

# ACE AVIATION



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**2005**

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION  
For the period ended December 31, 2005**

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**FEBRUARY 9, 2006**

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## 1. PREFACE

ACE Aviation Holdings Inc. (ACE), incorporated on June 29, 2004, is the parent holding company, directly or indirectly, of various transportation and other service companies and partnerships including the following principal operating companies and partnerships: Air Canada, AC Cargo Limited Partnership (Air Canada Cargo), ACGHS Limited Partnership (ACGHS), Touram Limited Partnership (Air Canada Vacations), Jazz Air LP (Jazz or Jazz LP), and ACTS Limited Partnership (ACTS). In addition, the Corporation holds an 85.6 per cent ownership in Aeroplan Limited Partnership (Aeroplan or Aeroplan LP).

Reference to “Corporation” in this Management Discussion and Analysis (MD&A) refers to, as the context may require, ACE and its subsidiaries collectively, ACE and one or more of its subsidiaries, one or more of ACE’s subsidiaries, or ACE itself.

This MD&A is current as of February 9, 2006.

On September 30, 2004, Air Canada and certain subsidiaries emerged from creditor protection under the provisions of the Companies’ Creditors Arrangement Act (Canada) (CCAA). Reference to “Predecessor Company” refers to Air Canada and its subsidiaries prior to September 30, 2004. In accordance with Section 1625 of the Canadian Institute of Chartered Accountants (CICA) Handbook, Comprehensive Revaluation of Assets and Liabilities (CICA 1625), prior period financial information has not been restated to reflect the impact of fair value adjustments and, accordingly, certain amounts in the Predecessor Company’s results are not directly comparable to those of the Corporation.

The consolidated financial statements are expressed in millions of Canadian dollars and are prepared in accordance with Generally Accepted Accounting Principles (GAAP) in Canada. The accounting policies of ACE are consistent with those of the Predecessor Company, with the exception of the fair value adjustments applied under fresh start reporting and certain accounting policies as outlined in Note 2 to the 2005 Annual Consolidated Financial Statements of ACE.

The consolidated statement of operations and the consolidated statement of cash flow for the three months ended December 31, 2005 and for the three months ended December 31, 2004 both reflect the results of operations of the Corporation. Consequently, the financial information for the fourth quarter of 2005 is directly comparable to that of the fourth quarter of 2004 with the exception of the adoption of Accounting Guideline 15 – Consolidation of Variable Interest Entities (AcG-15) on January 1, 2005, as further described in Note 2 to the 2005 Annual Consolidated Financial Statements of ACE. The consolidated statement of financial position as of December 31, 2005 and December 31, 2004 represents the accounts of the Corporation.

The consolidated statement of operations and the consolidated statement of cash flow for the year ended December 31, 2005 reflect the results of the Corporation. The consolidated statement of operations and the consolidated statement of cash flow for the nine months ended September 30, 2004 reflect the results of the Predecessor Company; the consolidated statement of operations and the consolidated statement of cash flow for the period from the incorporation of ACE to December 31, 2004 reflect the results of the Corporation. Refer to the section entitled “Non-GAAP Financial Measures” on page 4 of this MD&A for additional information on the 2004 results of operations.

For further information on ACE’s and Air Canada’s public disclosure file, including ACE’s Annual Information Form, please consult SEDAR at [www.sedar.com](http://www.sedar.com).

## **CAUTION REGARDING FORWARD-LOOKING INFORMATION**

*ACE’s communications often contain written or oral forward-looking statements which are included in the MD&A and may be included in filings with securities regulators in Canada and the United States. These forward-looking statements are identified by the use of 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. Such statements may involve but are not limited to comments with respect to strategies, expectations, planned operations or future actions.*

*Forward-looking statements, by their nature, are based on assumptions and are subject to important risks and uncertainties. Any forecasts or forward-looking predictions or statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Results indicated in forward-looking statements may differ materially from actual results for a number of reasons, including without limitation, energy prices, general industry, market and economic conditions, war, terrorist attacks, changes in demand due to the seasonal nature of the business, the ability to reduce operating costs and employee counts, employee relations, labour negotiations or disputes, restructuring, pension issues, currency exchange and interest rates, changes in laws, adverse regulatory developments or proceedings, pending litigation and actions by third parties as well as the factors identified throughout this MD&A and, in particular, those identified in the Risk Factors section to this MD&A. The forward-looking statements contained in this discussion represent ACE’s expectations as of February 9, 2006, and are subject to change after such date. However, ACE disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise.*

## **2. EXPLANATORY NOTES**

### **2.1. Glossary of Terms**

#### Revenue Passenger Miles (RPMs)

Revenue Passenger Miles is a measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried.

#### Available Seat Miles (ASMs)

Available Seat Miles is a measure of passenger capacity calculated by multiplying the total number of seats available for revenue traffic by the miles flown.

#### Passenger Load Factor

Passenger Load Factor is a measure of passenger capacity utilization derived by expressing revenue passenger miles as a percentage of available seat miles.

#### Passenger Revenue per Revenue Passenger Mile (yield)

Average passenger revenue per revenue passenger mile.

#### Passenger Revenue per Available Seat Mile (RASM)

Average passenger revenue per available seat mile.

“Subsidiary” or “subsidiaries” refers to, in relation to ACE, any entity, including a corporation or a limited partnership, which is controlled, directly or indirectly, by ACE.

### **2.2. Seasonality**

The Corporation has historically experienced considerably greater demand for its services in the second and third quarters of the calendar year and significantly lower demand in the first and fourth quarters of the calendar year. This demand pattern is principally a result of the high number of leisure travelers and their preference for travel during the spring and summer months. The Corporation has substantial fixed costs that do not meaningfully fluctuate with passenger demand in the short-term.

## 2.3. Non-GAAP Financial Measures

### Annual Supplementary Non-GAAP Combined Information for the year 2004

The Annual Supplementary Non-GAAP Combined Information for the year 2004 is the combination of financial results for the nine months ended September 30, 2004 of the Predecessor Company and financial results for the period ended December 31, 2004, which represents three months of operations, of the Corporation. Such combination is for illustrative purposes only. This combined information will hereinafter be referred in this MD&A as “Combined” information or “2004 Combined”. As a result of the application of fresh start reporting, application of new accounting policies, the effectiveness of certain lease contracts on emergence from CCAA and the debt and equity transactions that occurred on September 30, 2004, the Corporation’s financial statements are not directly comparable to those prepared for the Predecessor Company prior to the emergence. The combination of the financial information of Air Canada and ACE for the year ended December 31, 2004 should not be viewed as a continuum because the financial statements of Air Canada for periods prior to October 1, 2004 and the financial statements of ACE for the period ended December 31, 2004 are those of different reporting entities and are prepared using different bases of accounting and different accounting policies and are therefore not directly comparable.

#### 2004 Combined Income Statement

(\$ millions)	ACE Three months ended December 31, 2004	Air Canada Nine months ended September 30, 2004	2004 Combined
Operating Revenues			
Passenger	1,681	5,628	7,309
Cargo	151	405	556
Other	230	805	1,035
	2,062	6,838	8,900
Operating Expenses			
Salaries, wages and benefits	596	1,989	2,585
Aircraft fuel	432	1,174	1,606
Aircraft rent	111	521	632
Other	926	3,034	3,960
	2,065	6,718	8,783
Operating income (loss) before restructuring and reorganization items	(3)	120	117
Reorganization and restructuring items	-	(871)	(871)
Non-operating expense	(47)	(246)	(293)
Foreign exchange gain	78	104	182
Provision for income taxes	(13)	(2)	(15)
Income (loss) for the period	15	(895)	(880)

## 2004 Combined Statement of Cash Flow

(\$ millions)	ACE	Predecessor Company	
	Three Months ended December 31, 2004	Nine months ended September 30, 2004	2004 Combined
<b>Cash flows from (used for)</b>			
<b>Operating</b>			
Income (loss) for the period	15	(895)	(880)
Adjustments to reconcile to net cash provided by operations:			
Reorganization and restructuring items	-	786	786
Depreciation, amortization and obsolescence	85	312	397
Loss on sale of and provisions on assets	-	75	75
Foreign exchange	(98)	(104)	(202)
Future income taxes	11	(5)	6
Employee future benefit funding (more than) less than expense	(52)	126	74
Decrease (increase) in accounts receivable	269	(191)	78
Decrease (increase) in spare parts, materials & supplies	(30)	-	(30)
Increase (decrease) in accounts payable & accrued liabilities	(256)	34	(222)
Increase (decrease) in advance ticket sales, net of restricted cash	(77)	196	119
Aircraft lease payments in excess of rent expense	(14)	(31)	(45)
Other	35	57	92
Cash flows from (used for) operating activities before the following items:			
Settlement of lease obligations	(112)	360	248
Rebate on lease settlement	(290)	-	(290)
Payment of restructuring obligation	33	-	33
Fees conditional on emergence	(45)	-	(45)
	(12)	-	(12)
	(426)	360	(66)
<b>Financing</b>			
Issue of share capital	1	-	1
Aircraft-related borrowings	-	233	233
Credit facility borrowings	-	80	80
Reduction of long-term debt and capital lease obligations	(67)	(358)	(425)
Preferred shares issued to Cerberus for cash	238	-	238
Shares issued for cash under rights offering	852	-	852
GE DIP financing	(300)	300	-
Drawdown of Exit Financing	527	-	527
Other	-	(2)	(2)
	1,251	253	1,504
<b>Investing</b>			
Short-term investments	(151)	186	35
Additions to capital assets	(129)	(328)	(457)
Proceeds from sale of assets	-	2	2
Cash collateralization of letters of credit	(21)	-	(21)
	(301)	(140)	(441)
Increase in cash and cash equivalents	524	473	997
Cash and cash equivalents, beginning of period	-	484	484
Cash and cash equivalents, transferred to the Corporation	957	(957)	-
<b>Cash and cash equivalents, end of period</b>	<b>1,481</b>	<b>-</b>	<b>1,481</b>

## EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization and obsolescence and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before aircraft rent and depreciation, obsolescence and amortization, as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets.

EBITDAR is not a recognized measure for financial statement presentation under GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies. EBITDAR, before reorganization and restructuring items, is reconciled to operating income (loss) before reorganization and restructuring items, as follows:

(\$ millions)	ACE		\$ Change	Combined		\$ Change
	Three Months ended December 31, 2005	Three Months ended December 31, 2004		Twelve Months ended December 31, 2005	Twelve Months ended December 31, 2004	
GAAP operating income before reorganization and restructuring items (1)	(35)	(3)	(32)	452	117	335
Add back:						
Aircraft rent	117	111	6	417	632	(215)
Depreciation, amortization and obsolescence	125	85	40	482	397	85
EBITDAR, before reorganization and restructuring items (1)	207	193	14	1,351	1,146	205
EBITDAR margin (%) (2)	8.8	9.4	(0.6) pp	13.7	12.9	0.8 pp

(1) Reorganization and restructuring items were recorded while the Predecessor Company was under creditor protection from April 1, 2003 through to September 30, 2004. As the Corporation emerged from CCAA proceedings on September 30, 2004, reorganization and restructuring items were not recorded after that date.

(2) EBITDAR margin is calculated as EBITDAR divided by operating revenues.

## EBITDAR by Segment

Three Months ended December 31, 2005						
(\$ millions)	Transportation Services	Aeroplan	Jazz	ACTS	Inter-Segment Elimination	ACE Consolidated
GAAP operating income	(91)	30	34	(8)	-	(35)
Add back:						
Aircraft rent	90	-	28	-	(1)	117
Depreciation, amortization and obsolescence	110	3	4	8	-	125
EBITDAR	109	33	66	0	(1)	207

Three Months ended December 31, 2004						
(\$ millions)	Transportation Services	Aeroplan	Jazz	ACTS	Inter-Segment Elimination	ACE Consolidated
GAAP operating income	(58)	22	22	11	-	(3)
Add back:						
Aircraft rent	103	-	9	-	(1)	111
Depreciation, amortization and obsolescence	73	1	4	7	-	85
EBITDAR	118	23	35	18	(1)	193

Twelve Months ended December 31, 2005						
(\$ millions)	Transportation Services	Aeroplan	Jazz	ACTS	Inter-Segment Elimination	ACE Consolidated
GAAP operating income	174	102	129	47	-	452
Add back:						
Aircraft rent	343	-	80	-	(6)	417
Depreciation, amortization and obsolescence	424	8	18	32	-	482
EBITDAR	941	110	227	79	(6)	1,351

## 2.4. Aeroplan Loyalty Program

As a result of the application of fresh start reporting, the outstanding loyalty program mileage credits (Miles) were adjusted to reflect the estimated fair value of Miles to be redeemed in the future. As a consequence of this fair value adjustment and the evolving nature of the Aeroplan loyalty program, the Corporation changed the accounting policy effective September 30, 2004 for the recognition of its obligations relating to the loyalty program. The Predecessor Company recognized the obligation related to Miles earned through transportation services based on the incremental cost of providing future transportation services. On a prospective basis from the date of fresh start reporting, Miles earned by members through transportation services provided by the Corporation and the transportation services are treated as multiple elements. Miles are recorded at fair values with the residual allocated to transportation services. Consistent with the accounting policy of the Predecessor Company, the proceeds from the sale of Miles to loyalty program partners are deferred.

Effective September 30, 2004, Miles redeemed for travel on Air Canada and Jazz are included in the Passenger revenue category and Miles redeemed for other than travel are included in the Other revenue category. Under the accounting policy in the Predecessor Company, Aeroplan redemption revenues from Miles earned by members through loyalty program partners were included in the Other revenue category.

The net of passenger revenues from Miles redeemed for travel on Air Canada and Jazz and the reduction to passenger revenues for the fair value of Miles issued on qualifying travel on Air Canada and Jazz is referred to as “Aeroplan passenger revenues” in this MD&A. The following table summarizes the amounts recorded under the current and previous accounting policies:

(\$ millions)	2005	2004
<b>ACE Accounting Policy</b>		
Aeroplan Miles redeemed for travel on Air Canada and Jazz		
Miles earned through air transportation services	164	30
Miles earned through loyalty program partners	305	54
	469	84
Less the deferral of the fair value of Miles issued	(179)	(43)
Net recorded in Passenger revenue	290	41
<b>Predecessor Company Accounting Policy</b>		
Miles earned through loyalty program partners and redeemed for travel on Air Canada and Jazz (recorded in Other revenue).	-	173

### 3. OVERVIEW AND GENERAL BUSINESS SUMMARY

ACE is the parent holding company of Air Canada and ACE's other subsidiaries.



Air Canada is Canada's largest domestic and international full-service airline and the largest provider of scheduled passenger services in the domestic market, the US transborder market and each of the Canada Europe, Canada Pacific, Canada Caribbean/Central America and Canada South America markets. Passenger transportation is the principal business of the Corporation and, in 2005, represented 84 per cent of its total operating revenues.

Air Canada and Jazz, the Corporation's regional carrier, operate an extensive domestic, US transborder and international network. During 2005, Air Canada and Jazz operated, on average, approximately 1,200 scheduled flights each day and carried over 30 million passengers. In 2005, Air Canada and Jazz provided direct passenger air transportation to 159 destinations and, through commercial agreements with other unaffiliated regional airlines referred to as Tier III carriers, to an additional 11 destinations, for a total of 170 direct destinations on five continents. The Corporation's primary hubs are located in Toronto, Montréal, Vancouver and Calgary. In 2005, an independent survey by Skytrax of more than 12 million international air travelers ranked Air Canada as the Best Airline in North America.

Air Canada also operates an extensive global network in conjunction with its international partners. Air Canada is a founding member of the Star Alliance network, the world's largest airline alliance group. The Star Alliance network has grown, since its inception, to include 16 members and three regional members. Through its strategic and commercial arrangements with Star Alliance members and several other airlines, Air Canada offers service to over 795 destinations in 139 countries, with reciprocal participation in frequent flyer programs and use of airport lounges.

The Corporation has a controlling interest in Aeroplan which operates Canada's premier loyalty program. Aeroplan provides its commercial partners with loyalty marketing services designed to attract and retain customers and stimulate demand for such partners' products and services. Aeroplan's objective is to offer its commercial partners superior value relative to other marketing alternatives through access to Aeroplan's base of members and the design and execution of marketing programs aimed at increasing revenue, market share, and customer loyalty. The Aeroplan program is one of Canada's longest standing loyalty programs. It was founded in 1984 by Air Canada to manage the airline's frequent flyer program. Aeroplan benefits from its unique strategic relationship with Air Canada in addition to its contractual arrangements with leading commercial partners including AMEX, Bell Canada, CIBC, Future Shop, Imperial Oil (Esso), Star Alliance member airlines and numerous hotel chains and car rental companies.

Aeroplan offers its approximately five million active members the ability to accumulate Aeroplan Miles throughout its partner network through purchases of products and services. Aeroplan sells Aeroplan Miles to its extensive network of over 60 commercial partners, representing over 100 brands in the financial services, travel services and consumer products and services industries. Today, financial services partners generate the majority of Aeroplan's revenues.

Jazz is the largest regional airline and the second largest airline in Canada after Air Canada, based on fleet size and number of routes operated. Jazz forms an integral part of Air Canada's domestic and US transborder market presence and strategy. Jazz and Air Canada are parties to a capacity purchase agreement (CPA) effective September 30, 2004, pursuant to which Air Canada currently purchases substantially all of Jazz's fleet capacity based on predetermined rates. Under the CPA with Air Canada, Jazz provides service to and from lower density markets as well as higher density markets at off-peak times throughout Canada and to and from certain destinations in the United States. Jazz currently operates scheduled passenger service on behalf of Air Canada, with approximately 688 departures per weekday to 56 destinations in Canada and 17 destinations in the United States with an operating fleet of 121 aircraft as of December 31, 2005. Jazz and Air Canada have linked their regional and mainline networks in order to serve connecting passengers more efficiently and to provide valuable traffic feeds to Air Canada's mainline routes.

The Corporation also provides technical services through ACTS. ACTS is a full-service Maintenance, Repair and Overhaul (MRO) organization that provides airframe, engine and component maintenance and various ancillary services to a wide range of more than 100 global customers. ACTS operates maintenance centers across Canada, with principal centers located in Montréal, Toronto, Winnipeg and Vancouver.

The Corporation also provides cargo services through Air Canada Cargo; ground handling services through ACGHS; and tour operator services and leisure vacation packages through Air Canada Vacations.

## **Business Strategy**

In order to respond to a rapidly changing landscape, the Corporation has fundamentally changed its business strategy and has been redesigning its business processes since emergence from CCAA. ACE designed and embarked on a new business plan to: (i) consolidate its domestic market position through a superior product offering at a competitive cost; (ii) provide a sustainable foundation for its growing international markets; and (iii) highlight the value inherent in ACE's subsidiaries. The Corporation's new business strategy is based on the following four major components:

- (i) a competitive cost structure;
- (ii) a redesigned network to maximize efficiency and leverage international growth opportunities;
- (iii) a new revenue model for passenger services; and
- (iv) a new corporate structure to facilitate the implementation of strategic initiatives and to surface the value of its subsidiaries.

## **Competitive Cost Structure**

The Corporation's new business strategy is built on a significantly improved competitive cost structure. During the CCAA restructuring process and since emerging from the process, the following three main focus areas have contributed significantly to the Corporation's benefit:

- (i) Through the CCAA restructuring process, the Corporation dramatically reduced its operating costs.
- (ii) Following this, the Corporation embarked on a substantial re-engineering process to simplify its internal processes and reduce its costs even further by eliminating non-value adding tasks and procedures. This is an ongoing process of continuous improvement.
- (iii) Additionally, the Corporation has created a new business model whereby its customers can be served directly using web-enabled technology which is envisaged to further eliminate substantial external non-value adding processes between the Corporation and its customers. This too is an ongoing process of continuous improvement.

Stemming from the above focus areas, the Corporation has realized and envisages continuing to benefit from substantial cost reductions in the following areas:

- (i) substantially reduced supplier obligations, including aircraft and real estate;
- (ii) significantly improved labour productivity due to a rationalized work force and lower average salaries;
- (iii) lower trip costs due to better matching of capacity with demand;
- (iv) higher operating efficiencies through its fleet modernization program;
- (v) lower pilot training, inventory carrying and maintenance costs by reducing the number of aircraft types;
- (vi) significantly lower sales and distribution costs by improved and easy to use web-enabled technology for its customers;
- (vii) dramatically lower internal costs by eliminating business processes which do not fit the new revenue model.

Unlike its low-cost competitors, the Corporation incurs costs related to the offer of value-added transportation services, such as Executive Class services and other non-air services. The Corporation believes that these costs are offset by a revenue premium, driven primarily by higher passenger yield and passenger load factor, increased international connecting traffic and increased Aeroplan and cargo revenues. The Corporation expects to maintain this revenue premium by continuing to leverage its key competitive advantages, including:

- (i) a more extensive route network, greater flight frequency and greater market presence;
- (ii) value-added services, for which customers are willing to pay a premium, including unlimited schedule changes, same day stand by, advance seat selection, full Aeroplan mileage, concierge service and Executive Class service; and
- (iii) higher yielding international (including US transborder) connections.

### **Redesigned Network to Maximize Efficiency and Leverage International Growth Opportunities**

The Corporation's objective is to become the customer's clear choice in all the markets in which it competes by offering a better scheduled product at a competitive price. To this end, the Corporation's redesigned network focuses on offering better flight frequencies on key domestic and US transborder routes, while maintaining competitive frequency on other domestic and US transborder routes, and reducing the average seating capacity per departure.

Jazz, the Corporation's regional carrier, forms an integral part of Air Canada's domestic and US transborder market strategy. The Corporation expects to achieve its objectives through the increased use of large regional jet aircraft which have lower trip costs. This initiative, for which deliveries commenced in October 2004, will see Air Canada and Jazz add 90 new regional jet aircraft to their fleet by January 2008. By early 2006, the Corporation had received all fifteen 75-seat Bombardier CRJ 705 aircraft and fifteen 75-seat Embraer ERJ 175 aircraft under firm order as well as five 93-seat ERJ 190 aircraft. Forty additional Embraer ERJ 190 aircraft under firm order will be delivered in the remainder of 2006, during 2007 and in January 2008. In addition, as a result of agreements reached with Air Canada's and Jazz's unions during Air Canada's restructuring under the CCAA, all of the Corporation's Bombardier CRJ aircraft will be operated out of Jazz's regional operations. The Corporation expects that the lower trip costs of these regional jet aircraft will enable the Corporation to compete more effectively with low-cost carriers. This strategy should allow the Corporation to operate its network more efficiently by better matching capacity with demand and by facilitating connections in a timely fashion.

Since international services generally produce higher margins than domestic and transborder services, the Corporation also intends to expand its existing services to currently served international destinations as well as serve new international destinations. The Corporation believes that it is well positioned to grow its international services and increase its current market share by leveraging the following competitive advantages:

- (i) its superior international network;
- (ii) its widely recognized brand and its strong position in the market for trans-Atlantic and trans-Pacific travel to and from Canada and more recently the Canada-South America market; and
- (iii) its ability to capitalize on the relative speed and convenience associated with having its hubs located in Canada which, unlike the United States, does not currently require a visa from residents of certain countries transiting through the country.

For domestic, US transborder and international services, the Corporation will continue to leverage the strengths of its Aeroplan program.

### **Customer Driven Revenue Model for Passenger Services**

The Corporation's new revenue model for passenger services is aimed at improving customer satisfaction and retention by focusing on simplicity, value, choice, transparency and flexibility for the customer and is resulting in greater passenger volume, higher passenger load factors and increased cost efficiency for Air Canada and Jazz.

The new revenue model is based on five simple fare types ranging from low one-way fares, substantially similar to those offered by low-cost carriers, to Executive Class fares. The new fares are based on a different combination of product attributes, including the ability to make changes to reservations, seat selection and Aeroplan mileage. The new model provides transparency by allowing customers to compare prices and travel options and select the most suitable fare. The Corporation believes that this establishes a clear link between price and value and will be a key driver in achieving customer loyalty.

The new revenue model was introduced in Air Canada's and Jazz's domestic markets in May 2003. In February 2004, the new revenue model was expanded to most destinations in the continental United States served by Air Canada and Jazz in cooperation with United Airlines, one of Air Canada's Star Alliance partners. On January 4, 2006, Air Canada expanded its low, simplified fare structure for flights to and from London Heathrow and Manchester. Air Canada plans to convert more international destinations to its simplified fare structure in the near future. The Corporation believes that its increasing use of the internet to improve its distribution network has facilitated market acceptance of its new revenue model.

Another key step in the implementation of its new revenue model was the introduction in 2005 of a range of multi-trip online pass products that offer significant buy-in-bulk savings for frequent travelers. This product also provides online convenience that underlines Air Canada's commitment to lead the way by giving customers the ability to plan their travel budgets upfront and execute these plans with minimum variations. Among the products are Rapidair Flight Passes for travel between Toronto, Hamilton, Ottawa and Montréal, Western Canada Flight Passes for cities within Western Canada, City Flight Passes for travel within a specified radius around a city, Flight Passes to Sun destinations including Hawaii, Week-end Flight Passes and passes for businesses that permit travel on a pass by up to eight employees within a firm. In addition, in September of 2005, Air Canada expanded its line of multi-trip pass products to include the airline industry's first-ever subscription to unlimited flights. This "North America Unlimited

Pass” provided pass holders the freedom to fly as often as they wished to more than 100 destinations served by Air Canada and Jazz in North America for a two-month period from October 1 to November 30, 2005 inclusive.

