)	\$ (621)	\$ 438	\$ (2,694)	\$ (2,691)	\$ (3)
Effect of exchange rate changes on cash and cash equivalents	\$ 16	\$ 12	\$ 4	\$ 27	\$ (23)	\$ 50
Increase (decrease) in cash and cash equivalents	\$ (222)	\$ (504)	\$ 282	\$ (12)	\$ (145)	\$ 133

The following table provides the calculation of free cash flow for Air Canada for the periods indicated.

(Canadian dollars in millions)	Fourth Quarter			Full Year		
	2018	2017	\$ Change	2018	2017	\$ Change
Net cash flows from operating activities	\$ 360	\$ 389	\$ (29)	\$ 2,695	\$ 2,738	\$ (43)
Additions to property, equipment and intangible assets, net of proceeds from sale and leaseback transactions	(219)	(432)	213	(1,904)	(1,682)	(222)
Free cash flow ⁽¹⁾	\$ 141	\$ (43)	\$ 184	\$ 791	\$ 1,056	\$ (265)

(1) Free cash flow is a non-GAAP financial measure used by Air Canada as an indicator of the financial strength and performance of its business, indicating how much cash it is able to generate from operations and after capital expenditures. Free cash flow is calculated as net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale and leaseback transactions. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Free Cash Flow

In the fourth quarter of 2018, net cash flows from operating activities of \$360 million decreased \$29 million when compared to the same quarter in 2017. The cash flow benefit of an improvement in operating income quarter over quarter was more than offset by a decrease in cash from working capital. Free cash flow of \$141 million increased \$184 million from the fourth quarter of 2017 due to a lower level of capital expenditures.

In 2018, net cash flows from operating activities of \$2,695 million decreased \$43 million when compared to 2017. In 2018, free cash flow of \$791 million decreased \$265 million from 2017. In 2018, Air Canada received proceeds of \$293 million from the sale and leaseback of 25 Embraer 190 aircraft. In 2017, Air Canada received proceeds of \$740 million from the sale and leaseback of four Boeing 787 aircraft.

Net Cash Flows from (used in) Financing Activities

Reduction of long-term debt and finance lease obligations amounted to \$361 million in the fourth quarter of 2018 and \$1,170 million for the full year 2018 while proceeds from borrowings were nil in the fourth quarter of 2018 and totaled \$1,210 million in 2018.

Refer to sections 9.4 "Working Capital", 9.2 "Financial Position" and 9.3 "Adjusted Net Debt" of this MD&A for additional information.

9.6. Capital Expenditures and Related Financing Arrangements

Boeing 787 Aircraft

As of the date of this MD&A, Air Canada has outstanding purchase commitments with The Boeing Company ("Boeing") for two Boeing 787 aircraft to be delivered in 2019. Air Canada also has purchase options for 13 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing and delivery positions), and purchase rights for 10 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on Boeing's then current pricing and available delivery positions).

Boeing 737 MAX Aircraft

Air Canada has an agreement with Boeing for the purchase of Boeing 737 MAX aircraft which provides for:

- Firm orders for 61 737 MAX aircraft, consisting of 50 737 MAX 8 and 11 737 MAX 9 aircraft with substitution rights between them as well as for the 737 MAX 7 aircraft.
- Purchase options for 18 Boeing 737 MAX aircraft.
- Certain rights to purchase an additional 30 Boeing 737 MAX aircraft.

As of the date of this MD&A, 18 Boeing 737 MAX 8 aircraft have been delivered, with the remaining 43 Boeing 737 MAX aircraft scheduled for delivery from 2019 to 2024.

In April 2018, Air Canada concluded an amendment to its Boeing 737 purchase agreement, pursuant to which certain aircraft delivery positions were accelerated and others deferred. The amendment accelerates the delivery of five 737 MAX aircraft by one year, to 2020, and defers the delivery of 11 737 MAX aircraft by up to 36 months.

Subject to certain conditions, Air Canada also has financing commitments covering 25 firm Boeing 737 MAX aircraft scheduled for delivery in 2020, 2023 and 2024. The financing terms are for 80% of the aircraft delivery price and the term to maturity is 10 years with mortgage-style repayments.

Airbus A220-300 Aircraft

In June 2016, Air Canada and Bombardier Inc. ("Bombardier") finalized a purchase agreement which includes a firm order for 45 Airbus A220-300 aircraft (formerly called Bombardier C-Series CS300 aircraft) and options for an additional 30 Airbus A220-300 aircraft. Deliveries are scheduled to begin in late 2019 and extend to 2022. The first 25 aircraft on delivery are expected to replace Air Canada's existing mainline fleet of Embraer 190 aircraft, with incremental aircraft supporting Air Canada's hub and network growth.

Reconfiguration of Airbus A330 Aircraft

In order to provide customers with a product that is consistent across its wide-body fleet, Air Canada plans on reconfiguring 12 Airbus A330 aircraft (eight of which are currently in service and four scheduled to be added in 2019) to the new Boeing 787 state-of-the-art standard. The reconfiguration of the Airbus A330 aircraft is expected to begin in late 2019 for completion in the first half of 2020. The capital expenditure related to this refurbishment program (which is included in the projected committed expenditures in the table below) is approximately \$275 million.

Capital Commitments

As outlined in the table below, the estimated aggregate cost of the future firm Boeing 787, Boeing 737 MAX and Airbus A220-300 aircraft deliveries and other capital purchase commitments as at December 31, 2018 approximates \$6,076 million. The table below also includes the impact of the amendment to the Boeing 737 purchase agreement discussed above.

(Canadian dollars in millions)	2019	2020	2021	2022	2023	Thereafter	Total
Projected committed expenditures	\$ 2,382	\$ 1,556	\$ 815	\$ 753	\$ 375	\$ 195	\$ 6,076
Projected planned but uncommitted expenditures	324	441	440	228	186	Not available	Not available
Projected planned but uncommitted capitalized maintenance ⁽¹⁾	212	183	166	Not available	Not available	Not available	Not available
Total projected expenditures ⁽²⁾	\$ 2,918	\$ 2,180	\$ 1,421	\$ 981	\$ 561	Not available	Not available

(1) Future capitalized maintenance amounts for 2022 and 2023 and beyond are not yet determinable.

(2) U.S. dollar amounts are converted using the December 31, 2018 closing exchange rate of US\$1=C\$1.3637. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day U.S. LIBOR rate at December 31, 2018.

9.7. Pension Funding Obligations

Air Canada maintains several defined benefit pension plans, including domestic registered pension plans, supplemental pension plans and international pension plans. Air Canada also has several defined contribution pension plans as well as plans providing other retirement and post-employment benefits to its employees.

As at January 1, 2018, the aggregate solvency surplus in the domestic registered pension plans was \$2.6 billion. Based on preliminary estimates, including actuarial assumptions, as at January 1, 2019, the aggregate solvency surplus in Air Canada's domestic registered pension plans is projected to be \$2.4 billion. The final valuations to be made as at January 1, 2019 will be completed in the first half of 2019. Based on preliminary estimates, Air Canada does not expect to make any past service payments in 2019.

As permitted by applicable legislation and subject to applicable plan rules, amounts in excess of 105% on a solvency basis may be used to reduce current service contributions under the defined benefit component or to fund the employer contribution to a defined contribution component within the same pension plan.

On a cash basis, total employer pension funding contributions (including the international and supplemental plans) amounted to \$94 million in 2018, as described in the table below.

(Canadian dollars in millions)	2018
Current service domestic registered plans	\$ 1
Other pension arrangements ⁽¹⁾	93
Total employer pension funding contributions	\$ 94

(1) Includes retirement compensation arrangements, supplemental plans and international plans.

On a cash basis, total pension funding contributions (including the international and supplemental plans) are forecasted to be \$93 million in 2019, as described in the table below.

(Canadian dollars in millions)	2019
Current service domestic registered plans	\$ 2
Other pension arrangements ⁽¹⁾	91
Total projected employer pension funding contributions	\$ 93

(1) Includes retirement compensation arrangements, supplemental plans and international plans.

As at December 31, 2018, taking into account the effect of financial instrument risk management tools, approximately 81% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk. Air Canada may continue to increase the percentage of fixed income products matched to pension liabilities, subject to favourable market conditions.

9.8. Contractual Obligations

The table below provides Air Canada's contractual obligations as at December 31, 2018, including those relating to interest and principal repayment obligations on Air Canada's long-term debt and finance lease obligations, operating lease obligations and committed capital expenditures.

(Canadian dollars in millions)	2019	2020	2021	2022	2023	Thereafter	Total
<i>Principal</i>							
Long-term debt obligations	\$ 407	\$ 640	\$ 1,003	\$ 342	\$ 1,450	\$ 2,731	\$ 6,573
Finance lease obligations	48	50	17	15	16	41	187
Total principal obligations	\$ 455	\$ 690	\$ 1,020	\$ 357	\$ 1,466	\$ 2,772	\$ 6,760
<i>Interest</i>							
Long-term debt obligations	273	258	214	176	151	346	1,418
Finance lease obligations	14	10	6	5	4	10	49
Total interest obligations	\$ 287	\$ 268	\$ 220	\$ 181	\$ 155	\$ 356	\$ 1,467
Total long-term debt and finance lease obligations	\$ 742	\$ 958	\$ 1,240	\$ 538	\$ 1,621	\$ 3,128	\$ 8,227
Operating lease obligations	\$ 679	\$ 527	\$ 383	\$ 294	\$ 230	\$ 868	\$ 2,981
Committed capital expenditures	\$ 2,382	\$ 1,556	\$ 815	\$ 753	\$ 375	\$ 195	\$ 6,076
Total contractual obligations ⁽¹⁾	\$ 3,803	\$ 3,041	\$ 2,438	\$ 1,585	\$ 2,226	\$ 4,191	\$17,284

(1) Total contractual obligations exclude commitments for goods and services required in the ordinary course of business. Also excluded are long-term liabilities other than long-term debt and finance lease obligations due to reasons of uncertainty of timing of cash flows and items that are non-cash in nature.

Covenants in Credit Card Agreements

Air Canada's principal credit card processing agreements for credit card processing services contain triggering events upon which Air Canada is required to provide the applicable credit card processor with cash deposits. The obligations to provide cash deposits and the required amount of deposits are each based upon a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for Air Canada and the unrestricted cash, cash equivalents and short-term investments of Air Canada. In 2018, Air Canada made no cash deposits under these agreements (nil in 2017).

9.9. Share Information

The issued and outstanding shares of Air Canada, along with shares potentially issuable, as of the dates indicated below, are as follows:

	December 31, 2018	December 31, 2017
Issued and outstanding shares		
Variable voting shares	125,214,350	115,986,084
Voting shares	145,515,561	157,090,562
Total issued and outstanding shares	270,729,911	273,076,646
Class A variable voting and Class B voting shares potentially issuable		
Stock options	6,014,464	6,121,252
Total shares potentially issuable	6,014,464	6,121,252
Total outstanding and potentially issuable shares	276,744,375	279,197,898

Issuer Bid

In May 2018, Air Canada received approval from the Toronto Stock Exchange for the renewal of its normal course issuer bid for its Class A variable voting shares and Class B voting shares (collectively the "shares"), authorizing, between May 31, 2018 and May 30, 2019, the purchase of up to 24,040,243 shares, representing 10% of Air Canada's public float as at May 17, 2018. In 2018, Air Canada purchased, for cancellation 3,013,822 shares at an average cost of \$24.11 per share for aggregate consideration of \$73 million. At December 31, 2018, a total of 21,940,639 shares remained available for repurchase under the existing issuer bid.

10. QUARTERLY FINANCIAL DATA

The table below summarizes quarterly financial results for Air Canada for the last eight quarters.

