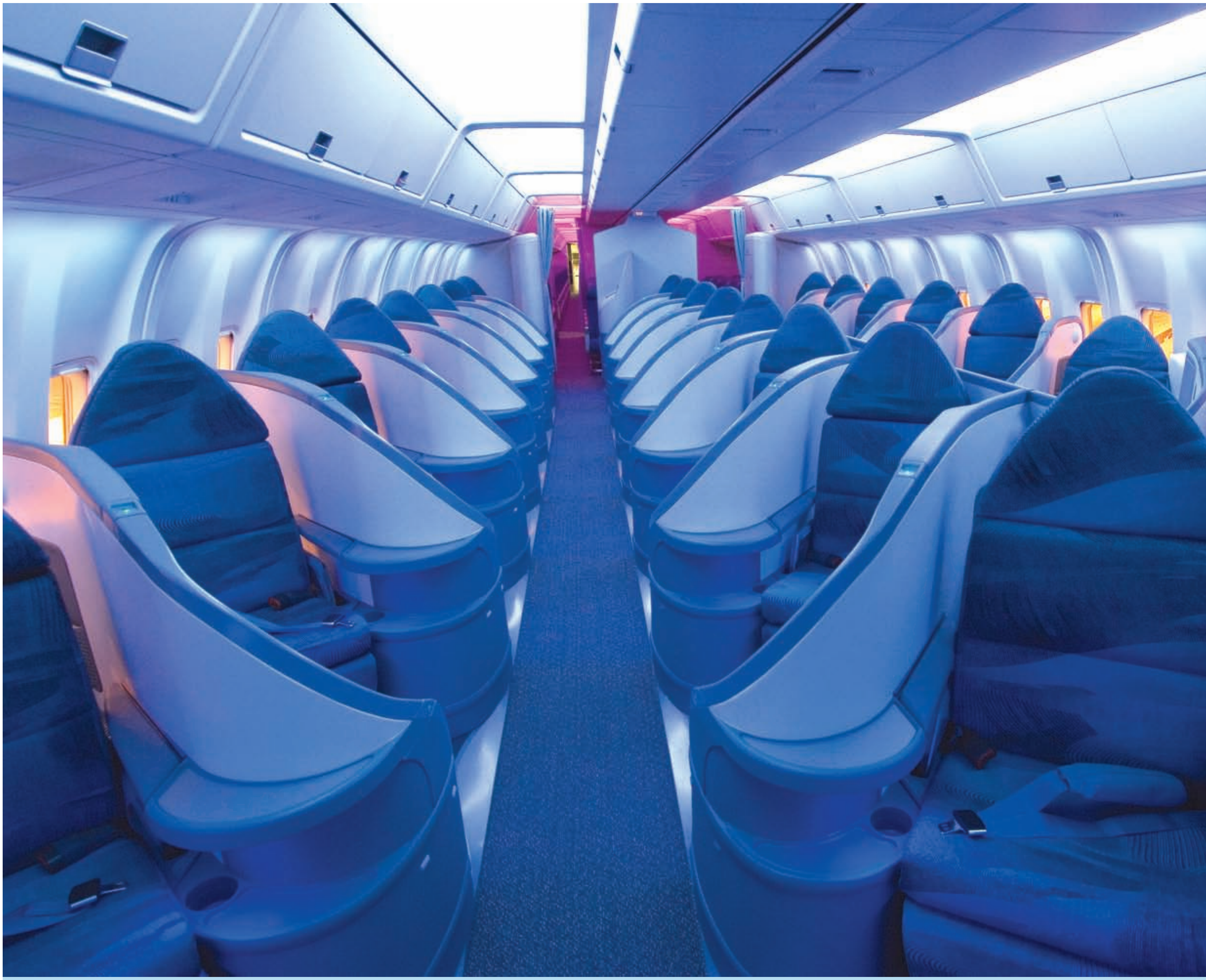

ANNUAL REPORT 2006

AIR CANADA

Highlights

Air Canada Services [1]

Financial (Canadian dollars in millions unless stated otherwise)	Quarter 4 2006	Quarter 4 2005	$ Change	2006	2005	$ Change
Operating revenues	**2,415**	2,271	144	**10,137**	9,509	628
Operating revenues, excluding the special charge for Aeroplan miles [3]	**2,415**	2,271	144	**10,239**	9,509	730
Operating income (loss)	**(5)**	(91)	86	**114**	191	(77)
Operating income (loss), excluding special charges [3]	**(13)**	(91)	78	**236**	191	45
Non-operating income (expense)	**(52)**	(86)	34	**(191)**	(224)	33
Income (loss) before non-controlling interest, foreign exchange and for income tax	**(57)**	(177)	120	**(77)**	(33)	(44)
Income (loss) for the period	**(144)**	(135)	(9)	**(74)**	(20)	(54)
Operating margin	**(0.2)%**	(4.0)%	3.8pp	**1.1%**	2.0%	(0.9)pp
Operating margin, excluding special charges [3]	**(0.5)%**	(4.0)%	3.5pp	**2.3%**	2.0%	0.3pp
EBITDAR [4]	**205**	105	100	**921**	936	(15)
EBITDAR, excluding special charges [3] [4]	**197**	105	92	**1,043**	936	107
EBITDAR margin	**8.5%**	4.6%	3.9pp	**9.1%**	9.8%	(0.7)pp
Cash, cash equivalents and short-term investments	**2,110**	1,302	808	**2,110**	1,302	808
Cash flows from (used for) operating activities	**$ (159)**	$ (48)	$ (111)	**$ 211**	196	15

Operating Statistics	Quarter 4 2006	Quarter 4 2005	% Change	2006	2005	% Change
Revenue passenger miles (millions) (RPM)	**11,160**	10,584	5	**48,993**	46,762	5
Available seat miles (millions) (ASM)	**14,343**	13,807	4	**61,083**	58,818	4
Passenger load factor	**77.8%**	76.7%	1.1pp	**80.2%**	79.5%	0.7pp
Passenger revenue yield per RPM (cents)	**18.5**	18.4	1	**18.1**	17.5	3
Passenger revenue per ASM (cents)	**14.4**	14.1	2	**14.5**	13.9	4
Operating revenue per ASM (cents)	**16.8**	16.5	2	**16.6**	16.2	3
Operating expense per ASM (cents)	**16.9**	17.1	(1)	**16.4**	15.8	4
Operating expense per ASM, excluding fuel expense (cents)	**12.8**	12.9	(1)	**12.2**	12.1	1
Operating expense per ASM, excluding fuel expense and the special charge for labour restructuring (cents) [3] [5]	**12.9**	12.9	(1)	**12.2**	12.1	1
Average number of full-time equivalent (FTE) employees (thousands)	**23.3**	24.1	(3)	**23.6**	24.0	(2)
Aircraft in operating fleet at period end [6]	**332**	322	3	**332**	322	3
Average aircraft utilization (hours per day) [7] [8]	**10.3**	10.0	3	**10.5**	10.6	(1)
Average aircraft flight length (miles) [8]	**847**	842	1	**873**	871	0
Fuel price per litre (cents) [9]	**64.1**	65.7	(2)	**66.2**	59.7	11
Fuel litres (millions)	**906**	874	4	**3,813**	3,643	5

Air Canada Combined Consolidated [2]

Financial (Canadian dollars in millions unless stated otherwise)	Quarter 4 2006	Quarter 4 2005	$ Change	2006	2005	$ Change
Operating revenues	**2,395**	2,256	139	**10,065**	9,458	607
Operating income (loss)	**29**	(57)	86	**259**	318	(59)
Operating income (loss), excluding special charges [3]	**21**	(57)	78	**381**	318	63
Income (loss) for the period	**(144)**	(135)	(9)	**(74)**	(20)	(54)
Operating margin	**1.2%**	(2.5)%	3.7pp	**2.6%**	3.4%	(0.8)pp
Cash, cash equivalents and short-term investments	**2,245**	1,336	909	**2,245**	1,336	909

(1) In accordance with Canadian GAAP ACG-15, Air Canada is required to consolidate the financial statements of Jazz, certain leasing entities and fuel facility corporations into its financial statements. Air Canada does not have any ownership interest in Jazz. The financial statements of Air Canada, the mainline airline, are termed "Air Canada Services".

(2) Air Canada's combined consolidated results include the financial position, results of operations and cash flows of the various components and entities (including Jazz Air LP) as described in Note 1 to Air Canada's combined consolidated financial statements. Air Canada has two business segments: Air Canada Services and Jazz. Refer to section 1 of Air Canada's 2006 Management Discussion and Analysis of Results ("MD&A").

(3) A special charge of $102 million was recorded to operating revenues in Quarter 3 2006 in connection with Air Canada's obligations for the redemption of pre-2002 Aeroplan miles ("Special charge for Aeroplan miles") Refer to section 20 "Non-GAAP Financial Measures" of Air Canada's 2006 MD&A. A special charge for labour restructuring of $28 million was recorded in Quarter 1 2006. During Quarter 4 2006, the estimated cost of this plan was revised due to the favourable impact of attrition and other factors and the charge was reduced by $8 million to $20 million.

(4) 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, amortization and obsolescence 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 is reconciled to operating income (loss) as follows ($ millions)	Quarter 4, 2006	Quarter 4, 2005	2006	2005
Operating income (loss)	**(5)**	(91)	**114**	191
Add back:				
Aircraft rent	**75**	90	**314**	341
Depreciation, amortization & obsolescence	**135**	106	**493**	404
EBITDAR	**205**	105	**921**	936
Add back:				
Special charge for labour restructuring [3]	**(8)**	-	**20**	-
Special charge for Aeroplan miles [3]	**-**	-	**102**	-
EBITDAR before special charges	**197**	105	**1,043**	936

(5) Operating expense per available seat mile, before fuel expense and the special charge for labour restructuring, is calculated as operating expense, removing fuel expense and the special charge for labour restructuring, divided by ASMs. Refer to section 20 "Non-GAAP Financial Measures" of Air Canada's 2006 MD&A for additional information.

(6) Operating fleet excludes chartered freighters in 2006 and 2005.

(7) Excludes maintenance down-time.

(8) Excludes third party carriers operating under capacity purchase arrangements.

(9) Includes fuel handling and fuel hedging expenses.

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Message from the President and Chief Executive Officer of Air Canada

In recent times, change at Air Canada meant consolidation and adapting to the market's increasing demand for lower fares. Three years of record load factors suggest we've done exceptionally well, (Excluding $122 million in one-time charges, Air Canada Services as a separate company made a full year non-GAAP operating profit of $236 million in 2006 even with fuel prices setting all-time highs.) In fact, from the moment we began rolling out our unique one-way fare structure in 2003, Air Canada has been phasing in one of the industry's most ambitious commercial strategies, the goal of which is nothing less than to change how people and businesses purchase air travel. With our IPO behind us, it will become more apparent this year and next that Air Canada is on the offensive, using our commercial, network and fleet strategies to boost passenger and cargo capacity and expand network utility as part of our objective to increase passenger yields, create new revenues and capture further significant cost savings. Customers are already seeing new daily routes like Toronto-Shanghai, Edmonton-London and Montreal-Rome, improved schedules, new unlimited travel passes and à la carte options for customizing fares. And there is much more coming, such as:

- an entirely new or refurbished fleet by mid-2008 with capacity to grow;
- more international flying, particularly in our most profitable and most promising markets;
- a new Web-based reservations system, Polaris, with which we will pursue new revenue streams and cost savings;
- passes and unique fare options for more of the airline's international system to shift more bookings to our website;
- new world-class connection capabilities at our Toronto main hub, making Air Canada a larger player in the global marketplace.

If you want a metaphor for our business strategy, visualize a championship speedboat skimming across calm water. The large, widening wake behind it represents simultaneous revenue growth and cost reduction, and almost every part of our model is meant to achieve both as these two game-changing examples demonstrate.

1. New widebody fleet

Beginning in March, we will begin replacing our 10 A340-300s and some of our oldest Boeing 767s with a combination of Boeing 777-300ER and 777-200LR twin-engine aircraft. The 777s have a lower cost per available seat-mile than both of our four-engine A340 models – up to 26 per cent lower – and can fly further with a full payload. Two engines versus four mean better fuel efficiency and less maintenance expense. When substituting a 349-seat 777-300ER for an A340-300 we gain 63 seats and several tonnes of freight capacity. Our 777s will have the same Executive First suite with a lie-flat bed being installed throughout the widebody fleet. Every passenger in the economy cabin will have the same personal in-seat video system being installed fleet-wide – and we intend to charge for premium content. The 777-300ER is destined for our busiest, most profitable markets like London, Frankfurt and Tokyo where we can sell the extra seats and cargo space and charge top dollar for the suites. The 270-seat 777-200LR will take over very long distance routes like Toronto-Hong Kong and do it at a 12 per cent lower seat-mile cost. And the best is yet to come: the Boeing 787s being delivered from 2010 on will be 30 per cent more cost-effective to operate than the 218-seat 767s they replace.

2. Web-based fares

When Air Canada introduced its current one-way branded fare structure, the airline's distribution costs – everything related to selling tickets, like advertising, call centres, commissions, booking fees and credit card charges – exceeded $1 billion annually. Our goal was to shrink that dramatically by encouraging passengers and travel agents to make and change bookings online. It costs the airline 51 per cent less to process a booking via aircanada.com than through other channels. Today, about 60 per cent of our domestic bookings are made on the Internet. Selling multi-trip and unlimited travel passes further reduces the number of purchase transactions. Our passes, unique for their breadth, lock in savings and lock out the competition. Ninety per cent of customers who buy a pass buy at least one more. Our pass sales grew by 225 per cent last year.

Experience has shown that our revenue model both raises yields and lowers costs:

- last year, our advertising, commissions and global distribution system costs were equal to 4.5 per cent of passenger revenue, down from 5.0 per cent in 2005;
- since being introduced, our fare structure has helped stimulate record load factors and consistent quarter-to-quarter yield growth;
- people buy up; last year, 46 per cent of all domestic sales were at higher fares than Tango, our lowest-priced, most restrictive fare.

Starting this year, Air Canada will be phasing in Polaris. Polaris will give us considerable additional functionality, such as the ability to customize the online booking process for each customer. Eventually, each one could have a subscription that's unique to him or her. With millions of customers, that means millions of different fare relationships. Our job will be to ensure that what is meaningful to each customer is presented in a simple and transparent manner. I don't know of another airline that is thinking through a reservations system like we are. Polaris will have powerful capabilities. It's being designed with added functionality to launch revenue generating initiatives while improving labour productivity, reducing accounting and administration expense and causing even more booking activity to shift to aircanada.com.

Air Canada is shaking up the airline business. By using our new corporate passes, large customers like TELUS® not only save on fares but are slashing their administration costs. At our instigation, travel agent reservations systems are altering their displays to accommodate our new à la carte fare options. Those options give consumers "the freedom to fly your way". Tango passengers can pay a fee to pre-select a seat. For additional discounts, Tango passengers can waive their right to change their itinerary and all passengers can decline the right to check luggage. In January, Air Transport World awarded Air Canada its Market Leadership Award, declaring that the airline's development of branded fares, passes and à la carte options "mark it as a Market Leader in reversing the commoditization of air travel and reestablishing a positive price/value equation for the customer."

Ultimately our message to consumers will be: we'll give you a great fare customized the way you like and put you on the newest aircraft and fly you non-stop to more places than any other airline by far. So why even shop elsewhere? Since October 2004, Air Canada has added frequency on 80 routes and added 17 new domestic and nine transborder point-to-point services. With the consolidation of all Air Canada flights in Toronto at Terminal 1, Air Canada will pursue a bigger share of the U.S./overseas market. We now provide an attractive option of flying via Canada (rather than a U.S. hub where U.S. transit visas may be required) to more people travelling between the Caribbean or Latin America and either Europe or Asia.

Within North America, passengers are giving us positive feedback on our new 93-seat Embraer E-190s with their spacious cabin and extra legroom. In situations where 93 seats are enough, the E-190s carry the same revenue but cost 18 per cent less to operate than our next largest aircraft. With 27 more 190s coming this year and in 2008 for a total of 45, the E-190 fleet is allowing us to strengthen the network and replace some A319s and A320s as part of fleet renewal and rightsizing capacity to our needs to improve our operating margins. Our approach to cost reduction also sets us apart from most airlines. Our preference is to focus on achieving a holistic understanding of total expenditures – how much it costs to offer services like telephone reservations, meals, checked baggage and carrying pets or sporting equipment and to recover those costs by altering the service or charging more for it.

Being a separate company will challenge us to make consistent profits carrying passengers and freight. Our new situation affords us opportunities that weren't available previously. Air Canada has negotiated competitive service contracts with other entities in the ACE Aviation fold. These agreements ensure ACE companies will keep delivering a high standard of service at a competitive price otherwise they risk losing our business.

While it pursues greater profitability, Air Canada is firmly committed to long-standing conservative values that define what this airline is about. There is no comprising the safety and security of our passengers and employees – this remains our top priority. Air Canada has over $2 billion in cash and, as of mid-February, a 44 per cent fuel hedge for 2007. We're firm believers in doing more of what is already highly profitable with plans this summer to operate up to 15 non-stops a day to London-Heathrow and 12 to Asia, and using bigger aircraft like the 777-300ER on some flights. That being said, our inclination is to be masters of change rather than slaves to it. In our commercial approach, that means more innovating and refining our innovations based on feedback from our customers and employees. The latter, with their dedication and professionalism are a major reason why Air Canada keeps winning awards as the North American airline people rate the highest. Employees are an airline's most effective advocates. With new aircraft, new routes, new products and leading edge strategies, we are creating an Air Canada of which our employees can be especially proud and which I am confident will be increasingly successful – and profitable.

Montie Brewer

Montie Brewer
President & Chief Executive Officer

1. PREFACE

The following management's discussion and analysis of results of operations and financial condition ("MD&A") should be read in conjunction with Air Canada's combined consolidated financial statements and notes which have been prepared in accordance with GAAP in Canada and are based on accounting policies consistent with those disclosed in Note 2 to Air Canada's combined consolidated financial statements. Except where the context otherwise requires, all monetary amounts are stated in millions of Canadian dollars. Except as otherwise noted, this MD&A is current as of February 14, 2007.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward Looking Statements" in this MD&A for a discussion of risks, uncertainties and assumptions relating to these statements. For a detailed description of the risks affecting the business of Air Canada and its subsidiaries, see the "Risk Factors" section in this MD&A.

Air Canada's combined consolidated financial statements include the financial position, results of operations and cash flows of the various entities as described in Note 1 to Air Canada's combined consolidated financial statements. In this MD&A, the term "Corporation" refers to, as the context may require, Air Canada and/or Jazz LP ("Jazz") and/or one or more of Air Canada's subsidiaries. Air Canada has two business segments: Air Canada Services and Jazz. Air Canada Services is the passenger and cargo transportation services business operated by Air Canada and related ancillary services. Jazz operates under the capacity purchase agreement between Air Canada and Jazz that came into effect September 30, 2004 (the "initial Jazz CPA") and was amended and restated effective January 1, 2006 (the "Jazz CPA"). Due to the terms of the Jazz CPA, Air Canada has a variable interest in Jazz, as defined under Accounting Guideline15 - Consolidation of Variable Interest Entities (AcG-15). It has been determined that Air Canada is most closely associated with Jazz and, as a result, Air Canada is the entity that consolidates Jazz. Notwithstanding the consolidation of Jazz by Air Canada, Air Canada does not hold any of the limited partnership units of Jazz Air LP or any of the shares of its general partner, Jazz Air Holding GP Inc.

Basis of Presentation

On November 24, 2006 Air Canada completed its initial public offering of class A variable voting shares and class B voting shares of Air Canada (the "Air Canada IPO"). Refer to Note 1 to Air Canada's combined consolidated financial statements for additional information. For periods prior to the Air Canada IPO, ACE Aviation Holdings Inc. ("ACE") was the direct or indirect parent holding company of Air Canada, ACGHS Limited Partnership ("Air Canada Ground Handling"), Touram Limited Partnership ("Air Canada Vacations") and AC Cargo Limited Partnership ("Air Canada Cargo"). Immediately prior to the closing of the Air Canada IPO, the partnership interests, as well as the interests in the general partners of Air Canada Cargo and Air Canada Ground Handling not held by Air Canada, were transferred to Air Canada and ACE transferred a 51 percent ownership interest in Air Canada Vacations and Air Canada Vacations' general partner to Air Canada. As at December 31, 2006, ACE directly holds 75 percent of Air Canada's outstanding shares.

In accordance with Emerging Issue Committee Abstract No. 89, Exchange of Ownership Interests between Enterprises under Common Control – Wholly and Partially-Owned Subsidiaries, Air Canada's combined consolidated financial statements combine the assets and liabilities, results of operations and cash flows of Air Canada, Jazz and all of Air Canada's subsidiaries as if they had been combined from September 30, 2004, the date Air Canada and these entities emerged from creditor protection under the provisions of the Companies' Creditors Arrangement Act (Canada) ("CCAA"). The assets and liabilities have been combined at their carrying values in the respective entities. The shareholders' equity reflects the shareholders' equity of Air Canada adjusted for the transactions related to the Air Canada IPO, as applicable.

For further information on Air Canada's public disclosure file, including Air Canada's Annual Information Form which will be filed by March 31, 2007, consult SEDAR at www.sedar.com.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

This MD&A includes forward-looking statements within the meaning of applicable securities laws. These statements relate to analyses and other information that are based on forecasts of future results and estimates of amounts not yet determinable. These statements may involve, but are not limited to, comments relating to strategies, expectations, planned operations or future actions.

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.

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 factors, 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, pension issues, currency exchange and interest rates, changes in laws, regulatory developments or proceedings, pending and future 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. The forward-looking statements contained in this MD&A represent the Corporation's expectations as of the date of this MD&A and are subject to change after such date. However, the Corporation disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

2. GLOSSARY

Available Seat Miles or ASMs — A measure of passenger capacity calculated by multiplying the total number of seats available for passengers by the miles flown;

CASM — Operating expense per ASM;

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

Initial Jazz CPA — The capacity purchase agreement between Air Canada and Jazz Air Limited Partnership which was in effect from October 1, 2004 until December 31, 2005;

Jazz CPA — The amended and restated capacity purchase agreement, effective January 1, 2006, between Air Canada and Jazz;

Passenger Load Factor — A measure of passenger capacity utilization derived by expressing Revenue Passenger miles as a percentage of Available Seat Miles;

Passenger Revenue per Available Seat Mile or RASM — Average passenger revenue per ASM;

Revenue Passenger Miles or RPMs — A measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried;

Subsidiary or subsidiaries — refers to, in relation to Air Canada, to any entity, including a corporation or a limited partnership, which is controlled, directly or indirectly, by Air Canada.

Yield — Average passenger revenue per RPM.

3. OVERVIEW AND GENERAL BUSINESS SUMMARY

The Air Canada Business

Air Canada is Canada's largest domestic and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market and in the international market to and from Canada.

In 2006, Air Canada, together with Jazz, operated an average of approximately 1,300 scheduled flights each day and carried over 32 million passengers. Air Canada, together with Jazz, provided direct passenger service to 161 destinations and, through commercial agreements with other unaffiliated regional airlines, to an additional 15 destinations, for a total of 176 direct destinations on five continents.

Air Canada enhances its network through a capacity purchase agreement with Jazz pursuant to which Air Canada purchases substantially all of Jazz's fleet capacity based on predetermined rates and determines the routes and schedule operated by Jazz. Jazz operates with smaller jet and turboprop aircraft that have lower trip costs than conventional large jet aircraft, allowing Jazz to provide service to Air Canada's customers in lower density markets and also in higher density markets at off-peak times throughout Canada and the United States.

Air Canada is a founding member of the Star Alliance® network, the world's largest airline alliance group. The Star Alliance® network currently includes 17 member airlines and three regional member airlines. Through its membership in the Star Alliance® network, Air Canada is able to offer its customers access to over 855 destinations in 155 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges.

Through its long-term relationship with Aeroplan, Air Canada's frequent flyer program, Air Canada is able to build customer loyalty by offering those customers who are Aeroplan members the opportunity to earn Aeroplan miles when they fly with Air Canada. Aeroplan is also Air Canada's single largest customer. The relationship with Aeroplan provides a long-term stable and growing source of revenue from the purchase by Aeroplan of Air Canada seats to be provided to Aeroplan members who choose to redeem their Aeroplan miles for air travel rewards.