### **New Corporate Structure to Maximize the Value of Subsidiaries**

A new corporate structure was established pursuant to which the various business segments that were formerly within Air Canada became stand-alone subsidiaries of ACE. The new corporate structure was designed to:

- (i) put in place separate management and business plans for each subsidiary to better focus their strategic direction and profit making efforts;
- (ii) align management, capital and human resource needs within each individual business;
- (iii) facilitate the development of each business segment to its fullest individual potential including, where appropriate, through the pursuit of third party sources of business; and
- (iv) maximize subsidiaries’ value that was not fully recognized.

As part of this strategy to maximize shareholder value by surfacing the underlying value of its subsidiaries, in June 2005, ACE and the Aeroplan Income Fund completed an initial public offering of its loyalty management subsidiary as an income trust. Aggregate net proceeds of the offering were \$267 million.

On February 2, 2006, the Jazz Air Income Fund (the Fund) sold 23.5 million units at a price of \$10 per unit for estimated net proceeds of \$222 million. The Fund is an unincorporated, open-ended trust created to indirectly acquire and hold 19.1 per cent of the outstanding limited partnership units of Jazz. ACE holds the remaining 80.9 per cent of the outstanding limited partnership units of Jazz.

The Fund has granted to the underwriters an over-allotment option (the Over-Allotment Option), exercisable for a period of 30 days following the closing date, to purchase up to 3.525 million additional units at \$10 per unit for net proceeds of \$33 million. In the event the underwriters exercise the Over-Allotment Option in full, the Fund and ACE will hold 22 per cent and 78 per cent of the outstanding limited partnership units of Jazz respectively.

ACE’s subsidiaries are at varying stages of their corporate development, and maximizing value at these entities is a priority in the efforts of senior management. ACE’s value enhancement strategy for its stand-alone subsidiaries includes considering stand-alone financings, sales or distributions of equity interests and involving outside investors for these and other purposes.

From time to time, ACE reviews acquisition opportunities in respect of businesses or assets that may be complementary to its own. Where appropriate, to increase shareholder value, ACE may consider entering into acquisitions and joint ventures.

In addition, ACE is pursuing internal growth opportunities at its various subsidiaries. In particular, Aeroplan intends to grow its revenues through greater access to Air Canada's network for mileage redemption and the addition of new partners across various retail segments. ACTS intends to leverage its expertise and develop its third party customer base, including US carriers that have recently increased their outsourcing of maintenance repair and overhaul work (MRO).

#### **Other Investments**

On September 27, 2005, the Corporation invested \$87 million (US\$75 million) in US Airways Group Inc. (US Airways) in conjunction with the carrier's exit from US bankruptcy proceedings. The Corporation's investment represented approximately 6 per cent of the equity of US Airways at December 31, 2005.

#### 4. CONSOLIDATED RESULTS OF OPERATIONS – FOURTH QUARTER ANALYSIS

The following table compares the consolidated results of operations of ACE for the fourth quarter of 2005 to the fourth quarter of 2004.

##### Consolidated Statement of Operations

(\$ millions, except per share figures) (Unaudited)	ACE			
	Three Months ended December 31, 2005	Three Months ended December 31, 2004	\$ Change	% Change
<b>Operating revenues</b>				
Passenger	1,969	1,681	288	17
Cargo	176	151	25	17
Other	217	230	(13)	(6)
	2,362	2,062	300	15
<b>Operating expenses</b>				
Salaries, wages and benefits	648	596	52	9
Aircraft fuel	578	432	146	34
Aircraft rent	117	111	6	5
Airport and navigation fees	222	198	24	12
Aircraft maintenance, materials and supplies	104	78	26	33
Communications and information technology	73	66	7	11
Food, beverages and supplies	81	76	5	7
Depreciation, amortization and obsolescence	125	85	40	47
Commissions	47	65	(18)	(28)
Other	402	358	44	12
	2,397	2,065	332	16
<b>Operating loss</b>	(35)	(3)	(32)	
Non-operating income (expense)				
Interest income	19	11	8	
Interest expense	(87)	(60)	(27)	
Interest capitalized	6	2	4	
Loss on sale of and provisions on assets	(30)	-	(30)	
Other	4	-	4	
	(88)	(47)	(41)	
<b>Loss before the following items:</b>	(123)	(50)	(73)	
Non-controlling interest	(8)	-	(8)	
Foreign exchange gain (loss)	(11)	78	(89)	
Recovery of (provision for) income taxes	39	(13)	52	
<b>Income (loss) for the period</b>	<b>(103)</b>	<b>15</b>	<b>(118)</b>	
Earnings (loss) per share				
- Basic	(1.02)	0.17	(1.19)	
- Diluted	(1.02)	0.17	(1.19)	
<b>EBITDAR<sup>(1)</sup></b>	<b>207</b>	<b>193</b>	<b>14</b>	

(1) Refer to “Non-GAAP Financial Measures” on page 6 of this MD&A for additional information on EBITDAR.

##### Operating Statistics

	ACE			
	Three Months ended December 31, 2005	Three Months ended December 31, 2004	Change	% Change
Revenue Passenger Miles (millions)	10,584	9,681	903	9
Available Seat Miles (millions)	13,808	12,815	993	8
Passenger Load Factor (%)	76.7	75.5	1.2 pp	

#### **4.1. Comparison of Results – Fourth Quarter 2005 versus Fourth Quarter 2004**

ACE applied fresh start reporting on September 30, 2004 and, therefore, the fourth quarter of 2005 is directly comparable to the fourth quarter of 2004, with the exception of the adoption of AcG-15.

Aircraft fuel expense was the most significant expense increase, affecting profitability in 2005, rising \$146 million or 34 per cent in the fourth quarter of 2005 and \$592 million or 37 per cent for the full year of 2005, when compared to 2004 levels. In the first three quarters of 2005, excluding fuel expense, unit cost, as measured by operating expenses per ASM, showed quarter-over-quarter decreases which largely reflected the impact of fresh start reporting on the 2005 quarters, the continuing cost reduction initiatives and increased employee productivity. Excluding fuel expense, unit cost for the fourth quarter of 2005 rose 4 per cent over the fourth quarter of 2004. Ownership costs, comprised of aircraft rent and depreciation, were significant factors in the increase in unit cost, excluding fuel. Ownership costs, as well as other costs, were affected by the addition of 41 new regional aircraft, such as the Embraer ERJ 175/190 and the Bombardier CRJ-705 aircraft, with higher unit costs but with lower trip costs, and two extra freighters in the 2005 quarter. These freighters incurred operating costs but produced no ASMs. Higher aircraft maintenance material and supplies expense was another significant negative factor.

For the fourth quarter of 2005, ACE reported an operating loss of \$35 million, a deterioration of \$32 million compared to the operating loss of \$3 million recorded in the same quarter of 2004. EBITDAR improved \$14 million over the 2004 quarter. Refer to “Non-GAAP Financial Measures” on page 6 of this MD&A for additional information on EBITDAR.

In the fourth quarter of 2005, total operating revenues increased \$300 million or 15 per cent compared to the fourth quarter of 2004. Passenger revenues were up \$288 million or 17 per cent reflecting increases in all markets due to both a yield improvement of 7 per cent as well as an increase in passenger traffic of 9 per cent. The system yield improvement was primarily due to increased fare levels in the domestic and US transborder markets and significantly increased fuel surcharges in the international markets to cover higher fuel costs. An improved domestic competitive position and a stronger market demand for the higher-priced Tango Plus product, the next level up from the basic best value fare, providing additional features such as advance seat selection and increased Aeroplan points, were also factors in the domestic yield improvement. Additionally, US transborder yield also improved as a result of a redesign of conditions underlying fares aimed at the business-oriented market which occurred in the fourth quarter of 2005.

Operating expenses increased \$332 million or 16 per cent versus the fourth quarter of 2004, including an increase in fuel expense of \$146 million or 34 per cent over the fourth quarter of 2004. Capacity, as measured in available seat miles (ASM), increased 8 per cent. Unit cost for the fourth quarter of 2005, as measured by operating expense per ASM, increased 8 per cent from the fourth quarter of 2004.

In the fourth quarter of 2005, non-operating expense amounted to \$88 million, an increase of \$41 million from the fourth quarter of 2004. In the fourth quarter of 2005, loss on sale of and provisions on assets of \$30 million was recorded, of which approximately \$15 million related to the write-down of inactive Boeing 747 inventory.

Losses from revaluation of foreign currency monetary items and the impact of foreign currency derivative contracts totaled \$11 million in the fourth quarter of 2005 and were mainly attributable to a weaker Canadian dollar versus the US dollar at December 31, 2005 compared to September 30, 2005. Foreign exchange gains of \$78 million were recorded in the fourth quarter of 2004.

The Corporation recorded a recovery of income taxes of \$39 million in the fourth quarter of 2005. This compared to a provision for income taxes of \$13 million in the 2004 quarter.

Net loss for the fourth quarter of 2005 was \$103 million compared to net income of \$15 million recorded in the fourth quarter of 2004, a deterioration of \$118 million.

## 4.2. Revenue Performance – Fourth Quarter 2005 versus Fourth Quarter 2004

### Passenger Revenues

As a result of the inclusion of Aeroplan passenger revenues in passenger revenues starting in October 2004, as described on page 8 of this MD&A, the year-over-year percentage changes by quarter are not directly comparable, with the exception of the fourth quarter. For comparative purposes, the table below describes, by major market, the percentage change from the prior year in passenger revenues for the eight most recent quarters, excluding the impact of the policy change related to Aeroplan passenger revenues.

#### Passenger Revenue % Change Year-over-Year by Quarter

	Predecessor Company Air Canada				ACE				
	Quarter 1 2004	Quarter 2 2004	Quarter 3 2004	Quarter 4 2004	Quarter 1 2005	Quarter 2 2005	Quarter 3 2005	Quarter 4 2005	Quarter 4 2005 including Aeroplan
Canada	(9)	8	3	0	1	13	17	19	20
US	(13)	5	(1)	(17)	(13)	0	6	21	23
Atlantic	(5)	6	6	4	8	10	9	13	14
Pacific	15	162	113	35	14	11	5	6	7
Other	24	38	25	22	17	18	18	11	12
System (excluding Aeroplan)	(5)	15	12	1	1	10	12	16	17
System (including Aeroplan)	(5)	15	12	4	5	14	16	17	17

The table below describes quarter-over-quarter percentage changes in passenger revenues, capacity as measured by available seat miles (ASMs), traffic as measured by RPMs, passenger load factor as measured by RPMs divided by ASMs, yield as measured by passenger revenue per RPM and RASM as measured by passenger revenue per ASM.

### Operating Statistics

#### Quarter 4, 2005 versus Quarter 4, 2004

	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	20	7	7	0.4	12	12
US	23	8	12	2.7	9	14
Atlantic	14	11	13	1.4	0	2
Pacific	7	5	7	1.0	0	2
Other	12	8	8	0.0	5	5
System	17	8	9	1.2	7	9

As compared to the fourth quarter of 2004, system passenger revenues were up \$288 million or 17 per cent in the fourth quarter of 2005. The passenger revenue growth versus the 2004 quarter was due to increases in both yield and passenger traffic. In the fourth quarter of 2005, system passenger traffic grew 9 per cent, reflecting a strong market demand for the Air Canada and Jazz products, on an increase of 8 per cent in ASM flying capacity. As a result of the growth in passenger traffic, system passenger load factor improved 1.2 percentage points to 76.7 per cent, a record high load factor for the fourth quarter. System yield improved 7 per cent and reflected yield increases in all markets with the exception of the

Atlantic and Pacific markets which remained unchanged. The system yield improvement was primarily due to increased fare levels in the domestic and US transborder markets. International fares remained under pressure in the quarter and the weakening of foreign currencies against the stronger Canadian dollar partially offset the additional revenue from fuel surcharges. An improved domestic competitive position and a stronger market demand for the higher-priced Tango Plus product were also factors in the domestic yield improvement. Additionally, US transborder yield also improved as a result of a redesign of conditions underlying fares aimed at the business-oriented market which occurred in the fourth quarter of 2005. System RASM rose 9 per cent over the fourth quarter of 2004, reflecting both the improvement in passenger load factor and the increase in yield.

Domestic passenger revenues amounted to \$854 million in the 2005 quarter, an increase of \$141 million or 20 per cent from the fourth quarter of 2004. Domestic traffic and ASM capacity were both up by 7 per cent resulting in a passenger load factor slightly above that of the fourth quarter of 2004. Capacity increases were largely on transcontinental services between Toronto and Calgary and Edmonton as well as services within Western Canada. Domestic yield improved 12 per cent mainly due to increased fare levels to cover higher fuel costs, the Corporation's improved domestic competitive position, as well as a stronger market demand for the higher-priced Tango Plus product, the next level up from the basic best value fare. The Tango Plus product provides additional features such as advance seat selection and increased Aeroplan points. Reflecting the yield improvement, domestic RASM rose 12 per cent above the 2004 level.

US transborder passenger revenues rose \$73 million or 23 per cent in the fourth quarter of 2005 versus the fourth quarter of 2004. US transborder traffic grew 12 percent on an ASM capacity increase of 8 per cent resulting in a passenger load factor improvement of 2.7 percentage points. Capacity increases were largely on the Las Vegas route and on certain California routes such as San Francisco and San Diego. New services to Las Vegas were launched from Vancouver and Calgary and frequencies were increased from both Montréal and Toronto. The additional capacity to California reflected a new service from Vancouver to San Diego as well as increased frequencies on existing services. US yield improved 9 per cent partly reflecting the redesign of conditions underlying fares aimed at the business-oriented market which occurred in the fourth quarter of 2005 as well as increased fare levels to cover higher fuel costs. As a result of both the yield improvement and the higher passenger load factor, RASM was up 14 per cent from the fourth quarter of 2004.

Atlantic passenger revenues increased \$44 million or 14 per cent in the fourth quarter of 2005. Despite increased fuel surcharges to cover higher fuel costs, Atlantic yield was essentially unchanged from the 2004 quarter reflecting a significant weakening of foreign currencies for sales denominated in euro and pound sterling as well as a competitive pricing environment as a result of growth in charter capacity to Europe and the United Kingdom. Atlantic traffic rose 13 per cent largely reflecting the addition of the routes to Zurich, Switzerland and to Rome, Italy and to a stronger market demand in France and the United Kingdom markets. Capacity increased 11 per cent largely due to the addition of the routes to Zurich and to Rome and, to a lesser extent, increased capacity to France. As a result of the traffic increase, Atlantic passenger load factor improved 1.4 percentage points. RASM increased 2 per cent reflecting the passenger load factor improvement.

Pacific passenger revenues were up \$15 million or 7 per cent from the fourth quarter of 2004. Despite increased fuel surcharges to cover higher fuel costs, Pacific yield was essentially unchanged from the fourth quarter of 2004. Yield improvements in the Korea, China and Hong Kong markets were offset by lower yields in the Japan market reflecting an increased competitive pricing environment as a result of significant growth in capacity from both 6<sup>th</sup> Freedom and foreign carriers. The weakening of the Japanese yen against the stronger Canadian dollar compared to the fourth quarter of 2004 also had a significant negative impact on Pacific yields. Pacific passenger traffic grew 7 per cent on a 5 per cent increase in ASM capacity, primarily due to the recently introduced Toronto-Beijing route and an upgrade from a Boeing 767 to an Airbus A340 on the Toronto to Tokyo route. The passenger load factor improved 1.0 percentage point compared to the 2004 quarter. As a result of the improvement in the passenger load factor, RASM increased 2 per cent.

The South Pacific, Caribbean, Mexico and South America passenger revenues were up \$15 million or 12 per cent from the fourth quarter of 2004. Traffic and ASM capacity both increased 8 per cent resulting in a passenger load factor unchanged from the 2004 quarter. Yield rose 5 per cent over the fourth quarter of 2004. RASM also increased 5 per cent as result of the yield improvement. The growth in these markets was largely from additional flying to South America, primarily capacity increases on Toronto-Sao Paulo and Toronto-Bogotá as well as increased frequency on Toronto-Santiago/Buenos Aires and, to a lesser extent, from increased service to traditional leisure destinations including the new Toronto-Santo Domingo route.

### **Cargo Revenues**

In 2005, the Corporation also provided cargo services from Toronto to key markets including Frankfurt, Shanghai and Los Angeles, using three chartered MD-11 all-cargo freighter aircraft. Two of the aircraft were added in 2005. The Frankfurt freighter operations commenced in November 2004, in order to replace cargo capacity following the earlier retirement of Boeing 747-400 Combi aircraft. The Shanghai freighter operations commenced in the spring of 2005.

Fourth quarter cargo revenues increased \$25 million or 17 per cent and cargo traffic increased 16 per cent over 2004. This was mainly due to the addition of the two freighter aircraft in 2005 and greater cargo volumes notably in the Pacific market. Freight revenues increased \$29 million over the fourth quarter of 2004 and represented almost one quarter of cargo revenues in the 2005 quarter. Yield per revenue ton mile was one per cent higher than in the fourth quarter of 2004. The favourable yield impact of higher fuel surcharges was largely offset by the relative growth in lower-yielding long-haul freight traffic and the adverse effect of a stronger Canadian dollar on foreign currency denominated revenues

### **Other Revenues**

Other non-transportation revenues were down \$13 million or 6 per cent in the fourth quarter of 2005 largely as a result of lower third party engine maintenance revenues as well as a decrease in revenues from Air Canada Vacations due to the worst hurricane season on record which resulted in significantly lower passenger volumes, information technology system implementation challenges, as well as Air Canada Vacations' response to an aggressive competitive environment.

### **4.3. Cost Performance – Fourth Quarter 2005 versus Fourth Quarter 2004**

#### **Impact of the Adoption of AcG-15**

Effective January 1, 2005, the Corporation adopted AcG-15. Refer to Note 2 to the 2005 Annual Consolidated Financial Statements for additional information on the adoption of AcG-15.

For the fourth quarter of 2005, the net impact of adopting AcG-15 on the Corporation's results was a before tax charge of \$17 million or \$0.17 per share, basic. The impact of the adoption of AcG-15 was a reduction to aircraft rent expense of \$33 million, an increase to depreciation expense of \$20 million, an increase to net interest expense of \$19 million, a foreign exchange loss of \$8 million and a non-controlling interest charge of \$3 million compared to financial results had AcG-15 not been effective.

#### **Operating Expenses**

In the fourth quarter of 2005, total operating expenses increased \$332 million or 16 per cent compared to the fourth quarter of 2004 and included a fuel expense increase of \$146 million or 34 per cent. Unit cost rose 8 percent over the 2004 level. Excluding fuel expense, unit cost increased 4 per cent in the fourth quarter of 2005. Ownership costs, comprised of aircraft rent and depreciation, were significant factors in the increase in unit cost, excluding fuel. Ownership costs, as well as other costs, were affected by the addition of 41 new regional aircraft, such as the Embraer ERJ 175/190 and the Bombardier CRJ-705 aircraft, with higher unit costs but with lower trip costs, and two extra freighters in the 2005 quarter. These freighters incurred operating costs but produced no ASMs. Higher aircraft maintenance material and supplies expense was another significant negative factor.

Salaries and wages expense totaled \$519 million in the fourth quarter of 2005, an increase of \$42 million from the fourth quarter of 2004. Also included in salaries and wages expense in the fourth quarter of 2005 was approximately \$40 million relating to employee profit sharing programs. Expenses of \$2 million related to the profit sharing programs were recorded in 2004. Average full-time equivalent (FTE) employees increased 3 per cent on a capacity increase of 8 per cent over the 2004 quarter. The increase resulting from higher employee levels was partly offset by a reduction in average salaries reflecting employees being hired at lower wage scales. Employee productivity, as measured by ASM per FTE employee, grew 4 per cent over the fourth quarter of 2004.

Employee benefits expense amounted to \$129 million in the fourth quarter of 2005, an increase of \$10 million or 8 per cent from the fourth quarter of 2004, largely relating to revised pension actuarial estimates and to an adjustment in 2005 relating to an updated actuarial evaluation of workers' compensation liability.

On a capacity increase of 8 per cent, fuel expense was up \$146 million or 34 per cent reflecting continuing record high fuel prices. The average base fuel price increase of \$129 million and the volume-related increase of \$42 million were partially offset by a reduction of \$28 million due to the favourable impact of a stronger Canadian dollar versus the US dollar during the quarter when compared to the fourth quarter of 2004. Beginning in September 2005, the Corporation has implemented a systematic fuel risk management strategy and has entered into contracts with financial intermediaries to manage its exposure

to jet fuel price volatility. A fuel hedging loss of \$3 million relating to these contracts was recorded in the fourth quarter of 2005. On a unit cost basis, fuel expense per ASM rose 24 per cent.

Aircraft rent expense increased \$6 million or 5 per cent over the fourth quarter of 2004 mainly as a result of aircraft additions to the fleet largely offset by the impact of the adoption of AcG-15.

Airport and navigation fees rose \$24 million or 12 per cent over the 2004 quarter. Higher landing and general terminal fees, primarily at Toronto's Lester B. Pearson (Pearson) International Airport, as well as an 8 per cent increase in aircraft departures versus the 2004 quarter were the main factors for the increase.

Aircraft maintenance, materials and supplies expense increased \$26 million or 33 per cent. The increase was primarily related to timing of engine maintenance activities and to the contracting out of heavy aircraft maintenance activities to outside maintenance, repair and overhaul (MRO) companies as ACTS, Air Canada and Jazz's primary MRO service provider, was operating at full capacity in the fourth quarter of 2005, and to the addition of Bombardier regional jet aircraft to the Jazz fleet. The increase was partly offset by the impact of the retirement of the BAe-146 aircraft fleet. The contracting out of maintenance activities to MRO companies resulted in increased aircraft maintenance, materials and supplies expense as all expenses (including labour) relating to the services purchased were included in this expense category.

Communications and information technology expense was up \$7 million or 11 per cent largely due to an increase in information technology projects and also included a higher volume of communication services for web and Global Distribution System (GDS). The volume-related increases were partly offset by renegotiated contract rates for information technology and communications services and by the impact of a stronger Canadian dollar versus the US dollar in the quarter when compared to the fourth quarter of 2004.

Food, beverage and supplies expense increased \$5 million or 7 per cent versus the 2004 quarter on a passenger traffic increase of 9 per cent. The volume-related increase was largely offset by cost reduction initiatives and the impact of the new catering and buy-on-board programs. Additional expenses related to international service improvements were also a factor in the overrun.

Depreciation, amortization and obsolescence expense rose \$40 million or 47 per cent largely due to the adoption of AcG-15 and as a result of a change in the estimated lives of certain aircraft.

Commission expense was down \$18 million or 28 per cent on combined passenger and cargo revenue growth of 17 per cent. The main reason for the decrease in commission expense was the impact of a new commission structure for web and GDS bookings as well as lower international commissions which more than offset the volume-related increase.

When compared to the fourth quarter of 2004, the other operating expense category was up \$44 million or 12 per cent and included increases in credit card fees as a result of increased volume and

average rates, legal and advisory fees, expenses related to the new uniform program and Aeroplan non-air redemption expenses. These increases were partly offset by lower advertising and promotion expense, reduced customer maintenance materials and lower expenses at Air Canada Vacations.

### **Non-Operating Expense**

Non-operating expense totaled \$88 million in the fourth quarter of 2005, a \$41 million increase from the fourth quarter of 2004. Net interest expense amounted to \$62 million in the 2005 quarter, an increase of \$15 million from the 2004 quarter, comprised primarily of higher interest expense of \$19 million as a result of the adoption of AcG-15 partially offset by an increase of \$8 million in interest income reflecting higher average interest rates. In the fourth quarter of 2005, loss on sale of and provision on assets of \$30 million was recorded of which approximately \$15 million related to the write-down of inactive Boeing 747 inventory.

### **Foreign Exchange Gains**

Loss from revaluation of foreign currency monetary items amounted to \$11 million in the fourth quarter of 2005 attributable to a weaker Canadian dollar versus the US dollar at December 31, 2005 compared to September 30, 2005. This loss included \$5 million related to capital lease obligations and \$8 million as a result of the adoption of AcG-15. In the fourth quarter of 2004, foreign exchange gains amounted to \$78 million.

### **Future Income Taxes**

Recovery for income taxes amounted to \$39 million in the fourth quarter of 2005 compared to a provision of \$13 million recorded in the fourth quarter of 2004.

The comparison of fourth quarter financial results has been provided based on the consolidated results of ACE. Effective September 30, 2004, the Corporation's businesses are operated through four reportable segments: Transportation Services, Aeroplan, Jazz and ACTS. Refer to Section 11 of this MD&A for additional analysis of fourth quarter results for ACE's four reportable segments.

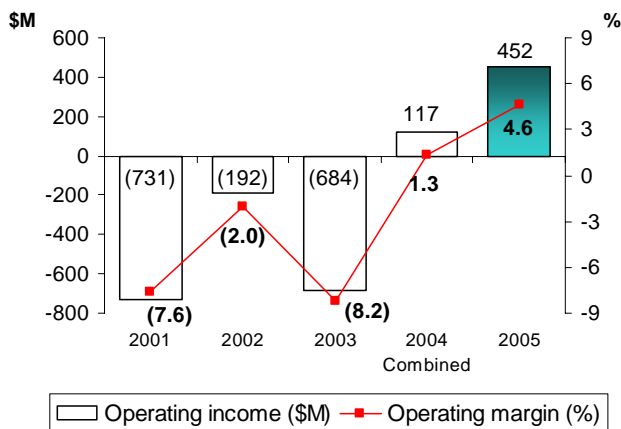
## 5. CONSOLIDATED RESULTS OF OPERATIONS - 2005 VERSUS 2004 COMBINED

### 5.1. Performance at a Glance

This section provides year-over-year comparisons for the years 2001 through to 2005 using Annual Supplementary Non-GAAP Combined Information for the year 2004, as defined on page 4 of this MD&A.