(Canadian dollars in millions, except where indicated)	2017 ⁽¹⁾				2018			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Passenger	\$ 3,120	\$ 3,550	\$ 4,514	\$ 3,409	\$ 3,489	\$ 3,921	\$ 5,018	\$ 3,795
Cargo	148	168	194	198	168	200	218	217
Other	374	192	172	213	414	212	179	234
Operating revenues	3,642	3,910	4,880	3,820	4,071	4,333	5,415	4,246
Aircraft fuel	659	701	832	735	825	964	1,222	958
Regional airlines expense								-
Aircraft fuel	95	96	109	112	114	135	149	133
Other	537	552	553	563	561	607	568	575
Wages, salaries & benefits	644	663	690	674	700	711	743	719
Airport and navigation fees	210	230	264	201	221	237	281	225
Aircraft maintenance	228	226	241	243	256	220	277	250
Depreciation, amortization and impairment	228	242	241	245	267	278	268	267
Sales and distribution costs	181	188	232	169	189	199	237	182
Ground package costs	256	103	73	106	276	114	86	126
Aircraft rent	122	130	125	126	125	123	137	133
Catering and onboard services	85	97	112	89	96	108	125	104
Communications and information technology	71	58	63	62	79	67	79	69
Special items	30	-	-	-	-	-	-	-
Other	326	332	369	362	376	344	403	383
Operating expenses	3,672	3,618	3,904	3,687	4,085	4,107	4,575	4,124
Operating income (loss)	(30)	292	976	133	(14)	226	840	122
Foreign exchange gain (loss)	70	68	44	(62)	(112)	(25)	89	(269)
Interest income	12	14	16	18	20	24	32	32
Interest expense	(79)	(80)	(73)	(79)	(83)	(84)	(80)	(84)
Interest capitalized	9	9	9	9	13	7	7	8
Net financing expense relating to employee benefits	(16)	(16)	(15)	(18)	(12)	(13)	(13)	(12)
Gain (loss) on financial instruments recorded at fair value	-	7	17	(1)	1	(9)	10	(3)
Gain on sale and leaseback of assets	26	26	-	-	-	-	-	-
Gain (loss) on debt settlements and modifications	-	-	(3)	24	11	(1)	(1)	-
Loss on disposal of assets	-	-	-	-	-	(186)	(2)	-
Other	(5)	(6)	(6)	(4)	(8)	(10)	(6)	(10)
Total non-operating income (expense)	17	22	(11)	(113)	(170)	(297)	36	(338)
Income (loss) before income taxes	(13)	314	965	20	(184)	(71)	876	(216)
Income tax (expense) recovery	-	(3)	758	(12)	14	(6)	(231)	(15)
Net income (loss)	\$ (13)	\$ 311	\$ 1,723	\$ 8	\$ (170)	\$ (77)	\$ 645	\$ (231)
Diluted earnings (loss) per share	\$ (0.05)	\$ 1.13	\$ 6.22	\$ 0.02	\$ (0.62)	\$ (0.28)	\$ 2.34	\$ (0.85)
EBITDAR ⁽²⁾	\$ 366	\$ 681	\$ 1,360	\$ 521	\$ 397	\$ 646	\$ 1,265	\$ 543
Adjusted pre-tax income (loss) ⁽²⁾	\$ (63)	\$ 229	\$ 922	\$ 77	\$ (72)	\$ 163	\$ 793	\$ 68
Adjusted net income (loss) ⁽²⁾	\$ (63)	\$ 226	\$ 922	\$ 60	\$ (52)	\$ 114	\$ 561	\$ 54
Adjusted earnings (loss) per share - diluted ⁽²⁾	\$ (0.23)	\$ 0.82	\$ 3.33	\$ 0.22	\$ (0.19)	\$ 0.41	\$ 2.03	\$ 0.20

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

(2) EBITDAR, adjusted pre-tax income (loss), adjusted net income (loss) and adjusted earnings (loss) per share - diluted are non-GAAP financial measures. Reconciliations of these measures to comparable GAAP measures can be found in section 20 "Non-GAAP Financial Measures" of this MD&A and in Air Canada's MD&A reports, available at aircanada.com.

The table below provides a breakdown of the most significant items included in regional airlines expense for the last eight quarters.

(Canadian dollars in millions)	2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Capacity purchase fees	\$ 308	\$ 314	\$ 315	\$ 330	\$ 319	\$ 360	\$ 318	\$ 336
Aircraft fuel	95	96	109	112	114	135	149	133
Airport and navigation fees	69	73	80	71	69	76	78	73
Sales and distribution costs	37	40	34	35	34	41	44	34
Depreciation, amortization and impairment	6	7	8	7	9	9	9	11
Aircraft rent	10	10	10	10	10	10	11	10
Other	107	108	106	110	120	111	108	111
Total regional airlines expense	\$ 632	\$ 648	\$ 662	\$ 675	\$ 675	\$ 742	\$ 717	\$ 708

The table below provides major quarterly operating statistics for Air Canada for the last eight quarters.

System	2017 ⁽¹⁾				2018			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Passenger PRASM (cents)	13.6	14.0	14.5	14.1	14.0	14.4	15.1	14.8
CASM (cents)	16.0	14.3	12.6	15.2	16.4	15.1	13.8	16.1
Adjusted CASM (cents) ⁽²⁾	11.5	10.7	9.3	11.3	11.5	10.6	9.4	11.4
Fuel cost per litre (cents) ⁽³⁾	63.2	61.3	59.4	67.5	73.3	80.3	83.0	84.3

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

(2) Adjusted CASM is a non-GAAP financial measure. A reconciliation of this measure to a comparable GAAP measure can be found in section 20 "Non-GAAP Financial Measures" of this MD&A and in Air Canada's MD&A reports, available at aircanada.com.

(3) Includes aircraft fuel expense related to regional airline operations. Includes fuel handling expenses.

The table below provides Air Canada's revenue passenger miles (RPMs), available seat miles (ASMs) and passenger load factors, on a system-basis and by market, for the last eight quarters.

System	2017				2018			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
RPMs (millions)	18,341	20,928	26,472	19,396	20,440	22,654	28,465	20,801
ASMs (millions)	22,894	25,357	31,050	24,191	24,862	27,269	33,137	25,598
Passenger load factor (%)	80.1	82.5	85.3	80.2	82.2	83.1	85.9	81.3%
Domestic								
RPMs (millions)	4,101	4,875	6,130	4,607	4,226	5,003	6,339	4,684
ASMs (millions)	5,108	5,837	7,173	5,584	5,280	6,026	7,482	5,667
Passenger load factor (%)	80.3	83.5	85.4	82.5	80.0	83.0	84.7	82.7%
U.S. transborder								
RPMs (millions)	3,782	3,609	3,951	3,408	4,037	3,848	4,172	3,734
ASMs (millions)	4,687	4,376	4,683	4,252	4,945	4,673	4,962	4,662
Passenger load factor (%)	80.7	82.5	84.4	80.1	81.6	82.3	84.1	80.1%
Atlantic								
RPMs (millions)	3,891	6,131	9,406	5,076	4,573	7,084	10,642	5,813
ASMs (millions)	5,248	7,661	11,087	6,582	5,753	8,571	12,231	7,206
Passenger load factor (%)	74.1	80.0	84.8	77.1	79.5	82.7	87.0	80.6%
Pacific								
RPMs (millions)	3,943	4,671	5,471	4,501	4,572	4,936	5,630	4,514
ASMs (millions)	4,862	5,540	6,412	5,586	5,447	5,829	6,484	5,541
Passenger load factor (%)	81.1	84.3	85.3	80.6	83.9	84.7	86.8	81.5%
Other								
RPMs (millions)	2,624	1,642	1,514	1,804	3,032	1,783	1,682	2,056
ASMs (millions)	2,989	1,943	1,695	2,187	3,437	2,170	1,978	2,522
Passenger load factor (%)	87.8	84.5	89.3	82.5	88.2	82.1	85.0	81.6%

11. SELECTED ANNUAL INFORMATION

The following table provides selected annual information for Air Canada for the years 2016 through 2018.

(Canadian dollars in millions, except per share figures)	Full Year		
	2018	2017 ⁽¹⁾	2016 ⁽¹⁾
Operating revenues	\$ 18,065	\$ 16,252	\$ 14,677
Operating expenses ⁽²⁾	16,891	14,881	13,332
Operating income	1,174	1,371	1,345
Income before income taxes	405	1,286	877
Recovery of (provision for) income taxes ⁽³⁾	(238)	743	(1)
Net income	\$ 167	\$ 2,029	\$ 876
EBITDAR ⁽⁴⁾	\$ 2,851	\$ 2,928	\$ 2,768
Adjusted pre-tax income ⁽⁴⁾	\$ 952	\$ 1,165	\$ 1,148
Adjusted net income ⁽⁴⁾	\$ 677	\$ 1,145	\$ 1,147
Basic earnings per share	\$ 0.61	\$ 7.44	\$ 3.16
Diluted earnings per share	\$ 0.60	\$ 7.31	\$ 3.10
Adjusted earnings per share – diluted ⁽⁴⁾	\$ 2.45	\$ 4.11	\$ 4.06
Cash, cash equivalents and short-term investments	\$ 4,707	\$ 3,804	\$ 2,979
Total assets ⁽⁵⁾	\$ 19,197	\$ 17,782	\$ 15,114
Total long-term liabilities ⁽⁶⁾	\$ 10,520	\$ 9,930	\$ 10,178
Total liabilities	\$ 15,164	\$ 14,360	\$ 13,895

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts. 2016 amounts have not been restated for the adoption of this new accounting standard.

(2) In 2017, Air Canada recorded a provision of \$30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations. In 2016, Air Canada recorded a past service cost expense of \$91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

(3) In 2017, Air Canada recorded a tax recovery of \$743 million (representing a deferred income tax recovery of \$759 million and a current income tax expense of \$16 million). This deferred income tax recovery was excluded from adjusted net income as it reflected a one-time recognition of previously unrecognized income tax assets.

(4) EBITDAR, adjusted pre-tax income, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Reconciliations of these measures to comparable GAAP measures can be found in section 20 "Non-GAAP Financial Measures" of this MD&A and in Air Canada's MD&A reports, available at aircanada.com.

(5) In 2017, Air Canada recorded a deferred income tax asset of \$456 million.

(6) Total long-term liabilities include long-term debt (including current portion) and finance leases, pension and other benefit liabilities, maintenance provisions and other long-term liabilities.

12. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Summary of Gain (Loss) on Financial Instruments Recorded at Fair Value

The following is a summary of gains (losses) on financial instruments recorded at fair value included in non-operating income (expense) on Air Canada's consolidated statement of operations for the periods indicated.

(Canadian dollars in millions)	Fourth Quarter		Full Year	
	2018	2017	2018	2017
Share forward contracts	\$ (3)	\$ -	\$ -	\$ 26
Fuel derivatives	-	(1)	(1)	(3)
Financial instruments recorded at fair value	\$ (3)	\$ (1)	\$ (1)	\$ 23

Risk Management

Under its risk management policy, Air Canada manages its fuel price risk, foreign exchange risk and interest rate risk through the use of various financial derivative instruments. Air Canada uses these instruments solely for risk management purposes and not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be an economic hedge and offset by changes in cash flows of the relevant risk being hedged.

The fair values of derivative instruments represent the amount of the consideration that could be exchanged in an arm's length transaction between willing parties who are under no compulsion to act. The fair value of these derivatives is determined using prices in active markets, where available. When no such market is available, valuation techniques such as discounted cash flow analysis are applied. The valuation techniques incorporate all factors that would be considered in setting a price, including Air Canada's and the counterparty's respective credit risk.

Fuel Price Risk Management

Fuel price risk is the risk that future cash flows will fluctuate because of changes in jet fuel prices. In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, Air Canada enters into derivative contracts with financial intermediaries. Air Canada may use derivative contracts based on jet fuel, heating oil and crude-oil. Air Canada's policy permits hedging of up to 75% of the projected jet fuel purchases for the current calendar year, 50% of the projected jet fuel purchases for the next calendar year, and 25% of projected jet fuel purchases for any calendar year thereafter. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. Air Canada performs regular reviews to assess market conditions and adjust its hedging strategy where management considers it warranted.

In 2018:

- Hedging losses on the settlement of fuel derivatives of \$19 million and the associated premium costs of \$17 million, for a hedging loss of \$36 million were reclassified from other comprehensive income to aircraft fuel expense (net fuel hedging loss of \$2 million was reclassified from other comprehensive income to aircraft fuel expense in 2017). No hedge ineffectiveness was recorded.
- Air Canada purchased crude-oil call options and swaps covering a portion of 2018 fuel exposure. The cash premium related to these contracts was \$17 million (\$18 million in 2017 for 2017 exposures).
- Fuel derivative contracts cash settled with a fair value of \$19 million in favour of the counterparties (\$26 million in favour of Air Canada in 2017).

There were no outstanding fuel derivatives as at December 31, 2018 and December 31, 2017.

Foreign Exchange Risk Management

Air Canada's financial results are reported in Canadian dollars, while a large portion of its expenses, debt obligations and capital commitments are in foreign currencies, primarily U.S. dollars. Foreign exchange risk is the risk that fluctuations in foreign exchange rates may have on operating results and cash flows. Air Canada's risk management objective is to reduce cash flow risk related to foreign denominated cash flows.

Air Canada generates certain sales in U.S. dollars and in other foreign currencies which are converted to U.S. dollars under the Corporation's risk management program. In 2018, these net operating cash inflows totaled approximately US\$4.2 billion and U.S. denominated operating costs amounted to approximately US\$6.4 billion. Non-operating cash outflows in U.S. dollars, primarily related to interest payments on U.S. dollar denominated debt and net financing outflows, amounted to approximately US\$1.9 billion. For 2018, this resulted in a U.S. dollar net cash flow exposure of approximately US\$4.1 billion.

Air Canada has a target coverage of 70% on a rolling 18-month basis to manage the net U.S. dollar cash flow exposure described above utilizing the following risk management strategies:

- Holding U.S. dollar cash reserves as an economic hedge against changes in the value of the U.S. dollar. U.S. dollar cash and short-term investment balances as at December 31, 2018 amounted to \$863 million (US\$635 million) (\$686 million (US\$542 million) as at December 31, 2017). A portion of the cash and investment reserves are an economic hedge against long-term U.S. dollar debt while the remainder of the cash is operational cash and investment reserves which are applied against the rolling 18-month net U.S. dollar cash flow exposure. In 2018, a gain of \$62 million (loss of \$58 million in 2017) was recorded in foreign exchange gain (loss) reflecting the change in Canadian equivalent market value of the U.S. dollar cash, cash equivalents and short-term investment balances held.
- Locking in the foreign exchange rate through the use of a variety of foreign exchange derivatives which have maturity dates corresponding to the forecasted dates of U.S. dollar net outflows.