The Corporation also generates revenues from cargo services provided by Air Canada and Air Canada Cargo, tour operator services provided by Air Canada Vacations and ground handling services provided by Air Canada Ground Handling.

Air Canada’s Business Strategy

Air Canada’s business model allows it to compete more effectively on multiple levels against the low-pricing structures offered by low-cost carriers and the extensive services and networks of leading international full service carriers. Air Canada's strategy is based on the following components:

<u>Leverage its Innovative Customer Driven Revenue Model</u>

The cornerstone of Air Canada's strategy is to leverage its innovative revenue model. Since its introduction, the revenue model has contributed to higher passenger load factors, higher yields, improved RASM and increased cost efficiency for Air Canada.

Air Canada is an industry leader in offering transparent pricing and simplified branded fares in an industry which has been characterized by multi-tiered fare structures with complex rules and restrictions. Air Canada believes this strategy has contributed to its achieving both record load factors and yield improvements. During 2006, Air Canada enjoyed record loads in all months except August and September, ending a record 27 consecutive months of record loads. Air Canada believes that these two months fell to levels of the previous year primarily as a result of the August 10, 2006 terrorist threat in the United Kingdom and resultant additional security measures. Air Canada’s transparent and simplified branded fare structure has given its customers the ability to pay for higher branded fares and enjoy the attributes which come with it or purchase a lower branded fare and then purchase selected attributes which typically are attached only to higher branded fares. This has allowed Air Canada to match the lowest fare in the markets in which it operates and maintain revenue premiums from customers who are willingly purchasing higher fares. For 2006, 46 percent of Air Canada’s domestic consumers picked a branded fare higher than Air Canada’s most competitive Tango product, a 30.6 percent improvement over 2005. The simplified pricing concept has been in place in the North American market since

2003 and certain features of the simplified pricing concept have been phased into most European markets during 2006.

New Developments in Its Innovative Strategy

In the drive to provide new and unique products that customers can only find at Air Canada, work continues to expand the offering of “passes”, “subscriptions” and “à la carte” pricing options tailored to different segments of the marketplace. “Passes” provide Air Canada customers with the ability to lock-in their cost of travel through advance purchase of multiple segments within a defined geographic area. This product is gaining popularity with large corporations as well as with small business and families who value the set price and more importantly the flexibility and ease of use**.** “Subscriptions” to travel are another Air Canada innovation, which allows unlimited travel within a geographic area and certain conditions, for a set flat fee. “Subscriptions” provide flexibility and ease of use. Both the pass and subscription products have also provided cost savings to Air Canada through reduced sales and servicing costs while providing a product that has been readily accepted by the market. Pass sales increased 148 percent in 2006**.** “À la carte**”** options provide customers with the ability to customize their purchase by selecting the items for which they would like to pay, or not. Examples of “à la carte“ options include, checked baggage, advance seat assignment, Aeroplan miles, Maple Leaf lounge access, among others. Air Canada is the only major international carrier that allows this degree of customization and Air Canada will continue to introduce new and innovative attributes on its “à la carte” menu. Since its inception on October 28, 2006, 13 percent of customers purchasing through the Air Canada website took advantage of the “à la carte“ offerings. While passes generate significant cost savings for Air Canada, the “à la carte” options generate higher incidental revenues and higher customer satisfaction resulting in brand preference. All are unique products that customers can only find at Air Canada.

High Degree of Web-Penetration

All three offerings, “passes”, “subscription” and “à la carte” options, are available on Air Canada websites. This strategy has generated a higher level of web-penetration. During 2006 Air Canada enjoyed an average system-wide web-penetration of 26 percent while web penetration in Canada reached 52 percent. Domestic web penetration for the fourth quarter 2006 was 57 percent and the year was capped with a 61 percent domestic web penetration figure for the month of December. Air Canada domestic direct sales (aircanada.com and call centres) for the fourth quarter 2006 was 69 percent. Transborder web penetration for the fourth quarter 2006 was 30 percent, an increase of 6 points from the previous year’s quarter. Air Canada believes that the growth in direct sales is due in part to the fact that these new and unique products that Air Canada’s customers desire can only be found through Air Canada’s websites and call centres. Air Canada maintains two websites, one for consumers and the other for travel agencies. Both websites offer the same unique products. The growth in web penetration continues to allow Air Canada to reduce its cost of distribution.

In addition, Air Canada’s customers continue to benefit from the ability to check into Air Canada flights departing from any Canadian city and from select U.S. and select international cities to Canada 24 hours prior to departure by using the web check-in facility provided on the Air Canada website. Air Canada believes this additional feature results in improved customer satisfaction and generates cost savings for Air Canada.

Potential for International Route Expansion

Air Canada believes that Canada’s multi-ethnic demography provides Air Canada with growing demand for international travel. Coupled with the large number of unused route authorities, Air Canada believes it is well poised for growth in the Canada-international market. Air Canada expects to expand its existing services to international destinations, including leveraging capacity growth using the Star Alliance® network, and serve new international destinations in order to benefit from the higher margins available in international markets.

Multi-hub Strategy and Seamless Transfers at Toronto

Air Canada uses three main hubs (Toronto, Montreal and Vancouver) across Canada for its domestic, transborder and international routes. Being geographically well positioned, Air Canada believes that all three hubs provide natural advantages to serve customers traveling to or from the U.S to Asia and Europe. Since the implementation of the latest development at Pearson International Airport, Toronto, through which, started on January 29, 2007, Air Canada operates all U.S. flights from Terminal 1. This provides Air Canada with the ability to more seamlessly transfer passengers to and from the U.S. to Europe and Asia. This is a dramatic improvement from the prior challenges of checking out of Terminal 2 and checking into Terminal 1 or vice-versa. Air Canada’s Toronto’s operation is now consolidated in one terminal, in one of North America’s newest and most convenient facilities from which to travel internationally.

Enhance its Product Offering through a Redesigned Network and a Renewed Fleet

Within North America, Air Canada adopted a demand-based network strategy. This resulted in offering improved frequencies on key routes, maintaining competitive frequencies on other routes and introducing new non-stop routes thus serving its customers to destinations where such demand was expected. Air Canada is achieving its network redesign in the North American market through the increased use of large regional jet aircraft which have lower trip costs than conventional narrow-body aircraft. In order to support the expansion of its international operations and deliver a superior aircraft product in the international market to and from Canada, Air Canada expects to introduce 19 Boeing 777 aircraft, beginning in March 2007, and 14 Boeing 787 aircraft, beginning in 2010. The new aircraft will be used to modernize and re-size the fleet, improve passenger load factors and yields, reduce operating costs through fuel efficiencies and are expected to provide Air Canada with the ability to serve new markets that could not be previously served in an efficient manner.

Air Canada recognizes the need for staying competitive by offering customers an enhanced flight experience. In addition to acquiring new aircraft, Air Canada commenced a major refurbishment of the interior of its existing aircraft in 2006. All existing aircraft, except for the Airbus A340 aircraft, will have refurbished interiors, including new seats and personal in-flight entertainment systems and in-seat power outlets at every seat in Economy Class and Executive Class. For aircraft that will be flying international routes, seats in the Executive Class cabin will also convert into lie-flat beds. Air Canada has completed the refurbishment of its 16th Airbus A320 and its fourth Boeing 767-300 aircraft. The refurbishment for the Airbus A319, A321 and A330 aircraft is expected to begin in early 2007. The new Embraer and Boeing 777 aircraft are being delivered with the new seats and entertainment systems already installed. The aircraft refurbishment program is scheduled to be completed by mid-2008.

Leveraging Technology for Enhanced Customer Service and Cost Containment

In order to support the rapid and efficient implementation of Air Canada's revenue model and to reduce transaction and distribution costs, Air Canada is developing a new web-enabled computer system to replace Air Canada's legacy systems for passenger reservation and airport customer service. Named POLARIS, this state-of-the-art new system is expected to be deployed in a phased manner commencing from late 2007 and running through a major part of 2008. The new technology is expected to be innovative, flexible and cost effective and will allow Air Canada to facilitate and streamline the reservation and travel processes for both its customers and employees. Air Canada's objective is to allow all travel transactions to be completed via Air Canada's websites, kiosks, personal handheld devices or other web-enabled platforms. The principal design focus is to create a platform that allows customers to complete any transaction required at any moment of their travel experience.

Continue to Improve its Cost Structure

Air Canada's business strategy is focused on continuously evaluating and improving its cost structure to remain highly competitive. Air Canada’s fleet renewal program will provide cost efficiencies; the Embraer 190 aircraft generates 18 percent lower trip costs as compared to the Airbus 321 aircraft. Improved technology used by Boeing in its 777 and 787 aircraft bodies is expected to generate lower fuel-burn rates for airlines. Air Canada expects the Boeing 777-300 to be 26 percent more efficient on a unit cost basis as compared to the Airbus 340-500 while the Boeing 787-8 is expected to be 30 percent more efficient on a unit cost basis for fuel and maintenance. At the same time, POLARIS is expected to generate productivity improvements in call centers, airport check-in and revenue accounting.

Maintaining Positive Employee and Labour Relations

As part of its focus on employee relations, Air Canada is committed to communicating with its employees in an open and transparent manner and to providing them with the tools they need to do their jobs. Air Canada is acting on this commitment by training managers to help them create and promote meaningful and positive employee relations and by providing its employees with increased opportunities for dialogue and feedback. As part of this commitment, in January 2007, Air Canada launched a leadership and employee relationship training initiative for all management employees entitled “Relationship Matters”.

Air Canada is focused on maintaining a cooperative relationship with its unions. Air Canada and some of its unions have also introduced new grievance procedures that provide for expedited resolution of grievances and are designed to facilitate the labour-management relationship and increase accountability on both sides.

4. FUEL RISK MANAGEMENT

Aircraft fuel is a major expense in the airline industry. During the period from January 1, 2006 to December 31, 2006, the price of Western Texas Intermediate ("WTI") crude oil ranged from a low of US$55.86 to a high of US$76.95. Fuel prices continue to be susceptible to factors such as political unrest in various parts of the world, Organization of Petroleum Exporting Countries (OPEC) policy, the level of demand from emerging economies such as China, the level of inventory carried by the industry, the level of fuel reserves maintained by governments, disruptions to production and refining facilities, alternative fuels and the weather. Based on 2006 volumes and US exchange rates, Management estimated that a US$1 per barrel movement in the price of WTI crude oil or in the refining spread between WTI and jet fuel impacted 2006 fuel expense by approximately C$27 million or US$24 million (excluding the impact of fuel surcharges and fuel hedging).

In order to manage the airline's exposure to the volatility of jet fuel prices, the Corporation has hedged a portion of its 2007 anticipated jet fuel requirements using mostly swap and collar option structures. The swap structure allows the Corporation to fix jet fuel price at a specific level, whereas the collar option structure creates a ceiling and a floor price, allowing the Corporation to protect itself against prices above the ceiling but exposing the Corporation to the floor if the price falls below the floor. As at December 31, 2006, the Corporation had 39 percent of its fuel requirement for 2007 hedged at prices that can fluctuate between an average of US$74 to US$85 per barrel for its heating oil-based contracts, an average of US$58 to US$69 per barrel for its WTI crude oil-based contracts and an average of US$81 to US$85 for jet-fuel based contracts. Since December 31, 2006, the Corporation has entered into new hedging positions, using collar option structures, which have added 5 percent coverage to 2007 increasing the total hedged volume for 2007 to 44 percent, as well as an additional 1 percent coverage to 2008. As at February 14, 2007, for 2007, the Corporation has hedged its projected fuel requirements as follows: 57 percent for Quarter 1, 44 percent for Quarter 2, 36 percent for Quarter 3 and 39 percent for Quarter 4.

For information on fuel hedging gains and losses recognized in fuel expense in 2006 and gains and losses recognized in “other” non-operating expense for derivative instruments that do not qualify for fuel hedging accounting, refer to section 12 of this MD&A.

5. EMPLOYEES AND LABOUR RELATIONS

As at December 31, 2006, the Corporation had 27,384 full-time equivalent ("FTE") employees (Air Canada Services – 23,101; Jazz – 4,283). The following table provides a breakdown of the Corporation's average FTE employees for the fourth quarter of 2006 and 2005 and for the full year 2006 and 2005 together with the unions that represent them.

Employee Group	Union[(1)]	Fourth quarter 2006	Fourth quarter 2005	2006	2005
Management and Administrative Support[(3)]	N/A[(2)]	3,017	3,504	3,191	3,410
Pilots	ACPA	2,708	2,541	2,625	2,546
Flight Attendants	CUPE	5,985	6,011	6,062	6,167
Customer Sales and Service Agents[(3)]	CAW/IBT	3,650	3,975	3,767	3,962
Technical Services, Ramp and Cargo[(3)]	IAMAW	6,812	6,924	6,812	6,766
United Kingdom Unionized Employees	Amicus/TGWU	697	682	691	704
Other Unionized		478	479	482	488
Air Canada Services		23,347	24,116	23,630	24,043
Jazz		4,272	3,801	4,144	3,582
Consolidated		27,619	27,917	27,774	27,625

(1) ACPA: Air Canada Pilots Association; CUPE: Canadian Union of Public Employees; CAW: National Automobile, Aerospace, Transportation and General Workers Union of Canada; IBT: International Brotherhood of Teamsters; IAMAW: International Association of Machinists and Aerospace Workers; and TGWU: Transport and General Workers Union.

(2) Certain administrative support employees are represented by IAMAW.

(3) Not included in the numbers presented in the table above, pursuant to the Aeroplan General Services Agreement ("Aeroplan GSA"), Aeroplan has agreed to reimburse Air Canada on a fully-allocated basis for all costs, including salary and benefits, related to a group of call centre employees who are represented by the CAW and are currently working for Aeroplan's benefit. Such group represented 853 FTE employees as at December 31, 2006 and 852 FTE employees as at December 31, 2005. In addition to the numbers presented in the above table, pursuant to the ACTS General Services Agreements ("ACTS GSAs"), ACTS has agreed to reimburse Air Canada on a fully-allocated basis for all costs, including salary and benefits, related to a group of unionized and a group of non-unionized employees currently working for the benefit of ACTS. Such groups represented 3,923 FTE employees as at December 31, 2006 and 4,063 FTE employees as at December 31, 2005.

Air Canada has long-term collective bargaining agreements with its pilots, flight attendants, maintenance personnel, certain clerical and finance personnel, customer service agents, ramp and cargo employees, dispatchers and crew schedulers which were concluded in 2003 and 2004 and which expire in 2009. No strikes or lock-outs may lawfully occur during the term of the collective agreements. In 2006, Air Canada concluded wage re-opener agreements, mediations or arbitrations under the collective agreements with all its union groups. It is still awaiting the arbitrator's decision in respect of its flight attendants, who are represented by CUPE. The wage increases awarded or agreed upon range from 0 to 2.5 percent per year until 2009. The CUPE arbitration award decision is expected during the first quarter of 2007.

Jazz has completed negotiation, mediation and arbitration with all of its unions with the exception of the Canadian Air Lines Dispatchers ("CALDA"), the union representing Jazz's dispatchers. The wage increases awarded range from 1 to 1.75 percent per year until 2009. The wage re-opener negotiations with CALDA are continuing.

Profit Sharing Plan
In 2005, the Corporation introduced incentive programs and Profit Sharing Plans in order to engage employees in their valuable role to ensure the Corporation's success. The Sharing Our Success Plan at Air Canada and Jazz's Ensemble Plan emphasize the relationship between performance and personal rewards. These Plans provide employees with financial rewards on a monthly basis when operational performance levels are achieved. The Air Canada Plans also permit employees to share in the fiscal year-end pre-tax profits and Jazz's Plans provide annual rewards where corporate, financial and operational targets are achieved. In each case, employees receive the greater of the amounts payable under either the Sharing Our Success or Jazz Emsemble Plan and the annual profit sharing plan.

Air Canada employees will receive a total of $29.2 million in respect of 2006 under the Profit Sharing Plan, of which $25.5 million has already been paid out during 2006 under the Sharing Our Success monthly incentive program. Employees at Jazz will receive a total of $10.1 million, of which $4.7 million has already been paid out during 2006 under the Jazz Ensemble Plan.

6. FLEET

The Corporation's operating fleet at December 31, 2006 was as follows:

	Total seats	Number of operating aircraft[1]	Average age	Owned [2]	Capital Lease [2]	Consolidated under AcG-15 [2]	Operating Lease
Air Canada Services							
Widebody Aircraft							
Airbus A340-500	267	2	2.5	2	-	-	-
Airbus A340-300	285-286	10	9.8	-	8	-	2
Airbus A330-300	274	8	6.2	-	8	-	-
Boeing 767-300	203-222	33	13.5	1	4	6	22
Boeing 767-200	207	11	20.1	11	-	-	-
Narrowbody Aircraft							
Airbus A321	166	10	4.8	-	-	5	5
Airbus A320	140	47	13.8	-	-	-	47
Airbus A319	120	45	8.2	-	17	17	11
Embraer 190	93	18	0.6	18	-	-	-
Embraer 175	73	15	1.3	15	-	-	-
Total Operating Aircraft		**199**	**9.6**	**47**	**37**	**28**	**87**
Jazz							
Bombardier CRJ-705	75	15	1.5	-	-	-	15
Bombardier CRJ-200	50	33	4.7	-	-	-	33
Bombardier CRJ-100	50	25	11.3	-	-	23	2
Dash-8-300	50	26	16.8	19	-	-	7
Dash-8-100	37	36	18.8	29	-	-	7
Total Operating Aircraft		**135**	**11.7**	**48**	**-**	**23**	**64**
Consolidated							
Total Operating Aircraft		**334**	**10.4**	**95**	**37**	**51**	**151**

(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 combined consolidated statement of financial position. Owned aircraft include aircraft financed under conditional sales agreements.

In 2006, Air Canada took delivery of one Embraer 175 and 15 Embraer 190 aircraft. During 2006, three Airbus A319 aircraft and two Airbus A320 aircraft were returned to the lessors, one Boeing 767-200 was removed from service and two Airbus A320 aircraft were removed from service at the end of 2006 pending return to the lessors. In addition, 10 Bombardier CRJ-100 aircraft were transferred to Jazz.

In 2006, Jazz took delivery of six Bombardier CRJ-200 aircraft and 10 Bombardier CRJ-100 aircraft were transferred from Air Canada to Jazz. Also during 2006, two Dash 8-100 aircraft were returned to the lessors. All aircraft in Jazz's operating fleet as of December 31, 2006 are Covered Aircraft, as defined under the Jazz CPA, with the exception of two Dash 8-100 which are being used for charter purposes.

7. RESULTS OF OPERATIONS – FOURTH QUARTER 2006 VERSUS FOURTH QUARTER 2005

The following table reflects the results of the Corporation as defined under "Basis of Presentation", the results of its reportable segments and certain non-GAAP measures for Quarter 4 2006 and for Quarter 4 2005.

	Quarter 4 2006				Quarter 4 2005			
Operating revenues	**Air Canada Services**	**Jazz**	**Inter-segment elimination**	**Consolidated total**	**Air Canada Services**	**Jazz**	**Inter-segment elimination**	**Consolidated total**
Passenger	$2,071	-	-	$2,071	$1,949	1	-	$1,950
Cargo	166	-	-	166	177	-	-	177
Other	178	352	(372)	158	145	303	(319)	129
	2,415	**352**	**(372)**	**2,395**	**2,271**	**304**	**(319)**	**2,256**
Operating expenses								
Salaries, wages and benefits	443	82	-	525	463	75	-	538
Aircraft fuel	583	69	(69)	583	577	62	(62)	577
Aircraft rent	75	34	(2)	107	90	28	(1)	117
Airport and navigation fees	232	46	(46)	232	222	37	(37)	222
Aircraft maintenance, materials and supplies	205	27	(4)	228	180	18	(4)	194
Communications and information technology	68	2	(1)	69	72	2	(1)	73
Food, beverages and supplies	76	4	-	80	78	3	-	81
Depreciation, amortization and obsolescence	135	5	-	140	106	4	-	110
Commissions	49	-	-	49	47	-	-	47
Capacity purchase fees paid to Jazz	224	-	(224)	-	194	-	(194)	-
Special charge for labour restructuring	(8)	-	-	(8)	-	-	-	-
Other	338	50	(27)	361	333	41	(20)	354
	2,420	**319**	**(373)**	**2,366**	**2,362**	**270**	**(319)**	**2,313**
Operating income (loss)	**(5)**	**33**	**1**	**29**	**(91)**	**34**	**-**	**(57)**
Non-operating income (expense)								
Interest income	24	2	(1)	25	14	-	1	15
Interest expense	(88)	(2)	(1)	(91)	(74)	(3)	(1)	(78)
Interest capitalized	22	-	-	22	6	-	-	6
Gain (loss) on sale of and provisions on assets	(10)	-	-	(10)	(30)	1	-	(29)
Other	-	(1)	1	-	(2)	-	-	(2)
	(52)	**(1)**	**(1)**	**(54)**	**(86)**	**(2)**	**-**	**(88)**
Income (loss) before the following items:	**(57)**	**32**	**-**	**(25)**	**(177)**	**32**	**-**	**(145)**
Non-controlling interest	(3)	-	(32)	(35)	(2)	-	(32)	(34)
Foreign exchange loss	(107)	-	-	(107)	(11)	-	-	(11)
Recovery of income taxes	23	-	-	23	55	-	-	55
Income (loss) for the period	**(144)**	**$32**	**(32)**	**($144)**	**($135)**	**$32**	**($32)**	**($135)**
EBITDAR(1)	**205**	**72**	**(1)**	**276**	**105**	**66**	**(1)**	**170**
EBITDAR(1) excluding special charges	**197**	**72**	**(1)**	**268**	**105**	**66**	**(1)**	**170**

(1) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).

The following table compares the results of the Corporation's reportable segments for Quarter 4 2006 to Quarter 4 2005. The amounts in the table below include inter-segment revenues and expenses.

	Air Canada Services				Jazz			
	Quarter 4		Change		Quarter 4		Change	
($ millions, except per share figures)	**2006**	**2005**	**$**	**%**	**2006**	**2005**	**$**	**%**
Operating revenues								
Passenger	$ 2,071	$ 1,949	$ 122	6	$ -	$ 1	$ (1)	(100)
Cargo	166	177	(11)	(6)	-	-	-	n/a
Other	178	145	33	23	352	303	49	16
	2,415	**2,271**	**144**	**6**	**352**	**304**	**48**	**16**
Operating expenses								
Salaries, wages and benefits	443	463	(20)	(4)	82	75	7	9
Aircraft fuel	583	577	6	1	69	62	7	11
Aircraft rent	75	90	(15)	(17)	34	28	6	21
Airport and navigation fees	232	222	10	5	46	37	9	24
Aircraft maintenance, materials and supplies	205	180	25	14	27	18	9	50
Communications and information technology	68	72	(4)	(6)	2	2	-	-
Food, beverages and supplies	76	78	(2)	(3)	4	3	1	33
Depreciation, amortization and obsolescence	135	106	29	27	5	4	1	25
Commissions	49	47	2	4	-	-	-	n/a
Capacity purchase fees paid to Jazz	224	194	30	15	-	-	-	n/a
Special charge for labour restructuring	(8)	-	(8)	n/a	-	-	-	n/a
Other	338	333	5	2	50	41	9	22
	2,420	**2,362**	**58**	**2**	**319**	**270**	**49**	**18**
Operating income (loss)	**(5)**	**(91)**	**86**		**33**	**34**	**(1)**	
Non-operating income (expense)								
Interest income	24	14	10		2	-	2	
Interest expense	(88)	(74)	(14)		(2)	(3)	1	
Interest capitalized	22	6	16		-	-	-	
Gain (loss) on sale of and provisions on assets	(10)	(30)	20		-	1	(1)	
Other	-	(2)	2		(1)	-	(1)	
	(52)	**(86)**	**34**		**(1)**	**(2)**	**1**	
Income (loss) before the following items:	**(57)**	**(177)**	**120**		**32**	**32**	-	
Non-controlling interest	(3)	(2)	(1)		-	-	-	
Foreign exchange loss	(107)	(11)	(96)		-	-	-	
Recovery of income taxes	23	55	(32)		-	-	-	
Segment income (loss)	**$ (144)**	**$ (135)**	**$ (9)**		**$ 32**	**$ 32**	**$ -**	
EBITDAR[(1)]	**205**	**105**	**100**		**72**	**66**	**6**	
EBITDAR excluding special charges [(1)]	**197**	**105**	**92**		**72**	**66**	**6**	

(1) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).