As a result of the inclusion of Aeroplan passenger revenues in passenger revenues starting in October 2004, as described on page 8 of this MD&A, year-over-year passenger revenue, RASM and yield information is not directly comparable to previous years. For comparative purposes, unless otherwise indicated, the following graphs and discussion will provide the reader with passenger revenue, RASM and yield changes that exclude the impact of the policy change related to Aeroplan passenger revenues. However, the graphs and discussion will also provide passenger revenue, RASM and yield changes that include the impact of the policy change related to Aeroplan passenger revenues.

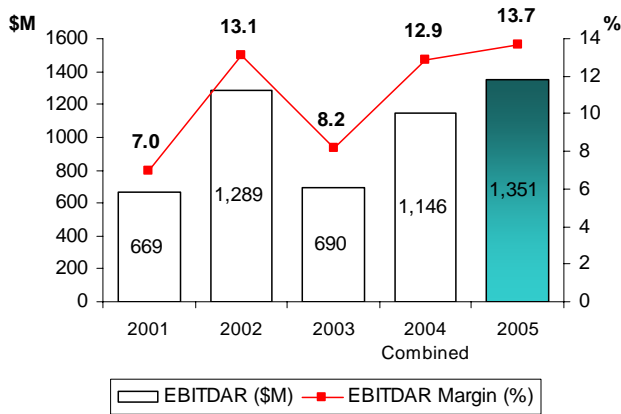
### Operating Income (loss) before reorganization and restructuring items and non-recurring labour expenses and Operating Margin



- Operating income of \$452 million, a \$335 million improvement from the 2004 Combined operating income, before reorganization and restructuring items, of \$117 million.
- Operating revenues increased \$930 million or 10 per cent over 2004 Combined, mainly reflecting passenger revenue increases in all markets and including the transfer of Aeroplan passenger revenues to the Passenger revenue category beginning in October 2004.

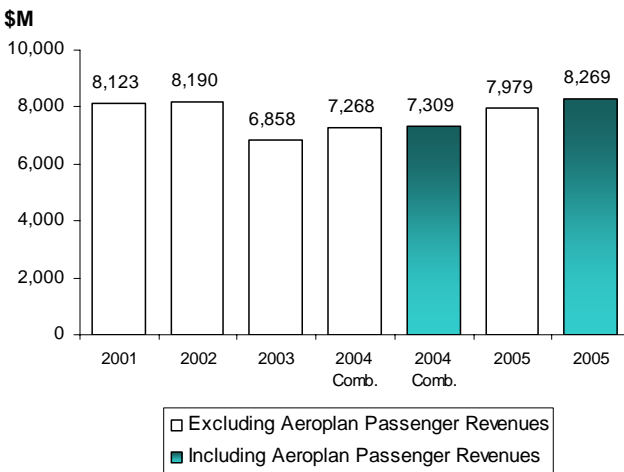
- Operating expenses up \$595 million or 7 per cent versus 2004 Combined, including a \$592 million or 37 per cent increase in fuel expense.
- Unit cost, as measured by operating expense per ASM, up 3 per cent over 2004 Combined.
- Excluding fuel expense, unit cost down 4 per cent, in part reflecting the impact of fresh start reporting.

## EBITDAR, before reorganization and restructuring items and non-recurring labour expenses



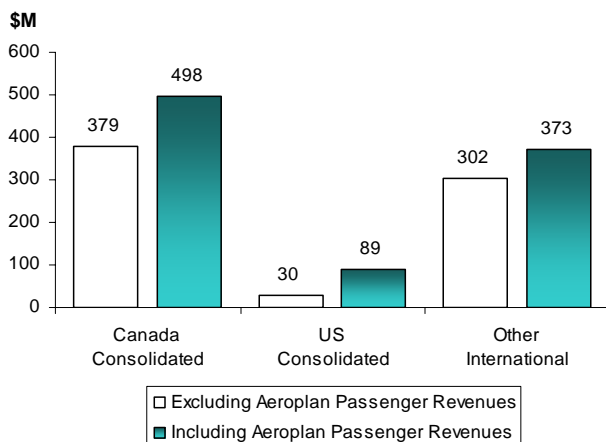
- EBITDAR increased \$205 million in 2005 to \$1,351 million despite an increase in fuel expense of \$592 million or 37 per cent over 2004 Combined.
- EBITDAR margin rose 0.8 percentage points over 2004 Combined. Refer to “Non-GAAP Financial Measures” on page 6 of this MD&A for additional information on EBITDAR.

## Passenger Revenue Change



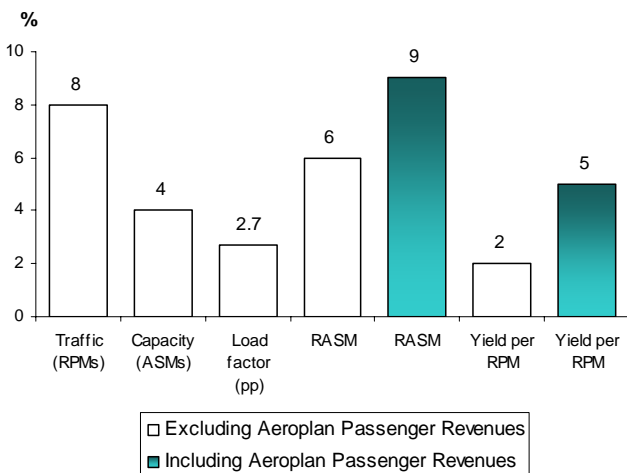
- In 2005, passenger revenues, including Aeroplan passenger revenues, increased \$960 million or 13 per cent reflecting increases in all markets and including the transfer of Aeroplan passenger revenues in the Passenger revenue category beginning in October 2004.

## Passenger Revenue \$M Change by Service - 2005 versus 2004 Combined



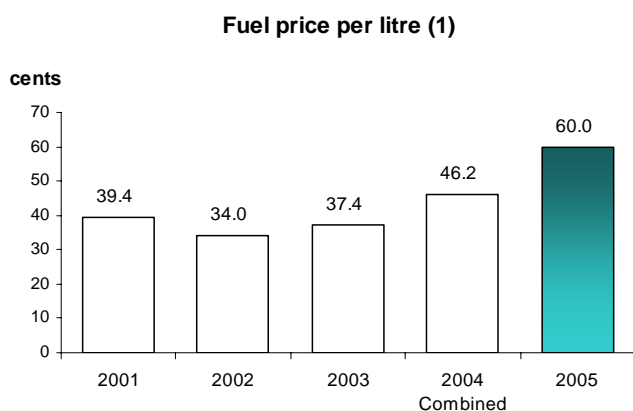
- Canada passenger revenues, including Aeroplan passenger revenues, showed considerable growth over 2004 Combined, rising \$498 million or 17 per cent.
- US transborder passenger revenues, including Aeroplan passenger revenues, were up \$89 million or 6 per cent.
- Other international revenues, including Aeroplan passenger revenues, increased \$373 million or 13 per cent.

## Passenger Revenues and Statistics - % change 2005 versus 2004 Combined



- RASM, including Aeroplan passenger revenues, improved 9 per cent year-over-year due to both a 2.7 percentage point improvement in passenger load factor and a yield increase of 5 per cent.
- 2005 system traffic was up 8 per cent on a 4 per cent increase in ASM capacity.

## Aircraft Fuel Expense



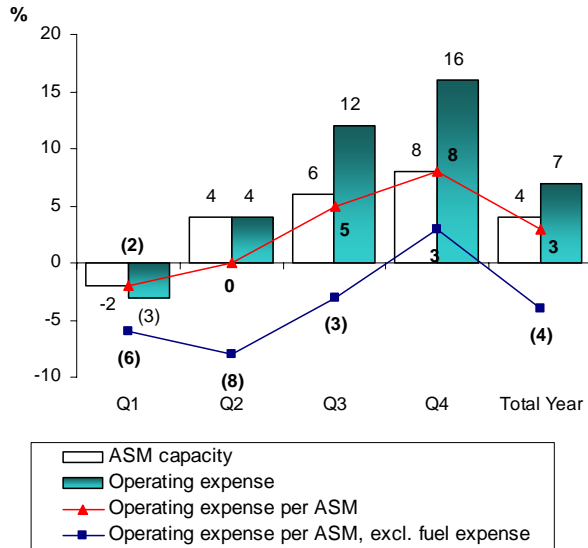
(1) Including fuel hedging and fuel handling expenses

- With record high fuel prices, aircraft fuel expense was up \$592 million or 37 per cent on a capacity increase of 4 per cent from 2004 Combined.
- The average base price of fuel increase of \$659 million and the volume-related increase of \$89 million were partly offset by a decrease of \$159 million as a result of the favourable impact of a stronger Canadian dollar.
- Average fuel price per litre rose 30 per cent over 2004 Combined.
- In 2005, the average price per litre was 60 cents with an average West Texas Intermediate (WTI) crude oil price per barrel of US\$55 compared to an average price per litre of 46 cents with an average WTI crude oil price per barrel of US\$40.

## Operating Cost Performance

### Changes in Operating Expense, ASM Capacity, Unit Cost (1) and Unit Cost, excluding fuel expense (2)

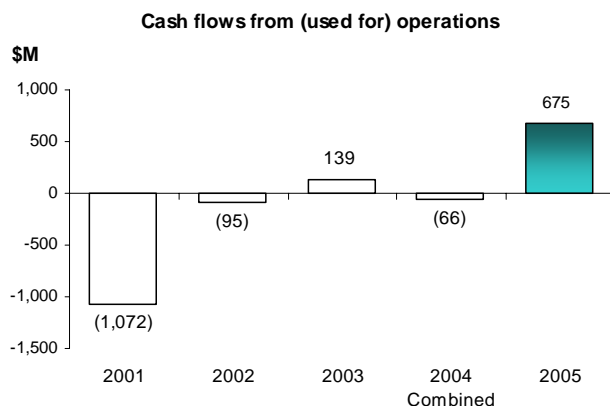
% change 2005 versus 2004 Combined



- For the full year 2005, unit cost was up 3 per cent over 2004 Combined.
- Excluding fuel expense, unit cost in 2005 was down 4 per cent.
- ASM capacity increased 4 per cent in 2005 versus 2004 Combined.

- (1) Unit cost is calculated as operating expense divided by ASMs.
- (2) Unit cost, excluding fuel expense, is calculated as operating expense, removing fuel expense, divided by ASMs.

## Cash Flows from (used for) Operations



- Cash flows from operations amounted to \$675 million in 2005, compared to cash flows used for operations of \$66 million in 2004 Combined.
- 2004 Combined cash flows used for operations included \$314 million of net payments made on September 30, 2004. These payments related mainly to settlement of restructuring obligations.

## 5.2. Comparison of Results – 2005 versus 2004 Combined

The following table compares the 2005 Consolidated Statement of Operations of ACE, the 2004 Combined Statement of Operations as defined on page 4 of this MD&A under “Non-GAAP Financial Measures”, and the 2003 Consolidated Statement of Operations of the Predecessor Company.

### Consolidated Statement of Operations

	ACE	Combined	Air Canada	% Change	% Change
(\$ millions, except per share figures)	2005	2004	2003	2005 versus 2004	2005 versus 2003
<b>Operating revenues</b>					
Passenger	8,269	7,309	6,858	13	21
Cargo	620	556	519	12	19
Other	941	1,035	996	(9)	(6)
	9,830	8,900	8,373	10	17
<b>Operating expenses</b>					
Salaries, wages and benefits	2,520	2,585	2,828	(3)	(11)
Aircraft fuel	2,198	1,606	1,253	37	75
Aircraft rent	417	632	1,008	(34)	(59)
Airport and navigation fees	924	814	743	14	24
Aircraft maintenance, materials and supplies	367	343	385	7	(5)
Communications and information technology	303	302	390	0	(22)
Food, beverages and supplies	334	340	334	(2)	0
Depreciation, amortization and obsolescence	482	397	366	21	32
Commissions	253	305	273	(17)	(7)
Other	1,580	1,459	1,477	8	7
	9,378	8,783	9,057	7	4
<b>Operating income (loss) before reorganization and restructuring items</b>	452	117	(684)		
Reorganization and restructuring items	-	(871)	(1,050)		
<b>Non-operating income (expense)</b>					
Aeroplan dilution gain	190	-	-		
Interest income	66	17	25		
Interest expense	(315)	(229)	(115)		
Interest capitalized	14	2	4		
Loss on sale of and provisions on assets	(28)	(75)	(168)		
Other	(12)	(8)	(28)		
	(85)	(293)	(282)		
<b>Income (loss) before the following items:</b>	367	(1,047)	(2,016)		
Non-controlling interest	(24)	-	-		
Foreign exchange gain	46	182	137		
Recovery of (provision for) income taxes	(131)	(15)	12		
<b>Income (loss) for the period</b>	<b>258</b>	<b>(880)</b>	<b>(1,867)</b>		
Earnings (loss) per share <sup>(1)</sup>					
- Basic	2.63	nm	(\$15.53)		
- Diluted	2.46	nm	(\$15.53)		
<b>EBITDAR</b> <sup>(2)</sup>	<b>1,351</b>	<b>1,146</b>	<b>690</b>		

(1) Pursuant to the Plan as further described in Note 19 to the 2005 Annual Consolidated Financial Statements, all issued and outstanding options of Air Canada and warrants were cancelled without payment or consideration on September 30, 2004. In addition, a new ACE share capital structure was established, as further described in Note 12 to the 2005 Annual Consolidated Financial Statements.

(2) Refer to “Non-GAAP Financial Measures” on page 6 of this MD&A for a reconciliation of EBITDAR for the years 2004 and 2005. 2003 EBITDAR of \$690 million is reconciled to operating income (loss) before reorganization and restructuring items, as follows: GAAP operating income before reorganization and restructuring items of (\$684) million, adding back aircraft rent of \$1,008 million and depreciation, amortization and obsolescence of \$366 million.

### Operating Statistics

	ACE	Combined	Predecessor Company	% Change	% Change
	2005	2004	2003	2005 versus 2004	2005 versus 2003
Revenue Passenger Miles (millions)	46,764	43,427	39,565	8	18
Available Seat Miles (millions)	58,822	56,536	54,160	4	9
Passenger Load Factor (%)	79.5	76.8	73.1	2.7 pp	6.4 pp

For the full year 2005, in spite of a fuel expense increase of \$592 million or 37 per cent, ACE reported operating income of \$452 million, an improvement of \$335 million over the same period in 2004. EBITDAR improved \$205 million over 2004 Combined. Refer to “Non-GAAP Financial Measures” on page 6 of this MD&A for additional information on EBITDAR.

In 2005, total operating revenues increased \$930 million or 10 per cent compared to 2004 Combined. Passenger revenues were up \$960 million or 13 per cent reflecting increases in all markets and including the transfer of Aeroplan passenger revenues into the Passenger revenue category starting in October 2004. Prior to October 2004, Aeroplan passenger revenues were recorded in the Other revenue category. In addition, to cover higher fuel costs, domestic and US transborder fare levels have been increased in 2005 and fuel surcharges have been significantly increased to and from most international destinations.

Operating expenses were up \$595 million versus 2004 Combined and included an increase in fuel expense of \$592 million or 37 per cent from 2005. ASM capacity increased 4 per cent compared to 2004 Combined. Unit cost for 2005, as measured by operating expense per ASM, rose 3 per cent from 2004 Combined. Excluding fuel expense, unit cost in 2005 was down 4 per cent. Unit cost reductions included aircraft rent, benefits expense, commissions, salaries and wages expense and food, beverages and supplies.

For the nine months ended September 30, 2004, reorganization and restructuring items amounted to \$871 million. As Air Canada emerged from CCAA proceedings on September 30, 2004, reorganization and restructuring items were not recorded after that date.

In 2005, non-operating expense decreased \$208 million and included a dilution gain of \$190 million (before tax) as a result of the dilution of the Corporation’s interest in Aeroplan relating to the Aeroplan transaction which was completed in the Second Quarter of 2005 and is further described in Note 13 to the 2005 Annual Consolidated Financial Statements.

In 2005, gains from revaluation of foreign currency monetary items amounted to \$46 million attributable to a stronger Canadian dollar versus the US dollar at December 31, 2005 compared to December 31, 2004. In 2004 Combined, foreign exchange gains on non-compromised monetary items totaled \$182 million.

A provision for income taxes of \$131 million was recorded in 2005, \$28 million of which related to the Aeroplan transaction which took place in the second quarter of 2005. No tax recovery was recorded on the loss for the first nine months of 2004. The provision for income taxes in 2004 Combined amounted to \$15 million.

Net income in 2005 was \$258 million compared to a net loss of \$880 million in 2004 Combined, an improvement of \$1,138 million.

### 5.3. Revenue Performance – 2005 versus 2004 Combined

#### Passenger Revenues

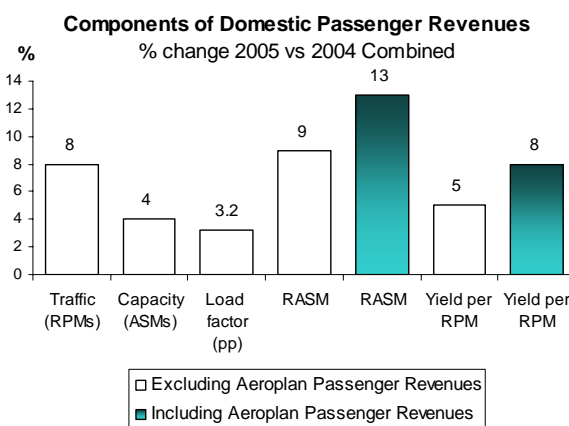
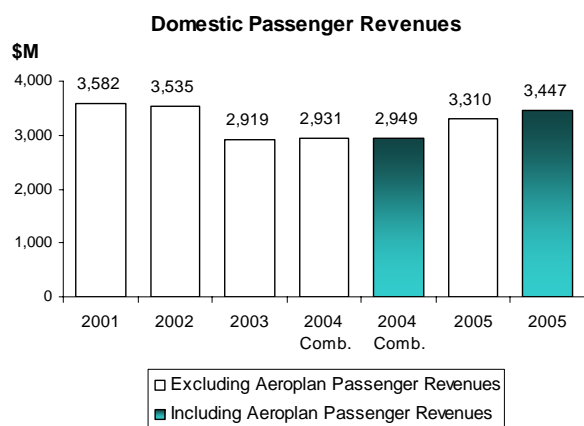
The table below describes, by major market, excluding the impact of the policy change related to Aeroplan passenger revenues, year-over-year percentage changes in passenger revenues, capacity as measured by ASMs, traffic as measured by RPMs, passenger load factor as measured by RPMs divided by ASMs, yield as measured by passenger revenue per RPM, and RASM as measured by passenger revenue per ASM.

#### Operating Statistics 2005 versus 2004 Combined

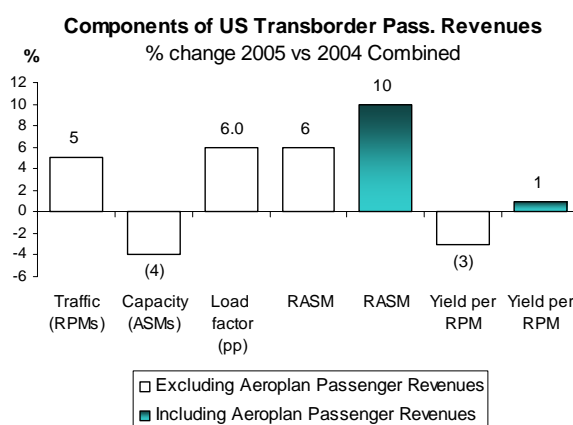
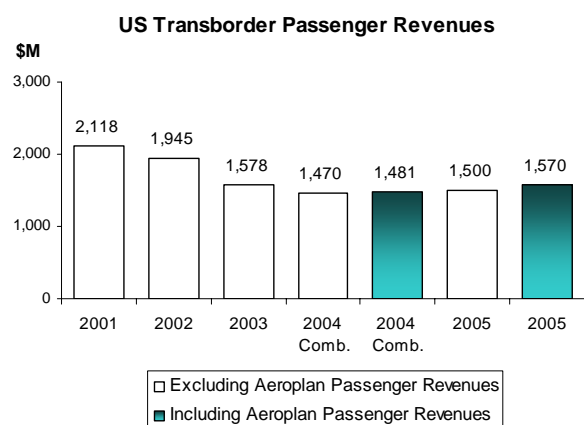
	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield per RPM % Change	RASM % Change
Canada	13	4	8	3.2	5	9
US	2	(4)	5	6.0	(3)	6
Atlantic	10	6	9	1.9	1	4
Pacific	8	6	6	(0.4)	3	2
Other	16	12	14	1.4	2	4
System (excluding Aeroplan)	10	4	8	2.7	2	6
System (including Aeroplan)	13	4	8	2.7	5	9

As compared to 2004 Combined, system passenger revenues, which included Aeroplan passenger revenues of \$290 million for the full year 2005 and \$41 million for the fourth quarter of 2004, were up \$960 million or 13 per cent.

In 2005, system passenger traffic rose 8 per cent on a 4 per cent increase in ASM flying capacity producing a 2.7 percentage point improvement in passenger load factor versus the 2004 Combined level. Increases in yield for the domestic and other international markets were partly offset by a decline in yield in the US transborder market, reflecting an extremely competitive US transborder market and a weaker US dollar which lowers the Canadian dollar value of revenues from the US. To partially offset the large spike in fuel prices, domestic fares were increased significantly in 2005, while fuel surcharges were added on international routes. System RASM, excluding Aeroplan passenger revenues, rose 6 per cent in 2005, mainly reflecting both the improvement in passenger load factor and the increase in system yield.

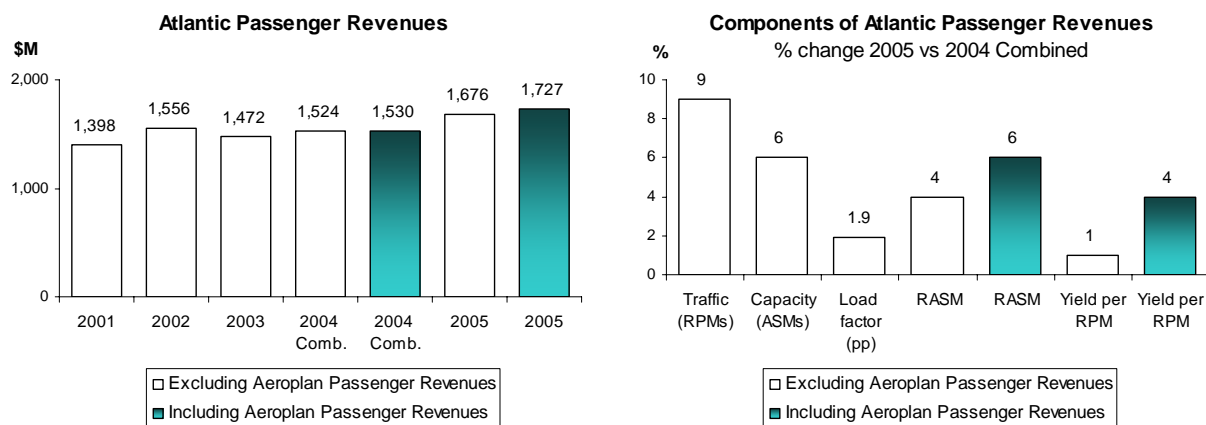


In 2005, domestic passenger revenues, which included Aeroplan passenger revenues of \$137 million for the full year 2005 and \$18 million for the fourth quarter of 2004, were up \$498 million or 17 per cent from 2004 Combined. Domestic passenger traffic grew 8 per cent on an ASM capacity increase of 4 per cent resulting in a passenger load factor improvement of 3.2 percentage points over the 2004 Combined level. Domestic yield increased 5 per cent in 2005, excluding Aeroplan passenger revenues, mainly due to increased fare levels to cover higher fuel costs, an improved domestic competitive position, as well as a stronger market for the higher priced Tango Plus product. Reflecting both the improvement in passenger load factor and the increase in yield, excluding Aeroplan passenger revenues, domestic RASM rose 9 per cent above 2004 Combined.