The level of foreign exchange derivatives entered into and their related maturity dates are dependent upon a number of factors, which include the amount of foreign revenue conversion available, U.S. dollar net cash outflows, as well as the amount attributed to aircraft and debt payments. Based on the notional amount of currency derivatives outstanding at December 31, 2018, as further described below, approximately 77% of net U.S. cash outflows are hedged for 2019 and 48% for 2020, resulting in derivative coverage of 68% over the next 18 months. Operational U.S. dollar cash and investment reserves combined with derivative coverage results in 75% coverage.

As at December 31, 2018, Air Canada had outstanding foreign currency options and swap agreements, settling in 2019 and 2020, to purchase at maturity \$4,987 million (US\$3,659 million) of U.S. dollars at a weighted average rate of \$1.2645 per US\$1.00 (2017 - \$3,400 million (US\$2,704 million) with settlements in 2018 and 2019 at a weighted average rate of \$1.2703 per \$1.00 U.S. dollar). Air Canada also has protection in place to sell a portion of its excess Euros, Sterling, YEN, and AUD (EUR €103 million, GBP £208 million, JPY ¥25,922 million, and AUD \$105 million) which settle in 2019 and 2020 at weighted average rates of €1.1910, £1.3567, ¥0.0092, and AUD \$0.7448 per \$1.00 U.S. dollar, respectively (as at December 31, 2017 - EUR €101 million, GBP £105 million, JPY ¥8,623 million, CNY ¥41 million, and AUD \$32 million with settlement in 2018 at weighted average rates of €1.1664, £1.3259, ¥0.0090, ¥0.1468 and AUD \$0.7576 respectively per \$1.00 U.S. dollar).

The hedging structures put in place have various option pricing features, such as knock-out terms and profit cap limitations and, based on the assumed volatility used in the fair value calculation, the net fair value of these foreign currency contracts as at December 31, 2018 was \$33 million in favour of the counterparties (2017 - \$215 million in favour of the counterparties). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2018, a gain of \$245 million was recorded in foreign exchange gain (loss) related to these derivatives (2017 - \$274 million loss). In 2018, foreign exchange derivative contracts cash settled with a net fair value of \$63 million in favour of Air Canada (2017 - \$55 million in favour of the counterparties).

Interest Rate Risk Management

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Air Canada enters into both fixed and floating rate debt and leases certain assets where the rental amount fluctuates based on changes in short-term interest rates. Air Canada manages interest rate risk on a portfolio basis and seeks financing terms in individual arrangements that are most advantageous taking into account all relevant factors, including credit margin, term and basis. The risk management objective is to minimize the potential for changes in interest rates to cause adverse changes in cash flows to Air Canada. The cash, cash equivalents and short-term investment portfolio, which earns a floating rate of return, is an economic hedge for a portion of the floating rate debt.

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in Air Canada's capital structure and is based upon a long-term objective of 60% fixed and 40% floating but allows the flexibility to adjust to prevailing market conditions. The ratio at December 31, 2018, was 81% fixed and 19% floating (73% and 27%, respectively, as at December 31, 2017).

13. CRITICAL ACCOUNTING ESTIMATES AND JUDGMENTS

Critical accounting estimates are those estimates of management that are most important to the portrayal of Air Canada's financial condition and results of operations. They require management's most difficult, subjective or complex judgments, often because of the need to make estimates and judgments about the effect of matters that are inherently uncertain. Actual results could differ from those estimates and judgments under different assumptions or conditions.

Air Canada has identified the following areas that depend on critical accounting estimates utilized in the preparation of its consolidated financial statements.

Employee Future Benefits

Air Canada maintains several defined benefit plans providing pension, other retirement and post-employment benefits to its employees. The cost and related liabilities of Air Canada's pensions, other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations involve assumptions, including discount rates, future salary increases, mortality rates and future benefit increases. Also, due to the long-term nature of these programs, such estimates are subject to significant uncertainty.

Assumptions

Management is required to make significant estimates about actuarial and financial assumptions to determine the cost and related liabilities of Air Canada's employee future benefits.

Financial Assumptions

Discount Rate

The discount rate used to determine the pension obligation was determined by reference to market interest rates on corporate bonds rated "AA" or better with cash flows that approximate the timing and amount of expected benefit payments.

Future increases in compensation are based upon the current compensation policies, labour and employment agreements and economic forecasts.

The significant weighted average assumptions used to determine Air Canada's accrued benefit obligations and cost are as follows:

	Pension Benefits		Other Employee Future Benefits	
	2018	2017	2018	2017
Discount rate used to determine:				
Net interest on the net benefit obligation for the year ended December 31	3.60%	3.90%	3.60%	3.90%
Service cost for the year ended December 31	3.70%	4.10%	3.70%	4.10%
Accrued benefit obligation as at December 31	3.81%	3.60%	3.81%	3.60%
Rate of future increases in compensation used to determine:				
Accrued benefit cost for the year ended December 31	2.50%	2.50%	Not applicable	Not applicable
Accrued benefit obligation as at December 31	2.50%	2.50%	Not applicable	Not applicable

Sensitivity Analysis

Sensitivity analysis is based on changing one assumption while holding all other assumptions constant. In practice, this may be unlikely to occur, and changes in some of the assumptions may be correlated. When calculating the sensitivity of the defined benefit obligation to variations in significant actuarial assumptions, the same method (present value of the defined benefit obligation calculated with the projected unit credit method at the end of the reporting period) has been applied as that used for calculating the liability recognized in the consolidated statement of financial position.

Sensitivity analysis on 2018 pension expense and net financing expense relating to pension benefit liabilities, based on different actuarial assumptions with respect to discount rate is set out below. The effects on each pension plan of a change in an assumption are weighted proportionately to the total plan obligation to determine the total impact for each assumption presented.

(Canadian dollars in millions)	0.25 Percentage Point	
	Decrease	Increase
Discount rate on obligation assumption		
Pension expense	\$ 22	\$ (21)
Net financing expense relating to pension benefit liabilities	23	(21)
Total	\$ 45	\$ (42)
Increase (decrease) in pension obligation	\$ 703	\$ (680)

The increase (decrease) in the pension obligation for a 0.25 percentage point change in the discount rate relates to the gross amount of the pension liabilities and is before the impact of any change in plan assets. As at December 31, 2018, approximately 81% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk.

An increase of one-year life expectancy would increase the pension benefit obligation by \$478 million.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 5.5% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2018 (2017 - 5.8%). The rate is assumed to decrease gradually to 5% by 2020 (2017 - assumed to decrease gradually to 5% by 2020). A one percentage point increase in assumed health care trend rates would have increased the total of current service and interest costs by \$4 million and the obligation by \$55 million. A one percentage point decrease in assumed health care trend rates would have decreased the total of current service and interest costs by \$4 million and the obligation by \$58 million.

A 0.25 percentage point decrease in discount rate for other employee future benefits would have increased the total of current and interest costs by less than \$1 million and the obligation by \$47 million. A 0.25 percentage point increase in discount rate would have decreased the total of current and interest costs by less than \$1 million and the obligation by \$44 million.

Depreciation and Amortization Period for Long-lived Assets

Air Canada makes estimates about the expected useful lives of long-lived assets and the expected residual value of the assets based on the estimated current and future fair values of the assets, Air Canada's fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by a variety of factors, including changes to maintenance programs, changes in jet fuel prices and other operating costs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. Estimates and assumptions are evaluated at least annually. Generally, these adjustments are accounted for on a prospective basis, through depreciation and amortization expense. For the purposes of sensitivity analysis on these estimates, a 50% reduction to residual values on aircraft with remaining useful lives greater than five years results in an increase of \$14 million to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.

Impairment Considerations of Long-lived Assets

Long-lived assets include property and equipment, definite lived intangible assets, indefinite lived intangible assets and goodwill. Assets that have an indefinite useful life, including goodwill, are tested annually for impairment or when events or circumstances indicate that the carrying value may not be recoverable. Assets that are subject to depreciation or amortization are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. When required, an impairment test is performed by comparing the carrying amount of the asset or cash generating unit to their recoverable amount. Recoverable amount is calculated as the higher of an asset's or cash-generating unit's fair value less costs to dispose and its value in use. For the purpose of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units or CGUs). Management has determined that the appropriate level for assessing impairments is at the narrow-body and wide-body fleet levels for aircraft and related assets supporting the operating fleet. Parked aircraft not used in operations and aircraft leased or subleased to third parties are assessed for impairment at the individual asset level. Fair value less costs to dispose may be calculated based upon a discounted cash flow analysis, which requires management to make a number of significant market participant assumptions including assumptions relating to future operating plans, discount rates and future growth rates. An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount.

Maintenance Provisions

The recording of maintenance provisions related to return conditions on aircraft leases requires management to make estimates of the future costs associated with the maintenance events required under the lease return condition and estimates of the expected future maintenance condition of the aircraft at the time of lease expiry. These estimates take into account current costs of these maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in aircraft maintenance expense in the period. The effect of any changes in estimates, including changes in discount rates, inflation assumptions, cost estimates or lease expiries, is also recognized in maintenance expense in the period. Assuming the aggregate cost for return

conditions increases by 5%, holding all other factors constant, there would be a cumulative balance sheet adjustment to increase the provision by \$62 million at December 31, 2018 and an increase to aircraft maintenance expense in 2019 of approximately \$6 million. Expected future cash flows to settle the obligation are discounted. If the discount rates were to increase by 1%, holding all other factors constant, there would be a cumulative balance sheet adjustment to decrease the provision by \$21 million at December 31, 2018. An equivalent but opposite movement in the discount rate would result in a similar impact in the opposite direction.

Income Taxes

Income tax assets and liabilities are measured at the amount that is expected to be realized or incurred upon ultimate settlement with taxation authorities. Such assessments are based upon the applicable income tax legislation, regulations and interpretations, all of which may be subject to change and interpretation. Deferred income tax assets and liabilities are composed of the tax effect of temporary differences between the carrying amount and tax basis of assets and liabilities, as well as the income tax effect of undeducted income tax losses. The timing of the reversal of temporary differences is estimated and the income tax rate substantively enacted for the periods of reversal is applied to the temporary difference. The carrying amounts of assets and liabilities are subject to the accounting estimates that are inherent in those balances. Assumptions as to the timing of reversal of temporary differences include expectations about the future results of operations and future cash flows. Changes in tax laws, tax rates or expected timing of reversal may have a significant impact on the amounts recorded for deferred income tax assets and liabilities.

Income tax recorded on Air Canada's consolidated statement of operations is presented below.

(Canadian dollars in millions)	Fourth Quarter		Full Year	
	2018	2017	2018	2017
Current income tax	\$ 3	\$ -	\$ (6)	\$ (16)
Deferred income tax	(18)	(12)	(232)	759
Income tax (expense) recovery	\$ (15)	\$ (12)	\$ (238)	\$ 743

In the third quarter of 2017, Air Canada determined that it was probable that substantially all of the deferred income tax assets would be realized. Accordingly, Air Canada recorded a tax recovery of \$774 million, which was revised to \$755 million with \$19 million related to share-based compensation reclassified to Retained earnings in the fourth quarter of 2017.

Income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full year. Air Canada's effective tax rate for 2018 26.78% (26.60% for 2017). The income tax expense differs from the amounts computed by applying the statutory tax rate, principally due to the impact of unrecognized tax benefits on foreign exchange capital losses and the effect of non-deductible expenses.

14. ACCOUNTING POLICIES

IFRS 16 – Leases

IFRS 16 replaces IAS 17 Leases and related interpretations. The core principle is that a lessee recognizes assets and liabilities for all leases with a lease term of more than 12 months. A lessee is required to recognize a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments. Assets and liabilities arising from a lease are initially measured on a present value basis. The measurement of the lease liability includes non-cancellable lease payments (including inflation-linked payments), and also includes payments to be made in optional periods if the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease. Purchase options which are reasonably certain of being exercised are also included in the measurement of the lease liability. Lease payments will not include variable lease payments other than those that depend on an index or rate. The right-of-use asset will

be derived from the calculation of the lease liability and will also include any provisions the lessee will owe for return conditions on leased assets.

The new standard is intended to provide an improved representation of leasing transactions, in particular those that do not currently require the lessee to recognize an asset and liability arising from an operating lease. IFRS 16 is effective for annual periods beginning on January 1, 2019. Entities have the option of adopting a full retrospective approach or a modified retrospective approach on transition to IFRS 16.

Air Canada will apply the standard effective January 1, 2019 and will transition with a full retrospective approach with restatement to each prior reporting period presented. Air Canada has elected the package of practical expedients to not reassess prior conclusions related to contracts containing leases and to apply the recognition exemption for short term leases and contracts for which the underlying asset has a low value.

This standard will have a significant impact on Air Canada's consolidated balance sheet, along with a change to the recognition, measurement and presentation of lease expenses in the consolidated statement of operations.

Aircraft Leases

As of December 31, 2018, Air Canada had 126 aircraft under operating leases (111 aircraft as at December 31, 2017), and Air Canada will record such aircraft as right-of-use assets and lease liabilities of Air Canada in accordance with the requirements of the new standard. Additionally, the Corporation has identified that, under IFRS 16, Air Canada is the lessee in respect of aircraft used by regional carriers providing services under the respective capacity purchase agreements ("CPA"), and will record such aircraft as right-of-use assets and lease liabilities of Air Canada. As at December 31, 2018, there were 132 aircraft (134 aircraft as at December 31, 2017) operating under these arrangements on behalf of Air Canada.