7.1 Summary of Air Canada Services Segment Results

The Air Canada Services segment reported an operating loss of $5 million in Quarter 4 2006, an improvement of $86 million from the operating loss of $91 million recorded in Quarter 4 2005. EBITDAR increased $100 million over Quarter 4 2005.

Passenger Revenues

System passenger revenues in Quarter 4 2006 increased $122 million or 6 percent over Quarter 4 2005, reflecting system traffic and yield improvements due to stronger market demand. The system yield improvement of 1 percent in Quarter 4 2006 over the same period in 2005 was principally due to fuel-related fare increases and increased fuel surcharges to offset higher fuel costs and, to a lesser extent, a higher average business class fare. The yield increase was partly offset by the negative effect of a stronger Canadian dollar on international, US transborder and domestic revenues. In Quarter 4 2006, traffic grew 5 percent on a capacity increase of 4 percent over Quarter 4 2005, resulting in a passenger load factor increase of 1.1 percentage points. RASM increased 2 percent compared to Quarter 4 2005 due to both the improvement in system passenger load factor and the growth in yield.

The table below describes quarter-over quarter percentage changes in passenger revenues, capacity, traffic, passenger load factor, yield and RASM.

Quarter 4 2006 versus Quarter 4 2005	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	6	4	6	1.7	-	2
US transborder	10	11	15	2.0	(4)	(1)
Atlantic	4	2	2	-	2	2
Pacific	1	-	-	0.1	1	1
Other	6	1	5	3.0	1	5
System	**6**	**4**	**5**	**1.1**	**1**	**2**

Domestic passenger revenues increased $54 million or 6 percent in Quarter 4 2006 compared to Quarter 4 2005 due to traffic growth. Yield was essentially unchanged from the same period in 2005. Traffic grew 6 percent on a capacity increase of 4 percent resulting in a passenger load factor improvement of 1.7 percentage points. Capacity increases were largely on transcontinental services. The suspension of Canjet's scheduled domestic operations in September 2006 also had a favourable impact on traffic in Quarter 4 2006. Domestic RASM increased 2 percent compared to Quarter 4 2005 due to the improvement in domestic passenger load factor.

US transborder passenger revenues rose $41 million or 10 percent in Quarter 4 2006 compared to the corresponding period in 2005 due to an increase in traffic, the result of more capacity, a stronger market demand and additional fuel-related fare increases to offset higher fuel costs. Yield decreased 4 percent in Quarter 4 2006, reflecting a growth over 2005 in longer-haul flying to key leisure destinations. Long-haul flights generally have a lower yield per revenue passenger mile than short-haul flights. When measured on a per mile basis, the average fare paid on long-haul flights is relatively lower than on short-haul flights. At the same time, since the costs of ground handling, take-off and landing are similar for both short and long-haul flights, unit costs per ASM are normally lower for long-haul flights due to distance flown. The growth in passenger traffic of 15 percent in Quarter 4 2006 was largely a result of increased capacity on routes to Las Vegas, San Francisco and Los Angeles and the addition of the Toronto-San Diego route in June 2006. US transborder RASM decreased 1 percent over Quarter 4 2005 as a 2.0 percentage point improvement in passenger load factor was more than offset by the decline in yield.

Atlantic passenger revenues increased $15 million or 4 percent in Quarter 4 2006 compared to the corresponding period in 2005 due equally to yield improvement and traffic growth. Yield improved 2 percent over the corresponding period in 2005 largely due to increased fuel surcharges to offset higher fuel costs. Traffic growth was essentially in line with capacity growth resulting in a passenger load factor unchanged from the same period in 2005. Atlantic RASM increased 2 percent due to the yield improvement.

Pacific passenger revenues increased $3 million or 1 percent in Quarter 4 2006 compared to the same period in 2005 mainly due to a yield improvement. Yield improved 1 percent largely due to increased fuel surcharges to offset higher fuel costs. A higher average business class fare was also a factor in the yield increase. Pacific RASM increased 1 percent due to yield growth as the passenger load factor was essentially unchanged.

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) increased $9 million or 6 percent in Quarter 4 2006 compared to Quarter 4 2005 due to traffic growth and a yield improvement. Traffic grew 5 percent on a capacity increase of 1 percent resulting in a passenger load factor improvement of 3.0 percentage points. Traffic growth occurred primarily in the South America and Mexico markets. Yield rose 1 percent as a result of increased fuel surcharges to offset higher fuel costs. A higher average business class fare was also a factor in the yield increase. For Quarter 4 2006, RASM increased 5 percent due primarily to the improvement in passenger load factor and partly to the yield increase.

Cargo Revenues

Cargo revenues for Quarter 4 2006 decreased $11 million or 6 percent from Quarter 4 2005. System traffic declined 4 percent and cargo yield per revenue ton mile was down 2 percent. Freighter operations were reduced from three to two chartered MD-11 aircraft effective November 2006 as compared to three MD-11 aircraft operated in Quarter 4 2005. As a result, freighter revenues declined $4 million or 9 per cent from 2005 on a 15 percent reduction to freighter capacity. Cargo revenues from non-freighter operations were down $7 million or 5 percent from the same period in 2005, mainly as a result of a 4 percent reduction to traffic and a 1 percent decline in yield per revenue ton mile. Lower cargo capacity in certain markets and adverse currency movements impacted Cargo revenues in the quarter.

Other Revenues

For Quarter 4 2006, other revenues increased $33 million or 23 percent over the same period in 2005. Higher revenues from Air Canada Vacations, mainly due to increased passenger volumes, accounted for approximately $18 million of the increase. Other increases included flight cancellation and change fees, buy-on-board revenues and other miscellaneous revenues.

Operating Expenses

Operating expenses in Quarter 4 2006 rose $58 million or 2 percent over the corresponding period in 2005. This increase in operating expenses over Quarter 4 2005 was largely connected to a 4 percent growth in capacity as well as higher aircraft maintenance, materials and supplies expense.

Unit cost, as measured by operating expense per ASM, decreased 1 percent over Quarter 4 2005. The following table compares Air Canada Services' operating expenses per ASM for Quarter 4 2006 to Air Canada Services' operating expenses per ASM to the corresponding period in 2005.

($ cents per ASM)	**Quarter 4**		**Change**	
	2006	**2005**	**$**	**%**
Salary and wages	2.60	2.63	(0.03)	(1)
Benefits	0.49	0.72	(0.23)	(32)
Ownership (DAR) (1)	1.46	1.42	0.04	3
Airport and navigation fees	1.62	1.61	0.01	1
Aircraft maintenance, materials and supplies	1.43	1.31	0.12	9
Food, beverages and supplies	0.53	0.56	(0.03)	(5)
Commissions	0.34	0.34	-	-
Capacity purchase fees paid to Jazz	1.56	1.40	0.16	11
Other	2.83	2.94	(0.11)	(4)
Operating expense, excluding fuel expense and the special charge for labour restructuring (2)	**12.86**	**12.93**	**(0.07)**	**(1)**
Aircraft fuel	4.06	4.18	(0.12)	(3)
Special charge for labour restructuring	(0.05)	-	(0.05)	n/a
Total operating expense	**16.87**	**17.11**	**(0.24)**	**(1)**

(1) DAR refers to the combination of Aircraft rent and Depreciation, amortization and obsolescence.
(2) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for additional information.

Salaries and wages expense totaled $373 million in Quarter 4 2006, an increase of $10 million or 3 percent from Quarter 4 2005 in part due to higher average salaries partly offset by a decrease of 3 percent or an average of 769 FTE employees.

A workforce reduction plan was announced in February 2006 to reduce the number of non-unionized employees by 20 percent. A charge of $28 million was recorded in Quarter 1 2006 relating to this program. During Quarter 4 2006, the estimated cost of this plan was revised due to the favourable impact of attrition and other factors which reduced the cost of achieving the target. As a result, the Air Canada Services segment recorded a reduction of $8 million in Quarter 4 2006 to the special charge for labour restructuring.

Employee benefits expense amounted to $70 million in Quarter 4 2006, a decrease of $30 million or 30 percent over Quarter 4 2005. Included in Quarter 4 2006 were favourable adjustments of $6 million pertaining to pension expense for the full year 2006 as a result of a revised pension expense estimate and $8 million related to an updated evaluation of workers' compensation liability. Included in Quarter 4 2005 was an unfavourable adjustment of $5 million relating to an updated actuarial evaluation of workers' compensation liability. Excluding these adjustments, the remaining $11 million decrease in employee benefits expenses was mainly due to a decline in post-employment benefits partly offset by higher pension expense which reflected a lower discount rate applied to pension obligations.

Fuel expense increased $6 million or 1 percent in Quarter 4 2006 due to a volume-related increase of $23 million bringing the total year 2006 fuel expense increase to $347 million or 16 percent. In Quarter 4 2006, a stronger Canadian dollar versus the US dollar reduced fuel expense by $24 million compared with Quarter 4 2005 and a lower average base fuel price decreased it by a further $22 million. These decreases were partly offset by an increased realized hedging loss of $29 million. The unit cost of fuel in Quarter 4 2006 was reduced by 3 percent when compared to Quarter 4 2005. Fuel expense for MD-11 freighter operations declined $6 million mainly on reduced flying.

Ownership costs, comprised of aircraft rent, depreciation, amortization and obsolescence expenses, increased $14 million in Quarter 4 2006. Increases in ownership costs included a change in assumptions relating to the residual value of certain aircraft and the addition of 16 Embraer aircraft to Air Canada's operating fleet. Decreases in ownership costs included the impact of aircraft returns and lease terminations, the transfer of 10 CRJ-100 aircraft to Jazz which shifts the ownership cost to the capacity purchase expense category, the reduction of one MD-11 freighter aircraft and the impact of a stronger Canadian dollar on aircraft rent.

Airport and navigation fees increased $10 million or 5 percent in Quarter 4 2006, mainly due to an increase of 7 percent in aircraft departures and increased rates for landing and general terminal fees, primarily at Toronto's Pearson International Airport. At Pearson, general terminal charges rose 9 percent per seat for domestic and international arrivals. These increases were partly offset by a rate reduction for navigation fees in Canada and favourable foreign exchange for international navigation fees.

Aircraft maintenance, materials and supplies increased $25 million or 14 percent in Quarter 4 2006 largely due to increased airframe maintenance activity for Boeing 767 aircraft and, to a lesser extent, Airbus A320 aircraft, due to cycle timing. Other increases included increased engine maintenance activity for Airbus A320 and A340 aircraft and expenses related to satisfying minimum return conditions on short-term leases and future return to lessor expenses. These increases were partly offset by an overall reduction in volume of aircraft components.

Food, beverage and supplies expense decreased $2 million or 3 percent versus Quarter 4 2005 on a passenger traffic increase of 5 percent. The volume-related increase was more than offset by cost reduction initiatives and the impact of new catering programs, including the buy-on-board program.

For Quarter 4 2006, capacity fees paid to Jazz, pursuant to the Jazz CPA, amounted to $224 million compared to capacity fees paid to Jazz of $194 million in Quarter 4 2005, pursuant to the Initial Jazz CPA. The increase of 15 percent in Quarter 4 2006 was mainly driven by a growth of 12 covered aircraft in Jazz's operating fleet, resulting in a 21 percent increase in block hours over Quarter 4 2005. ASM capacity for flights operated by Jazz increased 26 percent over Quarter 4 2005.

Non-operating expense amounted to $52 million in Quarter 4 2006 compared to non-operating expense of $86 million for Quarter 4 2005. For Quarter 4 2006, net interest expense decreased $12 million. The increase in interest expense, largely driven by the financing of additional aircraft, was more than offset by a higher amount of capitalized interest relating to the acquisition of the Boeing 777 and 787 aircraft and growth in interest income due to higher cash balances and higher average interest rates. Capitalized interest includes interest on funds used to finance the acquisition of new flight equipment and other property and equipment for periods preceding the dates that the assets are available for service. Refer to Note 2 to Air Canada's combined consolidated financial statements for additional information on interest capitalized. In Quarter 4 2006, the Air Canada Services segment recorded an impairment provision of $7 million relating to one property. In Quarter 4 2005, loss on sale and provisions on assets amounted to $30 million of which approximately $15 million related to the write-down of inactive Boeing 747 inventory.

Losses from the revaluation of foreign currency monetary items amounted to $107 million in Quarter 4 2006, attributable to a weaker Canadian dollar at December 31, 2006 compared to September 30, 2006. This compared to losses of $11 million in Quarter 4 2005.

A segment loss of $144 million was recorded in Quarter 4, 2006 compared to a segment loss of $135 million in Quarter 4 2005.

7.2 Summary of Jazz Segment Results

Jazz recorded operating income of $33 million in Quarter 4 2006, pursuant to the Jazz CPA, compared to operating income of $34 million in Quarter 4 2005, pursuant to the Initial Jazz CPA. EBITDAR for Quarter 4 2006 improved $6 million over the corresponding period in 2005. The increase in EBITDAR was mainly due to a growth in fleet size consistent with Jazz's plan to increase its relative share of the North American ASM capacity, an increase in hours of contract flying under the Jazz CPA, as well as cost control.

The Jazz CPA came into effect on January 1, 2006. The major changes from the Initial Jazz CPA include: a longer term, a larger number of Covered Aircraft with a guaranteed minimum of 133 aircraft throughout the term, and Jazz expenses now reimbursed by Air Canada at a higher mark-up for controllable costs, and on an at-cost basis by Air Canada for other expenses.

Operating revenues for Quarter 4 2006 increased $48 million or 16 percent compared to the corresponding period in 2005. The significant increase in revenues was due to a net addition of 14 aircraft operated by Jazz resulting in a 21 percent increase in block hours flown over Quarter 4 2005 as well as higher pass-though costs charged to Air Canada under the Jazz CPA.

Operating expenses increased $49 million or 18 percent compared to Quarter 4 2005 and included an increase in pass-through costs of $18 million or 17 percent in Quarter 4 2006, driven largely by a capacity increase of 26 percent over the corresponding period in 2005. Unit cost for Quarter 4 2006 decreased 8 percent over the same period in 2005, in part due to an increase in longer-haul flying which generally results in lower unit costs per ASM. Excluding fuel expense, unit cost for Quarter 4 2006 was down 5 percent over the corresponding period in 2005. The unit aircraft rental cost increase mainly reflected six CRJ-200 aircraft deliveries and the transfer of 10 CRJ-100 aircraft from Air Canada partly offset by a termination of two Dash 8 aircraft operating leases.

Segment income of $32 million was recorded in Quarter 4, 2006, unchanged from Quarter 4 2005.

7.3 Summary of Consolidated Results

The Corporation, as defined under "Basis of Presentation", recorded operating income of $29 million for Quarter 4 2006, an improvement of $86 million from the operating loss of $57 million recorded in the same period in 2005.

Losses from the revaluation of foreign currency monetary items amounted to $107 million in Quarter 4 2006 attributable to a weaker Canadian dollar at December 31, 2006 compared to September 30, 2006. This compared to losses of $11 million in Quarter 4 2005.

Net loss for Quarter 4 2006 amounted to $144 million or $1.55 per diluted share compared to a net loss of $135 million or $1.53 per diluted share for Quarter 4 2005.

Unit cost, as measured by operating expense per ASM, decreased 2 percent over Quarter 4 2005.

8. RESULTS OF OPERATIONS – 2006 VERSUS 2005

The following table reflects the results of the Corporation as defined under "Basis of Presentation", the results of its reportable segments and certain non-GAAP measures for the year ended December 31, 2006 and for the year ended December 31, 2005.

	Year ended December 31, 2006				Year ended December 31, 2005			
Operating revenues	**Air Canada Services**	**Jazz**	**Inter-segment elimination**	**Consolidated total**	**Air Canada Services**	**Jazz**	**Inter-segment elimination**	**Consolidated total**
Passenger	$8,887	-	-	$8,887	$8,197	2	-	$8,199
Cargo	629	-	-	629	625	-	-	625
Other	723	1,381	(1,453)	651	687	1,021	(1,074)	634
	10,239	**1,381**	**(1,453)**	**10,167**	**9,509**	**1,023**	**(1,074)**	**9,458**
Special charge for Aeroplan miles	(102)	-	-	(102)	-	-	-	-
	10,137	**1,381**	**(1,453)**	**10,065**	**9,509**	**1,023**	**(1,074)**	**9,458**
Operating expenses								
Salaries, wages and benefits	1,816	311	-	2,127	1,857	265	-	2,122
Aircraft fuel	2,544	285	(284)	2,545	2,197	177	(177)	2,197
Aircraft rent	314	134	(7)	441	341	80	(4)	417
Airport and navigation fees	982	178	(178)	982	924	124	(124)	924
Aircraft maintenance, materials and supplies	768	98	(11)	855	693	68	(10)	751
Communications and information technology	273	8	(3)	278	294	5	(2)	297
Food, beverages and supplies	322	15	(2)	335	326	8	-	334
Depreciation, amortization and obsolescence	493	21	-	514	404	18	-	422
Commissions	237	-	-	237	253	-	-	253
Capacity purchase fees paid to Jazz	871	-	(871)	-	693	-	(693)	-
Special charge for labour restructuring	20	-	-	20	-	-	-	-
Other	1,383	187	(98)	1,472	1,336	149	(62)	1,423
	10,023	**1,237**	**(1,454)**	**9,806**	**9,318**	**894**	**(1,072)**	**9,140**
Operating income	**114**	**144**	**1**	**259**	**191**	**129**	**(2)**	**318**
Non-operating income (expense)								
Interest income	82	6	(1)	87	48	1	(1)	48
Interest expense	(313)	(8)	-	(321)	(270)	(16)	2	(284)
Interest capitalized	62	(1)	-	61	14	-	-	14
Gain (loss) on sale of and provisions on assets	(6)	-	-	(6)	(31)	4	-	(27)
Other	(16)	(1)	-	(17)	15	-	1	16
	(191)	**(4)**	**(1)**	**(196)**	**(224)**	**(11)**	**2**	**(233)**
Income (loss) before the following items:	**(77)**	**140**	**-**	**63**	**(33)**	**118**	**-**	**85**
Non-controlling interest	(12)	-	(140)	(152)	(13)	-	(118)	(131)
Foreign exchange gain	12	-	-	12	47	-	-	47
Recovery of (provision for) income taxes	3	-	-	3	(21)	-	-	(21)
Income (loss) for the period	**(74)**	**$140**	**(140)**	**($74)**	**($20)**	**$118**	**($118)**	**($20)**
EBITDAR[(1)]	**921**	**299**	**(6)**	**1,214**	**936**	**227**	**(6)**	**1,157**
EBITDAR[(1)] excluding special charges	**1,043**	**299**	**(6)**	**1,336**	**936**	**227**	**(6)**	**1,157**

(1) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss) and EBITDAR excluding special charges for Aeroplan miles and labour restructuring to operating income (loss).

Special Charge for Aeroplan Miles

In 2001, Air Canada established Aeroplan Limited Partnership as a limited partnership wholly-owned by Air Canada. The Aeroplan loyalty program was previously a division of Air Canada. Under the Commercial Participation Services Agreement ("CPSA") between Air Canada and Aeroplan, Air Canada retained responsibility for the miles to be redeemed from accumulations of miles up to December 31, 2001. Aeroplan assumed responsibility for all miles issued beginning January 1, 2002. On December 31, 2001, there were 171 billion miles outstanding of which, after considering breakage, Management estimated that 103 billion miles would be redeemed.

With the assistance of independent actuaries, Management of Air Canada and Aeroplan re-estimated the number of miles expected to be redeemed from accumulations up to December 31, 2001. Management expects that 112 billion miles will be redeemed compared to the original estimate of 103 billion. Pursuant to the terms of the CPSA dated June 9, 2004, as amended, Management of Air Canada and Aeroplan agreed to further amend the terms of the CPSA. Effective October 13, 2006, by further amendment, Air Canada has assumed responsibility for the redemption of up to 112 billion miles and, as a result, has recorded a special charge of $102 million for the incremental 9 billion miles against operating revenues in the third quarter of 2006 and increased Aeroplan deferred revenues. This charge is referred to as the "special charge for Aeroplan miles" in this MD&A. This amendment to the CPSA represents full and final settlement between the parties in connection with Air Canada's obligations for the redemption of pre-2002 miles. Aeroplan is responsible for any redemption of miles in excess of the re-estimated 112 billion miles. The amount of the additional liability was determined by valuing the incremental miles at the current fair value.

Special Charge for Labour Restructuring

A workforce reduction plan was announced in February 2006 to reduce the number of non-unionized employees by 20 percent. As at February 14, 2007, approximately 75 percent of the planned reductions had been completed. A special charge of $28 million was recorded in the Air Canada Services segment in Quarter 1 2006 relating to this program. During Quarter 4 2006, the estimated cost of this plan was revised due to the favourable impact of attrition and other factors which reduced the cost of achieving the target. As a result, the Air Canada Services segment recorded a reduction of $8 million in Quarter 4 2006 to the special charge for labour restructuring.

The following table compares the results of the Corporation's reportable segments for the year ended December 31, 2006 to the year ended December 31, 2005. The amounts in the table below include inter-segment revenues and expenses.

	Air Canada Services				Jazz			
			Change				Change	
($ millions, except per share figures)	**2006**	**2005**	**$**	**%**	**2006**	**2005**	**$**	**%**
Operating revenues								
Passenger	$ 8,887	$ 8,197	$ 690	8	$ -	$ 2	$ (2)	(100)
Cargo	629	625	4	1	-	-	-	n/a
Other	723	687	36	5	1,381	1,021	360	35
	10,239	**9,509**	**730**	**8**	**1,381**	**1,023**	**358**	**35**
Special charge for Aeroplan miles	(102)	-	(102)	n/a	-	-	-	n/a
	10,137	**9,509**	**628**	**7**	**1,381**	**1,023**	**358**	**35**
Operating expenses								
Salaries, wages and benefits	1,816	1,857	(41)	(2)	311	265	46	17
Aircraft fuel	2,544	2,197	347	16	285	177	108	61
Aircraft rent	314	341	(27)	(8)	134	80	54	68
Airport and navigation fees	982	924	58	6	178	124	54	44
Aircraft maintenance, materials and supplies	768	693	75	11	98	68	30	44
Communications and information technology	273	294	(21)	(7)	8	5	3	60
Food, beverages and supplies	322	326	(4)	(1)	15	8	7	88
Depreciation, amortization and obsolescence	493	404	89	22	21	18	3	17
Commissions	237	253	(16)	(6)	-	-	-	n/a
Capacity purchase fees paid to Jazz	871	693	178	26	-	-	-	n/a
Special charge for labour restructuring	20	-	20	n/a	-	-	-	n/a
Other	1,383	1,336	47	4	187	149	38	26
	10,023	**9,318**	**705**	**8**	**1,237**	**894**	**343**	**38**
Operating income	**114**	**191**	**(77)**		**144**	**129**	**15**	
Non-operating income (expense)								
Interest income	82	48	34		6	1	5	
Interest expense	(313)	(270)	(43)		(8)	(16)	8	
Interest capitalized	62	14	48		(1)	-	(1)	
Gain (loss) on sale of and provisions on assets	(6)	(31)	25		-	4	(4)	
Other	(16)	15	(31)		(1)	-	(1)	
	(191)	**(224)**	**33**		**(4)**	**(11)**	**7**	
Income (loss) before the following items:	**(77)**	**(33)**	**(44)**		**140**	**118**	**22**	
Non-controlling interest	(12)	(13)	1		-	-	-	
Foreign exchange gain	12	47	(35)		-	-	-	
Recovery of (provision for) income taxes	3	(21)	24		-	-	-	
Segment income (loss)	**$ (74)**	**$ (20)**	**$ (54)**		**$ 140**	**$ 118**	**$ 22**	
EBITDAR(1)	**921**	**936**	**(15)**		**299**	**227**	**72**	
EBITDAR excluding special charges (1)	**1,043**	**936**	**107**		**299**	**227**	**72**	

(1) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss) and EBITDAR excluding special charges for Aeroplan miles and labour restructuring to operating income (loss).

8.1 Summary of Air Canada Services Segment Results

For the full year 2006, the Air Canada Services segment reported operating income of $114 million, a decrease of $77 million from the operating income of $191 million recorded in 2005. Excluding the special charges of $122 million for Aeroplan miles and labour restructuring, operating income increased $45 million over 2005. EBITDAR decreased $15 million from 2005. Excluding the special charge for Aeroplan miles and the special charge for labour restructuring, EBITDAR improved $107 million over 2005.