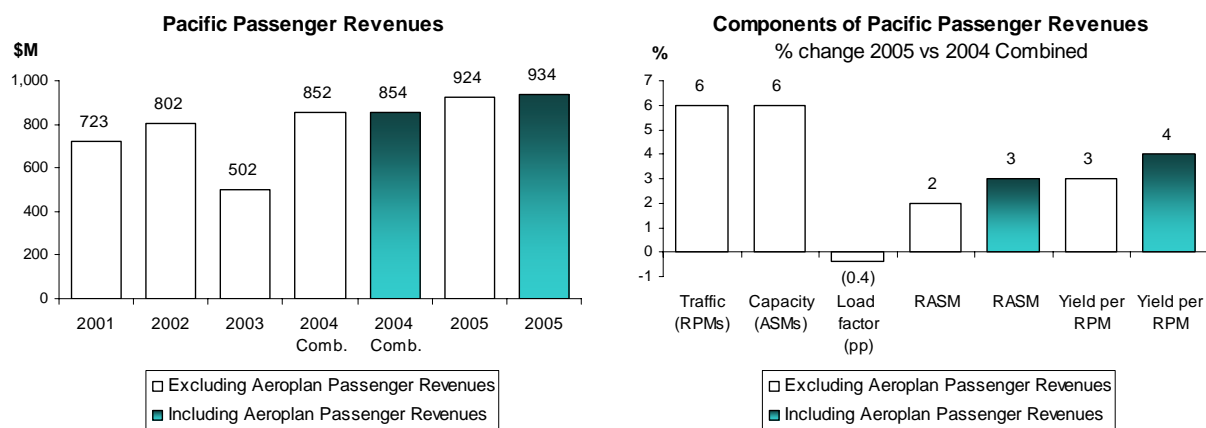


US transborder passenger revenues, which included Aeroplan passenger revenues of \$70 million for the full year 2005 and \$11 million for the fourth quarter of 2004, increased \$89 million or 6 per cent from the 2004 Combined level. In response to increased capacity from US carriers, US transborder ASM capacity was reduced by 4 per cent. In spite of the ASM capacity reduction, traffic increased 5 per cent resulting in a passenger load factor improvement of 6.0 percentage points. Excluding Aeroplan passenger revenues, yield declined 3 per cent reflecting the weakening of the US dollar for sales denominated in US dollars as well as an aggressive pricing environment resulting from increased capacity in the US transborder market by Canadian low-cost carriers. Excluding Aeroplan passenger revenues, US

transborder RASM was up 6 per cent as the large improvement in passenger load factor more than offset the yield decrease.

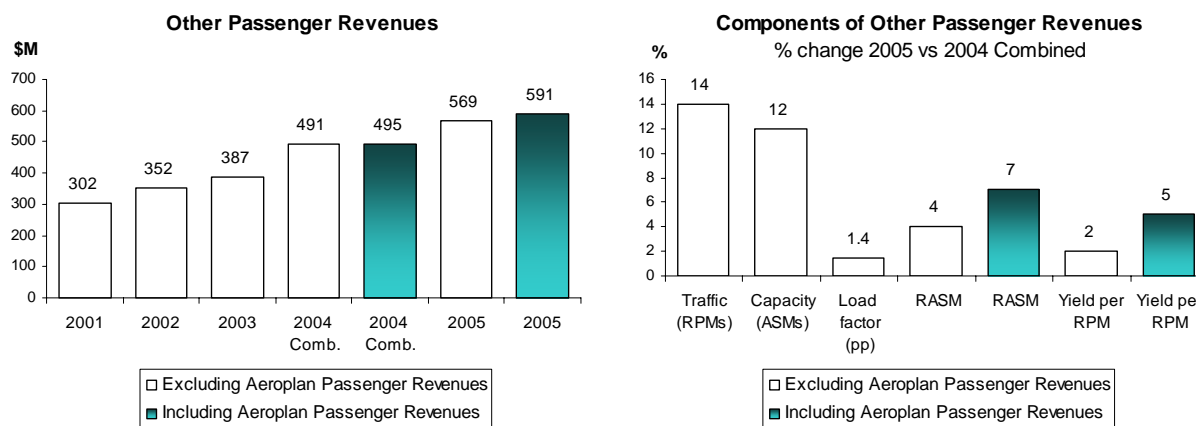


Atlantic passenger revenues, which included Aeroplan passenger revenues of \$51 million for the full year 2005 and \$6 million for the fourth quarter of 2004, increased \$197 million or 13 per cent in 2005 from the 2004 Combined level. Despite the increase in fuel surcharges to cover higher fuel costs, yield only increased 1 per cent, excluding Aeroplan passenger revenues, reflecting a significant weakening of currencies for sales denominated in Euro and Sterling Pound as well as competitive pricing environment due to growth in charter capacity to Europe and the United Kingdom. Atlantic traffic grew 9 per cent reflecting a strong market demand in the United Kingdom and France markets, as well as the addition of the route to Rome, Italy. Capacity was increased 6 percent largely due to the addition of the Rome route and additional frequencies to the United Kingdom, France and Switzerland. Excluding Aeroplan passenger revenues, RASM was up 4 per cent reflecting the improvement in the passenger load factor and, to a much lesser extent, the yield increase.



Pacific passenger revenues, which included Aeroplan passenger revenues of \$10 million for the full year 2005 and \$2 million for the fourth quarter of 2004, were up \$80 million or 9 per cent versus 2004 Combined. Excluding Aeroplan passenger revenues, yield improved 3 per cent from the 2004 Combined

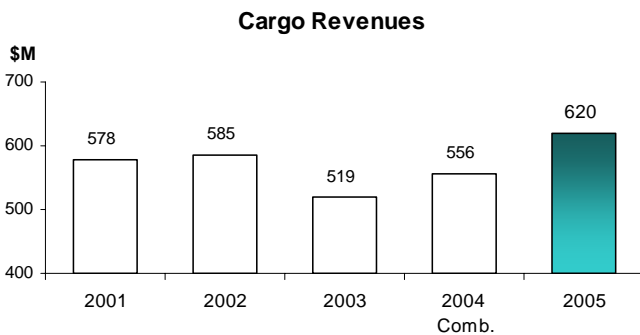
level due to increased fuel surcharges in 2005 to cover higher fuel costs as well as yield improvements in the Hong Kong and Korea markets due to an increased proportion of higher-yielding business travelers. Pacific traffic and ASM capacity both rose 6 per cent resulting in a passenger load factor essentially unchanged from 2004 Combined. Capacity increases were mostly reflected in the China market, which saw the introduction of non-stop Toronto-Beijing and Toronto-Seoul services. Excluding Aeroplan passenger revenues, RASM rose 2 per cent as a result of the yield increase, despite a negative currency impact caused by the stronger Canadian dollar versus the Japanese yen.



South Pacific, Caribbean, Mexico and South America (Other) passenger revenues, which included Aeroplan passenger revenues of \$22 million for the full year 2005 and \$4 million for the fourth quarter of 2004, increased \$96 million or 19 per cent in 2005. Traffic grew 14 per cent on an ASM capacity increase of 12 per cent resulting in a 1.4 percentage point improvement in passenger load factor compared to the 2004 Combined level. Excluding Aeroplan passenger revenues, yield was up 2 per cent over 2004 Combined in part due to increased fuel surcharges to cover higher fuel costs. RASM increased 4 per cent reflecting both the passenger load factor improvement and, to a lesser extent, the yield increase. The growth in these markets was largely from additional flying to South America, including Lima, Caracas and Bogotá.

## Cargo Revenues

Cargo revenues increased \$64 million or 12 per cent mainly due to the addition of two freighter aircraft in 2005 and greater cargo volumes notably in the Pacific market. With the introduction of Shanghai and the full year effect of Frankfurt freighter operations, freighter revenues increased \$98 million over 2004. This was partially offset by lower non-freighter revenues due to the retirement of the Boeing 747-400 Combi aircraft in late 2004. Yield per revenue ton mile was essentially unchanged from the 2004 Combined level. The favourable yield impact of increased fuel surcharges in 2005 was largely offset by the relative growth in lower-yielding long-haul freight traffic and unfavourable foreign exchange versus 2004 Combined.



## Other Revenues

Non-transportation revenues were down \$94 million or 9 per cent mainly as a result of the change in accounting policy for the loyalty program (Aeroplan) effective October 1, 2004, as described on page 8 of this MD&A. For the nine months ended September 30, 2004, Aeroplan revenues from Miles earned by members through the loyalty program partners amounted to \$173 million and were recorded in the Other revenue category. For the fourth quarter of 2004 and the full year 2005, Aeroplan revenues from Miles redeemed for air travel on Air Canada and Jazz are recorded in the Passenger revenue category. Partly offsetting the reduction from the change in accounting policy for the loyalty program was an increase in cancellation and change fees, higher third party maintenance revenues and various other increases.

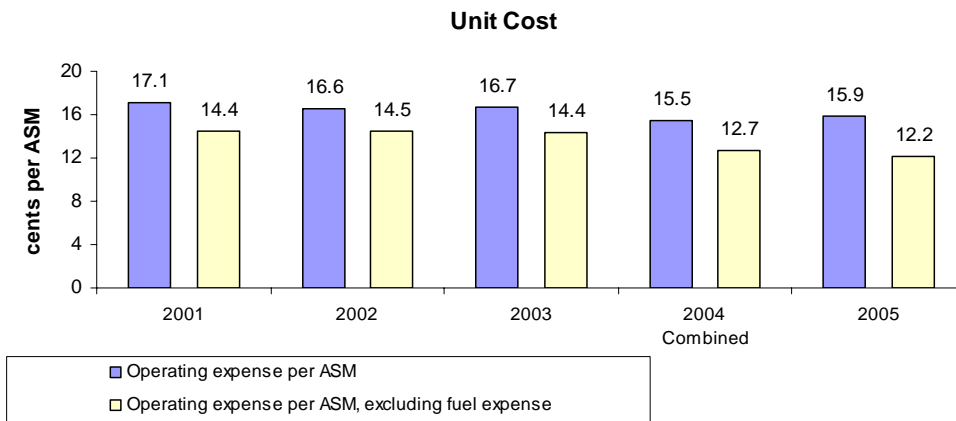
## 5.4. Cost Performance – 2005 versus 2004 Combined

### Impact of the Adoption of AcG-15

For the full year 2005, the net impact of adopting AcG-15 on the Corporation's results was a pre-tax charge of \$42 million or \$0.43 per share, basic. The impact of the adoption of AcG-15 was a reduction to aircraft rent expense of \$120 million, an increase to depreciation expense of \$86 million, an increase to net interest expense of \$88 million, a foreign exchange gain of \$26 million and a non-controlling interest charge of \$14 million compared to financial results had AcG-15 not been effective.

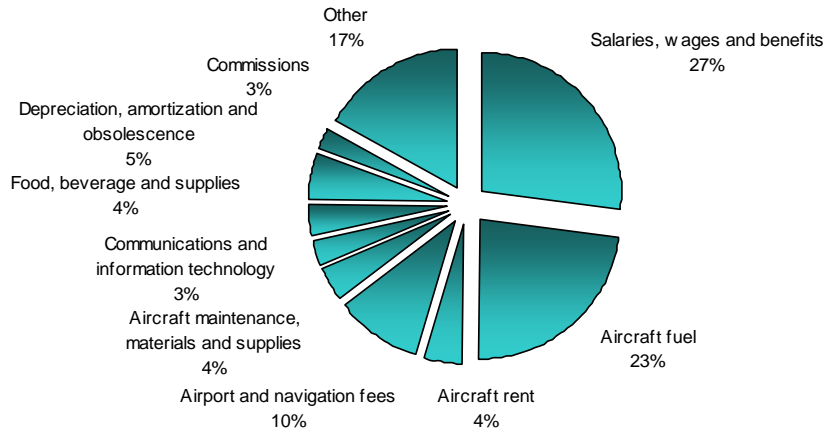
### Operating Expenses

For the full year 2005, operating expenses increased \$595 million or 7 per cent compared to 2004 Combined and included a fuel expense increase of \$592 million or 37 per cent. Unit cost increased 3 per cent versus the 2004 Combined level. Excluding fuel expense, unit cost declined 4 per cent in 2005.



### 2005 Operating Expenses

% of total



The following discussion summarizes those categories with significant year-over-year variances:

Salaries and wage expense totaled \$1,978 million in 2005, an increase of \$43 million or 2 per cent from the 2004 Combined level. Included in salaries and wages were expenses relating to employee profit sharing programs in 2005. The average number of full-time equivalent (FTE) employees in 2005 was essentially unchanged from 2004 Combined. Employee productivity, as measured by ASM per FTE employee, grew 4 per cent compared to the 2004 Combined level.

Employee benefits expense amounted to \$542 million in 2005, a decrease of \$108 million or 17 per cent from 2004 Combined. The decrease was largely due to lower pension and employee future benefits expenses as a result of the elimination of unamortized actuarial losses and prior service costs resulting from fresh start reporting.

Fuel expense increased \$592 million or 37 per cent, on a capacity increase of 4 per cent, reflecting continuing record high fuel prices. The average base fuel price increase of \$659 million and the volume-related increase of \$89 million were partially offset by a reduction of \$159 million due to the favourable impact of a stronger Canadian dollar versus the US dollar during the year. Beginning in September 2005, the Corporation has implemented a systematic fuel risk management strategy and has entered into contracts with financial intermediaries to manage its exposure to jet fuel price volatility. A fuel hedging loss of \$3 million relating to these contracts was recorded in the fourth quarter of 2005. Prior to these derivative instruments being designated as hedges for accounting purposes, an unrealized gain of \$2 million was recorded in other non-operating expense. On a unit cost basis, fuel expense per ASM rose 32 per cent.

Aircraft rent expense was down \$215 million or 34 per cent versus 2004 Combined largely due to the adoption of AcG-15, the impact of fair value adjustments as a result of fresh start reporting, the termination of Boeing 747-400 leases, the net reclassification of certain aircraft leases from operating to capital leases, lease renegotiations, as well as a stronger Canadian dollar versus the US dollar for leases denominated in US dollars when compared to 2004 Combined. These decreases were partly offset by aircraft additions to the fleet, net of aircraft returns or terminations.

Airport and navigation fees increased \$110 million or 14 per cent on a 1 per cent increase in aircraft departures. Higher landing and general terminal fees, primarily at Toronto's Pearson International Airport, and higher fees for air navigation services as a result of a 10 per cent average unit rate increase which came into effect in September 2004, were the main reasons for the increase. In addition, in the third quarter of 2004, the Corporation recorded a favourable adjustment of \$22 million to airport and navigation fees relating to Federal Aviation Administration (FAA) overflight fees.

Aircraft maintenance, materials and supplies expense increased \$24 million or 7 per cent. The increase is mainly due to the timing of engine maintenance activities, to the contracting out of heavy aircraft maintenance activities to outside maintenance, repair and overhaul (MRO) companies as ACTS, Air Canada and Jazz's primary MRO service provider, was operating at full capacity, and to the addition of Bombardier regional jet aircraft to the Jazz fleet. This increase was partly offset by the impact of the retirement of the BAe 146 aircraft fleet. The contracting out of maintenance activities to MRO companies resulted in increased aircraft maintenance, materials and supplies expense as all expenses (including labour) relating to the services purchased were included in this expense category.

Communications and information technology expense increased \$1 million from the 2004 level. Increased volume for communication services for web and Global Distribution System (GDS) as well as an increase in information technology projects were offset by renegotiated contract rates for information technology and communications services and by the impact of a stronger Canadian dollar versus the US dollar when compared to 2004 Combined.

Food, beverage and supplies expense decreased \$6 million or 2 per cent versus the 2004 Combined level on a passenger traffic increase of 8 per cent. The impact of the cost reduction initiatives and the new catering and buy-on-board programs implemented by the Corporation more than offset the volume-related and the international service improvement increases.

When compared to 2004 Combined, depreciation, amortization and obsolescence expense was up \$85 million or 21 per cent in 2005 largely related to the adoption of AcG-15.

In 2005, commission expense was down \$52 million or 17 per cent on combined passenger and cargo revenue growth of 10 per cent, excluding Aeroplan passenger revenues. The impact of a new commission structure introduced for web and GDS bookings as well as lower international commissions more than offset the volume-related increase.

The other operating expense category rose \$121 million or 8 per cent over the 2004 Combined level and included increases in credit card fees, advisory fees, customer inconvenience and baggage mishandling expenses, Aeroplan non-air redemption expenses, a higher volume and an increase in the cost of tour packages by Air Canada Vacations, as well as other categories of expenses mainly related to the 4 per cent growth in capacity. These increases were partly offset by a reduction in advertising and promotion expense and reductions in other categories.

### **Non-Operating Expense**

Non-operating expense amounted to \$85 million in 2005, a \$208 million decrease over 2004 Combined. In the second quarter of 2005, ACE recorded a dilution gain of \$190 million (before tax) as a result of the dilution of its interest in Aeroplan. Net interest expense amounted to \$235 million in 2005, an increase of \$25 million from 2004 Combined. Interest expense rose \$86 million and included the impact of the adoption of AcG-15 of \$88 million. Interest income totaled \$66 million in 2005, up \$49 million from the 2004 Combined level primarily related to higher cash balances and an increase in average interest rates. In addition, in 2004 Combined, prior to emergence from CCAA on September 30, 2004,

interest income of \$17 million was allocated to reorganization and restructuring items. Included in other non-operating expenses in 2005 was a charge of \$29 million relating to the repayment of the GE exit credit facility and income of \$17 million related to a settlement of interest rate swaps on aircraft leases.

In 2005, loss on sale of and provision on assets of \$28 million was recorded of which approximately \$15 million related to the write-down of inactive Boeing 747 inventory. In 2004 Combined, the Corporation recorded provisions of \$75 million relating mainly to non-operating aircraft, including \$18 million for spare parts.

### **Foreign Exchange**

Gains from revaluation of foreign currency monetary items amounted to \$46 million in 2005 attributable to a stronger Canadian dollar versus the US dollar at December 31, 2005 compared to December 31, 2004. The foreign exchange gains recorded in 2005 included gains of \$40 million related to capital lease obligations and \$26 million resulting from the adoption of AcG-15. This compared to foreign exchange gains on non-compromised monetary items of \$182 million recorded in 2004 Combined.

### **Future Income Taxes**

Provision for income taxes totaled \$131 million in 2005, of which \$28 million related to the Aeroplan transaction which took place in the second quarter of 2005. The Corporation recorded a provision for income taxes of \$15 million in 2004 Combined. No tax recovery was recorded on the loss in 2004 in the Predecessor Company. Refer to Note 8 to the 2005 Annual Consolidated Financial Statements of ACE for additional information on future income taxes.

## 6. THE STATEMENT OF FINANCIAL POSITION AND LIQUIDITY

The consolidated statements of financial position as at December 31, 2005 and December 31, 2004 represent the accounts of ACE and its subsidiaries on a post-emergence fresh start reporting basis, as further described in Notes 2 and 20 to the 2005 Annual Consolidated Financial Statements. The consolidated statement of financial position as of December 31, 2003 represents the accounts of the Predecessor Company. In accordance with CICA 1625, prior period financial information has not been restated to reflect the impact of fair value adjustments and, accordingly, amounts in the Predecessor Company are not directly comparable.

### Condensed Consolidated Statement of Financial Position

(\$ millions)	ACE At December 31, 2005	ACE At December 31, 2004	Predecessor Company At December 31, 2003
<b>ASSETS</b>			
Current			
Cash, cash equivalents and short-term investments	2,181	1,632	670
Other current assets	1,173	1,063	1,041
	3,354	2,695	1,711
Property and equipment	5,494	3,684	1,700
Deferred charges	145	167	2,340
Goodwill	-	-	510
Intangible assets	2,462	2,703	164
Other assets	392	137	485
	<b>11,847</b>	<b>9,386</b>	<b>6,910</b>
<b>LIABILITIES</b>			
Current liabilities	3,011	2,616	2,402
Long-term debt and capital lease obligations	3,543	2,328	332
Convertible preferred shares	148	132	-
Future income taxes	221	243	11
Pension and other benefit liabilities	2,154	2,344	964
Non-controlling interest	203	-	-
Deferred credits	-	-	827
Other long-term liabilities	1,399	1,520	1,216
	10,679	9,183	5,752
Liabilities subject to compromise	-	-	5,313
	<b>10,679</b>	<b>9,183</b>	<b>11,065</b>
<b>SHAREHOLDERS' EQUITY</b>			
Share capital and other equity	747	187	967
Contributed surplus	6	1	25
Retained earnings	415	15	(5,147)
	1,168	203	(4,155)
	<b>11,847</b>	<b>9,386</b>	<b>6,910</b>

As a result of the adoption of AcG-15 effective January 1, 2005, Air Canada consolidated the financial statements of certain aircraft and engine leasing entities and fuel facilities corporations. As at December 31, 2005, additional property and equipment of \$1,333 million, long-term debt, including current portion, of \$1,178 million, other assets of \$112 million, and non-controlling interest of \$203 million are consolidated under AcG-15. The impact of the adoption of AcG-15 on the consolidated statement of financial position is described in further detail in Note 2 to the 2005 Annual Consolidated Financial Statements of ACE.

## 6.1. Share Capital and Other Equity

At December 31, 2005, the issued and outstanding common shares of ACE, along with common shares potentially issuable, which are comprised of convertible preferred shares, convertible notes and stock options, are as follows:

	Authorized	ACE	
		At December 31, 2005	At December 31, 2004
		Outstanding (000)	
Issued and outstanding common shares			
Class A variable voting shares	Unlimited	76,735	74,813
Class B voting shares	Unlimited	25,059	8,813
Shares held in escrow		28	5,189
Total issued and outstanding common shares		101,822	88,815

	ACE	
	At December 31, 2005	At December 31, 2004
	Outstanding (000)	
Common shares potentially issuable		
Convertible preferred shares	10,228	9,375
Convertible notes	6,875	-
Stock options	3,187	3,028
Total common shares potentially issuable	20,290	12,403

### Share Capital and Other Equity Summary (net of issue costs):

(\$ millions)	ACE	
	At December 31, 2005	At December 31, 2004
Common shares	\$ 2,231	\$ 1,778
Convertible preferred shares	117	117
Convertible notes	92	-
	2,440	1,895
Adjustment to shareholders' equity <sup>(1)</sup>	(1,693)	(1,708)
Share capital and other equity	\$ 747	\$ 187

<sup>(1)</sup> Under fresh start reporting, the balance in shareholders' equity after a comprehensive revaluation is adjusted to the net value of identifiable assets and liabilities. CICA 1625 - Comprehensive Revaluation of Assets and Liabilities, does not permit goodwill to be recorded even if the fair value of net assets is less than the fair value of the enterprise as a whole.

During the second quarter of 2005, ACE completed the public offering of an aggregate of 12,485,000 Class A Variable Voting Shares and Class B Voting Shares at a price of \$37.00 per share for gross proceeds of approximately \$462 million (\$442 million, net of fees).

In the same period, ACE issued \$330 million of 4.25 per cent Convertible Senior Notes due 2035 (Convertible Notes) for net proceeds of \$319 million. At the date of issuance, the value ascribed to the holders' conversion option, which is presented as equity, was \$94 million less allocated fees of \$2 million. The value ascribed to the financial liability was \$236 million.

The Corporation used approximately \$557 million of the aggregate net cash proceeds of the offerings to repay all of its outstanding debt under the exit credit facility with GE, including \$16 million for early payment fees. The Corporation recorded a charge of \$29 million in other non-operating expenses for this transaction in the three months ended June 30, 2005, including \$13 million for the write-off of deferred financing charges.

The Court-appointed Monitor for the restructuring of the Predecessor Company under the CCAA completed its report on May 30, 2005 confirming that all remaining disputed unsecured claims had been resolved and recommended to the Ontario Superior Court of Justice that it authorize the Monitor to proceed with the final distribution of shares held by the Monitor in escrow in accordance with the restructuring plan. The shares were distributed with the exception of 27,927 shares that continue to be held in escrow by the Monitor pending resolution of tax obligations with governmental authorities.

## **6.2. Liquidity and Working Capital**

At December 31, 2005, the Corporation had cash, cash equivalents and short term investments of \$2,181 million and positive working capital of \$343 million. At December 31, 2004, the Corporation had cash, cash equivalents and short-term investments of \$1,632 million and positive working capital of \$79 million.

### **Air Canada**

On April 6, 2005, Air Canada entered into a senior secured syndicated revolving credit facility in an aggregate amount of up to \$300 million or the US dollar equivalent. The revolving credit facility has a two-year term which can be extended at Air Canada's option for additional one-year periods on each anniversary of closing, subject to prior approval by a majority of the lenders. Included in the aggregate amount is a swing line facility of up to \$20 million provided for cash management and working capital purposes. The amount available to be drawn by Air Canada under the revolving credit facility is limited to the lesser of \$300 million and the amount of a borrowing base determined with reference to certain eligible accounts receivable of Air Canada and certain eligible owned and leased real property of Air Canada. At December 31, 2005, no amount was drawn under this facility. The credit facility is secured, principally, by a first priority security interest and hypothec over the present and after-acquired property of Air Canada, subject to certain exclusions and permitted encumbrances.

### **Aeroplan**

During 2005, Aeroplan arranged for senior secured credit facilities in the amount of \$475 million. The credit facilities consist of one \$300 million (or the U.S. dollar equivalent thereof) term facility (Term A Facility), a \$100 million (or the U.S. dollar equivalent thereof) acquisition facility (Term B Facility) and a \$75 million (or the U.S. dollar equivalent thereof) revolving term credit facility. The Term A Facility was drawn on June 29, 2005 in the amount of \$300 million, in order to fund a portion of the \$400 million Aeroplan miles redemption reserve. Refer to Note 13 to the 2005 Annual Consolidated Financial Statements for additional information. The Term B Facility is available for multiple drawings to fund permitted acquisitions. Under the revolving facility, \$18 million was drawn on June 29, 2005 for general corporate and working capital purposes, and was repaid during the third quarter of 2005. At December 31, 2005, there were no amounts drawn under the Term B facility. Refer to Note 7 to the 2005 Annual Consolidated Financial Statements for additional information on the Aeroplan credit facilities.