Property Leases

Air Canada has leases related to airport terminal operations space and other real estate leases. For leases related to terminal operations space, there are generally effective substitution rights in the hands of the lessor and therefore these are not considered lease contracts under the standard. Leases with reciprocal termination rights with a notice period of less than 12 months would be considered short-term leases and therefore would be excluded from balance sheet recognition under the practical expedient. Finally, those airport terminal contracts with variable lease payments will also be excluded since variable lease payments, other than those based on an index or rate, are excluded from the measurement of the lease liability. This results in a portfolio of property leases that are expected to be recorded as right-of-use assets and lease liabilities under the standard which relate to dedicated space in Air Canada's hub locations of Toronto, Montreal and Vancouver, lease contracts on building space dedicated to Air Canada for offices, airport and maintenance operations, Maple Leaf Lounges and land leases.

Accounting for Leases and Right-of-Use Assets

Leases are recognized as a right-of-use asset and corresponding liability at the date of which the leased asset is available for use by the Corporation. Each lease payment is allocated between the liability and interest expense. The interest cost is charged to the consolidated statement of operations over the lease period to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Right-of-use assets will be accounted for under IAS 16 Property, Plant and Equipment. Aircraft recorded as right-of-use assets will have the same accounting policies as directly owned aircraft, meaning the right-of-use assets will be componentized and depreciated over the lease term. Consistent with owned aircraft, any qualifying maintenance events will be capitalized and depreciated over the lesser of the lease term and expected maintenance life.

Maintenance provisions for end-of-lease return obligations will be recorded, as applicable, on aircraft leases as a maintenance expense over the term of the lease. Any changes to the provision for end-of-

lease conditions will be recognized as an adjustment to the right-of-use asset and subsequently amortized to the income statement over the remaining term of the lease.

The application of IFRS 16 requires assumptions and estimates in order to determine the value of the right-of-use assets and the lease liabilities which mainly relate to the implicit interest rate for aircraft leases and the incremental borrowing rate at commencement date of the contract for property leases. Judgement must also be applied as to whether renewal options are reasonably certain of being exercised.

Income Statement Impacts

The impacts on the income statement will be an elimination of aircraft rent and building rent, which is recorded in other operating expenses, for those contracts which are recognized as leases, and instead will be replaced by an amortization of the right-of-use asset and interest costs on the lease liability. Maintenance expense is expected to decrease under the standard as qualifying maintenance events for the former operating leases will be capitalized as part of the right-of-use asset and depreciated over their expected maintenance life. This will be partially offset by higher maintenance provision expense recorded on all aircraft right-of-use assets which contain end of lease maintenance return conditions. Regional airlines expense is expected to decrease to the extent aircraft rent is removed and recorded in depreciation and interest expense outside of the regional airlines expense.

Since all the aircraft lease contracts are denominated in US dollars, there may be additional volatility in the foreign exchange recognized in the income statement due to the revaluation of the lease liabilities and maintenance provisions to the rate of exchange in effect at the date of the balance sheet.

Anticipated Impact to 2018 Results

Select adjusted financial statement information, which reflects the anticipated impact of adoption of IFRS 16 on January 1, 2018, is presented below. Line items that are not expected to be affected by the change in accounting policy have not been included. As a result, the sub-totals and totals disclosed cannot be recalculated from the numbers provided. In summary, the following adjustments are anticipated to be made to the amounts recognized in Air Canada's consolidated statement of financial position for the date of initial application on January 1, 2018.

(Canadian dollars in millions)	December 31, 2017 as Previously Reported	Air Canada Aircraft	Regional Aircraft	Property Leases	Expected January 1, 2018 as Restated
Accounts receivable	\$ 814	\$ (3)	\$ -	\$ -	\$ 811
Deposits and other assets	465	(63)	-	-	402
Property and equipment	9,252	1,649	766	160	11,827
Deferred income tax	456	71	144	13	684
Total assets	\$ 17,782	\$ 1,654	\$ 910	\$ 173	\$ 20,519
Accounts payable and accrued liabilities	1,961	(22)	(12)	-	1,927
Current portion of long-term debt and lease liabilities	671	357	146	12	1,186
Total current liabilities	5,101	335	134	12	5,582
Long-term debt and lease liabilities	5,448	1,452	1,092	198	8,190
Maintenance provisions	1,003	70	78	-	1,151
Other long-term liabilities	167	(8)	-	-	159
Total liabilities	\$ 14,360	\$ 1,849	\$ 1,304	\$ 210	\$ 17,723
Retained earnings	2,554	(195)	(394)	(37)	1,928
Total shareholders' equity	\$ 3,422	\$ (195)	\$ (394)	\$ (37)	\$ 2,796
Total liabilities and shareholders' equity	\$ 17,782	\$ 1,654	\$ 910	\$ 173	\$ 20,519

The expected impact of the adoption of IFRS 16 on Air Canada's 2018 consolidated statement of operations is presented below.

(Canadian dollars in millions)	December 31, 2018 as Previously Reported	Air Canada Aircraft	Regional Aircraft	Property Leases	Expected December 31, 2018 as Restated
Operating revenues					
Passenger	\$ 16,223	\$ -	\$ -	\$ -	\$ 16,223
Cargo	803	-	-	-	803
Other	1,039	-	-	-	1,039
Total revenues	18,065	-	-	-	18,065
Operating expenses					
Aircraft fuel	3,969	-	-	-	3,969
Regional airlines expense	2,842	-	(323)	-	2,519
Wages, salaries and benefits	2,873	-	-	-	2,873
Airport and navigation fees	964	-	-	-	964
Aircraft maintenance	1,003	(100)	-	-	903
Depreciation, amortization and impairment	1,080	424	197	16	1,717
Sales and distribution costs	807	-	-	-	807
Ground package costs	602	-	-	-	602
Aircraft rent	518	(512)	-	-	6
Catering and onboard services	433	-	-	-	433
Communications and information technology	294	-	-	-	294
Other	1,506	-	-	(27)	1,479
Total operating expenses	16,891	(188)	(126)	(11)	16,566
Operating income	1,174	188	126	11	1,499
Non-operating income (expense)					
Foreign exchange loss	(317)	(155)	(105)	(1)	(578)
Interest income	108	-	-	-	108
Interest expense	(331)	(131)	(91)	(14)	(567)
Interest capitalized	35	-	-	-	35
Net financing expense relating to employee benefits	(50)	-	-	-	(50)
Loss on financial instruments recorded at fair value	(1)	-	-	-	(1)
Gain on debt settlements and modifications	9	-	-	-	9
Loss on disposal of assets	(188)	-	-	-	(188)
Other	(34)	(2)	-	-	(36)
Total non-operating expense	(769)	(288)	(196)	(15)	(1,268)
Income before income taxes	405	(100)	(70)	(4)	231
Income tax expense	(238)	27	19	1	(191)
Net income	\$ 167	\$ (73)	\$ (51)	\$ (3)	\$ 40
EBITDAR	\$ 2,851	100	244	27	\$ 3,222

15. OFF-BALANCE SHEET ARRANGEMENTS

Guarantees

Guarantees in Fuel and De-icing Arrangements

Air Canada participates in fuel facility arrangements operated through eight Fuel Facility Corporations, and three aircraft de-icing service facilities, along with other airlines that contract for fuel and de-icing services at various major airports in Canada. These entities operate on a cost recovery basis. The aggregate debt of these entities that has not been consolidated by Air Canada under IFRS 10 Consolidated Financial Statements is approximately \$571 million as at December 31, 2018 (December 31, 2017 - \$529 million), which is Air Canada's maximum exposure to loss before taking into consideration the value of the assets that secure the obligations and any cost sharing that would occur amongst the other contracting airlines. Air Canada views this loss potential as remote. Each contracting airline participating in these entities shares pro rata, based on system usage, in the guarantee of this debt. The maturities of these debt arrangements vary but generally extend beyond five years.

Indemnification Agreements

In the ordinary course of Air Canada's business, Air Canada enters into a variety of agreements, such as real estate leases or operating agreements, aircraft financing or leasing agreements, technical service agreements, and director/officer contracts, and other commercial agreements, some of which may provide for indemnifications to counterparties that may require Air Canada to pay for costs and/or losses incurred by such counterparties. Air Canada cannot reasonably estimate the potential amount, if any, it could be required to pay under such indemnifications. Such amount would also depend on the outcome of future events and conditions, which cannot be predicted. While certain agreements specify a maximum potential exposure, certain others do not specify a maximum amount or a limited period. Historically, Air Canada has not made any significant payments under these indemnifications.

Air Canada expects that it would be covered by insurance for most tort liabilities and certain related contractual indemnities.

16. RELATED PARTY TRANSACTIONS

At December 31, 2018, Air Canada had no transactions with related parties as defined in the CPA Handbook, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

17. SENSITIVITY OF RESULTS

Air Canada's financial results are subject to many different internal and external factors which can have a significant impact on operating results. The following table describes, on an indicative basis, the financial impact that changes in fuel prices and the value of the Canadian dollar would generally have had on Air Canada's past operating results. An equivalent but opposite movement of the sensitivity factor in the table below would have generally resulted in a similar but opposite impact. These guidelines were derived from 2018 levels of activity and make use of management estimates. The impacts are not additive, do not reflect the interdependent relationship of the elements and may not be indicative of future trends or results which may vary significantly due to a wide range of factors many of which are beyond the control of Air Canada.

Key Variable (Canadian dollars in millions)	2018 Measure	Sensitivity Factor	Favourable/ (Unfavourable) Estimated Operating Income Impact
Fuel			
Fuel – Jet fuel price (US\$/barrel) ⁽¹⁾	93.0	US\$1/barrel increase	\$ (46)
Fuel – Jet fuel price (CAD cents/litre) ⁽¹⁾	80.4	1% increase	\$ (43)
Key Variable (Canadian dollars in millions)	2018 Measure	Sensitivity Factor	Favourable/ (Unfavourable) Estimated Operating Income and Pre-Tax Income Impacts
Currency Exchange			
C\$ to US\$	C\$1 = US\$1.33	1 cent increase (i.e. \$1.33 to \$1.32 per US\$)	
		Operating income ⁽²⁾	\$ 19
		Net interest expense	\$ 2
		Revaluation of long-term debt, U.S. dollar cash, cash equivalents and short-term investments and other long-term monetary items, net	\$ 44
		Remeasurement of outstanding currency derivatives	\$ (37)
		Pre-tax Income Impact	\$ 28

(1) Excludes the impact of fuel surcharges and fuel hedging. Refer to section 12 "Financial Instruments and Risk Management" of this MD&A for information on Air Canada's fuel derivative instruments.

(2) The operating income impact of currency exchange movements is before the impact of hedging activities, such as through the use of foreign currency derivatives and holding U.S. dollar cash reserves. The gains and losses related to these hedging activities are recorded in non-operating income (expense) on Air Canada's consolidated statement of operations.

18. RISK FACTORS

The risks described below should be read carefully when evaluating Air Canada's business and the forward-looking statements contained in this report and other statements Air Canada may make from time to time. Any of these risks could materially and adversely affect Air Canada's business, operating results, financial condition and the outcome of matters as to which forward-looking statements are made. In addition, these risks may not be the only risks faced by Air Canada. Other risks of which Air Canada is not aware or which Air Canada currently deems not to be material may surface and have a material and adverse impact on Air Canada, its business, results from operations, financial condition and the outcome of matters as to which forward-looking statements are made.

Risks Relating to Air Canada

Operating results - Air Canada may sustain significant losses and not be able to successfully achieve and/or sustain positive net profitability or realize the objectives of any or all of its initiatives

A variety of factors, including economic conditions and other factors described in this "Risk Factors" section, may result in Air Canada incurring significant losses. Despite ongoing strategic and business initiatives, Air Canada may not be able to successfully achieve and/or sustain positive net profitability or realize the objectives of any or all of its initiatives, including those which seek to increase revenues, decrease costs, improve margins, profitably deploy additional capacity, generate sufficient returns on its capital expenditures or offset or mitigate risks facing Air Canada, including those described in this "Risk Factors" section.

Economic and geopolitical conditions - Changes in economic and geopolitical conditions could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Airline operating results are sensitive to economic and geopolitical conditions which can have a significant impact on Air Canada. For example, economic and geopolitical conditions may impact demand for air transportation in general or to or from certain destinations, and may also impact Air Canada's operating costs, operating revenues, costs and availability of fuel, foreign exchange costs, pension plan contributions, and costs and availability of capital and supplies required by Air Canada. Especially in light of Air Canada's substantial fixed cost structure, any prolonged or significant impact arising from economic and geopolitical conditions, including weakness of the Canadian, U.S. or world economies, changes to political or economic relationships within or between jurisdictions where Air Canada operates, or threatened or actual outbreaks of hostilities in or adjacent to regions Air Canada serves or over which it operates flights (or to regions it plans to operate), could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Airline fares and passenger demand have fluctuated significantly in the past and may fluctuate significantly in the future. Air Canada is not able to predict with certainty market conditions and the fares that Air Canada may be able to charge. Customer expectations can change rapidly and the demand for lower fares may limit revenue opportunities. Travel, especially leisure travel, is a discretionary consumer expense. Demand for business and premium travel is also impacted by economic conditions. Depressed economic conditions in areas served by Air Canada, geopolitical instability in various areas of the world and concerns about the environmental impacts of air travel and tendencies towards less environmentally impactful travel where customers may reduce or alter their travel activities, could each have the effect of reducing demand for air travel in Canada and abroad and could materially adversely impact Air Canada, its business, results of operations and financial condition.