Passenger Revenues

System passenger revenues for 2006 increased $690 million or 8 percent, reflecting yield and traffic improvements due to stronger market demand. The system yield improvement of 3 percent in 2006 was principally due to fuel-related fare increases and increased fuel surcharges to offset higher fuel costs. A higher average business class fare was also a factor in the yield increase. The impact of the fuel-related fare increases, increased fuel surcharges and a higher business class fare was partially offset by the negative effect of a stronger Canadian dollar on international, US transborder and domestic revenues, which accounted for approximately $200 million in 2006. The August 10, 2006 terrorist threat in the United Kingdom and resultant additional security measures also had an adverse impact in 2006. For 2006, traffic grew 5 percent on a capacity increase of 4 percent over 2005 resulting in a passenger load factor improvement of 0.7 percentage points over 2005. RASM increased 4 percent compared to 2005 due primarily to the growth in system yield and partly to the improvement in passenger load factor.

The table below describes percentage changes in passenger revenues, capacity, traffic, passenger load factor, yield and RASM for 2006 to 2005.

2006 versus 2005	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	8	4	4	(0.5)	4	3
US transborder	17	12	16	2.5	1	4
Atlantic	5	2	2	0.5	2	3
Pacific	2	-	1	1.4	1	3
Other	9	1	3	1.8	6	8
System	**8**	**4**	**5**	**0.7**	**3**	**4**

Domestic passenger revenues increased $262 million or 8 percent in 2006 compared to 2005 due to traffic growth reflecting increased capacity and a 4 percent yield improvement. The suspension of Canjet's scheduled domestic operations in September 2006 also had a favourable impact on traffic. Yield increased 4 percent due to fuel-related fare increases to offset higher fuel costs. Increased demand for the higher-priced Tango Plus product was also a factor in the passenger yield growth over 2005. For 2006, domestic RASM rose 3 percent as a result of the yield improvement partly offset by a decrease of 0.5 percentage points in passenger load factor.

US transborder passenger revenues increased $268 million or 17 percent in 2006 compared to 2005 due to increased capacity, much stronger market demand and a yield improvement of 1 percent over 2005. Traffic increased 16 percent on a capacity increase of 12 percent resulting in a passenger load factor improvement of 2.5 percentage points. The growth in passenger traffic for 2006 was largely the result of increased capacity on routes to Las Vegas, San Francisco and Los Angeles and the addition of the Toronto-San Diego route in June 2006. The yield improvement over 2005 reflected fuel-related fare increases partly offset by the adverse impact of a stronger Canadian dollar and the impact of additional longer-haul flying to more key leisure destinations attracting traffic with lower average yields. For 2006, US transborder RASM increased 4 percent over 2005 as a result of the higher passenger load factor and, to a lesser extent, the yield growth.

Atlantic passenger revenues increased $83 million or 5 percent in 2006 compared to 2005 due to traffic growth and increased fuel surcharges to offset higher fuel costs. In 2006, Atlantic yield improved 2 percent over 2005. The favourable impact of increased fuel surcharges was partly offset by the adverse effect of a stronger Canadian dollar. A higher average business class fare was also a factor in the yield increase. Traffic grew 2 percent on a 2 percent capacity growth resulting in a half percentage point improvement in passenger load factor. Atlantic RASM increased 3 percent due to both the yield improvement and the higher passenger load factor. Changes to Air Canada's Atlantic network included the conversion of its service to Rome from summer to year-round service in the latter part of 2005. In addition, in September 2006, Air Canada modified its Halifax-St. John's-London route to operate non-stop between Halifax and London. In November 2006, Air Canada introduced new non-stop service between Edmonton and London. Air Canada's Atlantic service was impacted by the August 10, 2006 terrorist threat in the United Kingdom and the new security measures introduced subsequently across the entire network.

Pacific passenger revenues increased $22 million or 2 percent in 2006 compared to 2005 due to traffic growth and increased fuel surcharges to offset higher fuel costs. Yield improved 1 percent over 2005. The impact of increased fuel surcharges was largely offset by the negative effect of a stronger Canadian dollar on foreign currency denominated revenues. A higher average business class fare was also a factor in the yield increase. The traffic growth in 2006 was largely offset by the change in the India service in November 2005 from Toronto-Delhi to Toronto-Zurich-Delhi. In 2005, all revenues from the India services were reflected in the Pacific route grouping whereas in 2006 only Zurich-Delhi revenue was reflected in the Pacific route grouping. Excluding the change in the India services, traffic increased approximately 6 percent while all countries in the Pacific route grouping, with the exception of Japan, were strong. For 2006, Pacific RASM increased 3 percent over 2005 due to both the 1.4 percentage point improvement in passenger load factor and the growth in yield.

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) increased $55 million or 9 percent in 2006 compared to 2005 due to a yield improvement of 6 percent, as a result of increased fuel surcharges to offset higher fuel costs, and to an increase in traffic. Traffic grew 3 percent on a capacity increase of 1 percent resulting in a passenger load factor improvement of 1.8 percentage points over 2005. Traffic growth was primarily reflected in the Mexico and South America markets due to increased capacity and stronger market demand. For 2006, RASM increased 8 percent due to both the improvement in passenger load factor and the yield increase.

Cargo Revenues

For the year 2006, cargo revenues increased $4 million or 1 percent due to a growth in cargo traffic of 4 percent partly offset by a 3 percent decline in yield per revenue ton mile. Freighter revenues increased $28 million over 2005 mostly in the Pacific market during the first six months of 2006 where additional MD-11 freighter capacity was deployed. Effective November 2006, Air Canada reduced its freighter aircraft from three to two chartered MD-11 freighter aircraft. Shanghai operations have been reduced from five times a week to three times a week and freighter operations to Europe remain essentially unchanged.

Cargo revenues from non-freighter operations declined $24 million or 5 percent from 2005 mainly as a result of a 3 percent reduction in traffic and a 2 percent decline in yield per revenue ton mile. Of this, revenues from North American non-freighter services were down $10 million or 6 percent on reduced traffic partly offset by higher yield per revenue ton mile. International non-freighter revenues were down $14 million or 4 percent mainly as a result of lower yields. Adverse currency movements were an important factor in the yield decline.

Other Revenues

For 2006, other revenues increased $36 million or 5 percent over 2005. Increases included flight cancellation and change fees, buy-on-board revenues and other miscellaneous revenues.

Operating Expenses

Operating expenses increased $705 million or 8 percent in 2006 largely reflecting a 4 percent growth in capacity in addition to a $347 million or 16 percent increase in fuel expense.

For 2006, unit cost increased 4 percent over 2005. Excluding fuel expense and the special charge for labour restructuring, unit cost increased 1 percent over 2005.

The following table compares Air Canada Services' operating expenses per ASM for 2006 to Air Canada Services' operating expenses per ASM in 2005.

($ cents per ASM)			**Change**	
	2006	**2005**	**$**	**%**
Salary and wages	2.35	2.45	(0.10)	(4)
Benefits	0.62	0.70	(0.08)	(11)
Ownership (DAR) (1)	1.32	1.27	0.05	4
Airport and navigation fees	1.61	1.57	0.04	3
Aircraft maintenance, materials and supplies	1.26	1.18	0.08	7
Food, beverages and supplies	0.53	0.55	(0.02)	(4)
Commissions	0.39	0.43	(0.04)	(9)
Capacity purchase fees paid to Jazz	1.43	1.18	0.25	21
Other	2.70	2.78	(0.08)	(3)
Operating expense, excluding fuel expense and the special charge for labour restructuring (2)	**12.21**	**12.11**	**0.10**	**1**
Aircraft fuel	4.17	3.73	0.44	12
Special charge for labour restructuring	0.03	-	0.03	n/a
Total operating expense	**16.41**	**15.84**	**0.57**	**4**

(1) DAR refers to the combination of Aircraft rent and Depreciation, amortization and obsolescence.
(2) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for additional information.

Salaries and wages expense totaled $1,437 million in 2006, a decrease of $6 million from 2005, mainly reflecting a reduction of 2 percent or an average of 413 FTE employees.

Employee benefits expense amounted to $379 million in 2006, a decrease of $35 million or 8 percent over 2005. This decrease was largely due to a decline in post-employment benefits partly offset by higher pension expense which reflected a lower discount rate applied to pension obligations. Included in Quarter 4 2006 was a favourable adjustment of $8 million related to an updated evaluation of workers' compensation liability. Included in Quarter 4 2005 was an unfavourable adjustment of $5 million relating to an updated actuarial evaluation of workers' compensation liability.

Fuel expense increased $347 million or 16 percent in 2006, driven by high fuel prices. In 2006, an average base fuel price increase of $384 million, a volume-related increase of $100 million and an increased fuel hedging loss of $40 million were partially offset by a reduction of $177 million due to the favourable impact of a stronger Canadian dollar.

Ownership costs, comprised of aircraft rent, depreciation, amortization and obsolescence expenses, increased $62 million in 2006. Increases in ownership costs included a change in assumptions relating to the residual value of certain aircraft, the addition of 16 Embraer aircraft to Air Canada's operating fleet and increased MD-11 freighter aircraft flying in the first half of 2006. Decreases in ownership costs included the transfer of 10 CRJ-100 aircraft to Jazz, the impact of a stronger Canadian dollar on aircraft rent and the impact of aircraft returns and terminations.

Airport and navigation fees increased $58 million or 6 percent in 2006, mainly due to a 6 percent increase in aircraft departures and increased rates for landing and general terminal fees primarily at Toronto's Pearson International Airport. At Pearson, general terminal charges rose 9 percent per seat for domestic and international arrivals. These increases were partly offset by a rate reduction for navigation fees in Canada and Europe and favourable foreign exchange for international navigation fees.

Aircraft maintenance, materials and supplies increased $75 million or 11 percent in 2006 primarily due to growth in Airbus A320 aircraft maintenance costs and, to a lesser extent, in Boeing 767 aircraft maintenance costs. The Airbus A320 engines are in a work cycle that requires replacement of life limited parts as well as major inspections. Other engine maintenance increases were due to an increase in maintenance activity for Airbus A340 aircraft and overall engine price increases. These increases were partially offset by reduced Boeing 767 engine maintenance activity. An addition to maintenance reserves required to satisfy minimum return conditions on short-term leases and future return to lessor expenses were also factors in the increase over 2005.

Food, beverage and supplies expense decreased $4 million or 1 per cent versus 2005 on a passenger traffic increase of 5 per cent. The volume-related increase was more than offset by cost reduction initiatives and the impact of new catering programs, including the buy-on-board program.

Commission expense decreased $16 million or 6 percent in 2006 on combined passenger and cargo revenue growth in 2006 of 8 percent. The decrease in commission expense was largely due to the impact of a change in the base commission structure together with other commercial initiatives to reduce commission expense which more than offset the volume-related increase. Commissions, as a percent of passenger and cargo revenues, declined from 2.9 percent in 2005 to 2.5 percent in 2006. Approximately 61 percent of domestic bookings were via the web in December 2006, up approximately 11 percentage points from the same month last year.

For 2006, capacity fees paid to Jazz, pursuant to the Jazz CPA, amounted to $871 million compared to $693 million in 2005, pursuant to the Initial Jazz CPA. The increase of 26 percent was mainly driven by a growth of 12 covered aircraft in Jazz's operating fleet, resulting in a 27 percent increase in block hours over 2005. ASM capacity for flights operated by Jazz increased 51 percent over 2005.

For 2006, other expenses increased $47 million over 2005. Increases included credit card fees, consulting and advisory fees, advertising and promotion expenses, building rent and crew cycle expenses.

Non-operating expense amounted to $191 million for 2006 compared to non-operating expense of $224 million for 2005. For 2006, net interest expense decreased $39 million from 2005. The increase in interest expense, largely driven by the financing of additional aircraft, was more than offset by capitalized interest relating to the acquisition of the Boeing 777 and 787 aircraft and growth in interest income due to higher cash balances and higher average interest rates. In 2006, loss on sale and provision on assets of $6 million was recorded. The Air Canada Services segment recorded an impairment loss of $7 million on one of its buildings in Quarter 4 2006 and a gain on sale of assets of $5 million on one of its commercial real estate properties in Quarter 3 2006. In 2005, loss on sale and provision on assets amounted to $31 million of which approximately half related to the write-down of Boeing 747 inventory.

For 2006, gains from the revaluation of foreign currency monetary items amounted to $12 million, attributable to a stronger Canadian dollar at December 31, 2006 compared to December 31, 2005. This compared to foreign exchange gains of $47 million recorded in 2005.

Segment loss of $74 million was recorded in 2006 compared to a segment loss of $20 million in 2005, a deterioration of $54 million, for the reasons disclosed above.

8.2 Summary of Jazz Segment Results

For 2006, operating income amounted to $144 million, pursuant to the Jazz CPA, compared to operating income of $129 million in 2005, pursuant to the Initial Jazz CPA. EBITDAR for 2006 improved $72 million over 2005. The increase in operating income and EBITDAR in 2006 was mainly due to a growth in fleet size consistent with Jazz's plan to increase its relative share of the North American ASM capacity, an increase in hours of contract flying under the Jazz CPA, as well as cost control.

The Jazz CPA came into effect on January 1, 2006. The major changes from the Initial Jazz CPA include: a longer term, a larger number of Covered Aircraft with a guaranteed minimum of 133 aircraft throughout the term, and Jazz expenses now reimbursed by Air Canada at a higher mark-up for controllable costs, and on an at-cost basis by Air Canada for other expenses.

Operating revenues for 2006 increased $358 million or 35 percent over 2005. The significant increase in revenues was due to a net addition of 14 aircraft operated by Jazz resulting in a 27 percent increase in block hours flown over 2005 as well as higher pass-though costs charged to Air Canada under the Jazz CPA.

Operating expenses increased $343 million or 38 percent over 2005 and included an increase in pass-through costs of $177 million or 55 percent, driven largely by a capacity increase of 51 percent. Unit cost for 2006 decreased 12 percent compared to 2005, in part due to an increase in long-haul flying which generally results in lower unit costs per ASM. Excluding fuel expense, unit cost for 2006 was down 10 percent. Unit cost reductions were achieved in all expense categories with the exception of fuel expense and aircraft rent. The unit aircraft rental cost increase mainly reflected six CRJ-200 aircraft deliveries and the transfer of 10 CRJ-100 aircraft from Air Canada partly offset by a termination of two Dash 8 aircraft operating leases.

Segment income of $140 million was recorded in 2006 compared to segment income of $118 million in 2005.

8.3 Summary of Consolidated Results

The Corporation, as defined under "Basis of Presentation", recorded operating income of $259 million, a decrease of $59 million from the operating income of $318 million recorded in 2005. Excluding special charges of $122 million for Aeroplan miles and labour restructuring, operating income increased $63 million over 2005.

Gains from the revaluation of foreign currency monetary items amounted to $12 million in 2006 attributable to a stronger Canadian dollar at December 31, 2006 compared to December 31, 2005. This compared to gains of $47 million in 2005.

Net loss in 2006 amounted to $74 million or $0.83 per diluted share compared to a net loss of $20 million or $0.25 per diluted share in 2005. The 2006 net loss included special charges of $122 million ($83 million after tax).

Unit cost, as measured by operating expense per ASM, increased 3 percent in 2006 compared to 2005. For 2006, excluding fuel expense and the special charge for labour restructuring, unit cost was essentially unchanged from 2005.

9. FINANCIAL AND CAPITAL MANAGEMENT

9.1 Financial Position

The Corporation's combined consolidated statement of financial position includes the accounts of certain entities which are not legally controlled by Air Canada, including Jazz and certain aircraft and engine leasing entities and fuel facility corporations. While the assets and liabilities of these entities are included in Air Canada's combined consolidated financial statements, there is no recourse to Air Canada for the liabilities of the separate legal entities except to the extent of any existing obligations under agreements such as the Jazz CPA or guarantees. The information in the discussion of financial position has been presented on a consolidated basis. Creditors of Jazz have no recourse to Air Canada with respect to Jazz's recognized liabilities.

Consolidated Summary

As at December 31, 2006, current assets have increased $1,811 million since December 31, 2005, largely due to an increase in cash, cash equivalents and short-term investments of $909 million, reflecting in part the net proceeds from the Air Canada IPO of $187 million and the proceeds of $1,156 million from the transfer of investments to ACE as further described in Note 1 to Air Canada's combined consolidated financial statements. Current assets also include a future income tax asset of $345 million arising from a tax loss utilization strategy, offset by a tax payable of $345 million, and a prepaid maintenance asset of $535 million with ACTS LP ("ACTS"), both of which were related to the Air Canada IPO. Property and equipment increased $495 million mainly due to additions, primarily aircraft, offset by depreciation. Intangible assets decreased $617 million mainly due to the reversal by ACE of future income tax valuation allowance which results in a pro-rata reduction to Air Canada's intangible asset. Refer to Note 8 to Air Canada's combined consolidated financial statements for additional information.

As at December 31, 2006, current liabilities have increased $1,187 million, largely reflecting an increase in current portion of long-term debt and current taxes payable of $345 million relating to the Air Canada IPO.

Long-term debt and capital lease obligations increased $200 million and included the impact of certain financing activities, as described under "Financial and Capital Management — Liquidity and Working Capital" in this MD&A, as well as the favourable impact of a stronger Canadian dollar on US dollar debt and capital leases.

Prior to the completion of the Air Canada IPO, it was determined that a portion of valuation allowance recorded by ACE should be reversed as it was more likely than not that certain future income tax assets of $504 million, which a valuation allowance had been recorded against at the time of fresh start reporting, would be realized. Consistent with the income tax accounting policy of Air Canada while it was wholly-owned by ACE, the reversal of the valuation allowance by ACE results in a reduction of Air Canada's intangible assets (on a pro-rata basis) of $374 million.

Refer to section 9.6 of this MD&A for the Corporation's projected planned and committed capital expenditures and for the impact these expenditures will have on property and equipment and long-term debt in the future.

The following provides an overview of the financial position of the Corporation as defined under “Basis of Presentation” and its two reportable segments for the periods indicated.

($ millions)	**December 31, 2006**				**December 31, 2005**			
	Air Canada Services	**Jazz**	**Inter-segment elimination**	**Consolidated total**	**Air Canada Services**	**Jazz**	**Inter-segment elimination**	**Consolidated total**
ASSETS								
Current								
Cash and cash equivalents	$ 1,312	$ 135	$ -	$ 1,447	$ 1,000	$ 34	$ -	$ 1,034
Short-term investments	798	-	-	798	302	-	-	302
	2,110	**135**	**-**	**2,245**	**1,302**	**34**	**-**	**1,336**
Restricted cash	109	-	-	109	86	-	-	86
Accounts receivable	739	71	(122)	688	699	198	(237)	660
Spare parts, materials and supplies	119	29	-	148	154	25	-	179
Prepaid expenses and other current assets	115	9	-	124	115	7	-	122
Prepaid maintenance to ACTS	535	-	-	535	-	-	-	-
Future income tax	345	-	-	345	-	-	-	-
	4,072	**244**	**(122)**	**4,194**	**2,356**	**264**	**(237)**	**2,383**
Property and equipment	5,747	199	-	5,946	5,257	194	-	5,451
Deferred charges	73	30	-	103	94	33	-	127
Intangible assets	1,185	9	-	1,194	1,799	10	2	1,811
Deposits and other assets	311	1	-	312	489	3	(2)	490
	11,388	**483**	**(122)**	**11,749**	**9,995**	**504**	**(237)**	**10,262**
LIABILITIES								
Current								
Accounts payable and accrued liabilities	1,430	213	(122)	1,521	1,476	172	(237)	1,411
Advance ticket sales	1,019	-	-	1,019	893	-	-	893
Aeroplan Miles obligation	58	-	-	58	89	-	-	89
Current portion of long-term debt and capital leases	367	-	-	367	262	3	-	265
Note payable to ACTS	535	-	-	535	-	-	-	-
Current taxes payable	345	-	-	345	-	-	-	-
	3,754	**213**	**(122)**	**3,845**	**2,720**	**175**	**(237)**	**2,658**
Long-term debt and capital leases	3,081	115	-	3,196	2,786	210	-	2,996
Notes payable to ACE subsidiary	-	-	-	-	340	-	-	340
Future income taxes	134	-	-	134	217	-	-	217
Pension and other benefit liabilities	1,867	9	-	1,876	2,147	7	-	2,154
Other long-term liabilities	410	62	-	472	437	59	-	496
Preferred shares	-	-	-	-	50	-	-	50
	9,246	**399**	**(122)**	**9,523**	**8,697**	**451**	**(237)**	**8,911**
NON-CONTROLLING INTEREST	**212**	**-**	**162**	**374**	**203**	**-**	**130**	**333**
SEGMENT EQUITY	**1,930**	**84**	**(162)**	**1,852**	**1,095**	**53**	**(130)**	**1,018**
	$ 11,388	**$ 483**	**$ (122)**	**$ 11,749**	**$ 9,995**	**$ 504**	**$ (237)**	**$ 10,262**

9.2 Liquidity and Working Capital

Air Canada Services

At December 31, 2006, Air Canada Services had cash, cash equivalents and short-term investments of $2,110 million and positive working capital of $318 million. Compared to December 31, 2005, cash, cash equivalents and short-term investments have increased $808 million mainly due net proceeds of $187 million and a transfer of Air Canada's investment to ACE of $1,156 million ($673 million related to the transfer of ACTS to ACE and $483 million related to the transfer of Jazz to ACE).

The introduction of Air Canada's innovative customer driven revenue model in conjunction with a redesigned network and a renewed fleet is expected to generate increased revenue and improved cost efficiencies going forward. This, in turn, is expected to improve cash generated from operations which will in part be used to fund capital expenditures as well as to pay down debt incurred to finance a large portion of the capital expenditures. The Corporation continues to closely monitor its liquidity requirements and is assessing various financing transactions and initiatives with the objective of ensuring its future liquidity needs are addressed. At December 31, 2006, Air Canada Services had an unused secured syndicated revolving credit facility of $400 million on which no amounts have been drawn.

Jazz

At December 31, 2006, Jazz had cash and cash equivalents of $135 million and positive working capital of $31 million. Compared to December 31, 2005, cash and cash equivalents have increased $101 million while working capital has decreased $58 million.

Consolidated Summary

At December 31, 2006, the Corporation had cash, cash equivalents and short-term investments of $2,245 million and positive working capital of $349 million. Compared to December 31, 2005, cash, cash equivalents and short-term investments have increased $909 million and working capital has improved $624 million.