### 6.3. Debt and Lease Obligations

As a result of the adoption of AcG-15, the Corporation has consolidated leasing entities covering aircraft and engine leasing agreements previously accounted for as operating leases. Future minimum lease payments under existing operating leases of aircraft and other property, excluding leases accounted for as capital leases and Variable Interest Entities (VIEs), amounted to \$3.4 billion at December 31, 2005 compared to \$3.3 billion at December 31, 2004. Refer to the table below for additional information on the Corporation's future minimum lease payments under existing operating leases.

#### Summary of Principal Repayment and Future Minimum Lease Payment Requirements at December 31, 2005

The table below summarizes the Corporation's principal repayment requirements at December 31, 2005 through to 2010 on long-term debt, capital lease obligations, and aircraft, engine and fuel facility debt consolidated as VIEs under AcG-15. The table also summarizes the Corporation's future minimum lease payments under existing operating leases at December 31, 2005.

(\$ millions)	2006	2007	2008	2009	2010
Long-term debt principal obligations	48	50	70	349	35
Debt consolidated under AcG-15 (1)	76	119	117	59	118
Capital lease principal obligations	141	174	172	84	82
Total long-term debt and capital lease obligations	265	343	359	492	235
Future minimum lease payments under existing aircraft operating leases	458	406	335	300	259
Future minimum lease payments under existing leases for other property	83	68	51	37	28
Total future minimum lease payments under existing leases	541	474	386	337	287

(1) Includes end of lease debt principal payments due on aircraft and engine leasing entities consolidated under AcG-15 before taking into account the anticipated fair value of the aircraft and engines at the time of lease expiry. In 2007, amounts due of approximately US\$39 million relate to end of lease obligations with current aircraft fair values of approximately US\$36 million. In 2008, amounts due of approximately US\$51 million relate to end of lease obligations with current aircraft fair values of approximately US\$93 million. In 2010, amounts due of approximately US\$54 million relate to end of lease obligations with current aircraft fair values of approximately US\$59 million. In these leasing transactions, Air Canada has the option to either refinance the aircraft on lease expiry or to return the aircraft to the lessor. On a lease return, Air Canada may be required to make a residual value payment in the event aircraft sale proceeds are less than amounts outstanding under the lease.

## 6.4. Capital Expenditures

The table below provides projections for aircraft expenditures for firm aircraft orders, net of aircraft financing, combined with planned and committed expenditures for aircraft engines, inventory, property and equipment, net of related financing, if applicable, for the years 2006 through to 2010.

In addition to the firm aircraft orders, the Corporation's purchase agreements include options, cancelable orders and purchase rights, all of which are not included in these projections.

Projected Planned and Committed Capital Expenditures (1) (\$ millions)	2006	2007	2008	2009	2010
	Projected committed expenditures	826	1,950	1,213	428
Projected planned but uncommitted expenditures	252	405	317	273	285
Total projected expenditures	1,078	2,355	1,530	701	1122
Projected financing on committed expenditures	(467)	(1,560)	(1,090)	(297)	(801)
Total projected expenditures, net of financing	611	795	440	404	321

(1) US dollar amounts are converted using the December 31, 2005 noon day rate of \$1.1659. Final aircraft delivery prices include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day LIBOR rate at December 31, 2005.

### Boeing

In November 2005, the Corporation concluded agreements with The Boeing Company (Boeing) for the acquisition of up to 36 Boeing 777 aircraft and up to 60 Boeing 787 Dreamliners. The agreements include firm orders for 18 Boeing 777 aircraft, plus purchase rights for an additional 18 aircraft, in a yet-to-be determined mix of the 777 family's newest models. Deliveries of the Boeing 777 aircraft are scheduled to commence in March 2007. Seven Boeing 777 aircraft are expected to be delivered in 2007, nine aircraft in 2008, and two aircraft in 2009. The agreements also include firm orders for 14 Boeing 787 Dreamliners, plus options and purchase rights for an additional 46 aircraft. Air Canada's first Boeing 787 aircraft is scheduled for delivery in 2010. The Corporation has received financing commitments from Boeing and the engine manufacturer covering all firm aircraft orders for approximately 90 per cent of the capital expenditure.

The Corporation expects to remove from operations all 20 Airbus A330 and A340 aircraft as well as all 12 Boeing 767-200 aircraft as the new committed Boeing 777 and 787 aircraft are delivered. The debt and other obligations associated with these aircraft are approximately US\$850 million at December 31, 2005.

## **Embraer**

In 2004, Air Canada signed a definitive purchase agreement with Empresa Brasileira de Aeronautica S.A. (Embraer) covering firm orders for 45 Embraer 190 series aircraft as well as 15 Embraer 175 series aircraft. The purchase agreement also contains rights to exercise options for up to 60 additional Embraer 190 series aircraft as well as providing for conversion rights to other Embraer models.

Deliveries of the 15 Embraer 175 series aircraft commenced in July 2005 and the last aircraft was delivered in January 2006. All Embraer 175 deliveries were 80 percent financed by a third party.

The Embraer 190 series deliveries commenced in December 2005. At December 31, 2005, three of the Embraer 190 series firm aircraft orders have been completed and the remaining 42 deliveries are planned to be completed by January 2008. For the first 18 firm Embraer 190 deliveries, the Corporation has received loan commitments from a syndicate of banks and the manufacturer covering 80 percent of the capital expenditure. For the remaining 27 firm Embraer 190 deliveries, the Corporation has received loan commitments from the manufacturer covering 85 percent of the capital expenditures.

## **Bombardier**

In 2004, Air Canada signed a definitive purchase agreement with Bombardier Inc. (Bombardier) for the acquisition of regional jet aircraft. The agreement with Bombardier covered firm orders for 15 Bombardier CRJ705 and 15 Bombardier CRJ200 aircraft, all of which were delivered to the Corporation in late 2004 and throughout 2005. The agreement with Bombardier contains orders for 15 additional Bombardier CRJ200 aircraft which can be cancelled without penalty. The agreement also contains options for an additional 45 aircraft. As of February 9, 2006, no commitments have been made on the cancelable orders or on the additional options for the 45 aircraft. The Corporation has financing commitments for 85 percent of capital expenditures from the manufacturer on the cancellable aircraft orders should the Corporation decide to commit to acquire these aircraft.

## **Aircraft Reconfiguration**

On November 10, 2005, Air Canada announced its intention to provide all-new seating across its entire fleet, featuring a state-of-the-art lie-flat seat for its international Executive First customers. In addition, Air Canada is outfitting its Executive Class cabins on North American routes with new premium seats, and all of its Hospitality cabins fleet-wide will be reconfigured with new seats offering personal seat back entertainment systems with an increased choice of audio and video programming. The capital expenditures relating to this program are reflected in the projected planned and committed expenditures table above.

### Projected Cash Debt Payments for Committed Aircraft Deliveries

The following table provides for the Corporation's cash debt payments for the future firm aircraft deliveries for the years 2006 through to 2010.

The projected principal repayments disclosed below are based on the assumption that all aircraft acquisitions will be financed under debt. Air Canada has not yet decided whether certain aircraft acquisitions will be financed under debt or operating lease arrangements

(\$ millions) (1)	2006	2007	2008	2009	2010
Principal repayment on aircraft-related long-term debt	8	37	95	130	154

(1) Based on 10-year US treasury rate and swap rate as at December 31, 2005. US dollar amounts are converted using the December 31, 2005 noon day rate of \$1.1659. Final aircraft delivery prices include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day LIBOR rate at December 31, 2005.

## 6.5. Pension Funding Obligations

The table below provides the Corporation's 2005 pension funding as well as projections for its pension funding obligations from 2006 through to 2010:

(\$ millions)	2005	2006	2007	2008	2009	2010
Past service domestic registered plans	99	198	214	207	211	212
Current service domestic registered plans	133	139	141	146	152	158
Other pension arrangements	52	52	56	61	65	69
Projected pension funding obligations	284	389	411	414	428	439

The above pension funding requirements are in respect of the Corporation's pension arrangements. For Domestic Registered Plans, the funding requirements are based on the minimum past service contributions from the January 1, 2005 actuarial valuations plus a projection of the current service contributions. The required contributions disclosed above do not reflect actual experience of 2005 and assume no future gains and losses on plan assets and liabilities over the projection period. The changes in the economic conditions, mainly the return on assets generated by the fund and the change in interest rates, will impact projected required contributions.

## 7. FINANCIAL MANAGEMENT – 2005 VERSUS 2004 COMBINED

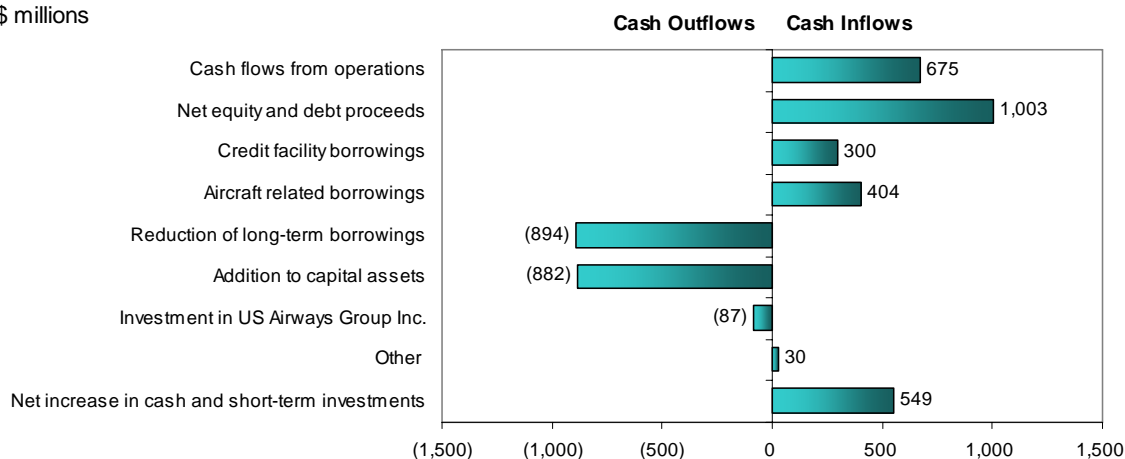
The following table reflects the 2005 Consolidated Statement of Cash Flow of ACE, and the 2004 Combined Statement of Cash Flow, as defined on page 4 of this MD&A.

### Consolidated Statement of Cash Flow

(\$ millions)	ACE	2004 Combined
	Twelve Months ended December 31, 2005	Twelve Months ended December 31, 2004
<b>Cash flows from (used for)</b>		
<b>Operating</b>		
Income (loss) for the period	258	(880)
Adjustments to reconcile to net cash provided by operations		
Reorganization and restructuring items	-	786
Depreciation, amortization and obsolescence	482	397
Loss on sale of and provisions on assets	28	75
Aeroplan dilution gain	(190)	-
Foreign exchange	(83)	(202)
Future income taxes	116	6
Employee future benefit funding (more than) less than expense	(74)	74
Decrease (increase) in accounts receivable	(43)	78
Decrease (increase) in spare parts, materials and supplies	(92)	(30)
Increase (decrease) in accounts payable and accrued liabilities	45	(222)
Increase (decrease) in advance ticket sales, net of restricted cash	132	119
Aircraft lease payments (in excess of ) less than rent expense	33	(45)
Other	63	92
Cash flows from (used for) operating activities before the following items:	675	248
Settlement of lease obligations	-	(290)
Rebate on lease settlement	-	33
Payment of restructuring obligation	-	(45)
Fees conditional on emergence	-	(12)
	675	(66)
<b>Financing</b>		
Issue of share capital	452	1
Issue of convertible notes	319	-
Issue of Aeroplan subsidiary units	232	-
Aircraft-related borrowings	404	233
Credit facility borrowings	300	80
Reduction of long-term debt and capital lease obligations	(894)	(425)
Preferred shares issued to Cerberus for cash	-	238
Shares issued for cash under Rights Offering	-	852
GE DIP financing	-	-
Drawdown of exit financing	-	527
Distributions paid to non-controlling interest holders	(8)	-
Other	(4)	(2)
	801	1,504
<b>Investing</b>		
Short-term investments	(465)	35
Sale of Aeroplan units	35	-
Additions to capital assets	(882)	(457)
Proceeds from sale of assets	42	2
Cash collateralization of letters of credit	(35)	(21)
Investment in US Airways	(87)	-
	(1,392)	(441)
Increase in cash and cash equivalents	84	997
Cash and cash equivalents, beginning of period	1,481	484
Cash and cash equivalents transferred to the Corporation	-	-
Cash and cash equivalents, end of period	1,565	1,481
Short-term investments	616	151
<b>Total</b>	<b>2,181</b>	<b>1,632</b>

## 2005 Changes in Cash Position including Short-Term Investments

\$ millions



### 7.1. Cash Flows from (used for) Operations

The 2005 cash flows from operations were \$675 million. This compared to cash flows used for operations of \$66 million in 2004 Combined. 2004 Combined cash flows used for operations included \$314 million of net payments made on implementation of the consolidated plan of reorganization, compromise and arrangement (the Plan), relating mainly to the settlement of restructuring obligations. Before these payments, 2004 Combined cash flows from operations amounted to \$248 million.

Further components of the cash flow change are described below:

Accounts receivable was a use of funds of \$43 million in 2005. This compared to a source of funds of \$78 million in 2004 Combined, a decrease of \$121 million. The main factor in the use of funds was an increase in commodity tax receivables on aircraft deliveries which will be collected in the first quarter of 2006. Another factor in the use of funds included an increase in cargo-related receivables due mainly to the increase in cargo revenues over 2004 Combined.

Spare parts, materials and supplies was a use of funds of \$92 million, compared to a use of funds of \$30 million in 2004 Combined. The use of funds reflected increases in spare parts for servicing third party maintenance contracts as well as spare parts for the Embraer and CRJ aircraft deliveries during the year. In addition, fuel inventories increased \$41 million during the year, in part reflecting the higher cost of fuel.

In 2005, employee future benefit funding exceeded the accounting expense by \$74 million.

Other cash from operations of \$63 million during the year included the change in prepaid expenses and other current assets. In 2005, a prepayment made while under CCAA was repatriated resulting in a cash inflow of \$63 million.

## **7.2. Cash Flows from (used for) Financing Activities**

In 2005, aircraft-related borrowings totaled \$404 million and related mainly to the acquisition of Embraer aircraft.

In 2005, reduction of long-term debt and capital lease obligations amounted to \$894 million. The Corporation repaid all of its outstanding debt of \$540 million under the exit credit facility with GE and proceeds of \$29 million resulting from the sale of one Boeing 747-400 aircraft were used to repay the GE Limited Recourse Loan. Scheduled payments of \$158 million were made on capital lease obligations and scheduled payments of \$43 million were made on the secured non-revolving term credit facility with Amex Bank of Canada Inc. Other mandatory scheduled payments amounted to \$124 million.

In addition, in 2005, ACE completed the public offering of an aggregate of 12,485,000 Class A Variable Voting Shares and Class B Voting Shares at a price of \$37.00 per share for gross proceeds of approximately \$462 million (\$442 million, net of fees). The Corporation also issued \$330 million of 4.25 per cent Convertible Senior Notes due 2035 (Convertible Notes) for net proceeds of \$319 million. Also in 2005, ACE and Aeroplan Income Fund (the Fund) completed an Initial Public Offering of the Aeroplan Income Fund for aggregate net proceeds of \$267 million, of which \$232 million is included in financing activities and \$35 million is included in investing activities. The amount of \$35 million included in investing activities relates to the net over-allotment proceeds which were the sale to the Fund of units held by ACE. Also in 2005, the Corporation issued 521,976 common shares on the exercise of stock options for cash consideration of \$10 million.

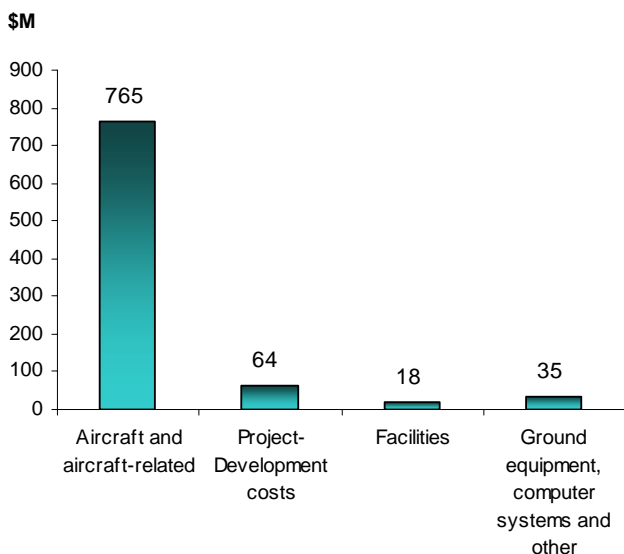
In 2005, Air Canada entered into a senior secured syndicated revolving credit facility in an aggregate amount of up to \$300 million or the US dollar equivalent. At December 31, 2005, the full amount available under the credit facility was undrawn.

During 2005, Aeroplan arranged for senior secured credit facilities in the amount of \$475 million. The credit facilities consist of one \$300 million (or the U.S. dollar equivalent thereof) term facility (Term A Facility), a \$100 million (or the U.S. dollar equivalent thereof) acquisition facility (Term B Facility) and a \$75 million (or the U.S. dollar equivalent thereof) revolving term credit facility. The Term A Facility was drawn on June 29, 2005 in the amount of \$300 million in order to fund a portion of the \$400 million Aeroplan Miles Redemption Reserve, included in cash and cash equivalents and short-term investments. At December 31, 2005, no amounts were drawn under the Term B Facility.

### 7.3. Cash Flows from (used for) Investing Activities

In 2005, short-term investments increased by \$465 million. Short-term investments have original maturities over three months, but not more than one year. These investments can be readily converted to cash and are with institutions that have high credit ratings.

#### 2005 Capital Expenditures



- In 2005, additions to capital assets totaled \$882 million. Included in this amount were \$508 million related to the purchase of Embraer aircraft and \$185 million related to a deposit for the acquisition of Boeing aircraft partly offset by a \$50 million refund relating to deposits on Bombardier aircraft which have been delivered. Other additions to capital assets included inventory and spare engines, ground equipment, facilities and system development costs.

#### US Airways Group Inc.

On September 27, 2005, the Corporation invested \$87 million (US\$75 million) in US Airways Group Inc. (US Airways) in conjunction with the carrier's exit from US bankruptcy proceedings. The Corporation's investment represented approximately 6 per cent of the equity of US Airways at December 31, 2005. The equity investment is subject to a six-month holding period from the closing date. This investment has been accounted for using the cost method. In connection with the equity investment, ACE also received options to purchase additional common stock in US Airways. On closing of the transaction, ACE sold these options for proceeds of \$1 million.

## 8. FLEET

### Air Canada

In 2005, Air Canada took delivery of one Airbus A340-300 aircraft, three Boeing 767-300 aircraft, 14 Embraer 175 and three Embraer 190 aircraft. During 2005, three Airbus A321 aircraft and one Airbus 320 aircraft were returned to the lessors, one Boeing 747-400 aircraft was sold and one Boeing 737-200 aircraft was donated to the Museum of Alberta. In addition, 15 Bombardier CRJ100 aircraft were transferred to Jazz and one Boeing 767-200 aircraft was removed from the fleet. The average age of Air Canada's operating fleet was 9.5 years at December 31, 2005. Air Canada's operating fleet, excluding Jazz aircraft, at December 31, 2005, was as described below:

	Total seats	Number of operating aircraft (1)	Average Age	Owned (2)	Capital Lease (2)	Consolidated under AcG-15 (2)	Operating Lease
<u>Widebody Aircraft</u>							
Airbus A340-500	267	2	1.5	2	-	-	-
Airbus A340-300	285-286	10	7.7	-	8	-	2
Airbus A330-300	274	8	5.2	-	8	-	-
Boeing 767-300	203-222	33	12.5	1	2	6	24
Boeing 767-200	207	12	19.4	12	-	-	-
<u>Narrowbody Aircraft</u>							
Airbus A321	166	10	3.8	-	-	5	5
Airbus A320	140	51	12.8	-	-	-	51
Airbus A319	120	48	7.0	-	17	17	14
Embraer 190	93	3	0.0	3	-	-	-
Embraer 175	73	14	0.3	14	-	-	-
CRJ100	50	10	10.6	-	-	10	-
<b>Total Operating Aircraft</b>		<b>201</b>	<b>9.5</b>	<b>32</b>	<b>35</b>	<b>38</b>	<b>96</b>

(1) Excludes aircraft which have been permanently removed from service.

(2) Owned aircraft as well as capital leases and leases consolidated under AcG-15 are carried on the Consolidated Statement of Financial Position.

The following table reflects the impact on Air Canada's fleet of the future committed aircraft deliveries and projected aircraft removals resulting from the new deliveries. The aircraft options, cancelable orders and purchase rights are not included in this table.

	Number of operating aircraft at December 31, 2005	Future committed aircraft deliveries at December 31, 2005	Estimated future projected aircraft removals	Resulting number of operating aircraft
<u>Widebody Aircraft</u>				
Boeing 777 – 300ER/200LR/200F	-	18	-	18
Boeing 787 – 900/800	-	14	-	14
Boeing 767-300	33	-	-	33
Boeing 767-200	12	-	(12)	-
Airbus A340-500	2	-	(2)	-
Airbus A340-300	10	-	(10)	-
Airbus A330-300	8	-	(8)	-
<u>Narrowbody Aircraft</u>				
Airbus A321	10	-	(3)	7
Airbus A320	51	-	(10)	41
Airbus A319	48	-	(3)	45
Embraer 190	3	42	-	45
Embraer 175	14	1	-	15
CRJ100 <sup>(1)</sup>	10	-	(10)	-
<b>Total Operating Aircraft</b>	<b>201</b>	<b>75</b>	<b>(58)</b>	<b>218</b>

(1) The 10 CRJ100s will be transferred to Jazz.

In conjunction with the deliveries of the Boeing 777 and 787 aircraft, the Corporation expects to remove 20 widebody Airbus aircraft (two A340-500s, ten A340-300s and eight A330-300s) from its fleet as well as 12 Boeing 767-200 aircraft. Two of the Airbus A340-300 aircraft are held under operating leases with lease terminations in 2009.

### **Jazz**

During 2005, Jazz took delivery of 15 Bombardier CRJ705 aircraft and 13 Bombardier CRJ200 aircraft, nine of which were entered into service at December 31, 2005 and four of which were received in 2005 but not entered into service at December 31, 2005 and are not shown as operating aircraft. In addition, 15 Bombardier CRJ100 aircraft were transferred from Air Canada to Jazz. Also during 2005, eight BAe 146 aircraft and four Dash 8-100 aircraft were returned to lessors and 27 Fokker F28 aircraft were sold. The average age of Jazz's operating fleet was 11.2 years at December 31, 2005.

Jazz's operating fleet at December 31, 2005 was as described below:

	<u>Total seats</u>	<u>Number of operating aircraft (1)</u>	<u>Average Age of Operating Aircraft</u>	<u>Owned</u>	<u>Capital Lease</u>	<u>Consolidated under AcG-15</u>	<u>Operating Lease</u>
Bombardier CRJ705	75	15	0.5	-	-	-	15
Bombardier CRJ200	50	27	3.9	-	-	-	27
Bombardier CRJ100	50	15	9.9	-	-	13	2
Dash-8-300	50	26	15.8	17	-	-	9
Dash-8-100	37	38	18.0	38	-	-	-
Total Operating Aircraft		121	11.2	55	-	13	53

(1) Excludes aircraft which have been permanently removed from service.

Jazz has a planned operating fleet of 135 aircraft in July 2006. The increase is due to the addition of ten CRJ100 aircraft transferred from Air Canada and six CRJ200 aircraft as well as the removal of two Dash-8-100 aircraft.

## 9. PEOPLE

In 2004, the Corporation concluded long-term collective agreements with all union groups which expire in 2009. These collective agreements provide for a process to revise wage levels in 2006 by negotiation or, failing negotiation, by mediation or arbitration without resort to strike or lock out.

In the fourth quarter of 2005, the Corporation had an average of 33,090 FTE employees compared to an average of 31,991 FTE employees in the fourth quarter of 2004. This reflects a 3 per cent increase from the fourth quarter of 2004, as shown in the table below:

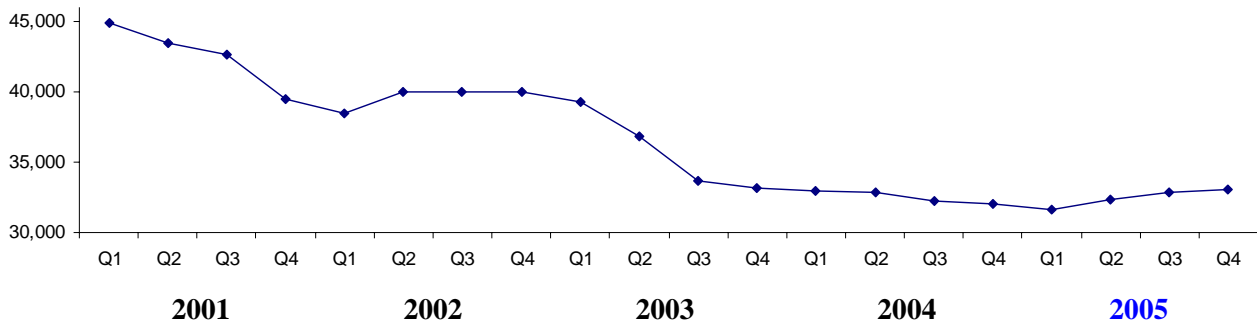
	<u>Union</u>	<u>Fourth Quarter 2005</u>	<u>Fourth Quarter 2004</u>	<u>Change</u>	<u>% Change</u>
<b>Transportation Services</b>					
Management & Administrative Support	-	3,565	3,523	42	1
Pilots	ACPA	2,541	2,563	(22)	(1)
Flight Attendants	CUPE	6,010	5,837	173	3
Customer sales & Service Agents	CAW / IBT	3,927	3,942	(15)	(0)
Technical Services, Ramp & Cargo	IAMAW	6,924	6,775	149	2
UK Unionized employees	AMICUS / TGWU	682	749	(67)	(9)
Other unionized		528	494	34	7
<b>Transportation Services total <sup>(1)</sup></b>		<b>24,177</b>	<b>23,883</b>	<b>294</b>	<b>1</b>
<b>Aeroplan</b>		<b>1,057</b>	<b>1,185</b>	<b>(128)</b>	<b>(11)</b>
<b>ACTS</b>		<b>4,055</b>	<b>3,560</b>	<b>495</b>	<b>14</b>
<b>Jazz</b>		<b>3,801</b>	<b>3,363</b>	<b>438</b>	<b>13</b>
<b>ACE</b>		<b>33,090</b>	<b>31,991</b>	<b>1,099</b>	<b>3</b>

Note: Certain prior year's information was reclassified to conform to the current year's presentation.