Fuel costs - Significant fluctuations or increases in fuel prices could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Fuel costs constitute one of Air Canada's largest operating cost items. Fuel prices have and may continue to fluctuate widely depending on many factors, including international market conditions, geopolitical events, jet fuel refining costs and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict the future price of fuel. Due to the competitive nature of the airline industry, Air Canada may not be able to pass on increases in fuel prices to its customers by increasing its fares. In addition, Air Canada may be unable to appropriately or sufficiently, or may not, hedge the risks associated with fluctuations in fuel prices. Furthermore, the impact of lower jet fuel prices could be offset by increased price competition, and a resulting decrease in revenues, for all air carriers. Significant fluctuations (including increases) in fuel prices could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Foreign exchange - A significant deterioration of the Canadian dollar relative to the U.S. dollar could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada's financial results are sensitive to the fluctuating value of the Canadian dollar. Air Canada incurs significant expenses in U.S. dollars for items such as fuel, aircraft purchases, aircraft leasing and maintenance, airport charges, ground package costs, sales and distribution costs, interest and debt servicing payments, while a substantial portion of its revenues are generated in Canadian dollars. Due to the competitive nature of the airline industry and customer sensitivity to travel costs, Air Canada may not be able to pass on increases in foreign exchange costs to its customers by increasing its fares. In addition, Air Canada may be unable to appropriately or sufficiently hedge the risks associated with fluctuations in exchange rates. A significant deterioration of the Canadian dollar relative to the U.S. dollar or other foreign currencies would increase the costs of Air Canada relative to its U.S. or other foreign competitors. Any of these factors could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Competition - Air Canada operates in a highly competitive environment and faces increasing competition in North America and internationally

Air Canada operates within a highly competitive industry and continuously encounters substantial price competition. Carriers, including low-cost, ultra-low-cost, domestic, U.S. and foreign carriers, have entered, announced their intention to enter or continue to enter or expand into markets Air Canada operates in or plans to operate in, including domestic, U.S. transborder, international and leisure-oriented markets.

Carriers against which Air Canada competes, including U.S. carriers, may also undergo (and some have undergone) substantial reorganizations (including by way of merger with or acquisition by another carrier), creating reduced levels of indebtedness, lower operating costs and other competitive advantages, and may therefore be able to more effectively compete against Air Canada. Consolidation within the airline industry and carriers increasingly entering into integrated commercial cooperation arrangements, such as joint ventures, which may be able to compete more effectively, could result in increased competition.

The proximity of several American airports in cities close to the Canadian border has also presented an additional challenge for Air Canada. Higher taxes, charges and fees for passengers departing from Canada has redirected appreciable passenger traffic away from Canadian airports to airports in the United States. Carriers operating from the United States have and may continue to increase their capacity at these airports and attract Canadian-originating, price-sensitive customers.

The prevalence of Internet travel websites and other travel product distribution channels has also resulted in a substantial increase in discounted and promotional fares initiated by Air Canada's competitors. Competitors also continue to pursue commissions/incentive actions and, in many cases, increase these payments.

Air Canada's ability to reduce its fares in order to effectively compete is dependent on Air Canada's ability to achieve acceptable operating margins and may be limited by applicable laws or government policies to encourage competition.

Increased competition, from existing, emerging or new competitors, including competitors entering into new or expanded joint ventures and other arrangements, or utilizing disruptive business models or technologies, and other competitive actions, or benefiting from foreign subsidies or other advantages not available to Air Canada, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Dependence on technology - Air Canada relies heavily on technology to operate its business and any technology systems failure or data breach could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada relies heavily on technology to operate its business, increase its revenues and reduce its costs. These systems include those relating to Air Canada's communications, websites, reservations, airport customer services and flight operations. Air Canada depends on the performance of its many suppliers, whose performance is in turn dependent upon their respective technologies.

As part of regular business operations, Air Canada collects, processes and stores sensitive data, including personal information of our passengers, employees and information of our business partners. The secure operation of the networks and systems on which this type of information is stored, processed and maintained is critical to our business.

Technology systems may be vulnerable to a variety of sources of failure, interruption or misuse, including by reason of human error, third party suppliers' acts or omissions, natural disasters, terrorist attacks, telecommunications failures, power failures, unauthorized or fraudulent users (including cyber-attacks, malware, ransomware, computer viruses and the like), and other operational and security issues.

It is generally viewed that cyber-attacks have increased and will continue to increase in both prevalence and sophistication. Air Canada invests in initiatives, including security initiatives and disaster recovery plans; however, these initiatives may not be successful or adequately address a highly dynamic and continually evolving threat landscape. Any technology systems failure, interruption or misuse, security breach or failure to comply with applicable data confidentiality, privacy, security or other related obligations, whether at Air Canada or a third party on whom Air Canada relies, could adversely affect Air Canada's reputation and expose Air Canada to litigation, claims for contract breach, fines, sanctions or otherwise materially and adversely affect Air Canada's operations, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Strategic, business, technology and other important initiatives - A delay or failure to identify and devise, invest in and implement certain important initiatives could have a material impact on Air Canada, its business, results from operations and financial condition

In order to operate its business, achieve its goals and remain competitive, Air Canada continually seeks to identify and devise, invest in, implement and pursue strategic, business, technology and other important initiatives, such as those relating to the implementation of Amadeus Altéa Suite to replace its existing passenger services system, the integration of the Aeroplan loyalty business following its acquisition in early 2019, the launch of Air Canada's new loyalty program, its aircraft fleet renewal program (including the planned re-fleeting of its narrow-body aircraft with Boeing 737 MAX aircraft and Airbus A220 (formerly Bombardier C-Series) aircraft and disposal of aircraft that are being replaced), participation in the leisure or lower cost market (including through Air Canada Rouge), joint venture arrangements, revenue enhancement initiatives, business processes, information technology, revenue management, cost transformation, improving premium passenger revenues, expansion of flying capacity (including in respect of new aircraft and routes), corporate culture transformation initiatives seeking to ensure a consistently high-quality customer service experience and others. These initiatives, including activities relating to their development and implementation, may be adversely impacted by a

wide range of factors, many of which are beyond Air Canada's control. Such factors include the need to seek legal or regulatory approvals, the performance of third parties (including suppliers), the implementation and integration of such initiatives into Air Canada's other activities and processes as well as the adoption and acceptance of these initiatives by Air Canada's customers, suppliers and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement any of these initiatives could adversely affect Air Canada's ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key supplies and suppliers - Air Canada's failure or inability to obtain certain goods and services from key suppliers on favourable terms could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services of desirable quality, in a timely manner, including those available at airports or from airport authorities, or otherwise required for Air Canada's business or operations, such as fuel, aircraft and related parts, airport services, aircraft maintenance services, and information technology systems and services. In certain cases, Air Canada may only be able to access goods and services from a limited number of suppliers (or from sole source suppliers) and the transition to new or alternative suppliers, which may be necessitated by reason of such suppliers increasing their rates or by their failure to perform, may not be possible or may take a significant amount of time or require significant resources. A failure, refusal or inability of a supplier may arise as a result of a wide range of causes, many of which are beyond Air Canada's control. Any failure or inability of Air Canada to successfully source goods and services, or to source goods and services of desirable quality on terms and pricing and within the timeframes acceptable to Air Canada, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Aeroplan loyalty program - Loss of redemption partners, increased redemption rates of loyalty points, or disruptions or other interruptions of services affecting the Aeroplan loyalty program could have a material adverse effect on Air Canada, its business, results from operations and financial condition

In January 2019, Air Canada completed the acquisition of Aimia Canada Inc., owner and operator of the Aeroplan loyalty business and program. Through Aeroplan, Air Canada offers its customers who are Aeroplan members the opportunity to earn Aeroplan Miles, which management believes is a significant factor in many customers' decision to travel with Air Canada and contributes to building customer loyalty. The success of the Aeroplan program is dependent on maintaining sufficient accumulation and redemption partners. Increases in redemption rates for outstanding Aeroplan points may also have a material adverse effect. Difficulties integrating the Aeroplan business into Air Canada's business, any failures to adequately operate the Aeroplan program or interruptions or disruptions of Aeroplan program services, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Building on the Aeroplan program, Air Canada is working to implement a new loyalty program which involves significant investments as well as certain risks and uncertainties, including risks relating to attracting new and retaining current members, implementing the required information technology and loyalty management systems, successfully concluding strategic commercial arrangements, and transitioning from the Aeroplan program to the new loyalty program. Though Air Canada believes it would be able to mitigate and overcome risks and successfully create and launch its new loyalty program, the transition from the Aeroplan program and the launch and operation of Air Canada's new loyalty program entail risks which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Air Canada's brand - The failure to preserve or grow the value of Air Canada's brand could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada believes that its success is dependent on the value of its brand and on Air Canada's ability to preserve, grow and leverage that value. The Air Canada brand is recognized throughout the world,

and Air Canada has received high ratings in external brand value studies, based in part on consumer perceptions on a variety of subjective qualities. Air Canada believes it has and continues to build an excellent reputation globally for the safety and quality of its services, and for the delivery of a consistently positive passenger experience. Air Canada's reputation and brand could also be damaged if exposed to significant adverse publicity through social media. Adverse publicity, whether justified or not, can rapidly spread through social or digital media. To the extent we are unable to respond timely and appropriately to adverse publicity, our brand and reputation may be damaged. Any failure to preserve or grow Air Canada's brand, including by reason of the conduct of Air Canada or any of its business partners or other external parties, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Airport user fees and air navigation fees – Increases in airport user fees and air navigation fees could have a material adverse effect on Air Canada, its business, results from operation and financial condition

Airport and air navigation authorities have or could significantly increase their fees. Though certain authorities have implemented some fee reductions, if authorities in Canada or elsewhere were to significantly increase their fees, Air Canada, its business, results from operations and financial condition could be materially adversely affected.

Leverage - Air Canada has a significant amount of indebtedness, and there can be no assurance that it will be able to satisfy its debt, lease and other obligations

Air Canada has a significant amount of indebtedness, including substantial fixed obligations under aircraft leases, aircraft purchases and other financings, and as a result of any challenging economic or other conditions affecting Air Canada, Air Canada may incur greater levels of indebtedness than currently exist or are planned. Although Air Canada has been focusing on reducing its level of indebtedness and improving its leverage ratios, the amount of indebtedness that Air Canada has and which it may incur in the future could have a material adverse effect on Air Canada, for example, by (i) limiting Air Canada's ability to obtain additional financing, (ii) requiring Air Canada to dedicate a substantial portion of its cash balances or cash flow from operations to payments on its indebtedness and fixed cost obligations, thereby reducing the funds available for other purposes, (iii) making Air Canada more vulnerable to economic downturns and (iv) limiting Air Canada's flexibility in planning for, or reacting to changes in its business environment, including competitive pressures.

The ability of Air Canada to make scheduled payments under its indebtedness will depend on, among other things, its future operating performance and its ability to refinance its indebtedness, if necessary. In addition, as Air Canada incurs indebtedness which bears interest at floating interest rates, to the extent these interest rates increase, its interest expense will increase. Moreover, Air Canada incurs a significant proportion of its indebtedness in foreign currencies, primarily in U.S. dollars, and as a result, future debt servicing repayments are subject to foreign exchange risk and the Canadian equivalent amount of indebtedness may increase. There can be no assurance that Air Canada will at all times be able to generate sufficient cash from its operations to satisfy its debts, lease and other obligations. Each of these factors is, to a large extent, subject to economic, financial, competitive, regulatory, operational and other factors, many of which are beyond Air Canada's control.

High fixed costs and low margins – The airline industry may suffer from low profit margins and high fixed costs

The airline industry has historically been characterized by low profit margins and high fixed costs. The costs of operating a flight do not vary significantly with the number of passengers carried and, therefore, a relatively small change in the number of passengers, fare pricing or traffic mix could have a significant impact on Air Canada's operating and financial results. This condition may be exacerbated by aggressive pricing by competitors, which could have the effect of driving down fares in certain markets. Although Air Canada's margins have improved in recent years, a shortfall from expected revenue levels or profit margins could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Air Canada has focused on improving resiliency to weather downturns in its business;

however, such efforts may not be successful. As a result of high fixed costs, should Air Canada be required to reduce its overall capacity or the number of flights operated, it may not be able to successfully reduce certain fixed costs within a timeframe required to sufficiently mitigate the effects of any downturns, and Air Canada may also be required to incur significant termination or other restructuring costs, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Regional carriers - The failure by regional carriers to fulfill their obligations to Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada seeks to enhance its network through capacity purchase agreements with regional airlines such as Jazz, Sky Regional and other airlines operating flights on behalf of Air Canada. Pursuant to the terms of the Jazz CPA, Air Canada pays Jazz a number of fees, some of which are fixed and others which are determined based upon certain costs incurred by Jazz. Air Canada also reimburses Jazz for certain pass-through costs incurred by Jazz (or arranges to provide the related supplies to Jazz), such as fuel, navigation, landing and terminal fees. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization guarantee which requires Air Canada to utilize Jazz for that amount of flying. Significant increases in Jazz's costs, the failure by Jazz to adequately fulfill its obligations under the Jazz CPA, factors which may reduce the utilization of the Jazz fleet, including economic or market downturns, and unexpected interruptions or cessation of Jazz's services could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

The failure by Air Canada's other regional carriers to fulfill their obligations under their respective agreements, or unexpected interruptions or disruptions of their services, as well as minimum guarantees in capacity purchase agreements which may limit Air Canada's ability to effectively manage regional capacity in response to economic downturns, market pressures or other external events, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Labour costs and labour relations - Air Canada may not be able to maintain labour costs at appropriate levels or secure labour agreements which permit it to successfully pursue its strategic initiatives. There can be no assurance that collective bargaining agreements will be further renewed without labour conflicts and/or disruptions

Labour costs constitute one of Air Canada's largest operating cost items. There can be no assurance that Air Canada will be able to maintain such costs at levels that do not negatively affect its business, results from operations and financial condition. Most of Air Canada's employees are unionized. While Air Canada has established long term arrangements with unions representing a significant portion of its unionized employees, there can be no assurance that future agreements with employees' unions or the outcome of arbitrations will be on terms consistent with Air Canada's expectations or comparable to agreements entered into by Air Canada's competitors. Any future agreements or outcomes of negotiations or arbitrations, including in relation to wages or other labour costs or work rules, may result in increased labour costs or other charges, or terms and conditions restricting or reducing, Air Canada's ability to sustain its business objectives or pursue its strategic initiatives, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

There can be no assurance that collective agreements will be further renewed without labour conflict or action or that there will not otherwise be any labour conflict or action that could also lead to a degradation, interruption or stoppage in Air Canada's service or otherwise adversely affect the ability of Air Canada to execute on its business plans or operate its business, either of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In respect of the unions for Canadian-based employees, strikes or lock-outs may lawfully occur following the term and negotiations of the renewal of collective agreements once a number of pre-conditions prescribed by the *Canada Labour Code* have been satisfied.