9.3 Cash flows for Quarter 4 2006 and Quarter 4 2005

The following table provides an overview of the cash flows of the Corporation as defined under “Basis of Presentation” and its two reportable segments for the periods indicated:

($ millions)	Three months ended December 31, 2006				Three months ended December 31, 2005			
	Air Canada Services	Jazz	Inter-segment elimination	Consolidated total	Air Canada Services	Jazz	Inter-segment elimination	Consolidated total
Cash from (used for) operating activities								
Income (loss) for the period	$ (144)	$ 32	$ (32)	**$ (144)**	$ (136)	$ 32	$ (32)	**$ (136)**
Adjustments to reconcile to net cash provided by operations								
Depreciation, amortization and obsolescence	135	6	-	**141**	106	4	-	**110**
(Gain) loss on sale of assets	10	-	-	**10**	30	(1)	-	**29**
Foreign exchange (gain) loss	134	-	-	**134**	11	-	-	**11**
Future income taxes	(23)	-	-	**(23)**	(57)	-	-	**(57)**
Employee future benefit funding more than expense	(98)	-	-	**(98)**	(26)	-	-	**(26)**
Decrease (increase) in accounts receivable	93	7	3	**103**	271	(32)	23	**262**
Decrease (increase) in spare parts, materials and supplies	(27)	(3)	-	**(30)**	(70)	(2)	-	**(72)**
Increase (decrease) in accounts payable and accrued liabilities	(131)	(12)	(3)	**(146)**	74	39	(24)	**89**
Increase (decrease) in advance ticket sales, net of restricted cash	(32)	-	-	**(32)**	(164)	-	-	**(164)**
Increase (decrease) in Aeroplan miles obligation	(25)	-	-	**(25)**	(40)	-	-	**(40)**
Non-controlling Interest	-	-	36	**36**	-	-	35	**35**
Allocation of corporate expenses	2	-	-	**2**	2	-	-	**2**
Aircraft lease payments (in excess of) less than rent expense	(3)	-	-	**(3)**	9	30	-	**39**
Other	(50)	3	(4)	**(51)**	(58)	3	(2)	**(57)**
	(159)	**33**	**-**	**(126)**	**(48)**	**73**	**-**	**25**
Cash from (used for) financing activities								
Issue by Air Canada of share capital	187	-	-	**187**	-	-	-	**-**
Transfer of ACTS investments to ACE	673	-	-	**673**	20	-	-	**20**
Transfer of Jazz investments to ACE	83	-	-	**83**				
Aircraft-related borrowings	76	-	-	**76**	191	-	-	**191**
Cash management with related parties	-	-	-	**-**	(50)	-	-	**(50)**
Distributions paid to non-controlling interest	-	(15)	-	**(15)**	-	-	-	**-**
Settlement of notes payable to ACE	(140)	-	-	**(140)**	-	-	-	**-**
Reduction of long-term debt and capital lease obligations	(71)	-	-	**(71)**	(60)	-	-	**(60)**
Other	-	-	-	**-**	-	(1)	-	**(1)**
	808	**(15)**	**-**	**793**	**101**	**(1)**	**-**	**100**
Cash from (used for) investing activities								
Short-term investments	(383)	-	-	**(383)**	921	-	-	**921**
Additions to capital assets	(206)	(7)	-	**(213)**	(465)	(2)	-	**(467)**
Reduction of note receivable from ACE	186	-	-	**186**	-	-	-	**-**
Proceeds from sale of assets	-	-	-	**-**	-	1	-	**1**
Decrease (increase) in amount receivable from Air Canada	-	-	-	**-**	42	(42)	-	**-**
Cash management with related parties	40	-	-	**40**	(43)	-	-	**(43)**
Cash collateralization of letters of credit	18	-	-	**18**	-	-	-	**-**
Other	2	-	-	**2**	5	(5)	-	**-**
	(343)	**(7)**	**-**	**(350)**	**460**	**(48)**	**-**	**412**
Increase (decrease) in cash and cash equivalents	306	11	-	317	513	24	-	537
Cash and cash equivalents, end of period	**$ 1,312**	**$ 135**	**-**	**$ 1,447**	**$ 1,000**	**$ 34**		**$ 1,034**

As described in Note 1 to Air Canada's combined consolidated financial statements, inter-company accounts between ACE and Air Canada were settled at the time of the Air Canada IPO which resulted in an increase to cash and cash equivalents of $170 million, a reduction to deposits and other assets of $269 million (consisting of an advance of $186 million and a note receivable on the transfer of the Jazz investment of $83 million), a reduction to accounts receivable of $41 million and a reduction of long-term debt of $140 million. These cash flows are included in the applicable section of the cash flows, as described further below.

Cash Flows from Operating Activities

In Quarter 4, cash flows used from operations were $159 million, a deterioration of $111 million over Quarter 4 2005, primarily as a result of unfavourable variances in working capital items affecting cash, as well as an increase in pension plan funding of $72 million over Quarter 4 2005. The variances in working capital items relate mainly to timing differences in the settlement of amounts related to normal operating activities.

The Jazz segment delivered cash flows from operations of $33 million in Quarter 4 2006, which was generated in large part by Jazz's positive operating results under the Jazz CPA with Air Canada offset by cash costs incurred.

Cash Flows from Financing Activities

Cash flows from financing activities included net proceeds of $187 million, a transfer of Air Canada's investment to ACE of $756 million ($673 million related to the transfer of ACTS to ACE and $83 million relating to the settlement of a note receivable from ACE on the transfer of Air Canada's investment in Jazz) and a settlement of notes payable to ACE of $140 million, all of which were in conjunction with the Air Canada IPO.

Aircraft-related borrowings for the Air Canada Services segment amounted to $76 million in Quarter 4 2006 and related mainly to the delivery of three Embraer aircraft in Quarter 4 2006. Scheduled and other debt and capital lease payments in Quarter 4 2006 amounted to $71 million.

Cash used for financing activities for the Jazz segment amounted to $15 million in Quarter 4 2006 and related to distributions paid to non-controlling interest.

Cash Flows used for Investing Activities

For Quarter 4 2006, additions to capital assets totaled $206 million for the Air Canada Services segment. These additions included $89 million related to three Embraer aircraft and $50 million to the aircraft interior refurbishment program and to the installation of an in-flight entertainment system on Jazz Bombardier CRJ-705 aircraft. Other additions to capital assets related to inventory and spare engines, systems development projects as well as ground equipment and facilities. In addition, Air Canada Services received $186 million from ACE related to the settlement of notes receivable in connection with the Air Canada IPO.

Cash used for investing activities for the Jazz segment amounted to $7 million in Quarter 4 2006, primarily related to aircraft improvements and to the purchase of two Dash 8-300 aircraft.

9.4 Cash flows for 2006 and 2005

The following table provides an overview of the cash flows of the Corporation as defined under "Basis of Presentation" and its two reportable segments for the periods indicated:

($ millions)	Year ended December 31, 2006				Year ended December 31, 2005			
	Air Canada Services	Jazz	Inter-segment elimination	Consolidated total	Air Canada Services	Jazz	Inter-segment elimination	Consolidated total
Cash from (used for) operating activities								
Income (loss) for the period	$ (74)	$ 140	$ (140)	**$ (74)**	$ (20)	$ 117	$ (117)	**$ (20)**
Adjustments to reconcile to net cash provided by operations								
Depreciation, amortization and obsolescence	493	21	-	**514**	404	18	-	**422**
(Gain) loss on sale of assets	6	-	-	**6**	31	(4)	-	**27**
Foreign exchange (gain) loss	6	-	-	**6**	(83)	-	-	**(83)**
Future income taxes	(3)	-	-	**(3)**	11	-	-	**11**
Employee future benefit funding more than expense	(228)	-	-	**(228)**	(74)	-	-	**(74)**
Decrease (increase) in accounts receivable	(81)	124	(115)	**(72)**	176	(146)	157	**187**
Decrease (increase) in spare parts, materials and supplies	35	(4)	-	**31**	(51)	(13)	-	**(64)**
Increase (decrease) in accounts payable and accrued liabilities	30	(125)	115	**20**	(218)	215	(157)	**(160)**
Increase (decrease) in advance ticket sales, net of restricted cash	103	-	-	**103**	183	-	-	**183**
Increase (decrease) in Aeroplan miles obligation	(108)	-	-	**(108)**	(146)	-	-	**(146)**
Non-controlling Interest	-	-	152	**152**	-	-	131	**131**
Special charge for Aeroplan miles	102	-	-	**102**	-	-	-	**-**
Allocation of corporate expenses	11	-	-	**11**	21	-	-	**21**
Aircraft lease payments (in excess of) less than rent expense	(16)	-	-	**(16)**	21	12	-	**33**
Other	(65)	26	(12)	**(51)**	(59)	(7)	(14)	**(80)**
	211	**182**	**-**	**393**	**196**	**192**	**-**	**388**
Cash from (used for) financing activities								
Issue by Air Canada of share capital	187	-	-	**187**	-	-	-	**-**
Issue of Jazz units	-	218	-	**218**	-	-	-	**-**
Transfer of ACTS investments to ACE	673	-	-	**673**	-	-	-	**-**
Transfer of Jazz investments to ACE	483		-	**483**	-	-	-	**-**
Transfer of Aeroplan investments to ACE	-	-	-	**-**	1,070			**1,070**
Acquisition promissory note paid by Jazz to ACE	-	(424)	-	**(424)**	-	-	-	**-**
Jazz credit facility borrowings	-	113	-	**113**	-	-	-	**-**
Aircraft-related borrowings	397	-	-	**397**	404	-	-	**404**
Cash management with related parties	-	-	-	**-**	(4)	-	-	**(4)**
Distributions paid to non-controlling interest	-	(86)	-	**(86)**	-	-	-	**-**
Settlement of notes payable to ACE	(140)	-	-	**(140)**	-	-	-	**-**
Reduction of long-term debt and capital lease obligations	(264)	(14)	-	**(278)**	(351)	(3)	-	**(354)**
Increase (decrease) in Air Canada indebtedness	-	-	-	**-**	5	(5)	-	**-**
Other	(1)	-	-	**(1)**	(5)	(1)	-	**(6)**
	1,335	**(193)**	**-**	**1,142**	**1,119**	**(9)**	**-**	**1,110**
Cash from (used for) investing activities								
Short-term investments	(496)	-	-	**(496)**	(250)	-	-	**(250)**
Additions to capital assets	(863)	(25)	-	**(888)**	(852)	(16)	-	**(868)**
Reduction of note receivable from ACE	186	-	-	**186**	-	-	-	**-**
Proceeds from sale of assets	40	-	-	**40**	37	4	-	**41**
Decrease (increase) in amount receivable from Air Canada	(137)	137	-	**-**	137	(137)	-	**-**
Cash management with related parties	32	-	-	**32**	(59)	-	-	**(59)**
Cash collateralization of letters of credit	4	-	-	**4**	(35)	-	-	**(35)**
	(1,234)	**112**	**-**	**(1,122)**	**(1,022)**	**(149)**	**-**	**(1,171)**
Increase (decrease) in cash and cash equivalents	312	101	-	413	293	34	-	327
Cash and cash equivalents, end of period	**$ 1,312**	**$ 135**	**-**	**$ 1,447**	**$ 1,000**	**$ 34**	**-**	**$ 1,034**

Cash Flows from Operating Activities

For 2006, cash flows from operations for the Air Canada Services segment were $211 million, an increase of $15 million over 2005, primarily due to improved operating results partly offset by increased pension plan funding. Pension funding amounted to $447 million in 2006 versus $278 million in 2005.

The Jazz segment delivered positive cash flows from operations of $182 million in 2006, which was generated in large part by Jazz's positive operating results under the Jazz CPA with Air Canada offset by cash costs incurred.

Cash Flows from Financing Activities

Cash flows from financing activities included net proceeds of $187 million related to the issue of Air Canada shares, a transfer of Air Canada's investments to ACE of $1,156 million ($673 million related to the transfer of ACTS to ACE, $483 million related to the transfer of Air Canada's investment in Jazz) and a settlement of notes payable to ACE of $140 million.

Aircraft-related borrowings for the Air Canada Services segment amounted to $397 million in 2006 and related mainly to the delivery of 16 Embraer aircraft in 2006. Scheduled and other debt and capital lease payments in 2006 amounted to $264 million.

Cash used for financing activities for the Jazz segment amounted to $193 million in 2006. Net proceeds to Jazz from the issuance of Jazz units were $218 million. Also in connection with the offering, Jazz arranged for senior secured syndicated credit facility in the amount of $150 million. Jazz received proceeds of $115 million ($113 million, net of fees of $2 million), representing the drawing under this new credit facility. In connection with the initial public offering, Jazz Air Limited Partnership transferred substantially all of its assets and liabilities to the new Jazz Air LP that was wholly-owned by ACE. In consideration, ACE received 99,365,143 units of the partnership and an acquisition promissory note of $424 million. The acquisition promissory note was repaid to ACE from proceeds received from the offering, from the new term credit facility and from working capital.

Other cash used for financing activities for the Jazz segment mainly related to distributions paid to non-controlling interests which amounted to $86 million in 2006.

Cash Flows used for Investing Activities

For 2006, Air Canada Services additions to capital assets totaled $863 million. These additions included $481 million related to 16 Embraer aircraft and $148 million related to the aircraft interior refurbishment program and to the installation of an in-flight entertainment system on Jazz Bombardier CRJ-705 aircraft. In addition, pre-delivery payments made on Boeing aircraft amounted to $44 million. Other additions to capital assets related to inventory and spare engines, systems development projects as well as ground equipment and facilities. In addition, Air Canada Services received $186 million from ACE related to the settlement of notes receivable in connection with the Air Canada IPO.

In 2006, additions to capital assets for the Jazz segment amounted to $25 million and were primarily related to aircraft improvements and to the purchase of two Dash 8-300 aircraft.

9.5 Debt and Lease Obligations

The debt and lease obligations reported in Air Canada's combined consolidated statement of financial position includes debt incurred by Air Canada, its subsidiaries, including those consolidated under Accounting Guideline of the CICA Handbook, Consolidation of Variable Interest Entities ("AcG-15:), and other entities which have been combined in Air Canada's combined consolidated financial statements. Entities consolidated under AcG-15 include Jazz and certain engine leasing entities and fuel facilities corporations.

Summary of Principal Repayment and Future Minimum Lease Payment Requirements as at December 31, 2006

The table below summarizes the principal repayment requirements as at December 31, 2006 for the years 2007 through to 2011 and thereafter on long-term debt and capital lease obligations.

	2007	2008	2009	2010	2011	Thereafter
($ millions)						
Long-term debt principal obligations	67	85	70	55	70	710
Debt consolidated under AcG-15[(1)]	120	117	60	118	248	447
Capital lease principal obligations	180	179	92	90	87	653
Air Canada Services	367	381	222	263	405	1,810
Jazz — Long-term debt obligations	-	-	115	-	-	-
Consolidated total	367	381	337	263	405	1,810

(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. In 2008, amounts due of approximately US$51 million relate to end of lease obligations. In 2010, amounts due of approximately US$54 million relate to end of lease obligations. In 2011, amounts due of approximately US$183 million relate to end of lease obligations. 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.

The table below summarizes the future minimum lease payments for the years 2007 through to 2011 and thereafter under existing operating leases as at December 31, 2006.

($ millions)	2007	2008	2009	2010	2011	Thereafter
Air Canada Services						
Aircraft operating leases[(1)]	403	334	304	269	200	1,072
Other property	53	46	32	27	24	140
Total Air Canada Services	456	380	336	296	224	1,212
Jazz						
Aircraft operating leases	3	1	1	1	-	-
Other property	13	12	11	7	1	3
Total Jazz	16	13	12	8	1	3
Consolidated total	472	393	348	304	225	1,215

(1) Includes aircraft leased and subleased to Jazz.

9.6 Capital Expenditures

In 2004, Air Canada signed definitive purchase agreements with Embraer - Empresa Brasileira de Aeronautica S.A. ("Embraer") for the acquisition of regional jet aircraft. In November 2005, Air Canada also concluded agreements with The Boeing Company ("Boeing") for the acquisition of Boeing 777 and Boeing 787 aircraft.

Embraer

The agreement with Embraer covers firm orders for 15 Embraer 175 series aircraft as well as 45 Embraer 190 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. As at December 31, 2006, 49 options remain exercisable.

Deliveries of the 15 Embraer 175 series aircraft commenced in July 2005 and the last aircraft was delivered in January 2006. All Embraer ERJ-175 deliveries were 80 percent financed by a third party as described in Note 7 to Air Canada's combined consolidated financial statements.

The Embraer 190 series deliveries commenced in December 2005. As at December 31, 2006, 18 of the Embraer 190 series firm aircraft orders have been completed and the remaining 27 deliveries were planned to be completed by November 2007 in accordance with the purchase agreement. Certain aircraft deliveries, which were planned to be completed by November 2007, have been delayed with the last delivery expected by January 2008. The impact of these delays has been reflected in the projected planned and committed capital expenditures table below. These projections are based on estimates using information currently available and are subject to change.

For the first 18 firm Embraer 190 deliveries, all of which have been delivered, Air Canada received loans from a syndicate of banks and the manufacturer covering 80 percent of the capital expenditure as described in Note 7 to Air Canada's combined consolidated financial statements.

Air Canada has also received loan commitments from a third party for an additional 18 firm Embraer 190 series aircraft covering approximately 80 percent of the capital expenditure to be repaid in quarterly installments for a 12-year term. Financing for a maximum of five of these aircraft may be based on fixed rates while the remaining 13 aircraft will be based on floating rates. The borrowings bear interest at the 90-day USD LIBOR rate plus a margin of 1.90 percent or, as appropriate, the fixed rate equivalent.

Air Canada also received loan commitments from a syndicate of banks for the remaining nine Embraer 190 series firm aircraft to cover approximately 80 percent of the capital expenditure and to be repaid in quarterly installments for a 12-year term. The borrowings bear interest either at the 90-day USD LIBOR rate plus a margin of 1.70 percent or the fixed rate equivalent.

Boeing

In November 2005, Air Canada concluded agreements with Boeing for the acquisition of up to 36 Boeing 777 aircraft and up to 60 Boeing 787 aircraft.

The order for the 36 Boeing 777 aircraft is comprised of firm orders for 18 aircraft plus purchase rights for 18 more, in a yet-to-be determined mix of the 777 family's newest models. As of December 31, 2006, Air Canada has confirmed with Boeing the delivery of eight Boeing 777-300ER aircraft and six Boeing 777-200LR aircraft. The models of the remaining four firm Boeing 777 aircraft are yet to be determined. Delivery of the first Boeing 777 aircraft is scheduled for March 2007.

The order for the 60 Boeing 787 aircraft is comprised of firm orders for 14 aircraft plus options and purchase rights for an additional 46 aircraft. Air Canada's first Boeing 787 aircraft is scheduled for delivery in 2010.

Air Canada has received financing commitments from Boeing and the engine manufacturer for all firm aircraft orders covering up to 90 percent of the capital expenditure. This available financing would be at an interest rate of 9.86 percent, based on interest rates as at December 31, 2006. The term to maturity would be 15 years with principal payments made on a mortgage style basis resulting in equal installment payments of principal and interest over the term to maturity. On November 3, 2006, Air Canada made an application for loan guarantee support from the Export-Import Bank of the United States for the first seven Boeing 777 aircraft deliveries in 2007. The loan guarantee, if provided, would cover a 12-year loan term for 85 percent of the capital expenditure at an interest rate of approximately 5.36 percent, based on interest rates as at December 31, 2006.

Air Canada has signed a 10-year lease agreement for one Boeing 777-300ER from International Lease Finance Corporation ("ILFC"), which is scheduled to be delivered in May 2007.

Refurbishment of Existing Aircraft

In addition to acquiring new aircraft, Air Canada commenced a major refurbishment of the interior of its existing aircraft in April 2006. Air Canada has completed the refurbishment of its 16th Airbus A320 and its fourth Boeing 767-300 aircraft. The refurbishment for the Airbus A319, A321 and A330 aircraft is expected to begin in early 2007. The Embraer and Boeing 777 aircraft are being delivered with the new seats and entertainment systems already installed. The aircraft refurbishment program is scheduled to be completed by mid-2008. The capital expenditure associated with this program will be amortized over a five-year period.

Projected Planned and Committed 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 2007 through to 2011.

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

Air Canada Services Projected planned and committed capital expenditures (1)(2)(3)	**2007**	**2008**	**2009**	**2010**	**2011**
Projected committed expenditures	2,144	1,458	448	933	868
Projected planned but uncommitted expenditures	246	293	158	148	154
Total projected expenditures	2,390	1,751	606	1,081	1,022
Projected financing on committed expenditures	(1,533)	(1,293)	(302)	(834)	(732)
Total projected expenditures, net of financing	857	458	304	247	290

Jazz Projected planned and committed capital expenditures(1)(2)	**2007**	**2008**	**2009**	**2010**	**2011**
Projected committed expenditures	7	-	-	-	-
Projected planned but uncommitted expenditures	20	28	23	23	23
Total projected expenditures	27	28	23	23	23

(1) US dollar amounts are converted using the December 31, 2006 noon day rate of $1.1653. Final aircraft delivery prices include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day USD LIBOR rate at December 31, 2006.

(2) The dollar amounts reflected above do not include obligations pertaining to day-to-day operations.

(3) The projected financing amounts include loan commitments obtained as at December 31, 2006.

Projected Cash Payments for Committed Aircraft Deliveries

The following table provides Air Canada Services' cash principal payments for the future firm aircraft deliveries for the years 2007 through to 2011. Jazz has no projected principal repayments relating to new deliveries in these years.

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)	2007	2008	2009	2010	2011
Principal repayment on aircraft-related long-term debt(1)(2)	25	94	132	156	201

(1) US dollar amounts are converted using the December 31, 2006 noon day rate of $1.1653. Final aircraft delivery prices include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day USD LIBOR rate at December 31, 2006.

(2) The projected principal repayment amounts reflect certain loan commitments received and Management's best estimate as to market terms available.

9.7 Pension Plan Cash Funding Obligations

As at December 31, 2006 and based on the January 1, 2006 solvency valuations, the table below provides projections for the Corporation's cash pension plan funding obligations for the years 2007 through to 2011. The final funding obligation for 2007 will be determined based on the January 1, 2007 valuation.

($ millions)	2007	2008	2009	2010	2011
Past service costs for domestic registered plans	248	242	245	246	246
Current service costs for domestic registered plans	155	160	165	170	175
Other pension arrangements(1)	86	86	65	69	74
Air Canada Services	489	488	475	485	495
Jazz	9	9	9	9	7
Consolidated total	498	497	484	494	502

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

The above pension funding requirements are in respect of all the Corporation's pension arrangements. The most recent actuarial valuation is as at January 1, 2006 and the effective date of the next required actuarial valuation is January 1, 2007. For domestic registered pension plans, the funding requirements are based on the minimum past service contributions disclosed in the January 1, 2006 valuations plus a projection of the current service contributions based upon the January 1, 2006 actuarial valuation. The required contributions disclosed above do not reflect actual experience of 2006 and assume no future gains or 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.

The Corporation maintains several benefit and defined contribution plans providing pension, other retirement and post-employee benefits to its employees, including those employees of the Corporation who are contractually assigned to ACTS and Aeroplan. Air Canada's combined consolidated financial statements include all of the assets and liabilities of all the Corporation sponsored plans. Employee benefits expense reflects a cost recovery which is charged to the related parties for those employees currently performing work for their benefit.

The deficit, on an accounting basis, at December 31, 2006 for pension benefits was $1.4 billion compared to $2.5 billion at December 31, 2005. The decrease in the accounting deficit was mainly the result of a return on plan assets of approximately 13.8 percent during 2006 and funding of past service contributions of $261 million. The solvency deficit on the registered pension plans at January 1, 2007 is also expected to decrease significantly compared to January 1, 2006 and, as a result, employer contributions determined in accordance with regulations are expected to decline by $90 million in 2007 and $120 million each year thereafter.

9.8 Share Information

An aggregate of 100 million Class A variable voting shares and Class B voting shares in the capital of Air Canada are issued and outstanding. On November 24, 2006, Air Canada sold an aggregate of 9,523,810 Class A variable voting shares and Class B voting shares at $21 per share for net proceeds of $187 million. The transaction was part of Air Canada's IPO which included a secondary offering whereby ACE sold an aggregate of 15,476,190 Class A variable voting shares and Class B voting shares also at $21 per share for gross proceeds of $325 million.

The authorized share capital of Air Canada consists of an unlimited number of Class A variable voting shares and an unlimited number of Class B voting shares. The Class A variable voting shares may only be held, beneficially owned or controlled, directly or indirectly, by persons who are not Canadians, as such term is defined in the Canada Transportation Act ("Qualified Canadians"). The Class B voting shares may only be held, beneficially owned and controlled, directly or indirectly, by Qualified Canadians. The two classes of shares have equivalent rights except for voting rights. Holders of Class A variable voting shares are entitled to one vote per share unless (i) the aggregate number of Class A variable voting shares outstanding, as a percentage of the total number of votes attaching to all issued and outstanding voting shares of Air Canada exceeds 25 percent, or (ii) the total number of votes cast by or on behalf of holders of Class A variable voting shares at any meeting exceeds 25 percent of the total number of votes that may be cast at such meeting. If the 25 percent threshold would be surpassed at any time, the votes attaching to the Class A variable voting shares would be proportionately reduced. Class A variable voting shares will be automatically converted, without any further act of Air Canada or the holder, to Class B voting shares if the shares become held, beneficially owned and controlled, directly or indirectly, by a Qualified Canadian. Class B Voting shares will be automatically converted, without any further act of Air Canada or the holder, to Class A variable voting shares if the shares become held, beneficially owned or controlled, directly or indirectly, by a party that is not a Qualified Canadian.

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

	Number of shares (000)
	At January 31, 2007
Issued and outstanding shares	
Class A variable voting shares	17,572,543
Class B voting shares	82,427,457
Total issued and outstanding shares	**100,000,000**

	Number of shares (000)
	At January 31, 2007
Class A variable voting and Class B voting shares potentially issuable	
Stock options	1,695,035
Total shares potentially issuable	**1,695,035**

	Number of shares (000)
	At January 31, 2007
Total outstanding and potentially issuable shares	**101,695,035**

10. QUARTERLY FINANCIAL DATA

The table below describes quarterly financial results and major operating statistics for the Corporation and its two reportable segments since the first quarter of 2005. The amounts in the tables below include inter-segment revenues and expenses.