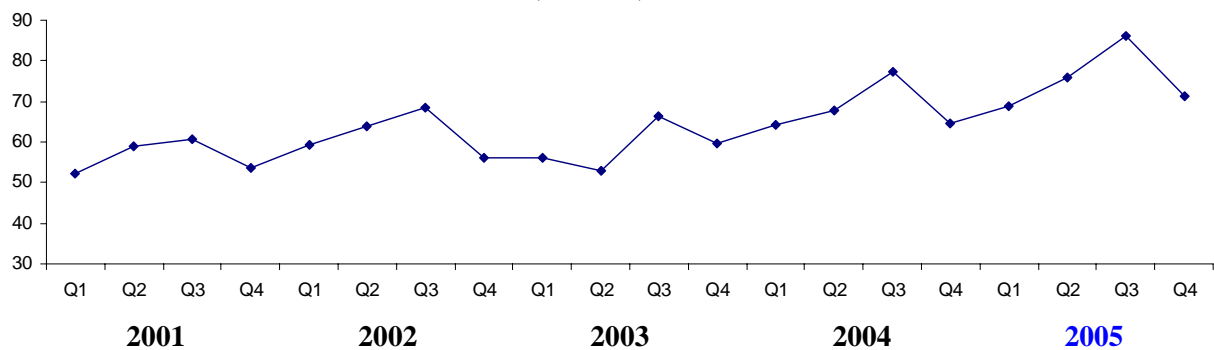
<sup>(1)</sup> Transportation Services includes the following FTEs: Air Canada 15,414; Air Canada Cargo 1,223; ACGHS 7,038; Air Canada Vacations 441; Other 61.

The graphs below reflect the significant reduction in average quarterly FTE employee levels from 2001 to 2005 as well as the increase in productivity as measured by operating revenue per FTE employee and ASM per FTE employee:

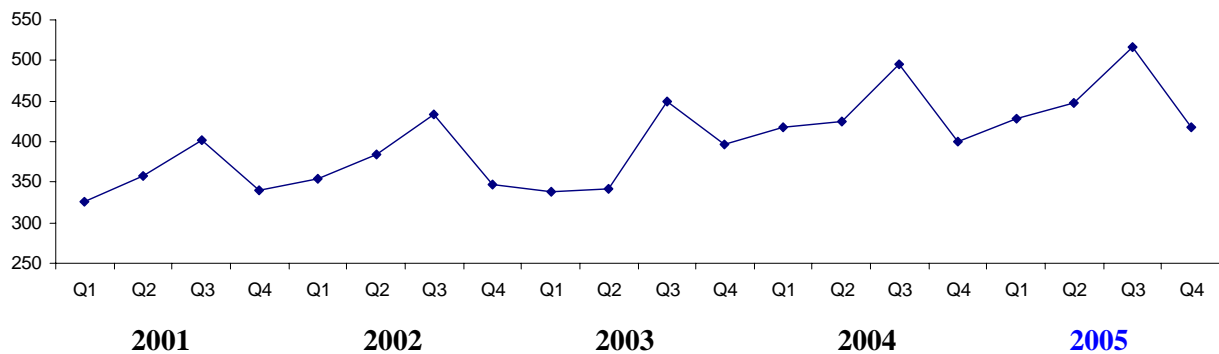
Average Number of FTE Employees



Operating Revenue per FTE Employee  
(\$ thousands)



ASM per FTE Employee  
(thousands)



## 10. QUARTERLY FINANCIAL DATA

The table below describes quarterly financial results and major operating statistics of Air Canada for the first three quarters of 2004 and the financial results of ACE for the fourth quarter of 2004 and the full year 2005:

### Quarterly Financial Results and Major Operating Statistics – Condensed Consolidated

\$ millions (except per share figures)	Predecessor Company Air Canada			ACE				
	2004			2005				
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Passenger revenues	1,661	1,844	2,123	1,681	1,739	2,100	2,461	1,969
Cargo revenues	126	137	142	151	135	147	162	176
Other revenues	334	240	231	230	303	211	210	217
Operating revenues	2,121	2,221	2,496	2,062	2,177	2,458	2,833	2,362
Operating expenses	2,266	2,199	2,253	2,065	2,187	2,281	2,513	2,397
<b>Operating income (loss) before reorganization and restructuring items</b>	<b>(145)</b>	<b>22</b>	<b>243</b>	<b>(3)</b>	<b>(10)</b>	<b>177</b>	<b>320</b>	<b>(35)</b>
Reorganization and restructuring items	(132)	(426)	(313)	-	-	-	-	-
Non-operating income (expense)	(43)	(72)	(131)	(47)	(63)	104	(38)	(88)
<b>Income (loss) before the following items:</b>	<b>(320)</b>	<b>(476)</b>	<b>(203)</b>	<b>(50)</b>	<b>(73)</b>	<b>281</b>	<b>282</b>	<b>(123)</b>
Non-controlling interest	-	-	-	-	(3)	(4)	(9)	(8)
Foreign exchange gain (loss) on non-compromised monetary items	17	(34)	121	78	(15)	(53)	125	(11)
Recovery of (provision for) income taxes	(1)	-	(1)	(13)	14	(56)	(128)	39
<b>Net income (loss)</b>	<b>(304)</b>	<b>(510)</b>	<b>(81)</b>	<b>15</b>	<b>(77)</b>	<b>168</b>	<b>270</b>	<b>(103)</b>
Earnings (loss) <sup>(1)</sup>								
Per share – basic	(2.53)	(4.24)	(0.67)	0.17	(0.87)	1.67	2.66	(1.02)
Per share - diluted	(2.53)	(4.24)	(0.67)	0.17	(0.87)	1.49	2.33	(1.02)
Revenue passenger miles (millions)	10,057	10,836	12,853	9,681	10,586	11,613	13,981	10,584
Available seat miles (millions)	13,797	13,931	15,993	12,815	13,566	14,487	16,961	13,808
Passenger load factor (%)	72.9	77.8	80.4	75.5	78.0	80.2	82.4	76.7
Operating expense per available seat mile (CASM) (cents)	16.4	15.8	14.1	16.1	16.1	15.7	14.8	17.4
Operating expense per available seat mile excl. fuel expense (cents)	14.0	13.1	11.2	12.7	13.1	12.1	10.8	13.2

(1) Pursuant to the Plan as further described in Note 19 to the 2005 Annual Consolidated Financial Statements, all issued and outstanding options of Air Canada and warrants were cancelled without payment or consideration on September 30, 2004. In addition, a new ACE share capital structure was established, as further described in Note 12 to the 2005 Annual Consolidated Financial Statements.

## 11. SEGMENT INFORMATION

The segment reporting structure for the Corporation reflects four reportable segments: Transportation Services, Aeroplan, Jazz and ACTS. In the Predecessor Company, there was only one reportable segment.

This segment reporting was applied on a prospective basis. Prior period segment information is presented for comparative purposes for Aeroplan and Jazz, however, for the reasons described below, segment reporting information pertaining to periods prior to September 30, 2004 is not directly comparable.

Segment financial information has been prepared consistent with how financial information is produced internally for the purposes of making operating decisions. Segments negotiate transactions with each other as if they were unrelated parties.

In the Predecessor Company, ACTS was a cost centre within Air Canada and discrete financial information is not available. In addition, a capacity purchase agreement between Air Canada and Jazz came into effect on September 30, 2004. Jazz segment information, for periods prior to September 30, 2004, is not comparable as a result of this new agreement.

As described on page 8 of this MD&A, the Corporation changed the accounting policy effective September 30, 2004 for the recognition of its revenues relating to the loyalty program. As a result, Aeroplan segment results for periods prior to September 30, 2004 are not directly comparable.

## Fourth Quarter Segment Results

The tables below provide total amounts reported by each segment in the consolidated financial statements for the fourth quarter of 2005 and in the consolidated financial statements for the fourth quarter of 2004.

Three Months ended December 31, 2005						
(\$ millions)	Transportation Services	Aeroplan	Jazz	ACTS	Inter-Segment Elimination	ACE Consolidated
Passenger revenue	1,969	-	-	-	-	1,969
Cargo revenue	176	-	-	-	-	176
Other revenue	25	150	3	39	-	217
External revenue	2,170	150	3	39	-	2,362
Inter-segment revenue	37	4	301	153	(495)	-
Total revenue	2,207	154	304	192	(495)	2,362
Aircraft rent	90	-	28	-	(1)	117
Amortization of capital assets	110	3	4	8	-	125
Other operating expenses	2,098	121	238	192	(494)	2,155
Total operating expenses	2,298	124	270	200	(496)	2,397
Operating income (loss)	(91)	30	34	(8)	-	(35)
Total non-operating income (expense), non-controlling interest, foreign exchange and income taxes	(62)	-	(2)	(4)	-	(68)
Segment Results	(153)	30	32	(12)	-	(103)
Operating Margin %	(4.1)	19.5	11.2	(4.2)		(1.5)
EBITDAR <sup>(1)</sup>	109	33	66	0	(1)	207

Three months ended December 31, 2004						
(\$ millions)	Transportation Services	Aeroplan	Jazz	ACTS	Inter-Segment Elimination	ACE Consolidated
Passenger revenue	1,681	-	-	-	-	1,681
Cargo revenue	151	-	-	-	-	151
Other revenue	44	121	3	62	-	230
External revenue	1,876	121	3	62	-	2,062
Inter-segment revenue	54	6	185	106	(351)	-
Total revenue	1,930	127	188	168	(351)	2,062
Aircraft rent	103	-	9	-	(1)	111
Amortization of capital assets	73	1	4	7	-	85
Other operating expenses	1,812	104	153	150	(350)	1,869
Total operating expenses	1,988	105	166	157	(351)	2,065
Operating income (loss)	(58)	22	22	11	-	(3)
Total non-operating income (expense), foreign exchange and income taxes	26	-	(4)	(4)	-	18
Segment Results	(32)	22	18	7	-	15
Operating Margin %	(3.0)	17.3	11.7	6.5		(0.1)
EBITDAR <sup>(1)</sup>	118	23	35	18	(1)	193

(1) Refer to "Non-GAAP Financial Measures" on page 6 of this MD&A for additional information on EBITDAR.

## 2005 Segment Results

Total amounts reported by each segment in the consolidated financial statements for the full year 2005 are as follows:

Twelve Months ended December 31, 2005							
(\$ millions)	Transportation Services	Aeroplan	Jazz	ACTS	Inter-Segment Elimination	ACE Consolidated	
Passenger revenue	8,269	-	-	-	-	-	8,269
Cargo revenue	620	-	-	-	-	-	620
Other revenue	117	627	10	187	-	-	941
External revenue	9,006	627	10	187	-	-	9,830
Inter-segment revenue	194	13	1,013	567	(1,787)	-	-
Total revenue	9,200	640	1,023	754	(1,787)	-	9,830
Aircraft rent	343	-	80	-	(6)	-	417
Amortization of capital assets	424	8	18	32	-	-	482
Other operating expenses	8,259	530	796	675	(1,781)	-	8,479
Total operating expenses	9,026	538	894	707	(1,787)	-	9,378
Operating income	174	102	129	47	-	-	452
Total non-operating income (expense), non-controlling interest, foreign exchange and income taxes	(167)	(2)	(11)	(14)	-	-	(194)
Segment Results	7	100	118	33	-	-	258
Total assets	11,001	674	504	381	(713)	-	11,847
Additions to capital assets	849	12	16	5	-	-	882
Operating Margin %	1.9	15.9	12.6	6.2	-	-	4.6
EBITDAR <sup>(1)</sup>	941	110	227	79	(6)	-	1,351

(1) Refer to "Non-GAAP Financial Measures" on page 6 of this MD&A for additional information on EBITDAR.

Subsequent to the dilution of ACE's interest in Aeroplan, a non-controlling interest charge is recorded upon the consolidation of Aeroplan. As Aeroplan's non-controlling interest capital is in a deficit position, the non-controlling interest charge is equal to the greater of the non-controlling interest holders' share of the Aeroplan earnings for the period or the amount of distributions to the non-controlling interest holder during the period.

Refer to Note 15 to the 2005 Annual Consolidated Financial Statements for additional information on segment results.

## **11.1. Analysis of Results – Fourth Quarter 2005 versus Fourth Quarter 2004**

### **Transportation Services**

For the fourth quarter of 2005, the Transportation Services segment reported an operating loss of \$91 million, a deterioration of \$33 million compared to the operating loss of \$58 million recorded in the same quarter of 2004.

EBITDAR for Transportation Services amounted to \$109 million, a decrease of \$9 million from the fourth quarter of 2004, despite a \$146 million rise in the cost of fuel. A factor in the deterioration of EBITDAR, other than fuel expense, was in the weaker results of Air Canada Vacations largely due to the impact of the hurricane season. Refer to page 7 of this MD&A for a reconciliation of EBITDAR by segment.

Passenger revenues increased \$288 million or 17 per cent on a capacity increase of 8 per cent reflecting both yield improvements and traffic growth. The system yield improvement was primarily due to increased fare levels in the domestic and US transborder markets to partially offset higher fuel costs. An improved domestic competitive position and a stronger market demand for the higher-priced Tango Plus product were also factors in the domestic yield improvement. Additionally, US transborder yield also improved as a result of a redesign of conditions underlying fares aimed at the business-oriented market which occurred in the fourth quarter of 2005. International yields rose just under 1 per cent as higher fuel surcharges were mostly offset by weaker foreign currencies and competitive pricing. Higher unit revenues (passenger revenue per ASM), due mostly to increased North America fare levels but also to a 1.2 percentage point rise in passenger load factor, offset the growth in unit cost resulting primarily from the sharply higher fuel prices.

Operating expenses increased \$310 million or 16 per cent over the fourth quarter of 2004 and included a \$146 million or 34 per cent increase in fuel expense as well as an increase in inter-segment fees (which are eliminated on consolidation) charged by Jazz under the CPA of approximately \$70 million mainly reflecting an increase in Jazz's block hours, capacity and fleet size. Under Air Canada's CPA with Jazz, Jazz is paid fees based on a variety of different operational metrics in addition to aircraft ownership costs. Jazz is also reimbursed for certain pass-through costs which are further detailed in the discussion on the Jazz segment. Other increases included depreciation, amortization and obsolescence, airport and navigation fees, aircraft maintenance, materials and supplies expense and salaries, wages and benefits. Decreases in operating expenses over the 2004 quarter included commissions, aircraft rent, advertising and promotion expenses and various other reductions.

### **Aeroplan**

Operating revenues amounted to \$154 million in the fourth quarter of 2005, up \$27 million from the fourth quarter of 2004, primarily due to an increase in revenues recognized from the sale of redemption of Aeroplan Miles (including breakage). The increase in revenues recognized was mainly attributable to an increase in the number of Aeroplan Miles redeemed combined with increased capacity available from Air Canada related to Avenue rewards, which were introduced in late April 2004, as well as the continued expansion of non-air rewards.

Operating expenses amounted to \$124 million in the fourth quarter of 2005, an increase of \$19 million from the fourth quarter of 2004, mainly due to a higher cost of rewards primarily attributable to a greater number of Aeroplan Miles redeemed.

Operating income amounted to \$30 million in the fourth quarter of 2005 compared to \$22 million in the fourth quarter of 2004, an increase of \$8 million or 36 per cent.

### **Jazz**

Under the initial CPA, effective for the period October 1, 2004 to December 31, 2005, and the new CPA, which became effective January 1, 2006, Jazz is paid fees based on a variety of different metrics, including block hours flown, cycles (number of take-offs and landings) and passengers in addition to certain variable and fixed aircraft ownership rates. In addition, Jazz is entitled to repayment of certain pass-through costs, including fuel, navigation, landing and terminal fees and certain other costs. Jazz is also eligible to receive payments for successfully achieving certain performance incentives on a quarterly basis related to on-time performance, controllable flight completion, baggage handling performance and overall customer satisfaction.

For the fourth quarter of 2005, Jazz reported an operating income of \$34 million, an improvement of \$12 million compared to the operating income of \$22 million recorded in the same quarter of 2004. EBITDAR was \$66 million in the fourth quarter of 2005 compared to EBITDAR of \$35 million in the fourth quarter of 2004, an increase of \$31 million or 89 per cent which is the result of fleet additions, increased hours of contract flying, cost control and performance incentives earned in the latest quarter. Refer to page 7 of this MD&A for a reconciliation of EBITDAR by segment.

Operating revenue was up \$116 million or 62 per cent. The increase in revenues was due to a net increase of 30 aircraft operated by Jazz, an increase in block hours flown by these aircraft of 33 per cent, and an increase in the pass-through costs charged to Air Canada under the CPA of \$52 million.

Operating expenses rose \$104 million or 63 per cent compared to the fourth quarter of 2004, including an increase in fuel expense of \$33 million or 114 per cent. Fuel expense is a pass-through cost charged to Air Canada under the CPA. Capacity, as measured by available seat miles (ASM) increased by 82 per cent. Unit cost for the fourth quarter of 2005 decreased by 10 per cent from fourth quarter of 2004. Excluding fuel expense, unit cost was down 16 percent compared to the 2004 fourth quarter. Unit cost reductions were achieved in all expense categories except fuel expense, aircraft rent and terminal handling services. Unit aircraft rental costs increased quarter-over-quarter reflecting the new aircraft deliveries throughout 2005.

In the fourth quarter of 2005, non-operating expense amounted to \$2 million, essentially unchanged from the fourth quarter of 2004. Gain on the disposal of property and equipment in the fourth quarter of 2005 was \$1 million.

Net income for the fourth quarter of 2005 was \$32 million compared to net income of \$18 million recorded in the fourth quarter of 2004, an improvement of \$14 million. The increase in net income was due to an increased fleet and effective cost control.

## **ACTS**

During 2005, ACTS continued its focus on increasing its customer base and developing into a stand-alone MRO. In the fourth quarter of 2005, significant effort and focus went into the review and planned improvement of operational processes and systems.

Additionally, ACTS completed a review of all existing accounting policies and practices and in many cases, implemented new practices consistent with those of a stand-alone MRO. This activity is expected to continue into the first quarter of 2006.

During the fourth quarter of 2005, ACTS changed its accounting policy, mainly related to engine maintenance services provided to Air Canada, from proportional performance to the completed contract method. This change in accounting policy was applied from October 1, 2004. The change in accounting policy had the effect of decreasing the reported segment results for the fourth quarter of 2004 by \$11 million. The impact of this change was to defer costs and adjust revenues in relation to work in process at the end of each quarter. Additionally, in the fourth quarter of 2005, ACTS recorded other adjustments of \$7 million including the results of a complete physical inventory count.

Inter-segment revenue for the fourth quarter of 2005 increased by \$47 million or 44 per cent compared to the fourth quarter of 2004, mostly due to increased activity in engine and component maintenance for Air Canada. In addition, revenues for the fourth quarter of 2004 were negatively impacted by the change of accounting policy to the completed contract method which meant that the number of completed events during this first quarter of operation was significantly lower than the ongoing trend. Other revenue for the quarter decreased by \$23 million mostly due to a reduction in third party revenue for engine maintenance due to increased competitive market conditions.

ACTS reported a net loss of \$12 million for the fourth quarter of 2005 compared to net income of \$7 million in the fourth quarter of 2004. The unfavorable variance to last year is mainly due to the reduced profitability of the airframe maintenance division. This reduced profitability is attributable primarily to greater than expected operational challenges relating to significant production capacity growth initiatives at ACTS' Montréal and Vancouver maintenance centers, which required the integration of additional staff and new customer processes.

## **12. OFF-BALANCE SHEET ARRANGEMENTS**

### **Guarantees**

As a result of the adoption of AcG-15 on January 1, 2005, the Corporation no longer has any residual value guarantees under any of its aircraft leasing agreements accounted for as operating leases. The entire debt balance under these leasing agreements is on the Consolidated Statement of Financial Position of the Corporation and, as a result, the residual value support previously applicable under these leasing agreements is no longer characterized as a guarantee of the Corporation, on an accounting basis.

### **Retained or Contingent Interest in Assets Transferred**

ACE has no material arrangements involving the transfer of assets to an unconsolidated entity where those assets serve as credit, liquidity or market risk support to that entity.

### **Derivative Instruments**

Under its risk management policy, the Corporation manages its exposure to changes in interest rates, foreign exchange rates and jet fuel prices through the use of various derivative financial instruments. The Corporation uses derivative financial instruments only for risk management purposes, not for generating trading profit. ACE's risk management policies and use of derivative financial instruments are further described in Note 17 to ACE's 2005 Annual Consolidated Financial Statements. The Corporation has entered into certain derivative financial instrument agreements to manage interest rate and currency risk in certain aircraft lease agreements.

### **Interest Rate Contracts**

During 2005, the Corporation reached a settlement with a third party related to interest rate swaps covering two Boeing 767 aircraft leases which were terminated as a result of Air Canada's filing for CCAA on April 1, 2003. A dispute arose following termination between Air Canada and the unrelated third party with respect to replacement arrangements for the swaps. The settlement agreement provided for a payment to Air Canada of US\$8 million related to a portion of the net payments the Corporation would have received had the swaps not been terminated. The replacement swaps that were put in place with another unrelated third party have a fair value of \$9 million in favour of the Corporation on inception. As a result of these transactions, the Corporation recorded a gain of \$17 million, net of transaction fees of \$3 million, in the third quarter of 2005. The swaps have a term to January 2024 and convert lease payments related to two Boeing 767 aircraft leases consolidated under AcG-15, from fixed to floating rates. These swaps have not been designated as hedges for accounting purposes. At December 31, 2005, these two swaps have a fair value of \$7 million in favour of the Corporation.

### **Foreign Exchange Contracts**

At December 31, 2005, the Company has entered into foreign currency forward contracts and option agreements on US\$521 million of future purchases. The fair value of these foreign currency contracts at December 31, 2005 is \$1 million in favour of third parties. These derivative instruments have not been designated as hedges for accounting purposes. The unrealized loss has been recorded in foreign exchange gain (loss). The Corporation had no foreign exchange forward contracts outstanding at December 31, 2004.

The Corporation has entered into currency swap agreements for 16 Bombardier Regional Jet operating leases until lease terminations between 2007 and 2011. Currency swaps for five Canadian Regional Jet operating leases, with unrelated creditworthy third parties, were put in place on the inception of the leases and have a fair value at December 31, 2005 of \$13 million in favour of third parties (2004 - \$12 million in favour of unrelated creditworthy third parties), taking into account foreign exchange rates in effect at that time. Currency swaps for 11 Bombardier Regional Jet operating leases have a fair value at December 31, 2005 of \$3 million in favour of the Corporation. These swaps have not been designated as hedges for hedge accounting purposes. The unrealized changes in fair value have been recorded in foreign exchange gain (loss).

## **Fuel Contracts**

In order to minimize the Corporation's exposure to the volatility of fuel prices, a systematic fuel risk management strategy has been implemented using financial instruments to build up the Corporation's hedge position in increments of approximately 4 per cent per month to a target level of approximately 50 per cent of its anticipated jet fuel requirements, beginning in September 2005 for a 24-month period.

At December 31, 2005, the Corporation had collar option structures in place to hedge a portion of its anticipated jet fuel requirements over the 2006 to 2007 period. For all heating and crude oil fuel hedges, the prices disclosed below do not include the jet fuel premium.

### 2005 Fuel Hedges

For 2005, the Corporation had hedged approximately 3 per cent of its 2005 jet fuel requirements through jet fuel-based contracts at prices that fluctuated between an average of US\$75.00 to US\$92.00 per barrel. All of the Corporation's fourth quarter 2005 hedges were also effectively jet fuel-based contracts. The Corporation had hedged 12 per cent of its fourth quarter 2005 jet fuel requirements at prices that fluctuated between an average of US\$75.00 to US\$92.00 per barrel.

### 2006 Fuel Hedges

For 2006, the majority of the Corporation's hedge positions are effectively in the form of jet fuel and heating oil-based contracts. The Corporation has hedged 21 per cent of its 2006 requirements at prices that can fluctuate between an average of US\$75.00 to US\$87.00 per barrel for the jet fuel contracts and an average of US\$74.00 to \$86.00 per barrel for the heating-oil based contracts.