Any labour disruption or work stoppage by any of the unionized work groups of Jazz, or other airlines operating flights on behalf of Air Canada, or other key suppliers, or of other parties with whom Air Canada conducts business or relies on could have a material adverse effect on Air Canada, its business,

results from operations and financial condition. In addition, labour conflicts at Star Alliance® partners or involving the operations of key airports could result in lower demand for connecting traffic with Air Canada, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Star Alliance and Joint Ventures - Departure of a key member from Star Alliance or the failure by a key member to meet its obligations, including under joint ventures arrangements, could have a material adverse effect on Air Canada, its business, results from operations and financial condition

The strategic and commercial arrangements with Star Alliance members, including Air Canada's A++ joint venture counterparties, Lufthansa AG and United Airlines, provide Air Canada with important benefits, including codesharing, efficient connections and transfers, reciprocal participation in frequent flyer programs and use of airport lounges from the other members. Should a key member leave Star Alliance or otherwise fail to meet its obligations towards Air Canada, Air Canada, its business, results from operations and financial condition could be materially adversely affected.

Interruptions or disruptions in service - Interruptions or disruptions in service could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada's business is significantly dependent upon its ability to operate without interruption to or from a number of hub airports, including Toronto Pearson. Delays or disruptions in service, including those due to security, computer malfunctions or other incidents, weather conditions, labour conflicts with airport workers, baggage handlers, air traffic controllers, security personnel, and other workers not employed by Air Canada or other causes beyond the control of Air Canada could have a material adverse impact on Air Canada, its business, results from operations and financial condition.

Interruptions and disruptions in service may be caused by, and the demand and cost of air travel may be adversely impacted by, environmental conditions, technology issues and factors in addition to those relating to the weather. Environmental conditions and factors, such as those arising from volcanic eruptions or other natural phenomena, as well as those arising from man-made sources, could cause interruptions and disruptions in service, increase Air Canada's costs or adversely impact demand for air travel, any of which could have a material adverse impact on Air Canada, its business, results from operations and financial condition.

Need for capital and liquidity - Air Canada may not be able to obtain sufficient funds in a timely way and on acceptable terms to provide adequate liquidity and to finance necessary operating and capital expenditures

Air Canada's liquidity levels may be adversely impacted by risks identified in this MD&A, including economic conditions, foreign exchange rates, increased competition from domestic, international, and U.S. transborder carriers, including lower cost carriers, volatile fuel prices, labour issues, and contractual covenants (which require Air Canada to maintain minimum cash reserves and which could require Air Canada to deposit cash collateral with third parties). As part of Air Canada's efforts to manage such challenges and to support Air Canada's business strategy, significant liquidity and significant on-going operating and capital expenditures are required.

Although Air Canada's liquidity levels have significantly improved over the last several years, there can be no assurance that Air Canada will continue to maintain sufficient liquidity, whether from operations or by obtaining funds on terms acceptable to Air Canada, to finance the operating and capital expenditures necessary to manage any challenges and support its business strategy.

A major decline in the market price of Air Canada's securities may negatively impact Air Canada's ability to raise capital, issue debt, retain employees, make strategic acquisitions or enter into business arrangements. Differences between Air Canada's actual or anticipated financial results and the published expectations of financial analysts, as well as events affecting our business or operating environment, may contribute to volatility in Air Canada's securities. A major decline in the capital markets in general, or an adjustment in the market price or trading volumes of Air Canada's securities,

may negatively affect our ability to raise capital, issue debt, retain senior executives and other key employees, make strategic acquisitions or enter into business arrangements.

Failure to maintain or generate required funds, whether from operations or financings, could require Air Canada to delay or abandon some or all of its anticipated expenditures or to modify its business strategy and this could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Furthermore, competitors with greater liquidity or the ability to raise money more easily or on less onerous terms could represent a competitive disadvantage to Air Canada.

Air Canada's credit ratings influence its ability to access capital markets and maintain required liquidity levels. There can be no assurance as to Air Canada's credit ratings, and downgrades or improvements to credit ratings that do not materialize and that may otherwise be anticipated by the market, may adversely impact Air Canada's borrowing costs, its ability to attract capital, its liquidity and its ability to operate its business, all of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Pension plans - Failure or inability by Air Canada to make required cash contributions to its pension plans could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada maintains several defined benefit pension plans, including domestic registered pension plans, supplemental pension plans and international pension plans. Canadian federal pension legislation requires that the funded status of registered pension plans be determined periodically, on both a going concern basis (essentially assuming indefinite plan continuation) and a solvency basis (essentially assuming immediate plan termination).

Air Canada's pension funding obligations (including projected funding obligations) may vary significantly based on a wide variety of factors, including pension plan solvency valuations, regulatory developments, plan demographics, changes to plan provisions, assumptions and methods used and changes in economic conditions (mainly the return on fund assets and changes in interest rates) and other factors, as well as the application of normal past service contribution rules which would generally require one fifth of any solvency deficit in a domestic registered plan, determined on the basis of an average over the previous three years, to be funded each year. Actual contributions that are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition, current service contributions in respect of a domestic registered plan are required unless they are funded (if permitted subject to applicable plan rules and legislation) through a sufficient surplus in such plan. Deteriorating economic conditions or a prolonged period of low or decreasing interest rates may result in significant increases in Air Canada's funding obligations, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its pension plans could have a material adverse effect on Air Canada, its business, results from operations and financial condition. See section 9.7 "Pension Funding Obligations" of this MD&A for additional information.

Limitations due to restrictive covenants - Covenants contained in agreements to which Air Canada is a party may affect and, in some cases, significantly limit or prohibit the manner in which Air Canada operates its business

Some of the financing and other major agreements to which Air Canada is a party contain, and in the future may contain, restrictive, financial (including in relation to asset valuations, liquidity, fixed charge coverage ratio) and other covenants which affect and, in some cases, significantly limit or prohibit, among other things, the manner in which Air Canada may structure or operate its business, including by reducing Air Canada's liquidity, limiting Air Canada's ability to incur indebtedness, create liens, sell assets, pay dividends, make capital expenditures, and engage in acquisitions, mergers or restructurings or a change of control. Although Air Canada has, in the last few years, been able to negotiate more favourable and less restrictive covenants, there can be no assurance that it will be able to continue to do so. Future financing and other significant agreements may be subject to similar or stricter covenants which limit Air Canada's operating and financial flexibility, which could materially and adversely affect Air Canada's ability to operate its business and its profitability.

A failure by Air Canada to comply with its contractual obligations (including restrictive, financial and other covenants), or to pay its indebtedness and fixed costs, could result in a variety of material adverse consequences, including the acceleration of its indebtedness, the withholding of credit card proceeds by the credit card service providers and the exercise of remedies by its creditors, lessors or other co-contracting parties, and such defaults could trigger additional defaults under other indebtedness or agreements. In such a situation, Air Canada may not be able to repay the accelerated indebtedness or fulfill its obligations under certain contracts, make required aircraft lease payments or otherwise cover its fixed costs. Also, the lenders under the financing arrangements could foreclose upon all or substantially all of the assets of Air Canada which secure Air Canada's obligations.

Refer to section 9.8 "Contractual Obligations" of this MD&A for information on Air Canada's credit card processing agreements.

Current legal proceedings - Air Canada is involved in or may be subject to legal proceedings which could materially adversely impact Air Canada

Investigations by Competition Authorities Relating to Air Canada Cargo

The European Commission, the United States Department of Justice and the Competition Bureau in Canada, among others, investigated alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators. The investigations conducted by the U.S. Department of Justice and by the Competition Bureau in Canada concluded with no proceedings against Air Canada.

After having rendered a decision against a number of airlines, including Air Canada in 2010, which was overturned by the European General Court in December 2015, in March 2017, the European Commission rendered another decision finding that 12 air cargo carriers, including Air Canada, had infringed European Union competition law in the setting of certain cargo charges and rates for various periods between 1999 and 2006, imposing a fine of 21 million Euros (approximately \$29 million) on Air Canada. Air Canada paid the fine as required in the second quarter of 2017, pending the outcome of an appeal to the European General Court. While Air Canada cannot predict with certainty the outcome of its appeal or any related proceedings, Air Canada believes it has reasonable grounds to challenge the European Commission's ruling.

Air Canada is also named as a defendant or is otherwise involved in a number of class action lawsuits and other proceedings in Canada, Europe and the United States in connection with these allegations. The class action proceeding in the United States were settled by Air Canada in 2012, and certain third-party proceedings in the United Kingdom relating to the same allegations were settled in 2018.

As at December 31, 2018, Air Canada has a provision of \$17 million (\$17 million as at December 31, 2017) relating to outstanding claims in these matters, which is recorded in Accounts payable and accrued liabilities. This provision is an estimate based upon the status of investigations and proceedings at this time and Air Canada's assessment as to the potential outcome for certain of them. The provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Air Canada has determined it is not possible at this time to predict with any degree of certainty the outcome of all remaining proceedings and investigations. Based on the outcome of any developments regarding proceedings and investigations, Air Canada may adjust the provision in its results for subsequent periods as required.

Mandatory Retirement

Air Canada has been engaged in a number of proceedings involving challenges to the mandatory retirement provisions of certain of its collective agreements. The remaining cases relate to retirement which occurred pursuant to the previous Air Canada-Air Canada Pilots Association collective agreement, which originally incorporated provisions of the pension plan terms and conditions applicable to pilots requiring them to retire at age 60. Those provisions were later amended and since 2012 a variety of retirement rules have been in force. Some of those new rules, notably about benefit coverage for pilots entitled to an unreduced pension and Air Canada's duty to accommodate pilots over age 65 who wish to continue working, are being challenged. Air Canada has fully or partially prevailed in defending some

of these complaints and is defending the remaining ones. At this time, it is not possible to determine with any degree of certainty the extent of any financial liability that may arise from Air Canada being unsuccessful in its defence of these proceedings, though any such financial liability, if imposed, would not be expected to be material.

Future legal proceedings

In the course of conducting their business, airlines are subject to various claims and litigation (including class action claims), including with respect to its contractual arrangements and current or new laws and regulations. Any future claims or litigation could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key personnel - Air Canada is dependent on key employees and could be materially adversely affected by a shortfall or substantial turnover

Air Canada is dependent on the industry experience, qualifications and knowledge of a variety of employees, including its executive officers, managers, airline flight and operations personnel and other key employees to execute its business plan and operate its business. If Air Canada were to experience a shortfall or a substantial turnover in its leadership or other key employees, Air Canada, its business, results from operations and financial condition could be materially adversely affected. Additionally, Air Canada may be unable to attract and retain additional qualified key personnel as needed in the future.

Risks Relating to the Airline Industry

Terrorist attacks and security measures - Terrorist attacks and related consequences could have a material adverse effect on Air Canada, its business, results from operations and financial condition

The potential for terrorist attacks and terrorist activity causes concern and uncertainty in the minds of the traveling public. The occurrence of a terrorist attack, an attempted attack or the perceived threat of one (whether or not involving Air Canada or another carrier, or involving Air Canada's destinations, or other destinations or regions), and restrictive security measures, such as those relating to the content of carry-on baggage, passenger identification document requirements, and passenger screening procedures, could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada's flights. It could also lead to a substantial increase in insurance, security and other costs, including higher operating costs to avoid flying over airspace near conflict zones. Any resulting reduction in passenger revenues and/or increases in costs, including insurance, security or other costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Casualty losses - Air Canada's business makes it subject to large liability claims for serious personal injury or death arising out of accidents or disasters

Due to the nature of its core business, Air Canada may be subject to liability claims arising out of accidents or disasters involving aircraft on which Air Canada's customers are traveling or involving aircraft of other carriers maintained or otherwise serviced by Air Canada or through third parties providing services to Air Canada, including claims for serious personal injury or death. Any such accident or disaster may significantly harm Air Canada's reputation for safety, which would have a material adverse effect on Air Canada, its business, results from operations and financial condition. There can be no assurance that Air Canada's insurance coverage will be sufficient to cover one or more large claims and any shortfall may be material.