Consolidated total	**Q1 2005**	**Q2 2005**	**Q3 2005**	**Q4 2005**	**Q1 2006**	**Q2 2006**	**Q3 2006**	**Q4 2006**
Operating revenues	$2,097	$2,363	$2,742	$2,256	$2,376	$2,559	$2,837	$2,395
Special charge for Aeroplan miles (1)	-	-	-	-	-	-	(102)	-
Operating revenues	**$2,097**	**$2,363**	**$2,742**	**$2,256**	**$2,376**	**$2,559**	**$2,735**	**$2,395**
Operating expenses (2)	(2,150)	(2,244)	(2,433)	(2,313)	(2,464)	(2,410)	(2,566)	(2,366)
Operating income (loss)	**(53)**	**119**	**309**	**(57)**	**(88)**	**149**	**169**	**29**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(63)	(129)	(68)	(78)	(38)	3	(125)	(173)
Net income (loss)	**($116)**	**($10)**	**$241**	**($135)**	**($126)**	**$152**	**$44**	**($144)**
Earning (loss) per share								
- Basic	**$ (1.85)**	**$ (0.12)**	**$ 2.73**	**$ (1.53)**	**$ (1.43)**	**$ 1.72**	**$ 0.50**	**$ (1.55)**
- Diluted	**$ (1.85)**	**$ (0.12)**	**$ 2.73**	**$ (1.53)**	**$ (1.43)**	**$ 1.72**	**$ 0.50**	**$ (1.55)**
Revenue passenger miles (millions)	10,586	11,613	13,981	10,584	11,240	12,248	14,346	11,160
Available seat miles (millions)	13,566	14,487	16,961	13,808	14,287	14,926	17,529	14,343
Passenger load factor (%)	78.0	80.2	82.4	76.7	78.7	82.1	81.8	77.8

Air Canada Services	**Q1 2005**	**Q2 2005**	**Q3 2005**	**Q4 2005**	**Q1 2006**	**Q2 2006**	**Q3 2006**	**Q4 2006**
Operating revenues	$2,108	$2,373	$2,757	$2,271	$2,394	$2,576	$2,854	$2,415
Special charge for Aeroplan miles (1)	-	-	-	-	-	-	(102)	-
Operating revenues	**$2,108**	**$2,373**	**$2,757**	**$2,271**	**$2,394**	**$2,576**	**$2,752**	**$2,415**
Operating expenses (2)	(2,190)	(2,281)	(2,485)	(2,362)	(2,518)	(2,463)	(2,622)	(2,420)
Operating income (loss)	**(82)**	**92**	**272**	**(91)**	**(124)**	**113**	**130**	**(5)**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(34)	(101)	(32)	(44)	(2)	39	(86)	(139)
Net income (loss)	**($116)**	**($9)**	**$240**	**($135)**	**($126)**	**$152**	**$44**	**($144)**
Revenue passenger miles (millions)	10,586	11,612	13,980	10,584	11,240	12,248	14,345	11,160
Available seat miles (millions)	13,565	14,486	16,960	13,807	14,287	14,925	17,528	14,343
Passenger load factor (%)	78.0	80.2	82.4	76.7	78.7	82.1	81.8	77.8
Operating expense per available seat mile (CASM) (cents)	16.2	15.8	14.7	17.1	17.6	16.5	15.0	16.9
CASM, excluding fuel expense (cents) (3)	13.1	12.1	10.7	12.9	13.7	12.3	10.6	12.8
CASM, excluding fuel expense and the special charge for labour restructuring (cents) (3)	13.1	12.1	10.7	12.9	13.5	12.3	10.6	12.9

(1) Quarter 3 2006 includes a special charge of $102 million in connection with Air Canada's obligation for the redemption of pre-2002 Aeroplan miles.

(2) Quarter 1 2006 includes a special charge for labour restructuring of $28 million. In Quarter 4, 2006, this charge was reduced by $8 million to $20 million.

(3) See section 20 "Non-GAAP Financial Measures" in this MD&A for additional information.

Jazz	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Passenger revenue	**$-**	**$1**	**$-**	**$1**	**$-**	**$-**	**$-**	**$-**
Other revenue	213	231	274	303	320	340	369	352
Operating revenues	**$213**	**$232**	**$274**	**$304**	**$320**	**$340**	**$369**	**$352**
Operating expenses	(183)	(205)	(236)	(270)	(285)	(303)	(330)	(319)
Operating income	**30**	**27**	**38**	**34**	**35**	**37**	**39**	**33**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(4)	(4)	(1)	(2)	(2)	(1)	-	(1)
Segment income	**$26**	**$23**	**$37**	**$32**	**$33**	**$36**	**$39**	**$32**

Seasonality

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 cost structure of the Corporation is such that its fixed costs do not fluctuate proportionately with passenger demand in the short-term.

11. SELECTED ANNUAL INFORMATION

The following table provides selected annual information for the Corporation, as defined under "Basis of Presentation", for the years 2006 and 2005 and for the three-month period ended December 31, 2004. The table also provides selected information for the nine-month period ended September 30, 2004 for the "Predecessor Company". "Predecessor Company" refers to Air Canada prior to September 30, 2004 and included the operations of the various entities included in the Air Canada Services segment, as well as those of Jazz, Aeroplan and ACTS and, as such, prior results may not be comparable.

	Air Canada			Predecessor Company
Consolidated total	**Year ended December 31, 2006**	**Year ended December 31, 2005**	**Three months ended December 31, 2004**	**Nine months ended September 30, 2004**
Operating revenues	$10,167	$9,458	$1,959	$6,838
Special charge for Aeroplan miles (1)	(102)	-	-	-
Operating revenues	**10,065**	**9,458**	**1,959**	**6,838**
Operating expenses (2)	(9,806)	(9,140)	(2,018)	(6,718)
Operating income (loss), before reorganization and restructuring items	**259**	**318**	**(59)**	**120**
Reorganization and restructuring items	-	-	-	(871)
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(333)	(338)	44	(144)
Net income (loss)	**(74)**	**(20)**	**(15)**	**(895)**
EBITDAR (3)	**1,214**	**1,157**		
EBITDAR excluding special charges (3)	**1,336**	**1,157**		
Earning (loss) per share				
- Basic	**($0.83)**	**($0.25)**	**($0.27)**	**($7.45)**
- Diluted	**($0.83)**	**($0.25)**	**($0.27)**	**($7.45)**
Cash, cash equivalents and short-term investments	**2,245**	**1,336**	**759**	
Total assets	**11,749**	**10,262**	**9,417**	
Total long-term liabilities (4)	**3,668**	**3,882**	**3,917**	

(1) 2006 includes a special charge of $102 million in connection with Air Canada's obligation for the redemption of pre-2002 Aeroplan miles.
(2) 2006 includes a special charge for labour restructuring of $20 million.
(3) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).
(4) Total long-term liabilities include long-term debt and capital leases and other long-term liabilities.

12. OFF-BALANCE SHEET ARRANGEMENTS

Refer to Notes 16 and 17 to Air Canada's combined consolidated financial statements for additional information regarding derivative financial instruments and guarantees of the Corporation. The following is summary of the more significant off-balance sheet arrangements.

Guarantees

Performance Obligations Relating to Aircraft Leasing Agreements

With respect to 45 aircraft leases, the difference between the amended lease payments from the CCAA restructuring arrangements and amounts due under the original lease contracts will be forgiven at the expiry date of the leases if no material defaults have occurred. If a material default occurs, this difference plus interest will become due and payable and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements and any liability would be recorded only at the time Management believes a material default under the leases is likely to occur.

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.

Interest Rate Risk Management

The Corporation from time to time enters into interest rate swaps to manage the risks associated with interest rate movement on US dollar. and Canadian dollar floating rate debt and investments, including anticipated debt transactions.

During 2006, the Corporation entered into 19 interest rate swaps with a notional value of US$414 million to receive floating rates and pay a weighted average fixed rate of 5.81 percent for the debt to be arranged in relation to the financing of Embraer 190 aircraft between June 2006 and November 2007. The swaps have 15-year terms from the expected delivery date of the aircraft and their maturities range from June 2021 to December 2022. The Corporation intends on settling the interest rate swaps upon delivery of the related aircraft. Before December 31, 2006, seven of these swaps were settled at a net loss of $4 million. As at December 31, 2006, the fair value of the remaining 12 swaps was $13 million in favour of the counterparty and is recorded in "other long-term liabilities" on Air Canada's combined consolidated statement of financial position. The Corporation has recognized a net loss of $17 million in "other" non-operating expense on Air Canada's consolidated statement of operations since inception of these swaps in the second quarter of 2006.

During 2006, Jazz entered into interest rate swaps to hedge its exposure to changes in interest rates on its outstanding senior secured credit facility. The interest rate swap is with third parties with a notional value of $115 million, which has effectively resulted in a fixed interest rate of 7.09 percent for the term of the senior secured credit facility until February 2, 2009. Effective February 2, 2006, the Corporation is applying hedge accounting to these financial instruments and no amount is recorded in Air Canada's combined consolidated financial statements. As at December 31, 2006, the fair value of these swaps was less than $1 million in favour of the counterparty.

The Corporation has interest rate swaps with 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. As at December 31, 2006, these two swaps have a fair value of $4 million in favour of the Corporation ($7 million in favour of the Corporation as at December 31, 2005).

Foreign Exchange Risk Management

Foreign exchange risk exposure is common to an international business such as Air Canada. To manage this risk exposure, Air Canada enters into various foreign currency hedging structures. These hedging structures provide protection to Air Canada in the form of reduced risk and volatility with respect to movements in the foreign exchange markets. At December 31, 2006, the Corporation had entered into foreign currency forward contracts and option agreements on US$503 million or approximately 31 percent of its projected net 2007 US dollar shortfall with the majority of hedges occurring in the first half of 2007. Based on foreign currency prices at December 31, 2006, the average price of the hedge portfolio is $1.1035. The fair value of the foreign currency contracts as at December 31, 2006 is $25 million in favour of the Corporation ($1 million in favour of third parties as at December 31, 2005 on currency forward contracts and option agreements on US$521 million). These derivative instruments have not been designated as hedges for accounting purposes. The unrealized gain has been recorded in “foreign exchange gain (loss)” on Air Canada’s combined consolidated statement of operations.

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 Bombardier regional jet operating leases, with third parties, were put in place on the inception of the leases and have a fair value at December 31, 2006 of $10 million in favour of third parties ($13 million in favour of third parties as at December 31, 2005), taking into account foreign exchange rates in effect at that time. Currency swaps for 11 Bombardier regional jet operating leases with third parties have a fair value as at December 31, 2006 of $3 million in favour of the Corporation ($3 million in favour of the Corporation as at December 31, 2005). 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)” on Air Canada’s combined consolidated statement of operations.

Fuel Price Risk Management

The Corporation enters into contracts with financial intermediaries to manage its exposure to jet fuel price volatility. As at December 31, 2006, the Corporation had collar option and swap structures in place to hedge a portion of its anticipated jet fuel requirements over the 2007 and 2008 period. Since jet fuel is not traded on an organized futures exchange, liquidity for hedging this commodity is mostly limited to a shorter time horizon. Crude oil and heating oil contracts are effective commodities for hedging jet fuel and the Corporation mainly uses these commodities for medium to longer term hedges. Refer to section 4 of this MD&A for the Corporation’s hedging position as at December 31, 2006 and as at February 14, 2007.

Hedge accounting was applied prospectively from October 1, 2005. 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 the commencement of the Corporation’s hedge accounting being applied, an unrealized gain of $2 million was recorded in “other” non-operating expense on Air Canada’s combined consolidated statement of operations.

In 2006, the Corporation recognized a net loss of $43 million as a component of fuel expense on its combined consolidated statement of operations (net loss of $3 million in 2005) on the settlement of matured contracts and amortization of deferred costs. The fair value of the Corporation’s fuel hedging contracts as at December 31, 2006 was $24 million (US$21 million) in favour of counterparties ($3 million in favour of counterparties as at December 31, 2005).

During 2006, the Corporation entered into two three-way collar option structures which are composed of one short put option, one long call option and one short call option. This structure creates a ceiling on the potential benefit to be realized by the Corporation if commodity prices increase above the threshold of the short call strike price. Due to the ceiling in these derivative instruments, this type of derivative does not qualify as a hedging instrument under GAAP. As at December 31, 2006, one of the three-way collar option structures remains outstanding. The fair value of these derivative instruments was $1 million in favour of the counterparty and is recorded in “accounts payable and accrued liabilities” on Air Canada's combined consolidated statement of financial position.

During 2005, the Corporation de-designated one contract previously under hedge accounting that was combined into a new net-written option. The net-written option has a fair value of less than zero at the time of inception and so it does not qualify as a hedging instrument under GAAP. As at December 31, 2006, the fair value of the net written option was $2 million in favour of the counterparty (less than $1 million in favour of the counterparty as at December 31, 2005) and is recorded in “accounts payable and accrued liabilities” on Air Canada’s combined consolidated statement of financial position.

In 2006 the Corporation recognized a net loss of $3 million in “other” non-operating expense on Air Canada’s consolidated statement of operations for the derivative instruments which do not qualify as hedge accounting.

Concentration of Credit Risk

The Corporation does not believe it is subject to any significant concentration of credit risk. Cash and short-term investments are in place with major financial institutions, Canadian governments and major corporations. Accounts receivable are generally the result of sales of tickets to individuals through geographically dispersed travel agents, corporate outlets or other airlines, often through the use of major credit cards.

13. RELATED PARTY TRANSACTIONS

The Corporation has various related party transactions with ACE (the principal shareholder with a 75 percent ownership interest in Air Canada at December 31, 2006 and a 79.7 percent ownership interest in Jazz, both at December 31, 2006) and with other entities under common control, including ACTS and Aeroplan. These transactions are recorded at the exchange amount.

Air Canada provides certain administrative services to ACE in return for a fee. Such services relate to finance and accounting, information technology, human resources and other administrative services.

Pursuant to the Jazz CPA effective January 1, 2006, Air Canada Services purchases substantially all of Jazz's fleet capacity based on predetermined rates, in addition to reimbursing Jazz, without mark-up, for certain pass-through costs as defined in the Jazz CPA. The capacity purchase fees paid to Jazz and the pass-through costs reimbursed to Jazz by Air Canada Services are eliminated within Air Canada's combined consolidated financial statements and are therefore not reflected in the table below.

Related party trade balances relate mainly to the provision of services, the allocation of employee-related costs, the allocation of corporate expenses and centralized cash management activities.

Refer to Notes 1, 6, 7 and 9 to Air Canada's combined consolidated financial statements for additional information.

Commercial Agreements – Aeroplan

Aeroplan is a subsidiary of ACE in which ACE has a 75.3 percent interest at December 31, 2006 (50.3 percent interest after January 10, 2006). Aeroplan operates a loyalty program which provides loyalty marketing services to its customers.

Pursuant to the Aeroplan Commercial Participation and Services Agreement ("CPSA"), Air Canada allocates fixed seat capacity to Aeroplan on Air Canada Flights. The rates charged for such seat capacity are fixed through the end of 2007. Air Canada pays a fee to participate in the Aeroplan Program, which fee is based on the Aeroplan Miles awarded to Air Canada customers who travel on Air Canada Flights. Aeroplan is required to purchase annually a minimum number of reward travel seats on Air Canada Flights, which number is a function of Aeroplan's consumption of seats in the three preceding calendar years. Moreover, Air Canada is required to purchase a minimum number of Aeroplan miles annually (2006 — $170 million).

Pursuant to the Aeroplan Master Services Agreement ("MSA"), Air Canada has agreed to provide certain services to Aeroplan (such as infrastructure support, information technology, human resources, finance, accounting and legal services) in return for a fee based on Air Canada's fully allocated cost of providing such services to Aeroplan plus a mark-up to reflect overhead and administrative costs.

Pursuant to the Aeroplan General Services Agreement ("GSA"), Air Canada provides Aeroplan with the services of a group of call centre employees of Air Canada for which is reimbursed by Aeroplan for all costs, including salary and benefits, on a fully allocated basis.

Commercial Agreements – ACTS

ACTS is a wholly owned subsidiary of ACE that provides full-service maintenance, repair and overhaul services to a wide range of customers, including to Jazz and Air Canada.

Pursuant to various service agreements between ACTS and Air Canada effective as of October 1, 2006, ACTS provides the following services to Air Canada with respect to certain of Air Canada's aircraft, engines and other aircraft equipment: aircraft heavy maintenance services (excluding line and cabin maintenance services which are primarily provided by Air Canada), engine maintenance services, component maintenance services, supply chain and asset management services, auxiliary power unit maintenance services, aircraft paint services and related services. ACTS serves as Air Canada's exclusive repair agency in respect of aircraft heavy maintenance, engine maintenance, auxiliary power unit maintenance services as well as for maintenance services relating to certain components. ACTS serves as Air Canada's non-exclusive repair agency in respect of other services provided. Except for the services agreements relating to aircraft heavy maintenance and paint services which expire in October 2009, each of the agreements referred to above expires in October 2013.

Pursuant to a component maintenance agreement (the “ACTS-Jazz Agreement”) dated August 1, 2005 between Jazz and ACTS, ACTS provides selected maintenance, repair, overhaul and related services with respect to Jazz’s CRJ regional jets. According to the ACTS-Jazz Agreement, ACTS serves as Jazz’s exclusive repair agency to provide component repair and overhaul work on parts which can be removed from the aircraft in respect of CRJ-100/200 and common CRJ-705 parts not performed internally by Jazz employees. The initial term of the ACTS-Jazz Agreement expires in August 2015 and it is renewable for three successive two-year periods. However, beginning in August 2008, either Jazz or ACTS may terminate the ACTS-Jazz Agreement upon 180 days’ prior written notice.

Pursuant to the ACTS Master Services Agreement (“MSA”), Air Canada has agreed to provide ACTS with services including infrastructure support and services which are mostly administrative in nature, including information technology, human resources, finance and accounting, and legal services in return for fees to be paid by ACTS to Air Canada. ACTS may elect to terminate any services under the ACTS MSA or the entire ACTS MSA upon six months' prior written notice, with the exception of services relating to information technology which ACTS cannot terminate prior to the expiry of the ACTS MSA. Air Canada may elect to terminate any services under the ACTS MSA or the entire ACTS MSA upon 18 months' prior written notice.

Pursuant to General Services Agreements between Air Canada and ACTS (the “ACTS GSAs”) Air Canada provides ACTS with the services of a group of unionized and non-unionized employees for which is reimbursed by ACTS for all costs, including salary and benefits, on a fully allocated basis. The ACTS GSAs may be terminated by either party at any time and without cause upon a 30 days' prior written notice.

For a summary of significant related party agreements, refer to Note 18 to Air Canada's combined consolidated financial statements.

The related party balances resulting from the application of the commercial and contractual practices were as follows:

	December 31 2006	December 31 2005
Accounts receivable		
ACE	-	57
Aeroplan	6	5
ACTS	97	75
	103	**137**
Accounts payable and accrued liabilities		
ACE	12	7
ACTS	111	96
	123	**103**

	Quarter 4 2006	Quarter 4 2005	2006	2005
Revenues				
Revenues from Aeroplan related to Aeroplan rewards	84	70	358	307
Revenue offset from purchase of Aeroplan miles	(62)	(54)	(243)	(204)
Property rental revenues from related parties	9	11	46	44
Revenues from information technology services	8	6	27	28
Revenues from corporate services and other	2	-	14	13
Cargo revenues from related parties	1	2	4	5
	42	**35**	**206**	**193**
Expenses				
Maintenance expense from ACTS	158	146	614	562
Call centre management and marketing fees from Aeroplan	3	5	10	13
Other expenses	10	4	39	25
Recovery of salary, wages and benefit expense for employees assigned to related parties	(106)	(99)	(413)	(374)
	65	**56**	**250**	**226**
Net interest expense from related parties	**1**	**7**	**6**	**21**

For a summary of accounting policies, refer to Note 2 to Air Canada's combined consolidated financial statements.

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:

Passenger and Cargo Revenues

Airline passenger and cargo advance sales are deferred and included in current liabilities. Advance sales include the proceeds from the sale of flight tickets to Aeroplan which provides loyalty program services to the Corporation and purchases seats from Air Canada under the CPSA. Passenger and cargo revenues are recognized when the transportation is provided, except for revenue on unlimited flight passes which is recognized on a straight-line basis over the period during which the travel pass is valid. The Corporation has formed alliances with other airlines encompassing loyalty program participation, code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided.

The Corporation performs regular evaluations on the deferred revenue liability which may result in adjustments being recognized as revenue. 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 relatively small amounts are recognized as revenue based on estimates. 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 Corporation maintains several defined benefit and defined contribution plans providing pension, other retirement and post-employment benefits to its employees, including those employees of Air Canada who are contractually assigned to ACTS and Aeroplan. These employees are members of Air Canada's sponsored defined benefit pension plans and also participate in Air Canada's sponsored health, life and disability future benefit plans. Air Canada's combined consolidated financial statements include all of the assets and liabilities of all sponsored plans of the Corporation.

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

	December 31, 2006	December 31, 2005
Weighted average assumptions used to determine accrued benefit obligation		
Discount rate as at period-end	5.00%	5.00%
Rate of compensation increase (1)	2.50%	4.00%
Weighted average assumptions used to determine pension costs		
Discount rate as at period-end	5.00%	5.75%
Expected long-term rate of return on plan assets	7.50%	7.50%
Rate of compensation increase (2)	4.00%	4.00%

(1) As a result of the pay awards during 2006, a rate of compensation increase of 1.75 percent was used for the years 2006 to 2008 in determining the net benefit obligation for the pension plan and 2.5 percent for the remaining years.

(2) A rate of compensation increase of 0 percent in 2005 and 2 percent in 2006 was used in determining the net benefit pension expense and 4 percent for the remaining years.

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 composition of the Domestic Registered Plan assets and the target allocation consists of the following:

	November 30 2005	November 30 2006	Target allocation
Equity	62.3%	59.1%	59.0%
Bonds and Mortgages	32.1%	34.7%	41.0%
Real Estate	0.1%	0.0%	0.0%
Short-term and Other	5.5%	6.2%	0.0%
Total	**100.0%**	**100.0%**	**100.0%**

Domestic Registered Plans

For the Domestic Registered Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Master Trust Fund (Fund). The investment return objective of the Fund is to achieve a total annualized rate of return that exceeds inflation by at least 3.75 percent 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 37 percent to 43 percent 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 40 percent of the total return of the Scotia Capital Universe Bond Index and 60 percent of the total return of the Scotia Capital Long Term Bond Index.

Similar investment policies are established for the other pension plans sponsored by the Corporation.

Best Estimate of Employer Contributions

Based upon an agreement between Air Canada and representatives of the unionized and non-unionized employees and retirees with respect to the funding of the domestic registered plans, which agreement is subject to approval of the Office of the Superintendent of Financial Institutions (Canada) ("OSFI"), the actual 2005 and 2006 contributions are as follows:

($ millions)	2006 Contributions	2005 Contributions
Past service cost for registered pension plans	224	99
Current service cost for registered pension plans	140	127
Other pension arrangements (1)	83	52
Air Canada Services(2)	**447**	**278**
Jazz	**8**	**6**
Consolidated	**455**	**284**

(1) Includes retirement compensation arrangements, supplemental plans and international plans.
(2) Includes obligations relating to employees who have been assigned to related parties.

As previously discussed, the Corporation recovers costs relating to some employees who have been contractually assigned to ACTS and Aeroplan. The cost recovery relating to Air Canada's sponsored defined pension plans amounted to $33 million for 2006 and $28 million for 2005. The cost recovery relating to Air Canada's sponsored future benefit plans amounted to $23 million for 2006 and $24 million for 2005.

Sensitivity Analysis

Sensitivity analysis on the 2006 pension expense based on different actuarial assumptions with respect to discount rate and expected return on plan assets is as follows:

Impact on 2006 pension expense in $ millions	0.25 percentage point Decrease	0.25 percentage point Increase
Discount rate on obligation assumption	29	(19)
Long-term rate of return on plan assets assumption	25	(25)

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 9.75 percent annual rate of increase in the per capita cost of covered health care benefits was assumed for 2006 (10 percent was assumed for 2005). The rate is assumed to decrease gradually to 5 percent 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 $17 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 $16 million.