### 2007 Fuel Hedges

For 2007, the majority of the hedge positions are heating oil and crude oil-based contracts. The Corporation has hedged 13 per cent of its 2007 requirements at prices that can fluctuate between an average of US\$74.00 to US\$86.00 per barrel for the heating oil-based contracts and an average of US\$56.00 to US\$68.00 per barrel for the crude oil-based contracts.

Contracts entered into before October 1, 2005 did not qualify for hedge accounting whereas contracts entered into after October 1, 2005 do qualify for hedge accounting. Under hedge accounting, gains or losses on fuel hedging contracts are recognized in earnings as a component of aircraft fuel expense when the underlying jet fuel being hedged is consumed. Prior to these derivative instruments being designated as hedges for accounting purposes, an unrealized gain of \$2 million was recorded in other non-operating expense. Subsequent to adopting fuel hedge accounting, the Corporation recognized a net loss of \$3 million as a component of fuel expense on the Consolidated Statement of Operations. The fair value of the Corporation's fuel hedging agreements at December 31, 2005 was \$3 million in favour of third parties.

## **13. CHANGES IN ACCOUNTING POLICIES**

### **Consolidation of Variable Interest Entities**

The Corporation adopted Accounting Guideline 15 – Consolidation of Variable Interest Entities (AcG-15) effective January 1, 2005. Refer to Note 2 to the 2005 Annual Consolidated Financial Statements for additional information on the adoption of AcG-15. AcG-15 relates to the application of consolidation principles to certain entities that are subject to control on a basis other than ownership of voting interests. The purpose of AcG-15 is to provide guidance for determining when an enterprise includes the assets, liabilities and results of activities of such an entity (variable interest entity) in its consolidated financial statements.

The adoption of AcG-15 and the consolidation of the variable interest entities (VIEs) does not alter the underlying contractual arrangements between Air Canada, as lessee, and its lessors, nor the cash payments from Air Canada to the lessors. Over the life of the lease, the accounting expense is consistent between an operating lease and an aircraft leasing entity consolidated under AcG-15. However, there may be timing differences in any given period between net expense recorded under an operating lease versus an aircraft leasing entity consolidated under AcG-15. The main reason for the difference is due to the fact that lease expense under operating leases is straight-lined over the term of the lease whereas the interest expense under the debt obligation in the variable interest entities is based on the effective interest rate method. The effective interest rate method results in interest expense being recorded proportionate to the amount of the outstanding debt, which declines over time. In addition, foreign currency adjustments are recorded on the outstanding debt obligations of the VIEs; changes in foreign exchange rates are straight-lined over the term of the lease under operating lease accounting.

### **Asset Retirement Obligations**

The Corporation records an asset and related liability for the costs associated with the retirement of long-lived tangible assets when a legal liability to retire such assets exists. The fair value of a liability for an asset retirement obligation is recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and then amortized over its estimated useful life. In subsequent periods, the asset retirement obligation is adjusted for the passage of time and any changes in the amount of the underlying cash flows through charges to earnings. A gain or loss may be incurred upon settlement of the liability.

**Future Accounting Standard Changes:  
Financial Instruments and Hedges**

The Accounting Standards Board has issued three new standards dealing with financial instruments: (i) Financial Instruments – Recognition and Measurement (ii) Hedges and (iii) Comprehensive Income. The key principles under these standards are that all financial instruments, including derivatives, are to be included on a company's Statement of Financial Position and measured, either at their fair values or, in limited circumstances when fair value may not be considered most relevant, at cost or amortized cost. Financial instruments intended to be held-to-maturity should be measured at amortized cost. Existing requirements for hedge accounting are extended to specify how hedge accounting should be performed. Also, a new location for recognizing certain unrealized gains and losses – other comprehensive income – has been introduced. This provides for certain unrealized gains and losses arising from changes in fair value to be temporarily recorded outside the Statement of Operations but in a transparent manner. The new standards are effective for the Corporation beginning January 1, 2007. The standards do not permit restatement of prior years financial statements, however, the standards have detailed transition provisions. As the Corporation has financial instruments, implementation planning will be necessary to review the new standards to determine the consequences for the Corporation. Accordingly, the Corporation has not yet evaluated all the consequences of the new standards; however, the adoption of the standards may have a material impact on the Corporation's Statement of Financial Position.

## **14. CRITICAL ACCOUNTING ESTIMATES**

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

The Corporation has identified the following areas that contain critical accounting estimates utilized in the preparation of its financial statements:

### **Air Transportation Revenues**

Airline passenger advance sales are deferred and included in current liabilities. Passenger revenues are recognized when the transportation is provided, except for revenues on unlimited flight passes which are recognized on a straight-line basis over the period during which the travel pass is valid. Due to the complex pricing structures, the complex nature of interline and other commercial agreements used throughout the industry, historical experience over a period of many years, and other factors including refunds, exchanges and unused tickets, certain amounts are recognized as revenue based on estimates. The Corporation performs regular evaluations on the deferred revenue liability which may result in adjustments being recognized as revenue. Events and circumstances may result in actual results that are different from estimates, however, these differences have historically not been material.

### **Employee Future Benefits**

The significant policies related to employee future benefits, consistent with CICA 3461 – Employee Future Benefits, are as follows:

The cost of pensions and other post-retirement benefits earned by employees is actuarially determined using the projected benefit method prorated on service, market interest rates, and management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and expected health care costs.

A market-related value method is used to value plan assets for the purpose of calculating the expected return on plan assets. Under the selected method, the differences between investment returns during a given year and the expected investment returns are amortized on a straight-line basis over four years.

Past service costs arising from plan amendments are amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment. This period does not exceed the average remaining service period of such employees up to the full eligibility date.

Cumulative unrecognized net actuarial gains and losses in excess of 10 per cent of the greater of the projected benefit obligation or market-related value of plan assets at the beginning of the year are amortized over the remaining service period of active employees.

Management makes a number of assumptions in the calculation of both the accrued benefit obligation as well as the pension costs:

	September 30, 2004	December 31, 2004	December 31, 2005
<b>Weighted average assumptions used to determine accrued benefit obligation</b>			
Discount rate as at period end	6.00%	5.75%	5.00%
Rate of compensation increase	4.00%	4.00%	4.00%
<b>Weighted average assumptions used to determine pension costs</b>			
Discount rate as at period end	6.00%	6.00%	5.75%
Expected long term rate of return on plan assets	7.50%	7.50%	7.50%
Rate of compensation increase	4.00%	4.00%	4.00%

#### 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 approximately match the timing and amount of expected benefit payments.

#### Expected Return on Assets Assumption

The Corporation’s expected long-term rate of return on assets assumption is selected based on the facts and circumstances that exist as of the measurement date and the specific portfolio mix of plan assets. Management, in conjunction with its actuaries, reviews anticipated future long-term performance of individual asset categories and considers the asset allocation strategy adopted by the Corporation, including the longer duration in its bond portfolio in comparison to other pension plans. These factors are used to determine the average rate of expected return on the funds invested to provide for the pension plan benefits. While the review considers recent fund performance and historical returns, the assumption is primarily a long-term, prospective rate.

#### Asset Allocation

The actual and target allocations of the pension assets are as follows:

	December 31, 2004	November 30, 2005	Target Allocation
Equity	64.8%	62.3%	65.0%
Bonds and Mortgages	33.1%	32.1%	35.0%
Real Estate	0.2%	0.1%	0.0%
Short-term and Other	1.9%	5.5%	0.0%
Total	100.0%	100.0%	100.0%

#### Investment Policy

For the Domestic Registered Pension Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Master Trust Fund (Fund). The Audit, Finance and Risk Committee of the Board of Directors reviews and confirms the policy annually. The investment return objective of the Fund is to achieve a total annualized rate of return that exceeds inflation by at least 3.75 per cent over the long term. In addition to the broad asset allocation, as summarized in the asset allocation section above, the following policies apply to individual asset classes:

Equity investments can include convertible securities and are required to be diversified among industries and economic sectors. Foreign equities can comprise 27 to 33 per cent of the total market value of the trust. Limitations are placed on the overall allocation to any individual security at both cost and market value. Derivatives are permitted to the extent they are not used for speculative purposes or to create leverage.

Fixed income investments are oriented toward risk averse, long-term, investment grade securities rated "A" or higher. With the exception of Government of Canada securities, or a province thereof, in which the plan may invest the entire fixed income allocation, fixed income investments are required to be diversified among individual securities and sectors. The target return is comprised of 50 per cent of the total return of the Scotia Capital Long Term Bond Index.

#### Best Estimate of Employer Contributions

Based upon an agreement, subject to approval of the Office of the Superintendent of Financial Institutions (Canada) (OSFI), between Air Canada and representatives of the unionized and non-unionized employees and retirees with respect to the funding of the Domestic Registered Plans, the estimated 2006 contributions are as follows:

	<u>2005 Contributions</u>	<u>2006 Contributions</u>
	(\$ millions)	
Current service cost for Registered Pension Plans	133	139
Past service cost for Registered Pension Plans	99	198
Other pension arrangements	52	52
Total	284	389

#### Sensitivity Analysis

Sensitivity analysis on the 2005 pension expense based on different actuarial assumptions with respect to discount rate and expected return on plan assets is as follows:

Impact on 2005 pension expense	<u>0.25 percentage point</u>	
	<u>Decrease</u>	<u>Increase</u>
	(\$ millions)	
Discount rate on obligation assumption	10	(10)
Long-term rate of return on plan assets assumption	23	(23)

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 10 per cent annual rate of increase in the per capita cost of covered health care benefits was assumed for 2005 (2004 - 10.75 per cent). The rate is assumed to decrease gradually to 5 per cent by 2013. A one percentage point increase in assumed health care trend rates would have increased the service and interest costs by \$1 million and the obligation by \$15 million. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by \$1 million and the obligation by \$20 million.

Upon emergence from CCAA, under fresh start reporting, all unamortized past service costs, net actuarial losses and net transition obligations, were written off and the Corporation recorded the estimated net accrued benefit obligations of the plans as at the date of emergence. At that time, all assumptions used in the calculations were revalidated.

### **Loyalty Program**

The Corporation's loyalty program, Aeroplan, awards mileage credits (Miles) to passengers who fly on Air Canada, Jazz, Star Alliance carriers and certain other airlines that participate in the program. Additionally, Aeroplan issues Miles to members for the purchase of goods and services from participating non-airline partners. The outstanding Miles may be redeemed for travel or other goods and services.

For additional information on the application of fresh start reporting and the change in accounting policy, refer to page 8 of this MD&A.

Based upon past experience, management anticipates that a number of Aeroplan Miles sold will never be redeemed by members. This is known as "breakage". For those Aeroplan Miles that Aeroplan does not expect will be redeemed by members, Aeroplan recognizes revenue on a straight-line basis over the average estimated life of an Aeroplan Mile, currently 30 months. The Corporation performs regular evaluations on the breakage estimate which may result in certain adjustments to revenues. During 2004, breakage was subject to a change in accounting estimate reducing it from 19 per cent to 17 per cent.

At December 31, 2005, the Corporation's estimated outstanding number of Miles was approximately 183 billion, as compared to substantially the same number at the end of the prior year. Management has recorded a liability of \$1,633 million, including \$680 million in Aeroplan deferred revenues, for the estimated number of Miles expected to be redeemed. A change to the estimate of Miles expected to be redeemed could have a significant impact on the liability in the period of change and in future periods.

In 2005, 52 billion Miles (2004 - 46 billion) were redeemed principally for travel. These redemptions represented approximately 10 per cent of Air Canada's total revenue passenger miles in 2005 (2004 - 10 per cent). Inventory controls over seat allocations keeps displacement of revenue passengers to a minimum. Total Miles redeemed for travel on Air Canada in 2005, including awards and upgrades, represented 78 per cent of the total Miles redeemed, of which 60 per cent were used for travel within the US and Canada. In addition to the awards issued for travel on Air Canada, approximately 16 per cent of the total Miles redeemed in 2005 was used for travel on partner airlines and 6 per cent were used for goods and services from non-airline partners.

A change to either the redemption patterns of the Miles or the award options provided could have a significant impact on the Corporation's revenues in the year of change as well as in future years.

## **Future Income Taxes**

The Corporation utilizes the liability method of accounting for income taxes under which future income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amount and the tax basis of assets and liabilities. Future income tax assets are recognized to the extent that realization is considered more likely than not. The Corporation considers past results, current trends and outlooks for future years in assessing realization of future income tax assets. The benefit of future income tax assets that existed at fresh start, and against which a valuation allowance is recorded, amounts to \$2,334 million. This benefit will be recognized first to reduce to nil any remaining intangible assets (on a pro-rata basis) that were recorded upon fresh start reporting with any remaining amount as a credit to Shareholders' Equity.

## **Impairment of Long-Lived Assets**

Long-lived assets are tested for impairment whenever the circumstances indicate that the carrying value may not be recoverable by comparing the estimate of future expected cash flows to the carrying amount of the assets or groups of assets. If the carrying value is not recoverable from future expected cash flows, any loss is measured as the amount by which the asset's carrying value exceeds fair value. Recoverability is assessed relative to undiscounted cash flows from the direct use and disposition of the asset or group of assets, which requires management assumptions as to estimated future aircraft fair values and estimated net future cash flows from use of the aircraft.

## **Property and Equipment**

Property and equipment are originally recorded at cost. Property under capital leases and the related obligation for future lease payments are initially recorded at an amount equal to the lesser of fair value of the property or equipment and the present value of those lease payments. Property and equipment are carried at the lesser of amortized cost and the net recoverable amount.

Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Property and equipment under capital lease and variable interest entities are depreciated to estimated residual values over the life of the lease. Air Canada aircraft and flight equipment are depreciated over 20 to 25 years, with 10 to 15 per cent estimated residual values. Jazz aircraft and flight equipment are depreciated over 20 to 30 years, with 20 per cent estimated residual values. Aircraft reconfiguration costs are amortized over three years. Aircraft introduction costs are amortized over three years. Betterments to owned aircraft are capitalized and amortized over the remaining service life of the aircraft. Betterments to aircraft on operating leases are amortized over the term of the lease.

Buildings are depreciated over their useful lives not exceeding 50 years on a straight-line basis (30 years in the Predecessor Company). An exception to this is where the useful life of the building is greater than the term of the land lease. In these circumstances, the building is depreciated over the life of the lease. Leasehold improvements are amortized over the lesser of the lease term or five years. Ground equipment is depreciated over three to 25 years (five to 25 years in the Predecessor Company). Computer equipment is depreciated over three years (five years in the Predecessor Company).

Aircraft depreciable life is determined through economic analysis, a review of existing fleet plans and comparisons to other airlines operating similar fleet types. Residual values are estimated based on Air Canada's historical experience with regard to the sale of both aircraft and spare parts, as well as future based valuations prepared by independent third parties.

### **Intangible Assets**

The identifiable intangible assets of the Corporation were fair valued based on valuation techniques for the purpose of financial reporting under fresh start reporting requirements as at September 30, 2004. The indefinite lives of the intangible assets recorded by the Corporation are significant and are tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. In addition, the Corporation is required to assess the remaining life of amortizable assets on a regular basis.

Fair value under Canadian GAAP is defined as "the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act". Assessing the fair value of intangible assets requires significant management estimates on future cash flows to be generated by the assets, including the estimated useful life of the assets.

## 15. SENSITIVITY OF CONSOLIDATED RESULTS

Financial results of the Corporation are subject to many different internal and external factors which can have a significant impact on operating results. In order to provide a general guideline, the following table describes, on an indicative basis, the financial impact that changes in operating assumptions would generally have had on the consolidated 2005 operating results. These guidelines were derived from 2005 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 vary significantly from actual results due to factors beyond the control of the Corporation. Conversely, an opposite change in the sensitivity factor would have had the opposite effect on operating income.

<u>Key Variable</u>		<u>2005 Measure</u>	<u>Sensitivity factor</u>	<u>Estimated Operating Income Impact</u> (\$ millions)
<b>Revenue Measures</b>				
Passenger yield (cents) (incl. Aeroplan)	System	17.6	1% change in yield	78
	Canada	23.1		32
Traffic (RPMs) (millions)	System	46.764	1 % change in traffic	71
	Canada	14,916		29
Passenger load factor	System	79.5	1 percentage point change	89
RASM (cents) (incl. Aeroplan)	System	14.0	1% change in RASM	74
<b>Cost Measures</b>				
Labour and benefits expenses (\$ millions)		2,520	1 % change	25
Fuel – WTI price (US\$/barrel)		55.33	US\$1/barrel change <sup>(1)</sup> to WTI	31
Fuel – jet fuel price (cents/litre)		59.39	1% change <sup>(1)</sup>	22
Cost per ASM (cents)		15.9	1% change	94

(1) Excludes impact of fuel surcharges and fuel hedging.

<u>Key Variable</u>	<u>2005 Measure</u>	<u>Sensitivity factor</u>	<u>Estimated Operating Income Impact</u> (\$ millions)	<u>Estimated Pre-Tax Income Impact</u> (\$ millions)
<b>Currency Exchange</b>				
Canada to US (\$)	1.21	1 cent change (e.g. \$1.20 to \$1.21)	11	39

## **16. RISK FACTORS**

The risk factors described herein may not be exhaustive. The Corporation operates under frequently shifting business environments and new risk factors may develop. The Corporation cannot forecast new risk factors, nor can it estimate the effect, if any, that such new risk factors may have on its businesses or the extent to which any factor or combination of factors may impact the Corporation's business.

### **16.1. Risks Relating to the Corporation**

#### **Operating Results**

The Predecessor Company sustained significant operating losses and the Corporation may sustain significant losses in the future. The Predecessor Company emerged from protection under the CCAA and implemented the consolidated plan of reorganization, compromise and arrangement (the Plan) on September 30, 2004. Although the Corporation has been successful in reducing its operating costs and is pursuing additional measures to further lower its costs and to offset record high fuel expenses, the Corporation may not be able to effectively achieve or maintain anticipated planned cost reductions or maintain and restore positive net profitability.

#### **Leverage and Liquidity**

The Corporation has, and will continue to have, a significant amount of indebtedness, including fixed obligations under aircraft leases as outlined in section 6.3 of this MD&A. The Corporation may incur additional debt, including secured debt, in the future. The amount of indebtedness that the Corporation incurs could have important consequences. For example, it could (i) limit the Corporation's ability to obtain additional financing for working capital, capital expenditures, acquisitions and general corporate purposes, (ii) require the Corporation to dedicate a substantial portion of its cash flow from operations to payments on its indebtedness, thereby reducing the funds available for other purposes, (iii) make the Corporation more vulnerable to economic downturns, (iv) limit its ability to withstand competitive pressures and reduce its flexibility in responding to changing business and economic conditions and, (v) limit the Corporation's flexibility in planning for, or reacting to, changes in its businesses and the industries in which it operates.

#### **Limitations Due to Restrictive Covenants**

Some of the financing arrangements entered into by the Corporation contain restrictive covenants which affect and, in some cases, significantly limit or prohibit, among other things, the Corporation's ability to incur indebtedness, create liens, sell assets, make capital expenditures and engage in acquisitions, mergers, amalgamations and consolidations. In addition, certain financing arrangements require the Corporation to maintain financial ratios. Any future borrowings may also be subject to covenants which limit the Corporation's operating and financial flexibility, which could materially and adversely affect the Corporation's profitability. If the Corporation fails to comply with the various covenants of its indebtedness, it may be in default under the terms thereof, which would permit holders of such indebtedness to exercise certain rights, which may include accelerating the maturity of such indebtedness, and, such defaults could cause defaults under other indebtedness or agreements. In such circumstances, the lenders under the financing arrangements could foreclose upon all or substantially all of the assets of the Corporation which secure the obligations of the Corporation.

The ability of the Corporation to make scheduled payments under its indebtedness will depend on, among other things, its future operating performance and its ability to refinance its indebtedness when necessary. Each of these factors is to a large extent subject to economic, financial, competitive, regulatory, operational and other factors, many of which are beyond the Corporation's control. There can be no assurance that the Corporation will be able to generate sufficient cash from its operations to pay its debts and lease obligations.

### **Need for Additional Capital**

The Corporation is facing a number of challenges in its current business operations, including high fuel prices and continued intense competition from US transborder and low-cost domestic carriers. There can be no assurance that the Corporation will continue to be able to obtain on a timely basis sufficient funds on terms acceptable to the Corporation to provide adequate liquidity and to finance the operating and capital expenditures necessary to implement its new business strategy if cash flow from operations and cash on hand are insufficient.

Failure to generate additional funds, whether from operations or additional debt or equity financings, may require the Corporation to delay or abandon some or all of its anticipated expenditures or to modify its new business strategy, which could have a material adverse effect on the Corporation's business, results from operations and financial condition. Furthermore, the ability of competitors to raise money more easily and on less onerous terms could create a competitive disadvantage for the Corporation.

In addition, the Corporation's credit ratings influence its ability to access capital markets. There can be no assurance that the Corporation's credit ratings will not be downgraded, which may add to the Corporation's borrowing and insurance costs, hamper its ability to attract capital and limit its ability to operate its business, all of which could have a material adverse effect on the Corporation's business, results from operations and financial condition.

### **Dependence upon Subsidiaries**

ACE is a holding company with no material sources of income, operations or assets of its own other than the cash resources it holds totaling approximately \$400 million at December 31, 2005, the interest that it has in its subsidiaries and the distributions it receives from its retained interests in Aeroplan and Jazz. The Corporation is entirely dependent on the operations and assets of its subsidiaries. Any possible declaration of dividends by the Corporation to its shareholders will be dependent on the ability of its subsidiaries to declare dividends or make other payments or advances to the Corporation, or the sale by the Corporation of its interest in its subsidiaries including its retained interests in Aeroplan and Jazz. The ability of the Corporation's subsidiaries to make distributions or other payments or advances will be subject to applicable laws and regulations and contractual restrictions that may be contained in the instruments governing any indebtedness of those entities. In addition, any right of the Corporation to receive assets of its subsidiaries upon their liquidation or reorganization will be structurally subordinated to the prior claims of creditors of such subsidiaries.

## **Aircraft Fleet**

A key component of the Corporation's business plan is the restructuring of its aircraft fleet, including the elimination and replacement of older, less efficient aircraft, the introduction of new regional jet aircraft (deliveries of which began in the fourth quarter of 2004), and the modernization of its international widebody fleet through the acquisition of new more economically efficient aircraft. With respect to the new regional jet aircraft, the Corporation's focus is on high frequency on key domestic and US transborder routes, while maintaining frequency on other domestic and US transborder routes through the increased use of large regional jet aircraft with lower trip costs in order to better match capacity with demand. Management expects that these regional jet aircraft will enable Air Canada to compete more effectively with low-cost carriers. Through the international widebody aircraft fleet renewal, management expects that these aircraft will allow Air Canada to place itself in a leadership position among North American international airlines and enable the airline to compete more effectively alongside the leading European, Middle East and Pacific carriers. A delay or failure in the completion of the Corporation's fleet restructuring, including a delay in delivery of the regional jet and widebody aircraft, or an inability to remove, as planned, certain widebody aircraft from the fleet in coordination with the planned entry into service of new widebody aircraft, could adversely affect the implementation of the Corporation's business plan which may, in turn, have a material adverse effect on the Corporation's business, results from operations and financial condition.

## **Key Personnel**

The Corporation is dependent on the experience and industry knowledge of its executive officers and other key employees to execute its business plans. If the Corporation were to experience a substantial turnover in its leadership or other key employees, the Corporation's business, results from operations and financial condition could be materially adversely affected. Additionally, the Corporation may be unable to attract and retain additional qualified key personnel as needed in the future.

## **Employee Relations**

Most of the Corporation's employees are unionized and new or modified collective agreements were concluded during the Predecessor Company's CCAA restructuring with each of the bargaining agents. The collective agreements permit bargaining on wages in 2006 but no strikes or lock-outs may lawfully occur until after the agreements expire in 2009. Despite this, there can be no assurance that there will not be a labour conflict that could lead to an interruption or stoppage in service at key airports. Any labour conflicts could have a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, labour problems at Air Canada's Star Alliance partners, including Lufthansa and United Airlines, could result in lower demand for connecting traffic with Air Canada and, ultimately, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

**Key Suppliers**

The Corporation's business is significantly dependent upon its ability to secure goods and services from a number of key suppliers, such as those relating to fuel and other key goods and services. An interruption in the provision of goods or services from a key supplier could have a material adverse impact on the Corporation's business, results from operations and financial condition. Such interruptions or stoppages may arise from a wide range of factors, including labour disputes and other factors, many of which are beyond the Corporation's control.

**Interruptions or Disruptions in Service**

The Corporation's business is significantly dependent upon its ability to operate without interruption at a number of key airports, including Pearson Airport. An interruption or stoppage in service at a key airport could have a material adverse impact on the Corporation's business, results from operations and financial condition.

**Dependence on Technology**

The Corporation relies in part on technology, including computer and telecommunications equipment and software and Internet-based commerce, to operate its business, including to increase revenues and to reduce costs. Proper implementation and operation of required technology initiatives is fundamental to the Corporation's ability to operate a profitable business. The Corporation continually invests in new technology initiatives to operate its business and remain competitive, and its continued ability to invest sufficient amounts in required technology initiatives is important to maintain the Corporation's ability to operate successfully. A failure or inability to invest in required technology initiatives could have a material adverse effect on the Corporation's business, results from operations and financial condition.