Accidents and disasters may occur despite all appropriate measures being taken, and as a result of a variety of factors beyond Air Canada's control including acts of terrorism and sabotage, severe weather, lightning strikes and other natural phenomenon, bird strikes as well as the increasing prevalence of unmanned aerial vehicles.

Regulatory matters - Air Canada is subject to extensive and evolving domestic and foreign regulation in a wide range of matters

The airline industry is subject to extensive legal, regulatory and administrative controls and oversight, including in relation to taxes, airport fees and operations, route rights, security, passenger and consumer rights, flight crew and other labour rules, advertising, privacy, data security, licensing, competition, pensions, environment (including noise levels and carbon emissions), foreign exchange controls and, in some measure, pricing.

Compliance with current or future Canadian and international laws, regulations and administrative requirements, including potentially inconsistent or conflicting laws or regulations, or laws or regulations which disproportionately apply to Canadian airlines or Air Canada specifically (such as the *Air Canada Public Participation Act*), may impose significant costs, impediments and/or competitive disadvantages, and there cannot be any assurance that current or future laws, regulations and administrative requirements will not adversely affect Air Canada, its business, results from operations and financial condition.

The ability of Air Canada to operate flights or otherwise offer air services on international routes between airports in Canada and other countries may be subject to change. Applicable arrangements between Canada and foreign governments, which govern many areas including traffic rights, may be amended from time to time, rules and policies with respect to airport operations may be revised, and the availability of appropriate slots or facilities may change. Air Canada currently operates a number of flights on international routes under government arrangements, regulations or policies that designate the number of carriers permitted to operate on such routes, the capacity of the carriers providing services on such routes, the airports at which carriers may operate international flights, or the number of carriers allowed access to particular airports. Any further limitations, additions or modifications to such arrangements, regulations or policies could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Additionally, if Canada were to adopt a more liberalized approach in relation to air services arrangements with foreign countries, such an approach could have a material adverse impact on Air Canada, its business, results from operations and financial condition and could result in the impairment of material amounts of related tangible and intangible assets.

Air Canada's current and future plans to enter into or expand revenue-sharing joint ventures and other alliance arrangements on various international routes are and may be subject to receipt of approvals from applicable Canadian and international authorities, to their not challenging them, and to satisfying the necessary applicable regulatory requirements. There can be no assurance that such conditions will be met or will continue in effect or that existing, or changes in, regulatory requirements or standards can be satisfied.

Many aspects of Air Canada's operations may also be subject to the proliferation of increasingly stringent laws and regulations relating to environmental reforms, such as in the area of climate change, and including the following:

The International Civil Aviation Organization ("ICAO") global market-based measure ("GMBM"), adopted in 2016, includes emissions from international flights. The GMBM is set to be implemented in phases, with the first two phases (occurring from 2021 to 2023, and 2024 to 2026, respectively) to be voluntary and with the third phase (from 2027 to 2035) to be mandatory. Canada voluntarily adopted the first phase. On the basis of the GMBM, the European Parliament and Council has continued exempting flights between Europe and third countries from the European Union ("EU") emissions trading system ("ETS").

In 2016, the Canadian Federal Government proposed a pan-Canadian benchmark for carbon pricing to be implemented in all Canadian jurisdictions by 2018, with pricing to be based on greenhouse gas emissions from all fossil fuels sources including jet fuel and other fuels used by Air Canada in ground operations and stationary combustion equipment. Canadian provinces may either apply an explicit price-

based system, such as a carbon tax or levy, or a cap and trade system. Certain provinces, such as Alberta, British Columbia and Québec have implemented a carbon pricing system; others have had the federal carbon pricing backstop system applied. Since 2017, Air Canada and regional carriers operating flights on behalf of Air Canada have been subject to a carbon tax for flights operating in British Columbia and in Alberta.

Air Canada cannot predict whether, or the manner in which, these or other initiatives will ultimately be implemented or their impact on Air Canada; however, future developments in Canada and abroad could adversely impact Air Canada, including by increasing its costs. While Air Canada is continually focused on efficiency improvements, including carbon footprint reduction initiatives, the impact to Air Canada of climate change and other environmental initiatives may, in part, depend upon the extent to which the increased costs relating such initiatives, if any, could be recovered, including in the form of higher passenger fares and cargo rates.

Air Canada is also subject to domestic and foreign laws regarding privacy and security of passenger, employee and other data, including advance passenger information and access to airline reservation systems, which are not consistent in all countries which may assert jurisdiction over Air Canada, including in countries where Air Canada operates or conducts business. These laws and regulations are proliferating, are becoming increasingly stringent and may conflict with one another. The need to comply with these laws and regulatory regimes results in additional operating costs and complexities, and further regulation in this area or non-compliance, including in relation to data privacy and security requirements, could have a material adverse effect on Air Canada, its business (including by impacting Air Canada's goodwill and reputation), results from operations and financial condition.

Certain jurisdictions (including Canada, the United States, European Union countries and other jurisdictions where Air Canada operates or conducts business) have enacted and implemented, and they and domestic regulators may in the future enact and implement, consumer protection and passenger rights measures which are being increasingly adopted. Such measures may impose significant, unique, inconsistent or even conflicting obligations on Air Canada, which may result in increased liability and costs to Air Canada and which could adversely impact Air Canada, its business, results from operations and financial condition.

In 2018, the Federal Government proposed the *Air Passenger Protection Regulations* pursuant for adoption under the *Canada Transportation Act*, which are stated to govern flights to, from and within Canada, including connecting flights. The proposed regulations, which have been published for comments and are scheduled to be in force on July 1, 2019, specify requirements governing a carrier's obligations in the case of flight delay, cancellation or denial of boarding, as well as minimum standards of treatment, compensation and assistance in completing the planned itinerary. The regulations prescribe minimum compensation for lost or damaged baggage, obligations with respect to delays over three hours where an aircraft is on the tarmac, and a carrier's obligation to seat young children near a parent, guardian or tutor. The Minister of Transport is also authorized to order the Canadian Transportation Agency to make regulations respecting any of a carrier's other obligations towards passengers.

Epidemic diseases - Epidemic diseases could impact passenger demand for air travel

Outbreaks or the threat of outbreaks of viruses or other contagions or epidemic diseases, including influenza, SARS, Ebola, Zika, as well as any travel or other advisories relating to same, whether domestic or international or whether relating to Canadian cities or regions or other cities, regions or countries, could have a material adverse effect on demand for air travel and could result in a major negative impact on traffic on Air Canada's network. Any resulting reduction in traffic in the markets served by Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Availability of insurance coverage and increased insurance costs - Increases in insurance costs or reduction in insurance coverage could have a material adverse effect on Air Canada, its business, results from operations and financial condition

The aviation insurance industry has been continually re-evaluating the terrorism risks that it covers which may adversely affect some of Air Canada's existing insurance carriers or Air Canada's ability to obtain future insurance coverage (including war risk insurance coverage). To the extent that Air Canada's existing insurance carriers are unable or unwilling to provide it with insurance coverage and in the absence of measures by the Government of Canada to provide the required coverage, Air Canada's insurance costs may increase further and may result in Air Canada being in breach of regulatory requirements or contractual arrangements requiring that specific insurance be maintained, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

19. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

Disclosure controls and procedures within the Corporation have been designed to provide reasonable assurance that all relevant information is identified to its President and Chief Executive Officer ("CEO"), its Deputy Chief Executive Officer and Chief Financial Officer ("CFO") and its Disclosure Policy Committee to ensure appropriate and timely decisions are made regarding public disclosure.

Internal controls over financial reporting have been designed by management, under the supervision of, and with the participation of the Corporation's CEO and CFO, to provide reasonable assurance regarding the reliability of the Corporation's financial reporting and its preparation of financial statements for external purposes in accordance with GAAP.

The Corporation will file certifications, signed by the Corporation's CEO and CFO, with the Canadian Securities Administrators ("CSA") upon filing of the Corporation's Annual Information Form. In those filings, the Corporation's CEO and CFO will certify, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design and effectiveness of the Corporation's disclosure controls and procedures and the design and effectiveness of internal controls over financial reporting. The Corporation's CEO and CFO also certify the appropriateness of the financial disclosures in the Corporation's interim filings with securities regulators. In those interim filings, the Corporation's CEO and CFO also certify the design of the Corporation's disclosure controls and procedures and the design of internal controls over financial reporting.

The Corporation's Audit, Finance and Risk Committee reviewed this MD&A and the audited consolidated financial statements, and the Corporation's Board of Directors approved these documents prior to their release.

Management's Report on Disclosure Controls and Procedures

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined under National Instrument 52-109) and concluded, as at December 31, 2018, that such disclosure controls and procedures were effective.

Management's Report on Internal Controls over Financial Reporting

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's internal controls over financial reporting (as defined under National Instrument 52-109). In making this evaluation, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commissions ("COSO") in Internal Control - Integrated Framework (2013). Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2018, the Corporation's internal controls over financial reporting were effective. This evaluation took into consideration the Corporation's Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee.

Changes in Internal Controls over Financial Reporting

There have been no changes to the Corporation's internal controls over financial reporting during the year ended December 31, 2018 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

20. NON-GAAP FINANCIAL MEASURES

Below is a description of certain non-GAAP financial measures used by Air Canada to provide readers with additional information on its financial and operating performance. Such measures are not recognized measures for financial statement presentation under GAAP, do not have standardized meanings, may not be comparable to similar measures presented by other entities and should not be considered a substitute for or superior to GAAP results.

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is commonly used in the airline industry and is used by Air Canada as a means to view operating results before interest, taxes, depreciation, amortization, impairment and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Air Canada excludes special items from EBITDAR as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

EBITDAR is reconciled to operating income as follows:

(Canadian dollars in millions)	Fourth Quarter			Full Year		
	2018	2017 ⁽¹⁾	\$ Change	2018	2017 ⁽¹⁾	\$ Change
Operating income – GAAP	\$ 122	\$ 133	\$ (11)	\$ 1,174	\$ 1,371	\$ (197)
Add back (as reflected on Air Canada's consolidated statement of operations):						
Depreciation, amortization and impairment	267	245	22	1,080	956	124
Aircraft rent	133	126	7	518	503	15
Add back (included in Regional airlines expense):						
Depreciation, amortization and impairment	11	7	4	38	28	10
Aircraft rent	10	10	-	41	40	1
EBITDAR (including special items)	\$ 543	\$ 521	\$ 22	\$ 2,851	\$ 2,898	\$ (47)
Remove effect of special items ⁽²⁾	-	-	-	-	30	(30)
EBITDAR (excluding special items)	\$ 543	\$ 521	\$ 22	\$ 2,851	\$ 2,928	\$ (77)

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

(2) In the first quarter of 2017, Air Canada recorded a provision of \$30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

Adjusted CASM

Air Canada uses adjusted CASM as a means to assess the operating and cost performance of its ongoing airline business without the effects of aircraft fuel expense, the cost of ground packages at Air Canada Vacations and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

In calculating adjusted CASM, aircraft fuel expense is excluded from operating expense results as it fluctuates widely depending on many factors, including international market conditions, geopolitical events, jet fuel refining costs and Canada/U.S. currency exchange rates. Air Canada also incurs expenses related to ground packages at Air Canada Vacations which some airlines, without comparable tour operator businesses, may not incur. In addition, these costs do not generate ASMs and therefore excluding these costs from operating expense results provides for a more meaningful comparison across periods when such costs may vary.

Excluding aircraft fuel expense, the cost of ground packages at Air Canada Vacations and special items from operating expenses generally allows for more meaningful analysis of Air Canada's operating expense performance and a more meaningful comparison to those of other airlines.

Adjusted CASM is reconciled to GAAP operating expense as follows:

(Canadian dollars in millions, except where indicated)	Fourth Quarter			Full Year		
	2018	2017 ⁽¹⁾	\$ Change	2018	2017 ⁽¹⁾	\$ Change
Operating expense – GAAP	\$ 4,124	\$ 3,687	\$ 437	\$ 16,891	\$ 14,881	\$ 2,010
Adjusted for:						
Aircraft fuel expense (as reflected on Air Canada's consolidated statement of operations)	(958)	(735)	(223)	(3,969)	(2,927)	(1,042)
Aircraft fuel expense (included in Regional airlines expense)	(133)	(112)	(21)	(531)	(412)	(119)
Ground package costs	(126)	(106)	(20)	(602)	(538)	(64)
Special items ⁽²⁾	-	-	-	-	(30)	30
Operating expense, adjusted for the above-noted items	\$ 2,907	\$ 2,734	\$ 173	\$ 11,789	\$ 10,974	\$ 815
ASMs (millions)	25,598	24,191	5.8%	110,866	103,492	7.1%
Adjusted CASM (cents)	¢ 11.36	¢ 11.30	0.5%	¢ 10.63	¢ 10.60	0.3%

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

(2) In the first quarter of 2017, Air Canada recorded a provision of \$30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

Adjusted Pre-tax Income

Adjusted pre-tax income is used by Air Canada to assess the overall pre-tax financial performance of its business without the effects of foreign exchange gains or losses, net financing expense relating to employee benefits, gains or losses on financial instruments recorded at fair value, gains or losses on sale and leaseback of assets, gains or losses on debt settlements and modifications, gains or losses on disposal of assets, and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful. Air Canada uses adjusted pre-tax income before interest to determine return on invested capital.