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 income tax consequences attributable to differences between the financial statement carrying value amount and the tax basis of assets and liabilities. Management uses judgment and estimates in determining the appropriate rates and amounts in recording future taxes, giving consideration to timing and probability. Actual taxes could significantly vary from these estimates as a result of future events, including changes in income tax law or the outcome of reviews by tax authorities and related appeals. The resolution of these uncertainties and the associated final taxes may result in adjustment to the Corporation's tax assets and tax 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 income tax assets. The benefit of future income taxes that existed at fresh start, including the benefit recognized by affiliates of the Corporation, and against which a valuation allowance is recorded, amounts to $1,169 million. For additional information refer to Note 8 to Air Canada's combined consolidated financial statements.

Cash Tax Projections

ACE and Air Canada implemented a tax loss utilization strategy prior the Air Canada IPO. Accordingly, certain tax attributes of Air Canada were transferred to ACE. Notwithstanding, as at December 31, 2006, Air Canada retains over $3 billion of tax attributes in the form of undepreciated capital cost and other tax attributes to shelter future taxable income. These tax attributes are expected to increase over the next few years due to capital expenditures related to aircraft acquisitions. Refer to section 9.6 of this MD&A for additional information on these capital expenditures. Based on projected results, Air Canada does not forecast having any significant current taxes payable within the foreseeable future.

Impairment of Long-Lived Assets

Long-lived assets are tested for impairment whenever circumstances indicate that the carrying value may not be recoverable. When events or circumstances indicate that the carrying value of long-lived assets, other than indefinite life intangibles, are not recoverable, the long-lived assets are tested for impairment by comparing the estimate of future expected cash flows to the carrying amount of the assets or groups of assets. If the carrying value of long-lived assets 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.

Property and Equipment

Property and equipment is 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. On the application of fresh start accounting effective September 30, 2004, the cost of the Corporation's property and equipment was adjusted to fair value. In addition, the estimated useful lives of certain assets were adjusted, including buildings where useful lives were extended to periods not exceeding 50 years.

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 leases and variable interest entities are depreciated to estimated residual values over the life of the lease. The Corporation's aircraft and flight equipment are depreciated over 20 to 30 years, with 10 to 20 percent estimated residual values. Aircraft reconfiguration costs are amortized over 3 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 40 to 50 years on a straight-line basis. 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 5 years. Ground and other equipment is depreciated over 3 to 25 years.

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 the Corporation's historical experience with regard to the sale of aircraft and spare parts, as well as forward-looking valuations prepared by independent third parties.

Intangible Assets

The identifiable intangible assets of the Corporation were recorded at their estimated fair values at September 30, 2004. Indefinite-life intangible assets are subject to impairment tests under Canadian GAAP on an annual basis or when events or circumstances indicate a potential impairment. If the carrying value of such assets exceeds the fair values, the assets are written down to fair value.

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. FUTURE ACCOUNTING STANDARD CHANGES

The Accounting Standards Board has issued three new standards dealing with financial instruments that the Corporation will be required to adopt in future years:

(i) Financial Instruments — Recognition and Measurement;

(ii) Hedges;

(iii) Comprehensive Income.

The key principles under these standards are that all financial instruments, including derivatives, are to be included on a company's balance sheet 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 the ability for certain unrealized gains and losses arising from changes in fair value to be temporarily recorded outside the income statement 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. The Corporation has evaluated the consequences of the new standards, which may have a material impact on the Corporation's financial statements. Refer to Note 16 to Air Canada’s combined consolidated financial statements for additional disclosure on the consequences of the new standards.

16. SENSITIVITY OF RESULTS

Financial results of the Air Canada Services segment 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 Air Canada Services segment operating results. These guidelines were derived from 2006 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 Air Canada Services segment. Conversely, an opposite change in the sensitivity factor would have had the opposite effect on operating income.

Key Variable		2006 Measure	Sensitivity factor	Estimated Operating Income Impact ($ millions)
Revenue Measures				
Passenger yield (cents)	System	18.1	1% change in yield	84
	Canada	23.7		35
Traffic (RPMs) (millions)	System	48,993	1% change in traffic	76
	Canada	15,465		31
Passenger load factor	System	80.2	1 percentage point change	95
RASM (cents)	System	14.5	1% change in RASM	80
Cost Measures				
Labour and benefits expenses ($ millions)		1,816	1% change	18
Fuel – WTI price (US$/barrel) (1)		65.8	US$1/barrel change to WTI	27
Fuel – jet fuel price (CAD cents/litre) (1)		65.0	1% change	25
Cost per ASM (cents)		16.4	1% change	100

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

Key Variable	2006 Measure	Sensitivity factor	Estimated Operating Income Impact ($ millions)	Estimated Pre-Tax Income Impact ($ millions)
Currency Exchange				
Canada to US ($)	1.13	1 cent change (e.g. $1.13 to $1.12)	16	48

17. RISK FACTORS

The risks described herein may not be the only risks faced by the Corporation. Other risks of which the Corporation is not aware or which the Corporation currently deems to be immaterial may surface and have a material adverse impact on the Corporation's business, results from operations and financial condition.

Risks Relating to the Corporation

Operating Results

In the recent past, the Corporation has sustained significant operating losses and may sustain significant losses in the future. On September 30, 2004, the Corporation and certain of its subsidiaries emerged from protection under the CCAA and implemented a plan of arrangement. For the years ended December 31, 2003, 2002 and 2001, Air Canada incurred operating losses before reorganization and restructuring items and non-recurring labour expenses of $684 million, $192 million and $731 million, respectively. For the nine-month period ended September 30, 2004, Air Canada realized operating income before reorganization and restructuring items of $120 million and, for the three-month period ended December 31, 2004, the Corporation incurred an operating loss of $59 million. For the years ended December 31, 2006 and 2005, the Corporation realized operating income of $259 million and $318 million, respectively. Prior to September 30, 2004, the operations or Air Canada included the operations of various entities included in the Air Canada Services segment, as well as those of Jazz, Aeroplan and ACTS and, as such, those prior results may not be comparable. Despite Air Canada's emergence from creditor protection under the CCAA, the resulting and ongoing business initiatives and efforts at cost reductions and its recent results, the Corporation may not be able to successfully achieve planned business initiatives and cost reductions, including those which seek to offset significant fuel and other expenses or restore positive net profitability and may sustain significant losses in the future.

Leverage and Liquidity

The Corporation has, and is expected to continue to have, a significant amount of indebtedness, including substantial fixed obligations under aircraft leases and financings. The Corporation may incur additional debt, including secured debt, in the future. The amount of indebtedness that the Corporation currently has and which it may incur in the future could have a material adverse effect on the Corporation, for example, by (i) limiting the Corporation's ability to obtain additional financing , (ii) requiring the Corporation to dedicate a substantial portion of its cash flow from operations to payments on its indebtedness and fixed cost obligations, thereby reducing the funds available for other purposes, (iii) making the Corporation more vulnerable to economic downturns, and (iv) limiting the Corporation's flexibility in planning for, or reacting to, competitive pressures or changes in its business environment.

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, if 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. In addition, as the Corporation incurs indebtedness which bears interest at fluctuating interest rates, to the extent these interest rates increase, its interest expense will increase. 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 faces a number of challenges in its current business operations, including high fuel prices and increased competition from international, transborder and low-cost domestic carriers. In order to meet such challenges and to support the Corporation's business strategy, significant operating and capital expenditures are, and may in the future be, required. 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 support its business strategy if cash flows 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 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 Air Canada.

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 would 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.

Limitations Due to Restrictive Covenants

Some of the financing and other major agreements of the Corporation contain restrictive covenants which affect and, in some cases, significantly limit or prohibit, among other things, the manner in which the Corporation may structure or operate its business, including by limiting the Corporation's ability to incur indebtedness, create liens, sell assets, make capital expenditures and engage in acquisitions, mergers or restructurings. In addition, certain financing arrangements require the Corporation to maintain financial ratios. Any future borrowings may also be subject to similar covenants which limit Air Canada's operating and financial flexibility, which could materially and adversely affect Air Canada's profitability.

A failure by the Corporation to comply with its contractual obligations (including restrictive covenants), or to pay its indebtedness and fixed costs could result in a variety of material adverse consequences, including the acceleration of its indebtedness, the withholding of credit card proceeds by the credit card service providers and the exercise of remedies by its creditors and lessors, and such defaults could trigger additional defaults under other indebtedness or agreements. In such a situation, it is unlikely that the Corporation would be able to repay the accelerated indebtedness or fulfill its obligations under certain contracts, make required lease payments or otherwise cover its fixed costs. Also, the lenders under the financing arrangements could foreclose upon all or substantially all of the assets of the Corporation which secure the Corporation's obligations.

Fuel Costs

Fuel costs constituted the largest percentage of the total operating costs of the Corporation in 2006. Fuel prices fluctuate widely depending on many factors including international market conditions, geopolitical events and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict fuel prices. During 2004, 2005 and 2006, fuel prices increased and fluctuated near or at historically high levels. Should fuel prices continue at, or continue to increase above, such high levels, fuel costs could have a material adverse effect 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 increases in fuel prices to its customers by increasing its fares. Based on 2006 volumes, Management estimates that a US$1 per barrel movement in the average price of West Texas Intermediate crude oil would have resulted in an approximate C$27 million change in 2006 fuel expense for the Corporation (excluding any impact of fuel surcharges and fuel hedging), assuming flying capacity remained unchanged and that refining spreads between West Texas Intermediate crude oil and jet fuel as well as foreign exchange rates remained constant.

Labour Costs and Labour Relations

Labour costs constitute one of the Corporation's largest operating cost items. There can be no assurance that the Corporation will be able to maintain such costs at levels which do not negatively affect its business, results from operations and financial condition. There can be no assurance that future agreements with employees' unions or the outcome of arbitrations will be on terms consistent with the Corporation's expectations or comparable to agreements entered into by the Corporation's competitors. Any future agreements or outcome of negotiations, mediations or arbitrations including in relation to wages or other labour costs or work rules may result in increased labour costs or other charges which could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Most of the Corporation's employees are unionized and long-term collective agreements were concluded in 2003 and 2004. No strikes or lock-outs may lawfully occur during the term of the collective agreements expiring in 2009. However, there can be no assurance that there will not be a labour conflict that could lead to an interruption or stoppage in the Corporation's service or otherwise adversely affect the ability of the Corporation to conduct its operations, all of which could have a material adverse effect on its business, results from operations and financial condition.

If there is a labour disruption or work stoppage by any of the unionized work groups of Jazz, there could also likely be a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, labour problems at the Corporation's Star Alliance® partners could result in lower demand for connecting traffic with the Corporation and, ultimately, could 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 and air navigation authorities over the last decade in Canada, new airport and air navigation authorities have imposed significant increases in their fees. If such 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.

Competition

The Corporation operates within a highly competitive industry. Over the past few years, several carriers have entered or announced their intention to enter into the domestic, the U.S. transborder and international markets in which the Corporation operates.

Canadian low-cost carriers have entered or announced their intention to compete in many of the Corporation's key domestic markets and have also entered the U.S. transborder market. U.S. carriers currently operate routes in the Corporation's transborder market. 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 Canadian low-cost carriers are successful in entering or expanding into the Corporation’s domestic and the U.S. transborder markets, if additional U.S. carriers are successful in entering the Corporation's transborder market or if carriers are successful in their expansion in international markets of the Corporation, the Corporation's business results from operations and financial condition 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 the Corporation’s 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 its fares in order to effectively compete with other carriers may be limited by government policies to encourage competition.

Internet travel websites have 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.

In addition, consolidation in the airline industry could result in increased competition as some airlines emerging from such consolidations may be able to compete more effectively against the Corporation which could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Strategic, Business, Technology and Other Important Initiatives

In order to operate its business, achieve its goals and remain competitive, the Corporation continuously seeks to identify and devise, invest in and implement strategic, business, technology and other important initiatives, such as those relating to the aircraft fleet restructuring program, the aircraft refurbishment program, the new revenue model, the reservation and airport customer service initiative (which will also support the revenue model), the business process initiatives as well as other initiatives. These initiatives, including activities relating to their development and implementation, may be adversely impacted by a wide range of factors, many of which are beyond the Corporation’s control. Such factors include the performance of third parties, including suppliers, the implementation and integration of such initiatives into the Corporation’s other activities and processes as well as the adoption and acceptance of initiatives by the Corporation’s customers, suppliers and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement these initiatives could adversely affect the Corporation’s ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on the Corporation's business, results from operations and financial condition.

For instance, 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, and the modernization of its international wide-body fleet through the acquisition of new and more efficient aircraft. A delay or failure in the completion of the Corporation's fleet restructuring, including a delay by the manufacturers in the delivery of the regional jet or wide-body aircraft, or an inability to remove, as planned, certain aircraft from the fleet in coordination with the planned entry into service of new 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.

Another important component of the Corporation's business plan is the replacement of its legacy systems for passenger reservation and airport customer service with a newly developed web-enabled system in order to support the rapid and efficient implementation of the Corporation's revenue model. The new system is expected to be deployed in phases from late 2007 to early 2008. A delay or failure in the implementation of the Corporation's new system 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.

<u>Dependence on Technology</u>

The Corporation relies on technology, including computer and telecommunications equipment and software and Internet-based systems, to operate its business, increase its revenues and reduce its costs. These systems include those relating to the Corporation's telecommunications, websites, computerized airline reservations and airport customer services and flight operations.

These technology systems may be vulnerable to a variety of sources of failure, interruption or misuse, including by reason of natural disasters, terrorist attacks, telecommunications failures, power failures, computer viruses, hackers, unauthorized or fraudulent users, and other operational and security issues. While the Corporation continues to invest in initiatives, including security initiatives and disaster recovery plans, these measures may not be adequate or implemented properly. Any such technology systems failure 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.

<u>Key Supplies and Suppliers</u>

The Corporation is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services in a timely manner, including those required for the Corporation's operations such as fuel, aircraft and related parts and aircraft and engine maintenance services (including maintenance services obtained from ACTS). In certain cases, such goods and services may only be available from a limited number of suppliers. Such failure, refusal or inability may arise as a result of a wide range of causes, many of which are beyond the Corporation's control. Any failure or inability of the Corporation to successfully source goods and services, including by reason of a failure, refusal or inability of a supplier, or to source goods and services on terms and pricing and within the timeframes acceptable to the Corporation, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

<u>Aeroplan</u>

Through its relationship with Aeroplan, the Corporation is able to offer its customers who are Aeroplan members the opportunity to earn Aeroplan miles. Based on customer surveys, Management believes that rewarding customers with Aeroplan miles is a significant factor in customers' decision to travel with Air Canada and Jazz and contributes to building customer loyalty. The failure by Aeroplan to adequately fulfill its obligations towards the Corporation under the Aeroplan CPSA and in connection with the Aeroplan program, or other unexpected interruptions of Aeroplan services which are beyond the Corporation's control could have a material adverse effect on the Corporation's business, results from operations and financial condition.

<u>Jazz</u>

Under the Jazz CPA, Jazz provides the Corporation's customers service in lower density markets and higher density markets at off-peak times throughout Canada and to and from certain destinations in the United States and also provides valuable traffic feed to the Corporation's mainline routes. The Corporation reimburses Jazz, without mark-up, for certain pass-through costs incurred directly by Jazz, such as fuel, navigation, landing and terminal fees and certain other costs. Significant increases in such pass-through costs, the failure by Jazz to adequately fulfill its obligations towards the Corporation under the Jazz CPA, or other unexpected interruptions of Jazz's services which are beyond the Corporation's control could have a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization guarantee which requires that the Corporation make certain minimum payments to Jazz regardless of the revenue generated by Jazz.

Pension Plans

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

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, Air Canada and the Office of the Superintendent of Financial Institutions 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 is required 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. See "Management's Discussion and Analysis — Critical Accounting Estimates — Employee Future Benefits — Sensitivity Analysis". Underfunded pension plans or a failure or inability by the Corporation to make required cash contributions to its registered pension plans could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Equal Pay Litigation

CUPE, which represents the Corporation’s flight attendants, has two complaints before the Canadian Human Rights Commission where it alleges gender-based wage discrimination. CUPE 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 on the merits because of a legal dispute over whether the three groups work in the same "establishment" within the meaning of the Canadian Human Rights Act. On January 26, 2006, the Supreme Court of Canada ruled that they do work in the same "establishment" and sent the case back to the Canadian Human Rights Commission, which may now proceed to assess the merits of CUPE's complaints.

As part of the restructuring under the 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 Air Canada has complied and continues to comply with the equal pay provisions of the Canadian Human Rights Act. Nonetheless, should these complaints succeed, the accrued liability and future costs could be very significant and Air Canada'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 the Corporation with important benefits, including codesharing, efficient connections and transfers, reciprocal participation in frequent flyer programs and use of airport lounges from the other members. Should a key member leave Star Alliance® or otherwise fail to meet its obligations thereunder, the Corporation's business, results from operations and financial condition could be materially adversely affected.

Interruptions or Disruptions in Service

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

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 U.S. dollars and is affected by fluctuations in the Canada/U.S. dollar exchange rate. Management estimates that during 2006, a $0.01 increase in the Canada/U.S. dollar exchange rate (i.e., $1.13 to $1.14 per U.S. dollar) would have had an estimated $16 million unfavourable impact on operating income and an estimated $48 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 U.S. 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 U.S. dollar would increase the costs of the Corporation relative to its U.S. competitors and could have a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, the Corporation may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

Current Legal Proceedings

The European Commission, the United States Department of Justice and the Competition Bureau in Canada, among other competition authorities, are investigating alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including the Corporation. Competition authorities have sought or requested information from the Corporation as part of their investigations. The Corporation is cooperating fully with these investigations. The Corporation is also named as a defendant in a number of class action lawsuits that have been filed before the United States District Court and in Canada in connection with these allegations. It is not possible at this time to predict with any degree of certainty the outcome of these proceedings. It is the Corporation's policy to conduct its business in full compliance with all applicable competition laws.

In October 2006, ACPA commenced proceedings before the Ontario Superior Court of Justice against Air Canada, ACE and certain members of the board of directors of Air Canada alleging that certain past and future actions are oppressive to them. A variety of remedies were sought against the parties including an injunction to impose, among other things, limits on corporate distributions including those contemplated under the ACE plan of arrangement which became effective on October 10, 2006. Following a hearing in December, 2006, Mr. Justice Cumming of the Ontario Superior Court of Justice dismissed ACPA's application for an injunction and granted Air Canada's motion to dismiss ACPA's claim. ACPA has not appealed the dismissal of the injunction application but has appealed the order dismissing its claim.

In addition, see above Risk Factor entitled “Equal Pay Litigation”.

Key Personnel

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

Risks Relating to the Industry

Airline Reorganizations

Since September 11, 2001, a number of U.S. air carriers have sought to reorganize under Chapter 11 of the United States Bankruptcy Code or outside the scope of formal reorganization proceedings. Successful completion of such reorganizations could present the Corporation with competitors having reduced levels of indebtedness and significantly lower operating costs derived from labour, supply and financing contracts renegotiated under the protections of the United States Bankruptcy Code or outside the scope of formal reorganization proceedings. In addition, certain air carriers, including those involved in reorganizations, may undertake 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 can 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 that the Corporation may be able to charge. Customer expectations can change rapidly and the demand for lower fares may limit revenue opportunities. Travel, especially leisure travel, is a discretionary consumer expense. A downturn in economic growth in North America, as well as geopolitical instability in various areas of the world, could 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 or world economies 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 airline industry generally and scheduled service in particular are characterized by low gross profit margins and high fixed costs. The costs of operating any particular 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 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 fares in general. Accordingly, a shortfall from expected revenue levels could have a material adverse effect on the Corporation's business, results from operations and financial condition. The Corporation incurs substantial fixed costs which do not meaningfully fluctuate with overall capacity. As a result, should the Corporation be required to reduce its overall capacity or the number of flights operated, it may not be able to successfully reduce certain fixed costs in the short term and may be required to incur important termination or other restructuring costs, which could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Terrorist Attacks and Security Measures

The September 11, 2001 terrorist attacks and subsequent terrorist activity, 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 or no carrier at all) and increasingly restrictive security measures, such as the current restrictions on the content of carry-on baggage, could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on the Corporation's flights. It could also lead to a substantial increase in insurance, airport security and other costs. Any resulting reduction in passenger revenues and/or increases in insurance, security or other costs could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Epidemic Diseases (Severe Acute Respiratory Syndrome (SARS), Influenza or Other Epidemic 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 seven day WHO travel advisory relating to Toronto, the location of the Corporation's primary hub, and the international SARS outbreak had a significant adverse effect on passenger demand for air travel destinations served by the Corporation and Jazz, and on the number of passengers traveling on the Corporation's and Jazz's flights and resulted in a major negative impact on traffic on the entire network. The WHO warns that there is a substantial risk of an influenza pandemic within the next few years. An outbreak of SARS or of another epidemic disease such as influenza (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 the Corporation's and Jazz's flights. Any resulting reduction in traffic on the Corporation's and Jazz's network could 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.

Seasonal Nature of the Business, Other Factors and Prior Performance

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 preference of a high number of leisure travelers to 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 or terrorist attacks, 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 and, in some measure, pricing. Additional laws and regulations may be proposed, and decisions rendered, from time to time which could impose additional requirements or restrictions on airline operations. The implementation of additional regulations or decisions by Transport Canada, the Competition Bureau and/or the Competition Tribunal, the Canadian Transportation Agency, the Treasury Board or other domestic or foreign 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 legislation, or decisions, will not be adopted or rendered. The adoption of such new laws and regulations or revisions, or the rendering of such decisions, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

The availability of international routes to Canadian 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 CTA, the Competition Act and the Air Canada Public Participation Act to address the competitive airline environment in Canada and ensure protection for consumers. This legislation included airline-specific provisions concerning "abuse of dominance" under the Competition Act, later supplemented by creating "administrative monetary penalties" for a breach of the abuse of dominance provisions by a dominant domestic air carrier.

In July 2003, the Competition Tribunal released its reasons and findings in a proceeding between the Commissioner of Canada and the Corporation which had considered the approach to be taken in determining whether the Corporation was operating below "avoidable costs" in violation of one of the new airline-specific abuse of dominance provisions. The Competition Tribunal applied a very broadly crafted cost test in its decision. In September 2004, the Commissioner of Competition published a letter describing the enforcement approach that would be taken in future cases involving the airline-specific abuse of dominance provisions, which included a statement that the Tribunal's approach to avoidable costs remains relevant.

In addition, on November 2, 2004, the Minister of Industry tabled amendments to the Competition Act in Bill C-19 which, if enacted, would have removed the airline-specific "abuse of dominance" provisions from the Competition Act. However, on November 29, 2005, the 38th Parliament of Canada was dissolved. As a result, the legislative process relating to the adoption of Bill C-19 was terminated. Management cannot predict if or when such proposed legislation will be re-introduced in the House of Commons.

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. 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

Since September 11, 2001 the aviation insurance industry has been continually reevaluating the terrorism risks that it covers 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, and in the absence of measures by the Government of Canada to provide the required coverage, the Corporation's insurance costs may increase further and may result in the Corporation being in breach of regulatory requirement or 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 currently provides 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. The Corporation estimates that such coverage would cost the Corporation approximately $15 million per year. Alternative solutions, such as those 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 achievement of a global solution is not likely in the immediate or near future. The U.S. federal government has set up its own facility to provide war risk coverage to U.S. 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 which is applicable to aircraft hull and spares war risk insurance, and intends to introduce similar exclusions to airline passenger and third party liability policies. Such clause 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 the Government of Canada has not yet decided to extend the existing 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 result in the Corporation being in breach of certain regulatory requirements or contractual arrangements, which may have a material adverse effect on the Corporation's business, results from operations and financial condition.

Risks Related to the Corporation's Relationship with ACE

Control of the Corporation and Related Party Relationship

ACE owns shares of Air Canada representing 75 percent of the voting interests in Air Canada. Voting control will enable ACE to determine substantially all matters requiring security holder approval as a result of its voting interest in Air Canada. ACE will exercise control over corporate transactions submitted to Air Canada's board of directors and/or Air Canada's security holders for approval. ACE will effectively have sufficient voting power to prevent a change in control of Air Canada. This voting control may discourage transactions involving a change of control of Air Canada, including as a result, transactions in which the public shareholders of Air Canada might otherwise receive a premium for their shares over the then-current market price.

The interests of ACE may conflict with those of other shareholders.

Future Sales of Shares by or for ACE

Sales of substantial amounts of Air Canada's shares by ACE, or the possibility of those sales by ACE, could adversely affect the market price of the shares and impede Air Canada's ability to raise capital through the issuance of equity securities.