The technology systems of the Corporation, including computer and telecommunications equipment and software and Internet-based technology systems, may be vulnerable to a variety of sources of failure, interruption or misuse, including natural disasters, terrorist attacks, telecommunications failures, power failures, computer viruses, hackers, unauthorized or fraudulent users, and other security issues. While the Corporation continues to invest in technology security initiatives and disaster recovery plans, these measures may not be adequate or implemented properly. Any such occurrence or event, including by reason of power, telecommunication or Internet interruptions, could materially and adversely affect the Corporation's operations and could have a material adverse effect on the Corporation's business, results from operations and financial condition.

## **Pension Plans**

Canadian federal pension legislation requires that the funded status of registered pension plans be determined periodically, on both a going concern basis (i.e., essentially assuming indefinite plan continuation) and a solvency basis (i.e., essentially assuming immediate plan termination).

The solvency liability is influenced primarily by long-term interest rates and by the investment return on plan assets. The interest rate used to calculate benefit obligations for solvency purposes is a prescribed rate derived from the interest rates on long-term Government of Canada bonds. In the current low interest rate environment, the calculation results in a higher present value of the pension obligations, leading to a larger unfunded solvency position.

In May 2004, the Corporation and OSFI agreed on a protocol pursuant to which the solvency funding requirements for the Corporation's registered pension plans provided for in the then existing regulations were amended retroactive to January 1, 2004. The Corporation will have to make substantial annual cash contributions, and the level of those contributions will increase in the event of poor pension fund investment performance and/or further declines in long-term Government of Canada bond rates.

## **Federal Court of Appeal Judgment - Equal Pay Litigation**

The flight attendants union at Air Canada has two complaints before the Canadian Human Rights Commission in which it alleges gender-based wage discrimination. The Canadian Union of Public Employees claims the predominantly female flight attendant group should be paid the same as the predominantly male pilot and mechanics groups because their work is of equal value. The complaints date from 1991 and 1992, but have not been investigated because of a legal dispute over whether the three groups work in the same "establishment" within the meaning of the Canadian Human Rights Act (the Act). On January 26, 2006, the Supreme Court of Canada ruled that they do, and remitted the case to the Commission, which may now proceed to assess the value of each group's work.

During the restructuring under CCAA, it was agreed that any resolution of the complaints would have no retroactive financial impact prior to September 30, 2004. It is the view of Air Canada that any investigation will show that it is complying with the equal pay provisions of the Act. Nonetheless, should these complaints succeed, the accrued liability and future costs could be very significant and the Corporation's business, results from operations and financial condition could be materially adversely affected.

## **Star Alliance**

The strategic and commercial arrangements with Star Alliance members 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 the Star Alliance or otherwise be unable to meet its obligations hereunder, the Corporation's business, results from operations and financial condition could be materially adversely affected.

**Foreign Exchange**

The Corporation's financial results are sensitive to the changing value of the Canadian dollar. In particular, the Corporation has a significant annual net outflow of US dollars and is affected by fluctuations in the Canada/US dollar exchange rate. The Corporation estimates that during 2005, a \$0.01 increase in the Canada/US dollar exchange rate (i.e. from \$1.20 to \$1.21 per US dollar) would have had an estimated \$11 million unfavourable impact on operating income and an estimated \$39 million unfavourable impact on pre-tax income. Conversely, an opposite change in the exchange rate would have had the opposite effect on operating income. The Corporation incurs significant expenses in US dollars for such items as fuel, aircraft rental charges, interest payments, debt servicing and computerized reservations system fees, while a substantial portion of its revenues are generated in Canadian dollars. A significant deterioration of the Canadian dollar relative to the US dollar would increase the costs of the Corporation relative to its US competitors and could have a material adverse effect on the Corporation's business, results from operations and financial condition.

**Business Initiatives**

The Corporation aggressively identifies and pursues important and innovative initiatives in the course of operating its business. Proper planning and implementation of these initiatives is important to the Corporation's profitability. There can be no assurance that these initiatives will be successfully implemented or achieve expected results. A failure to successfully implement such initiatives could have a material adverse effect on the Corporation's business, results from operations and financial condition.

## **16.2. Risks Relating to the Industry**

### **Competition**

Air Canada operates within a highly competitive industry. Over the past few years, several carriers have entered or announced their intent to enter into domestic and US transborder markets in which Air Canada operates.

Canadian low-cost airlines have significantly expanded in many of Air Canada's key domestic markets and have entered the US transborder market as well. Canjet operates flights to New York and Florida (during the winter) and WestJet provides regular scheduled service to Nevada, Hawaii, Florida, California, New York and Arizona. In February 2006, Porter Airlines announced its intent to offer short-haul flights from Toronto Island Airport to Canadian and US cities using 70-seat Q400 Bombardier turboprop aircraft.

If these carriers are successful in entering or continuing their expansion into the domestic and US transborder markets of Air Canada, the Corporation's business, financial condition and results from operations could be materially adversely affected.

US carriers currently operate routes in Air Canada's transborder market. If additional US carriers were to enter Air Canada's transborder market, or if US carriers were to introduce additional transborder services, this could have a material adverse effect on the Corporation's business, results from operations and financial condition.

The Corporation is also facing increasing competition in international markets as carriers increase their international capacity, both by expansion and by shifting existing domestic capacity to international operations to avoid low-cost domestic competition. If these carriers are successful in their expansion in the international markets, or if other carriers enter Air Canada's markets, the Corporation's business, financial condition and results from operations could be materially adversely affected.

The Corporation also encounters substantial price competition. The expansion of low-cost carriers in recent years has resulted in a substantial increase in discounted and promotional fares initiated by competitors. The decision to match competitors' fares, to maintain passenger traffic, results in reduced yields which, in turn, could have a material adverse effect on the Corporation's business, results from operations and financial condition. Furthermore, the Corporation's ability to reduce Air Canada's fares in order to effectively compete with other carriers may be limited by government policies to encourage competition. Such government policies could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Internet travel websites have driven significant distribution cost savings for airlines, but have also enabled consumers to more efficiently find lower fare alternatives by providing them with access to more pricing information. The increased price awareness of both business and leisure travelers as well as the growth in new distribution channels have further motivated airlines to price aggressively to gain fare and market share advantages. These factors will increase over time as Internet ticket sales increase, which will

reduce yields and, in turn, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

### **Airline Reorganizations**

Since September 11, 2001, a number of US air carriers have sought to reorganize under Chapter 11 of the United States Bankruptcy Code. Successful completion of such reorganizations (such as the successful emergence of US Airways and its merger with America West as well as the expected emergence of United Airlines) could present the Corporation with competitors having reduced levels of indebtedness and significantly lower operating costs derived from labour, supply and financing contracts that were renegotiated under the protections of the Bankruptcy Code. In addition, air carriers involved in reorganizations historically have undertaken substantial fare discounting in order to maintain cash flows and to enhance continued customer loyalty. Such fare discounting could result in lower yields for the Corporation which, in turn, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

### **Economic and Geopolitical Conditions**

Airline operating results are sensitive to economic and geopolitical conditions which have a significant impact on the demand for air transportation. Airline fares and passenger demand have fluctuated significantly in the past and may fluctuate significantly in the future. The Corporation is not able to predict with certainty market conditions and the fares Air Canada and Jazz will be able to charge. Customer expectations are changing rapidly and the demand for lower fares may limit revenue opportunities. A downturn in economic growth in North America, as well as geopolitical instability in various areas of the world, would have the effect of reducing demand for air travel in Canada and abroad and, together with the other factors discussed herein, could materially adversely impact the Corporation's profitability. Any prolonged or significant weakness of the Canadian and world economy could have a material adverse effect on the Corporation's business, results from operations and financial condition, especially given the Corporation's substantial fixed cost structure.

### **Airline Industry Characterized By Low Gross Profit Margins and High Fixed Costs**

The entire airline industry and scheduled service in particular are characterized by low gross profit margins and high fixed costs. The costs of operating each flight do not vary significantly with the number of passengers carried and, therefore, a relatively small change in the number of passengers or in fare pricing or traffic mix could, in the aggregate, have a significant effect on the Corporation's operating and financial results. This condition has been exacerbated by aggressive pricing by low-cost carriers, which has had the effect of driving down airline fares in general. Accordingly, a minor shortfall from expected revenue levels could have a material adverse effect on the Corporation's business, results from operations and financial condition.

## **Dependence of Other Operating Entities**

Many of the risks factors in the nature of those described herein, should they materialize, could have a material adverse effect on the Corporation's other operating entities, including Air Canada, Air Canada Cargo, ACGHS, Jazz, ACTS and Aeroplan, either directly, or indirectly, by affecting the air transportation industry generally and/or other air carriers, on which these other operating entities rely for the success of their business, results from operations and financial conditions.

## **Fuel Costs**

Fuel costs were the second largest expense to the Corporation in 2005. Fuel prices fluctuate widely depending on many factors including international market conditions, geopolitical events and the Canada/US dollar exchange rate. The Corporation cannot accurately predict fuel prices. During 2003, 2004 and 2005, fuel prices increased and currently remain at historically high levels. Should fuel prices continue at, or continue to increase above, such high levels, fuel costs could have a material adverse impact on the Corporation's business, results from operations and financial condition. Due to the competitive nature of the airline industry, the Corporation may not be able to pass on any increases in fuel prices to its customers by increasing its fares. Based on 2005 volumes, the Corporation estimates that a US\$1 per barrel movement in the average price of West Texas Intermediate (WTI) crude oil would have resulted in an approximate \$31 million change in 2005 fuel expense for Air Canada (excluding any impact of fuel surcharges and fuel hedging), assuming flying capacity remained unchanged and that refining spreads between WTI crude oil and jet fuel as well as foreign exchange rates remained constant.

In order to help minimize the Corporation's exposure to the volatility of fuel prices, a systematic fuel risk management strategy has been implemented using financial instruments to build up the Corporation's hedge position in increments of approximately 4 per cent per month to a target level of approximately 50 per cent of its anticipated jet fuel requirements, beginning in September 2005, for a 24-month period.

## **Terrorist Attacks**

The September 11, 2001 terrorist attacks and subsequent terrorist attacks, notably in the Middle East, Southeast Asia and Europe, caused uncertainty in the minds of the traveling public. The occurrence of a major terrorist attack (whether domestic or international and whether involving the Corporation or another carrier) 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 and airport security costs. Any resulting reduction in passenger revenues and/or increases in insurance and security costs could have a material adverse impact on the Corporation's business, results from operations and financial condition.

## **Epidemic Diseases (Severe Acute Respiratory Syndrome, Avian Flu or Other Diseases)**

As a result of the international outbreaks of Severe Acute Respiratory Syndrome (SARS) in 2003, the World Health Organization (the "WHO") issued on April 23, 2003 a travel advisory, which was subsequently lifted on April 30, 2003, against non-essential travel to Toronto, Canada. The WHO travel advisory relating to Toronto, the location of Air Canada's primary hub, and the international SARS outbreak had a significant adverse effect on passenger demand for air travel destinations served by Air

Canada and Jazz, and on the number of passengers traveling on Air Canada's and Jazz's flights and resulted in a major negative impact on traffic on the entire network. A further outbreak of SARS or of another epidemic disease (whether domestic or international) or a further WHO travel advisory (whether relating to Canadian cities or regions or other cities, regions or countries) could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada's and Jazz's flights. Any resulting reduction in traffic on Air Canada's and Jazz's network could have a material adverse effect on the Corporation's business, results from operations and financial condition.

### **Seasonal Nature of the Business, Other Factors and Prior Performance**

Air Canada has historically experienced considerably greater demand for its services in the second and third quarters of the calendar year and significantly lower demand in the first and fourth quarters of the calendar year. This demand pattern is principally a result of the high number of leisure travelers and their preference for travel during the spring and summer months. The Corporation has substantial fixed costs that do not meaningfully fluctuate with passenger demand in the short term.

As described elsewhere, demand for air travel is also affected by factors such as economic conditions, war or the threat of war, fare levels and weather conditions. Due to these and other factors, operating results for an interim period are not necessarily indicative of operating results for an entire year, and operating results for a historical period are not necessarily indicative of operating results for a future period.

### **Regulatory Matters**

The airline industry is subject to extensive Canadian and foreign government regulations relating to, among other things, security, safety, licensing, competition, noise levels and the environment. Additional laws and regulations may be proposed from time to time which could impose additional requirements or restrictions on airline operations. The implementation of additional limitations by governments, the Competition Bureau and/or the Competition Tribunal or other governmental entities may have a material adverse effect on the Corporation's business, results from operations and financial condition. The Corporation cannot give any assurances that new regulations or revisions to the existing regulations will not be adopted. The adoption of such new regulations or revisions could be materially adverse to the Corporation's business, results from operations and financial condition.

The availability of international routes to domestic air carriers is regulated by agreements between Canada and foreign governments. Changes in Canadian or foreign government aviation policy could result in the alteration or termination of these agreements and could adversely affect the Corporation's international operations.

In July 2000, the Government of Canada amended the Canada Transportation Act (CTA), the Competition Act and the Air Canada Public Participation Act (Canada) to address the competitive airline environment in Canada and ensure protection for consumers. This legislation increased the powers of the Canadian Transportation Agency with respect to pricing on non competitive domestic routes, and domestic terms and conditions of carriage.

This legislation also included airline specific provisions concerning “abuse of dominance” under the Competition Act, including the establishment of administrative monetary penalties for a breach of the “abuse of dominance” provision by a dominant domestic air carrier. In February 2001, the Competition Bureau released for consultation draft guidelines outlining the approach it proposed to take in enforcing the airline specific “abuse of dominance” provisions of the Competition Act.

In March 2001, the Commissioner of Competition brought an application under the “abuse of dominance” provisions of the Competition Act, seeking an order prohibiting Air Canada from charging fares on flights on certain routes in Eastern Canada if such fares would not cover the avoidable costs of such flights. By agreement of Air Canada and the Commissioner of Competition, the application was divided into two phases, Phase I of which considered the approach to be taken in reviewing an avoidable cost case against Air Canada. The Competition Tribunal released its reasons and findings regarding Phase I on July 22, 2003, and adopted a broadly crafted avoidable cost test. The decision of the Competition Tribunal does not constitute a determination that Air Canada breached the Competition Act by abusing its dominant position, which is an issue that would have been determined in Phase II of the application.

In September 2004, following extensive discussions with Air Canada about resolving the tribunal case and related issues, the Commissioner of Competition issued a letter describing the enforcement approach to be taken by the Competition Bureau to any new complaint made against a dominant domestic carrier in light of the changes in the airline industry that have occurred since 2000. The Commissioner has also indicated support for the repeal of the airline specific provisions at the Competition Act, although the timing for such legislative changes is unknown given the recent change in the Federal Government following the January 23, 2006 elections.

In light of these developments, and as part of the agreement to terminate the application to the Competition Tribunal, Air Canada determined that it would not appeal the Competition Tribunal’s decision in Phase I of the application. The Competition Bureau has expressed its view that the principles established by the Competition Tribunal in Phase I of the application regarding the application of the avoidable cost test would be relevant for any future cases which may arise in similar circumstances. If the Commissioner of Competition commences inquiries or brings similar applications with respect to significant competitive domestic routes and such applications are successful, it could have a material adverse effect on the Corporation’s business, results from operations and financial condition.

The Corporation is subject to domestic and foreign laws regarding privacy of passenger and employee data that are not consistent in all countries in which the Corporation operates. In addition to the heightened level of concern regarding privacy of passenger data in Canada, certain US and European government agencies are initiating inquiries into airline privacy practices. Compliance with these regulatory regimes is expected to result in additional operating costs and could have a material adverse effect on the Corporation’s business, results from operations and financial condition.

### **Increased Insurance Costs**

The terrorist attacks of September 11, 2001 (9/11), and the resulting staggering losses to the insurance industry, led to a significant increase in Air Canada's insurance premiums. While this premium increase has steadily decreased since 9/11, premiums have not returned to pre 9/11 levels and continue to negatively impact the financial results of the Corporation. In addition, the aviation insurance industry is continually reevaluating the terrorism risks that they do cover and this activity may adversely affect some of the Corporation's existing insurance carriers or the Corporation's ability to obtain future insurance coverage. To the extent that the Corporation's existing insurance carriers are unable or unwilling to provide it with insurance coverage, the Corporation's insurance costs may increase further and may result in the Corporation being in breach of contractual arrangements requiring that specific insurance be maintained, which may have a material adverse effect on the Corporation's business, results from operations and financial condition.

### **Third Party War Risk Insurance**

There is a risk that the Government of Canada may not continue to provide an indemnity for third party war risk liability coverage, which it is currently providing to the Corporation and certain other carriers in Canada. In the event that the Government of Canada does not continue to provide such indemnity or amends such indemnity, the Corporation and other industry participants would have to turn to the commercial insurance market to seek such coverage. Such coverage would cost the Corporation in excess of \$24 million per year. Alternative solutions, such as that envisioned by the International Civil Aviation Organization (ICAO) and the International Air Transport Association (IATA), have not developed as planned, due to actions taken by other countries and the recent availability of supplemental insurance products. ICAO and IATA are continuing their efforts in this area, however, the prospects for a global solution are not in the immediate or near future. The US federal government has set up its own facility to provide war risk coverage to US carriers, thus removing itself as a key component of any global plan.

Furthermore, the London aviation insurance market has introduced a new standard war and terrorism exclusion clause to apply to aircraft hull and spares war risk insurance, and intends to introduce similar exclusions to airline passenger and third party liability policies, that excludes claims caused by the hostile use of a dirty bomb, electromagnetic pulse device, or biochemical materials. The Government of Canada indemnity program is designed to address these types of issues as they arise, but it has not yet decided to extend the indemnity to cover this exclusion. Unless and until the Government of Canada does so, the loss of coverage exposes the Corporation to this new uninsured risk and may ultimately result in the Corporation being in breach of contractual arrangements, which may have a material adverse effect on the Corporation's business, results from operations and financial condition.

**Casualty Losses**

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

**Airport User Fees and Air Navigation Fees**

With the privatization of airports over the last several years in Canada, new airport authorities have imposed significant increases in airport user fees. If airport authorities continue to increase their fees at the rate at which they have increased them in the recent past, the Corporation's business, results from operations and financial condition could be materially adversely affected.

## **17. CONTROLS AND PROCEDURES**

### **17.1. Disclosure Controls and Procedures**

Disclosure controls and procedures within the Corporation are designed to provide reasonable assurance that all relevant information is identified to its Disclosure Policy Committee to ensure appropriate and timely decisions are made regarding public disclosure.

An evaluation of the effectiveness of the Corporation's disclosure controls and procedures, as defined under the rules of the Canadian Securities Administration (CSA) and the Securities and Exchange Commission (SEC), was conducted at December 31, 2005 by and under the Corporation's management, including the Chief Executive Officer and the Chief Financial Officer. Based on this evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures are effective.

### **17.2. Internal Controls over Financial Reporting**

Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of the Corporation's financial reporting and compliance with generally accepted accounting principles in its financial statements.

The Corporation's management have evaluated whether there were changes to its internal controls over financial reporting during the year ended December 31, 2005 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting. No such changes were identified through management's evaluation.

## 18. OUTLOOK

Over the past two years, the Corporation has implemented a new business model, restructured its operations, improved employee and asset productivity, reduced operating costs and established a new corporate and capital structure with reduced financial leverage. This has resulted in improved financial results and competitive position.

The Corporation is committed in 2006 to deliver its business plan including continued expansion of the new business model and improved cost and productivity through process re-design and technological enhancements. Key pillars of the 2006 plan are to:

- Grow revenues and customer loyalty, through further enhancement of the new business model including expansion of the subscription pass product.
- Deliver a superior customer experience with new aircraft and significantly improved in-flight product.
- Improve customer access to products and business unit productivity through simplifying processes, technology and process re-design.
- Improve labour relations and employee involvement.
- Enhance shareholder value through expansion of key businesses and potential monetization.

### Transportation Services

The airline business, in 2006, plans to increase its system ASM flying capacity by approximately 5 per cent compared to 2005. With the introduction of large regional jets, North American operations are expected to grow by approximately 7 per cent with greater point to point services. Jazz flying, in terms of ASMs, is planned to increase by over 50 per cent from the prior year in order to benefit from the lower operating costs of this business segment.

Low-cost carriers have achieved success in the North American market and a number of legacy carriers have or are in the process of restructuring their operations to lower costs and improve their competitive position. As a result, passenger fares and yields per RPM are expected to remain under pressure in 2006. Over the past 21 months, the Corporation has achieved record load factors with the successful implementation of its new business model. Load factors are expected to remain high in 2006, however, they may not continue at record levels. With competitively priced passenger fares, operating higher load factors enables greater revenue generation per flight and higher efficiency of ground and support operations.

The new Bombardier and Embraer regional jets allow the Corporation to offer greater aircraft frequencies and operate more profitably on specific routes with relatively fewer passengers per flight as compared to larger aircraft operated by either Air Canada or its low-cost carrier competition. Deliveries of the new Embraer-190 aircraft continue in 2006 and 45 of these aircraft are expected to be in service by early 2008. With these new aircraft, the Corporation is progressively expanding its point-to-point network to enhance its ability to compete with low-cost carriers operating larger aircraft on specific routes.

A cornerstone of the Corporation's strategy going forward will be the growth of its international operations. In order to support the expansion of these operations and deliver a superior customer product, the Corporation will be taking delivery of new Boeing 777 series aircraft beginning in 2007 and the highly efficient Boeing 787 aircraft commencing in 2010.

The airline industry is subject to numerous factors and costs over which it has little or no control (more fully described in the Risk Factors section). These include crude oil and jet fuel prices and quasi-government or airport authority fees for airport or navigation charges amongst others. With crude oil prices trading in the record US\$65-70 range and refining spreads subject to continuing volatility, fuel expense remains a major risk in 2006. The Corporation has progressively implemented fuel hedging in 2005 and has been able to mitigate a portion of previous fuel price increases through higher passenger and cargo charges. However, the pricing of crude oil and jet fuel is subject to market forces and it is not certain whether the Corporation will be able to mitigate, in a meaningful way, continuing record fuel prices in a highly competitive airline environment. 2005 saw major increases in airport fees especially at its main hub in Toronto. Further increases were implemented in 2006, but at a lower rate than in 2005. Nonetheless, these costs will continue to increase during the year.

In 2006, the Corporation has a wage review covering most of its unionized employees under the collective agreements which expire in 2009.

### **Aeroplan**

In 2006, Aeroplan will further enhance its partnerships and value-added services, as well as remain favourable to strategic acquisition opportunities, whilst sustaining a meaningful distributable cash growth.

It will also pursue further cost reductions and efficiency gains in operations, particularly with respect to call centre productivity improvements and use of web-based service products. New practices, such as work-at-home for the call centre agents, will also be investigated.

### **Jazz**

The recent Jazz public offering is in support of ACE's value enhancement strategy. Management remains fully committed to delivering continued improvements in financial and operational results in the future.

By July 2006, Jazz's operating fleet is scheduled to reach 135 aircraft.

Effective January 1, 2006, an amended and restated capacity purchase agreement with Air Canada, the CPA, will, among other things, establish the rates to be paid by Air Canada to Jazz for 2006 through 2008 and the minimum number of covered aircraft until December 2015. Management anticipates that substantially all of Jazz's currently contemplated growth will be attributable to the CPA with Air Canada and the increased fleet contemplated by such agreement.

## **ACTS**

As it begins its second full year as a stand-alone organization, ACTS will continue to work on developing its business model and will focus on its operations and productivity to improve financial results.

Increased productivity, enhanced processes and systems, cost improvement and sustainable growth will be ACTS's priorities in 2006. In addition, ACTS will continue to focus on meeting customer production requirements.

## **19. SUBSEQUENT EVENTS**

### **19.1. Jazz Air Income Fund**

On February 2, 2006, the Jazz Air Income Fund (the Fund) sold 23.5 million units at a price of \$10 per unit for net proceeds of approximately \$222 million. The Fund is an unincorporated, open-ended trust created to indirectly acquire and hold 19.1 per cent of the outstanding limited partnership units of Jazz. ACE holds the remaining 80.9 per cent of the outstanding limited partnership units of Jazz.

The Fund has granted to the underwriters an over-allotment option (the Over-Allotment Option), exercisable for a period of 30 days following the Closing Date, to purchase up to 3.525 million additional units at \$10 per unit for net proceeds of \$33 million. In the event the underwriters exercise the Over-Allotment Option in full, the Fund and ACE will hold 22 per cent and 78 per cent of the outstanding limited partnership units of Jazz respectively.

Pursuant to the limited partnership agreement, 20 per cent of Jazz's limited partnership units are subordinated by ACE in favour of the Fund until December 31, 2006. Distributions on the subordinated units will only be paid by Jazz to the extent that Jazz has met and paid its distributable cash target to the Fund as the holder of non-subordinated units.

In connection with the offering, the establishment of \$150 million senior secured syndicated credit facilities was completed. On closing of the offering, \$115 million was drawn under the credit facilities. The facility bears interest at floating rates and has a three-year term.

### **19.2. Non-unionized Labour Reductions**

In February 2006, the Corporation announced that certain ACE companies will proceed with the reduction of non-unionized staffing levels by 20 per cent. The non-unionized staff reductions are expected to take place primarily at Air Canada, Air Canada Cargo, ACGHS, and ACTS. The costs of this program will be recorded during the first quarter of 2006 once the details of the plan are finalized.