Adjusted pre-tax income is reconciled to GAAP income (loss) before income taxes as follows:

(Canadian dollars in millions)	Fourth Quarter			Full Year		
	2018	2017 ⁽¹⁾	\$ Change	2018	2017 ⁽¹⁾	\$ Change
Income (loss) before income taxes	\$ (216)	\$ 20	\$ (236)	\$ 405	\$ 1,286	\$ (881)
Adjusted for:						
Special items ⁽²⁾	-	-	-	-	30	(30)
Foreign exchange (gain) loss	269	62	207	317	(120)	437
Net financing expense relating to employee benefits	12	18	(6)	50	65	(15)
(Gain) loss on financial instruments recorded at fair value	3	1	2	1	(23)	24
Gain on sale and leaseback of assets	-	-	-	-	(52)	52
(Gain) loss on debt settlements and modifications	-	(24)	24	(9)	(21)	12
Loss on disposal of assets ⁽³⁾	-	-	-	188	-	188
Adjusted pre-tax income	\$ 68	\$ 77	\$ (9)	\$ 952	\$ 1,165	\$ (213)

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

(2) In the first quarter of 2017, Air Canada recorded a provision of \$30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

(3) In 2018, Air Canada recorded a loss on disposal of assets of \$188 million related to the sale of 25 Embraer 190 aircraft.

Adjusted Net Income (loss) and Adjusted Earnings (Loss) per Share – Diluted

Air Canada uses adjusted net income (loss) and adjusted earnings (loss) per share – diluted as a means to assess the overall financial performance of its business without the after-tax effects of foreign exchange gains or losses, net financing expense relating to employee benefits, gains or losses on financial instruments recorded at fair value, gains or losses on sale and leaseback of assets, gains or losses on debt settlements and modifications, gains or losses on disposal of assets, and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful. Starting as of and including the fourth quarter of 2017, adjusted net income is determined net of tax. Accordingly, the 2018 and 2017 information in the table below is not directly comparable.

Adjusted net income is reconciled to GAAP net income (loss) as follows:

(Canadian dollars in millions, except where indicated)	Fourth Quarter			Full Year		
	2018	2017 ⁽¹⁾	\$ Change	2018	2017 ⁽¹⁾	\$ Change
Net income (loss)	\$ (231)	\$ 8	\$ (239)	\$ 167	\$ 2,029	\$ (1,862)
Adjusted for:						
Special items ⁽²⁾	-	-	-	-	30	(30)
Recovery of deferred income taxes (one-time) ⁽³⁾	-	-	-	-	(759)	759
Foreign exchange (gain) loss	273	57	216	339	(125)	464
Net financing expense relating to employee benefits	10	13	(3)	37	60	(23)
Gain on financial instruments recorded at fair value	3	-	3	1	(23)	24
Gain on sale and leaseback of assets	-	-	-	-	(52)	52
Loss on debt settlements and modifications	(5)	(18)	13	(4)	(15)	11
Loss on disposal of assets ⁽⁴⁾	4	-	4	137	-	137
Adjusted net income	\$ 54	\$ 60	\$ (6)	\$ 677	\$ 1,145	\$ (468)
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	275	278	(3)	276	278	(2)
Adjusted earnings per share – diluted	\$ 0.20	\$ 0.22	\$ (0.02)	\$ 2.45	\$ 4.11	\$ (1.66)

(1) Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.

(2) In the first quarter of 2017, Air Canada recorded a provision of \$30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations

(3) In 2017, Air Canada recorded a tax recovery of \$743 million (representing a deferred income tax recovery of \$759 million and a current income tax expense of \$16 million). This deferred income tax recovery was excluded from adjusted net income as it reflected a one-time recognition of previously unrecognized income tax assets.

(4) In 2018, Air Canada recorded a loss on disposal of assets of \$188 million related to the sale of 25 Embraer 190 aircraft.

The following reflects the share amounts used in the computation of basic and diluted earnings per share on an adjusted-earnings per share basis:

(in millions)	Fourth Quarter		Full Year	
	2018	2017	2018	2017
Weighted average number of shares outstanding – basic	271	274	272	273
Effect of dilution	4	4	4	5
Weighted average number of shares outstanding – diluted	275	278	276	278

Return on Invested Capital

Air Canada uses return on invested capital ("ROIC") as a means to assess the efficiency with which it allocates its capital to generate returns. Return is based on adjusted pre-tax income (or loss, as applicable), excluding interest expense and implicit interest on operating leases. Invested capital includes (i) average year-over-year long-term debt, average year-over-year finance lease obligations, average year-over-year shareholders' equity and (ii) the value of capitalized operating leases (calculated by multiplying annualized aircraft rent by 7). Air Canada calculates invested capital based on a book value-based method of calculating ROIC, as described above. Following an increase in Air Canada's total cash, cash equivalents and short-term investments, Air Canada revised its methodology to reduce the average year-over-year book value of shareholders' equity by excess cash not required to run its core business operations. Air Canada uses average year-over-year advance ticket sales as a proxy for the minimum cash required for ongoing core business operations. This change results in invested capital more closely reflecting operating capital. Refer to the definition of adjusted pre-tax income (loss) for a discussion as to why Air Canada uses this measure to assess the overall pre-tax financial performance of its business.

Return on invested capital is reconciled to GAAP income before income taxes as follows:

(Canadian dollars in millions, except where indicated)	12 Months Ended		
	December 31, 2018	December 31, 2017 ⁽¹⁾	\$ Change
Income before income taxes	\$ 405	\$ 1,286	\$ (881)
Remove:			
Special items ⁽²⁾	-	30	(30)
Foreign exchange loss (gain)	317	(120)	437
Net financing expense relating to employee benefits	50	65	(15)
Loss (gain) on financial instruments recorded at fair value	1	(23)	24
Gain on sale and leaseback of assets	-	(52)	52
Gain on debt settlements and modifications ⁽³⁾	(9)	(21)	12
Loss on disposal of assets ⁽⁴⁾	188	-	188
Adjusted pre-tax income	\$ 952	\$ 1,165	\$ (213)
Adjusted for:			
Interest expense	331	311	20
Implicit interest on operating leases ⁽⁵⁾	274	266	8
Adjusted pre-tax income before interest	\$ 1,557	\$ 1,742	\$ (185)
Invested capital:			
Average long-term debt and finance lease obligations	6,386	6,369	17
Average shareholders' equity, net of excess cash	2,065	1,249	816
Capitalized operating leases ⁽⁶⁾	3,913	3,801	112
Invested capital	\$ 12,364	\$ 11,419	\$ 945
Return on invested capital (%)	12.6	15.3	(2.7) pp

- (1) *Air Canada adopted accounting standard IFRS 15 - Revenue from Contracts with Customers effective January 1, 2018 with restatement of 2017 amounts.*
- (2) *Special items for the 12 months ended December 31, 2017 included a provision of \$30 million related to cargo investigations.*
- (3) *Gain on debt settlements and modifications for the 12 months ended December 31, 2018 of \$9 million included a gain of \$11 million related to the repricing of its US\$1.1 billion senior secured credit facility and a loss of \$2 million related to the prepayment of fixed rate debt.*
Gain on debt settlements and modifications for the 12 months ended December 31, 2017 of \$21 million included a gain of \$27 million related to the repricing of its US\$1.1 billion senior secured credit facility, a loss of \$3 million related to the early exercise of a purchase option for an Airbus 330 aircraft and a loss of \$2 million related to the prepayment of fixed rate debt on four Embraer 190 aircraft.
- (4) *In 2018, Air Canada disposed of 25 Embraer 190 aircraft resulting in a loss on disposal of \$188 million.*
- (5) *Interest implicit on operating leases is equal to 7.0% of 7 times the trailing 12 months of aircraft rent. 7.0% is a proxy and does not necessarily represent the actual implicit interest on operating leases for any given period.*
- (6) *Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totaled \$559 million for the 12 months ended December 31, 2018 and \$543 million for the 12 months ended December 31, 2017 (includes aircraft rent related to regional operations).*

Adjusted Net Debt to Trailing 12-Month EBITDAR (Leverage Ratio)

Adjusted net debt to trailing 12-month EBITDAR ratio (also referred to as "leverage ratio" in this MD&A) is commonly used in the airline industry and is used by Air Canada as a means to measure financial leverage. Leverage ratio is calculated by dividing adjusted net debt by trailing 12-month EBITDAR. As mentioned above, Air Canada excludes special items from EBITDAR results (which are used to determine leverage ratio) as such items would distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP.

Free Cash Flow

Free cash flow is commonly used in the airline industry and is used by Air Canada as an indicator of the financial strength and performance of its business, indicating the amount of cash Air Canada is able to generate from operations and after capital expenditures. Free cash flow is calculated as net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale and leaseback transactions. Refer to section 0 "Consolidated Cash Flow Movements" of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP.

21. GLOSSARY

Adjusted CASM – Refers to operating expense per ASM adjusted to remove the effects of aircraft fuel expense, ground packages costs at Air Canada Vacations, and special items. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

Adjusted net income (loss) – Refers to the consolidated net income (loss) of Air Canada adjusted to remove the after-tax effects of foreign exchange gains or losses, net financing income (expense) relating to employee benefits, gains or losses on financial instruments recorded at fair value, gains or losses on sale and leaseback of assets, gains or losses on debt settlements and modifications, gains or losses on disposal of assets, and special items. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

Adjusted pre-tax income (loss) – Refers to the consolidated income (loss) of Air Canada before income taxes and adjusted to remove the effects of foreign exchange gains or losses, net financing income (expense) relating to employee benefits, gains or losses on financial instruments recorded at fair value, gains or losses on sale and leaseback of assets, gains or losses on debt settlements and modifications, gains or losses on disposal of assets, and special items. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

Air Georgian – Refers to Air Georgian Limited.

Atlantic passenger and cargo revenues – Refer to revenues from flights that cross the Atlantic Ocean with origins and destinations principally in Europe, India, the Middle East and North Africa.

Available seat miles or ASMs – Refers to a measure of passenger capacity calculated by multiplying the total number of seats available for passengers by the miles flown.

Average stage length – Refers to the average mile per departure seat and is calculated by dividing total ASMs by total seats dispatched.

Boeing – Refers to The Boeing Company.

Bombardier – Refers to Bombardier Inc.

CALDA – Refers to the Canadian Airline Dispatchers Association.

CASM – Refers to operating expense per ASM.

CUPE – Refers to the Canadian Union of Public Employees.

Domestic passenger and cargo revenues – Refer to revenues from flights within Canada.

EBITDAR – Refers to earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent. EBITDAR is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information. Air Canada excludes special items from EBITDAR.

EVAS – Refers to Exploits Valley Air Services Limited.

Free cash flow – Refers to net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale and leaseback transactions. Free cash flow is a non-GAAP financial measure. Refer to sections 0 and 20 of this MD&A for additional information.

IAMAW – Refers to the International Association of Machinists and Aerospace Workers.

Jazz – Refers to Jazz Aviation LP.

Jazz CPA – Refers to the capacity purchase agreement between Air Canada and Jazz dated January 1, 2015 which became effective on January 1, 2015.

Leverage ratio – Refers to the ratio of adjusted net debt to trailing 12-month EBITDAR (calculated by dividing adjusted net debt by trailing 12-month EBITDAR). Leverage ratio is a non-GAAP financial measure. Refer to sections 9.3 and 20 of this MD&A for additional information.

Loss (gain) on debt settlements and modifications – Refer to gains or losses related to debt settlements and modifications that, in management's view, are to be separately disclosed by virtue of their size or incidence to enable a fuller understanding of the Corporation's financial performance.

Other passenger and cargo revenues – Refer to revenues from flights with origins and destinations principally in Central and South America, the Caribbean and Mexico.

Pacific passenger and cargo revenues – Refer to revenues from flights that cross the Pacific Ocean with origins and destinations principally in Asia and Australia.

Passenger load factor – Refers to a measure of passenger capacity utilization derived by expressing Revenue Passenger Miles as a percentage of Available Seat Miles.

Passenger revenue per available seat mile or PRASM – Refers to average passenger revenue per ASM.

Percentage point (pp) – Refers to a measure for the arithmetic difference of two percentages.

Return on invested capital or ROIC – Refers to return on invested capital and is a measure used to assess the efficiency with which a company allocates its capital to generate returns. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Revenue passenger carried – Refers to the International Air Transport Association's (IATA) definition of passenger carried whereby passengers are counted on a flight number basis rather than by journey/itinerary or by leg.

Revenue passenger miles or RPMs – Refers to a measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried.

Seats dispatched – Refers to the number of seats on non-stop flights. A non-stop flight refers to a single takeoff and landing.

Sky Regional – Refers to Sky Regional Airlines Inc.

Special items – Refer to those items that, in management's view, are to be separately disclosed by virtue of their significance to the financial statements, to enable a fuller understanding of the Corporation's financial performance.

Toronto Pearson – refers to Lester B. Pearson International Airport.

Unifor – Refers to the trade union in Canada, launched in 2013, as a merger of the Canadian Auto Workers and Communications, Energy and Paperworkers unions.

Weighted average cost of capital or WACC – Refers to management's estimate of its cost of capital, in which each category of capital is proportionately weighted.

Yield – Refers to average passenger revenue per RPM.