ACE has no contractual obligation to retain any of the Air Canada shares, except for a period of 90 days ending on February 22, 2007 during which ACE is restricted from selling any of the Air Canada shares without the consent of RBC Dominion Securities Inc. This 90-day lock-up period was agreed to by ACE in connection with the closing of the Offering. The registration rights agreement that Air Canada entered into with ACE grants ACE the right to require Air Canada to file a prospectus and otherwise assist with a public offering of shares that ACE holds in specified circumstances. In addition, after the expiration of this 90-day lock-up period, Air Canada could issue and sell additional shares. Any sale by ACE or Air Canada of shares in the public market, or the perception that sales could occur could adversely affect prevailing market prices of the shares.

Refer to Note 18 to Air Canada's combined consolidated financial statements for additional information on related party transactions.

18. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures
Disclosure controls and procedures within Air Canada 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 Air Canada's disclosure controls and procedures, as defined under the rules of the Canadian Securities Administration (CSA) was conducted at December 31, 2006 by and under Air Canada's management, including the President and Chief Executive Officer and the Chief Financial Officer. Based on this evaluation, the President and Chief Executive Officer and the Chief Financial Officer have concluded that Air Canada's disclosure controls and procedures are effective.

Internal Controls over Financial Reporting
Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of Air Canada's financial reporting and the preparation of financial statements in compliance with Canadian generally accepted accounting principles.

An evaluation of the design effectiveness of Air Canada's internal controls over financial reporting was conducted at December 31, 2006 by Air Canada's management, including the President and Chief Executive Officer and the Chief Financial Officer. Based on this evaluation, management has concluded that the design of Air Canada's internal controls and procedures is effective except for controls related to accounting for income taxes, where process design improvements are required. Management has commenced remedial action to add additional qualified income tax professionals with the appropriate knowledge and experience which addresses this design area.

There were no changes to the Corporation's internal controls over financial reporting during the year ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

19. OUTLOOK

A fundamental building block of the airline industry is to match capacity with demand. Air Canada has successfully pursued this strategy as evidenced by its annual record load factors over the last three years. In 2006, Air Canada Services flew 61.1 billion available seat miles, an increase of 4 percent as compared to 2005. Air Canada Services had a load factor of 80.2 percent in 2006 versus 79.5 percent in 2005, an increase of 0.7 percentage points.

As at December 31, 2006, Air Canada operated 199 aircraft and 133 aircraft were operated by Jazz as Covered Aircraft as defined under the Jazz CPA. Air Canada anticipates operating 205 to 208 aircraft by December 31, 2007.

Twenty-five Embraer 190 aircraft are expected to be delivered by December 31, 2007 of which twenty-four are expected to be in operation prior to December 31, 2007. Eight Boeing 777 aircraft, inclusive of the one leased from ILFC, are expected to be delivered and in operation prior to December 31, 2007. Air Canada is planning to remove from service approximately 23 aircraft which consist of eight wide-body aircraft and 15 narrow-body aircraft. These aircraft removals would be in the form of aircraft retirements, returns to lessors or subleases. The Jazz operated Covered Aircraft is expected to remain at 133 aircraft for 2007. Capacity for Air Canada Services is expected to grow within a range of 3 to 4 percent in 2007 as compared to 2006.

20. NON-GAAP FINANCIAL MEASURES

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, amortization and obsolescence 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 Canadian 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 is reconciled to operating income (loss) as follows:

($ millions)	**Quarter 4**		**$**			**$**
	2006	**2005**	**Change**	**2006**	**2005**	**Change**
Air Canada Services						
GAAP operating income (loss)	(5)	(91)	86	114	191	(77)
Add back:						
Aircraft rent	75	90	(15)	314	341	(27)
Depreciation, amortization and obsolescence	135	106	29	493	404	89
EBITDAR	**205**	**105**	**100**	**921**	**936**	**(15)**
Add back:						
Special charge for labour restructuring	(8)	-	(8)	20	-	20
Special charge for Aeroplan miles	-	-	-	102	-	102
EBITDAR excluding special charges	**197**	**105**	**92**	**1,043**	**936**	**107**
Jazz						
GAAP operating income	33	34	(1)	144	129	15
Add back:						
Aircraft rent	34	28	6	134	80	54
Depreciation, amortization and obsolescence	5	4	1	21	18	3
EBITDAR	**72**	**66**	**6**	**299**	**227**	**72**
Consolidated total						
GAAP operating income (loss)	29	(57)	86	259	318	(59)
Add back:						
Aircraft rent	107	117	(10)	441	417	24
Depreciation, amortization and obsolescence	140	110	30	514	422	92
EBITDAR	**276**	**170**	**106**	**1,214**	**1,157**	**57**
Add back:						
Special charge for labour restructuring	(8)	-	(8)	20	-	20
Special charge for Aeroplan miles	-	-	-	102	-	102
EBITDAR excluding special charges	**268**	**170**	**98**	**1,336**	**1,157**	**179**

Operating Income excluding the Special Charge for Aeroplan Miles and the Special Charge for Labour Restructuring

The Air Canada Services segment uses operating income excluding the special charges for Aeroplan miles and labour restructuring to assess the operating performance of its ongoing business without the effects of these special charges. These items are excluded from Air Canada Services' segment results as they could potentially distort the analysis of trends in business performance. The special charge for Aeroplan miles is the full and final settlement between the parties in connection with Air Canada's obligations for the redemption of pre-2002 miles. The special charge for labour restructuring is the total cost of the 20 percent non-unionized workforce reduction plan announced in February 2006. The special charges for Aeroplan miles and labour restructuring are not reflective of the underlying financial performance of the Air Canada Services segment from ongoing operations.

The following measure is not a recognized measure for financial statement presentation under Canadian GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies.

Operating income excluding the special charge for Aeroplan miles and the special charge for labour restructuring is reconciled to operating income as follows:

($ millions)	**Q4 2006**	**Q4 2005**	**Change**	**2006**	**2005**	**Change**
Air Canada Services						
GAAP operating income (loss)	(5)	(91)	86	114	191	(77)
Add back:						
Special charge for Aeroplan miles	-	-	-	102	-	102
Operating income (loss), excluding the special charge for Aeroplan miles	**(5)**	**(91)**	**86**	**216**	**191**	**25**
Add back:						
Special charge for labour restructuring	(8)	-	(8)	20	-	20
Operating income (loss), excluding the special charges for Aeroplan miles and labour restructuring	**(13)**	**(91)**	**78**	**236**	**191**	**45**

($ millions)	**Q4 2006**	**Q4 2005**	**Change**	**2006**	**2005**	**Change**
Consolidated total						
GAAP operating income (loss)	29	(57)	86	259	318	(59)
Add back:						
Special charge for Aeroplan miles	-	-	-	102	-	102
Operating income (loss), excluding the special charge for Aeroplan miles	**29**	**(57)**	**86**	**361**	**318**	**43**
Add back:						
Special charge for labour restructuring	(8)	-	(8)	20	-	20
Operating income (loss), excluding the special charges for Aeroplan miles and labour restructuring	**21**	**(57)**	**78**	**381**	**318**	**63**

Operating Expense excluding Fuel Expense and the Special Charge for Labour Restructuring

The Air Canada Services segment uses operating expense excluding fuel expense and the special charge for labour restructuring to assess the operating performance of its ongoing business without the effects of fuel expense and the special charge for labour restructuring. These items are excluded from Air Canada Services' results as they could potentially distort the analysis of trends in business performance. Fuel expense has increased significantly year-over-year and excluding this expense from GAAP results allows Air Canada Services to compare its operating performance on a consistent basis. The special charge for labour restructuring is not reflective of the underlying financial performance of the Air Canada Services segment from ongoing operations.

The following measure is not a recognized measure for financial statement presentation under Canadian GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies.

($ millions)	**Q4 2006**	**Q4 2005**	**Change**	**2006**	**2005**	**Change**
Air Canada Services						
GAAP operating expense	2,420	2,362	58	10,023	9,318	705
Remove:						
Aircraft fuel	(583)	(577)	(6)	(2,544)	(2,197)	(347)
Operating expense, excluding fuel expense	**1,837**	**1,785**	**52**	**7,479**	**7,121**	**358**
Remove:						
Special charge for labour restructuring	8	-	8	(20)	-	(20)
Operating expense, excluding fuel expense and the special charge for labour restructuring	**1,845**	**1,785**	**60**	**7,459**	**7,121**	**338**

Management's Report

The combined consolidated financial statements have been prepared by management. Management is responsible for the fair presentation in the combined consolidated financial statements of financial position, results of operations and cash flows in conformity with generally accepted accounting principles. Management is responsible for the selection of accounting policies and making significant accounting judgements and estimates. Management is also responsible for all other financial information included in the annual report and for ensuring that this information is consistent, where appropriate, with the information contained in the combined consolidated financial statements.

Management is responsible for establishing and maintaining adequate internal control over financial reporting which includes those policies and procedures that provide reasonable assurance as to the completeness, fairness and accuracy of the combined consolidated financial statements and other financial information.

The Audit, Finance and Risk Committee reviews the quality and integrity of the Corporation's financial reporting and recommends approval to the Board of Directors; oversees management's responsibilities as to the adequacy of the supporting systems of internal controls; provides oversight of the independence, qualifications and appointment of the external auditor; and, pre-approves audit and audit-related fees and expenses. The Board of Directors approves the Corporation's combined consolidated financial statements, management's discussion and analysis and annual report disclosures prior to their release. The Audit, Finance and Risk Committee was appointed by the Board of Directors on November 15, 2006 and will meet with management, the internal auditors and external auditors at least four times each year to review and discuss financial reporting issues and disclosures, auditing and other matters.

The external auditors, PricewaterhouseCoopers LLP, conduct an independent audit of the combined consolidated financial statements in accordance with Canadian generally accepted auditing standards and express their opinion thereon. Those standards require that the audit is planned and performed to obtain reasonable assurance about whether the combined consolidated financial statements are free of material misstatement. The external auditors have unlimited access to the Audit, Finance and Risk Committee and meet with the Committee on a regular basis.

Joshua Koshy
Executive Vice President &
Chief Financial Officer

Montie Brewer
President &
Chief Executive Officer

Independent Auditors' Report

To the Shareholders of Air Canada

We have audited the combined consolidated statements of financial position of Air Canada as at December 31, 2006 and December 31, 2005 and the combined consolidated statements of operations, deficit and cash flows for the years then ended. These combined consolidated financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these combined consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the combined consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the combined consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall combined consolidated financial statement presentation.

In our opinion, these combined consolidated financial statements present fairly, in all material respects, the combined consolidated financial position of the company as at December 31, 2006 and December 31, 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants
Montreal, Quebec
February 13, 2007

Combined Consolidated Statement of Operations and Deficit

For the year ended December 31 **(in millions – Canadian dollars)**		**2006**	**2005**
			(note 1)
Operating revenues			
Passenger		$ 8,887	$ 8,199
Cargo		629	625
Other		651	634
		10,167	9,458
Special charge for Aeroplan Miles	note 20	(102)	-
		10,065	9,458
Operating expenses			
Salaries, wages and benefits		2,127	2,122
Aircraft fuel		2,545	2,197
Aircraft rent		441	417
Airport and navigation fees		982	924
Aircraft maintenance, materials and supplies		855	751
Communications and information technology		278	297
Food, beverages and supplies		335	334
Depreciation, amortization and obsolescence	note 14	514	422
Commissions		237	253
Special charge for labour restructuring	note 10	20	-
Other		1,472	1,423
		9,806	9,140
Operating income		**259**	**318**
Non-operating income (expense)			
Interest income		87	48
Interest expense		(321)	(284)
Interest capitalized		61	14
Loss on sale of and provisions on assets	note 3	(6)	(27)
Other		(17)	16
		(196)	(233)
Income before the following items		63	85
Non-controlling interest		(152)	(131)
Foreign exchange gain		12	47
Recovery of (provision for) income taxes		3	(21)
Loss for the year		**$ (74)**	**$ (20)**
Deficit, beginning of year		(41)	(21)
Deficit, end of year		**$ (115)**	**$ (41)**
Loss per share			
Basic and diluted	note 13	$ (0.83)	$ (0.25)

The accompanying notes are an integral part of the combined consolidated financial statements.

Combined Consolidated Statement of Financial Position

As at December 31 (in millions – Canadian dollars)		2006	2005
ASSETS			(note 1)
Current			
Cash and cash equivalents	note 2P	$ 1,447	$ 1,034
Short-term investments	note 2Q	798	302
		2,245	1,336
Restricted cash	note 2R	109	86
Accounts receivable		688	660
Spare parts, materials and supplies		148	179
Prepaid expenses and other current assets		124	122
Prepaid maintenance to ACTS	note 1	535	-
Future income tax	note 8	345	-
		4,194	2,383
Property and equipment	note 3	5,946	5,451
Deferred charges	note 4	103	127
Intangible assets	note 5	1,194	1,811
Deposits and other assets	note 6	312	490
		$ 11,749	**$ 10,262**
LIABILITIES			
Current			
Accounts payable and accrued liabilities		$ 1,521	$ 1,411
Advance ticket sales		1,019	893
Aeroplan Miles obligation	note 2F	58	89
Current portion of long-term debt and capital leases	note 7	367	265
Note payable to ACTS	note 1	535	-
Current taxes payable	note 8	345	-
		3,845	2,658
Long-term debt and capital leases	note 7	3,196	2,996
Notes payable to ACE subsidiary	note 1	-	340
Future income taxes	note 8	134	217
Pension and other benefit liabilities	note 9	1,876	2,154
Other long-term liabilities	note 10	472	496
Preferred shares	note 12	-	50
		9,523	8,911
Non-controlling interest		374	333
SHAREHOLDERS' EQUITY			
Share capital	note 12	274	22
Contributed surplus	note 12	1,693	1,037
Deficit		(115)	(41)
		1,852	1,018
		$ 11,749	**$ 10,262**

The accompanying notes are an integral part of the combined consolidated financial statements.
Commitments (Note 15); Contingencies, Guarantees and Indemnities (Note 17)

On behalf of the Board of Directors:

Signed
Robert A. Milton
Chairman

Signed
Richard H. McCoy
Director

Combined Consolidated Statement of Cash Flow

For the year ended December 31 **(in millions – Canadian dollars)**		**2006**	**2005**
Cash flows from (used for)			(note 1)
Operating			
Loss for the period		$ (74)	$ (20)
Adjustments to reconcile to net cash provided by operations			
Depreciation, amortization and obsolescence		514	422
Loss on sale of and provisions on assets		6	27
Foreign exchange (gain) loss		6	(83)
Future income taxes		(3)	11
Employee future benefit funding more than expense		(228)	(74)
Decrease (increase) in accounts receivable		(72)	187
Decrease (increase) in spare parts, materials and supplies		31	(64)
Increase (decrease) in accounts payable and accrued liabilities		20	(160)
Increase (decrease) in advance ticket sales, net of restricted cash		103	183
Increase (decrease) in Aeroplan Miles obligation		(108)	(146)
Non-controlling interest		152	131
Special charge for Aeroplan Miles	note 20	102	-
Allocation of corporate expenses	note 1	11	21
Aircraft lease payments (in excess of) less than rent expense		(16)	33
Other		(51)	(80)
		393	**388**
Financing			
Issue by Air Canada of share capital	note 1	187	-
Issue of Jazz units	note 19	218	-
Transfer of ACTS investment to ACE	note 1	673	-
Transfer of Jazz investment to ACE	note 1	483	-
Transfer of Aeroplan investment to ACE	note 1	-	1,070
Acquisition promissory note paid by Jazz to ACE	note 19	(424)	-
Jazz – Credit facility borrowings	note 7	113	-
Aircraft related borrowings	note 7	397	404
Cash management with related parties	note 18	-	(4)
Distributions paid to non-controlling interest		(86)	-
Settlement of notes payable to ACE	note 1	(140)	-
Reduction of long-term debt and capital lease obligations		(278)	(354)
Other		(1)	(6)
		1,142	**1,110**
Investing			
Short-term investments		(496)	(250)
Additions to capital assets		(888)	(868)
Reduction of note receivable from ACE	note 1	186	-
Proceeds from sale of assets		40	41
Cash management with related parties		32	(59)
Cash collaterization of letters of credit		4	(35)
		(1,122)	**(1,171)**
Increase in cash and cash equivalents		**413**	**327**
Cash and cash equivalents, beginning of year		1,034	707
Cash and cash equivalents, end of year		**$ 1,447**	**$ 1,034**

Cash and cash equivalents exclude Short-term investments of $798 as at December 31, 2006 ($302 as at December 31, 2005).
The accompanying notes are an integral part of the combined consolidated financial statements.

For the years ended December 31, 2006 and 2005
(currencies in millions – Canadian dollars)

1. BASIS OF PRESENTATION AND NATURE OF OPERATIONS

A) INITIAL PUBLIC OFFERING

The accompanying combined consolidated statement of financial position and combined consolidated statements of operations and cash flows are of Air Canada (the “Corporation”), a subsidiary of ACE Aviation Holdings Inc. ("ACE").

In conjunction with the initial public offering of Air Canada (the “Air Canada IPO”), which closed on November 24, 2006:

- Prior to the Air Canada IPO and in connection with internal planning by the ACE group of entities, Air Canada prepaid an amount of approximately $595 to ACTS Limited Partnership (“ACTS”) for the estimated equivalent of 12 months of service to be rendered by ACTS starting on November 1, 2006.

  The amount of such prepayment was immediately loaned back by ACTS to Air Canada through a non-interest bearing loan. The loan is repayable in installments equal to the amount that would otherwise be payable by Air Canada to ACTS for services to be rendered, starting on November 1, 2006. This is considered to be a non-cash transaction in substance and have been excluded from the combined consolidated statement of cash flows.

- ACE transferred to Air Canada all of its interests in Air Canada Ground Handling, all of its interests in Air Canada Cargo and 51% of its interests in Touram Limited Partnership (“Air Canada Vacations”) in consideration for the issuance to ACE of additional common shares of Air Canada. In addition, ACE exchanged all the preferred shares it held in Air Canada for common shares of Air Canada at an exchange ratio equal to the price of shares sold in the Air Canada IPO resulting in the issuance of additional common shares. No effect is given to this transaction in these combined consolidated financial statements as the preferred shares would be classified as equity. Following these transactions, ACE held 90,476,190 common shares in the restructured Air Canada immediately prior to the offering.

- For consideration of $673, special investments in ACTS were transferred to ACE from Air Canada and were recorded in Contributed surplus (refer to Excluded Inter-company Investments section below).

- Inter-company accounts between ACE and Air Canada were settled that resulted in an increase to Cash and cash equivalents of $170, a reduction to Deposits and other assets of $269 (consisting of an advance of $186 and a note receivable on the transfer of the Jazz investment of $83), a reduction to Accounts receivable of $41 and a reduction of Long-term debt of $140.

- The Air Canada IPO consisted of an offering by Air Canada of an aggregate of 9,523,810 variable voting shares and voting shares for gross proceeds of $200 ($187 net of offering costs of $13) and a secondary offering by ACE of an aggregate of 15,476,190 variable voting shares and voting shares for gross proceeds of $325 ($304 net of offering costs of $21). The offering costs incurred were allocated between ACE and Air Canada on a pro rata basis in relation to size of the aggregate offering. Air Canada did not receive any proceeds from the secondary offering from ACE.

In accordance with Emerging Issue Committee Abstract No. 89, Exchange of Ownership Interests between Enterprises under Common Control – Wholly and Partially-Owned Subsidiaries, these financial statements of Air Canada combine the assets and liabilities, results of operations and cash flows of Air Canada and all of the affiliates combined with Air Canada as noted above as if they had been combined from September 30, 2004, the date Air Canada and the affiliates emerged from proceedings under the Companies’ Creditors Arrangement Act (the “CCAA”). The assets and liabilities have been combined at their carrying values in the respective companies. The shareholders’ equity reflects the shareholders’ equity of Air Canada adjusted for the above transactions, as applicable.

B) BASIS OF PRESENTATION

These combined consolidated financial statements include the financial position, results of operations and cash flows of:

- Air Canada, which provides transportation services;
- Air Canada Capital Ltd., a wholly owned subsidiary of Air Canada, which owns and leases certain aircraft which are subleased to Air Canada, Jazz and unrelated third parties;
- 1209265 Alberta Ltd., a wholly owned subsidiary of Air Canada, which holds and manages cash and investments of Air Canada;
- Simco Leasing Ltd., a wholly owned subsidiary of Air Canada, which owns certain flight equipment which is leased to Air Canada;
- ACGHS Limited Partnership ("Air Canada Ground Handling Services" or "ACGHS"), a wholly owned subsidiary of Air Canada, which provides ground handling services;
- Touram Limited Partnership for the periods subsequent to January 30, 2005 and Touram Inc. for periods prior to January 31, 2005 (“Touram" or "Air Canada Vacations"), which provides tour operator services and leisure vacation packages and in which Air Canada has a 51% ownership interest;
- AC Cargo Limited Partnership ("Air Canada Cargo"), a wholly owned subsidiary of Air Canada, which, along with Air Canada, provides cargo services;
- Jazz Air LP (“Jazz” or “Jazz LP”), which provides both domestic and transborder services for Air Canada under a capacity purchase agreement (ACE holds a 79.7% interest in the general partner of Jazz and 79.7% of the limited partnership units of Jazz Air LP; Air Canada does not hold any of the limited partners' units of Jazz), and has been consolidated under AcG-15 as Air Canada has been determined to be the primary beneficiary of Jazz;
- Maple Leaf Holdings USA Inc., which holds certain cost based investments in other enterprises;
- Certain aircraft and engine leasing entities and fuel facility corporations, which are consolidated under Accounting Guideline of the CICA Handbook, Consolidation of Variable Interest Entities (“AcG-15”), as Air Canada has been determined to be the primary beneficiary; and
- Destina eCommerce Group LP (‘‘Destina’’), which provided web based travel services and an online travel site that offered customers both air and non-air products. During 2006, a substantial portion of the assets of Destina were transferred to Air Canada (Note 18).

The activities of these operations are described further below in part C) Nature of Operations. These combined consolidated financial statements also include certain limited partnerships that are holding companies of the limited partnerships and the general partners of the limited partnerships described above; these entities do not carry on any active business.

Air Canada has two business segments: Air Canada Services and Jazz. Air Canada Services is the passenger and cargo transportation services business operated by Air Canada and related ancillary services. Jazz operates under the capacity purchase agreement with Air Canada that came into effect September 30, 2004 (the “initial Jazz CPA”), which was amended and restated effective January 1, 2006 (the “Jazz CPA”).

These combined consolidated financial statements are expressed in millions of Canadian dollars and are prepared in accordance with generally accepted accounting principles ("GAAP") in Canada.

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 cost structure of the Corporation is such that its fixed costs do not fluctuate proportionately with passenger demand in the short-term.

Allocation of Corporate Expenses

The Corporation receives services from ACE and other affiliates outside the Corporation. Similarly the Corporation also provides services to ACE and other affiliates outside the Corporation. Direct costs of the services received, as well as management fees charged by ACE to the components of the Corporation have been included in these combined consolidated financial statements as described in Note 18. The costs of services provided to other affiliates outside the Corporation have been reflected in these combined consolidated financial statements in accordance with the terms of the relevant agreement. In addition, for the period prior to November 24, 2006, these combined consolidated financial statements include an allocation of the general corporate expenses incurred by ACE based upon the proportion of the Corporation's consolidated revenues compared to ACE's consolidated revenues. The allocation of general corporate expenses to the Corporation includes its proportionate share of such general corporate expenses incurred by ACE, including executive management, legal, investor relations, treasury, finance, financial reporting, tax, internal audit and human resources services as well as costs of governance, professional fees and regulatory filings, all of which amounted to $11 for the year ended December 31, 2006 ($21 for the year ended December 31, 2005). This allocation of corporate expenses is recorded within the Air Canada Services segment. This allocation of corporate expenses is recorded as a credit to contributed surplus. The allocation of general corporate expenses ceased on November 24, 2006.

These combined consolidated financial statements do not include an allocation of additional interest expense on corporate debt issued by ACE which has a weighted average effective interest rate of 12% for the period ended November 24, 2006 (12% for the year ended December 31, 2005). In conjunction with the Air Canada IPO described above, the Corporation settled the outstanding loans due to ACE and its affiliates of $140. As at December 31, 2005 the Corporation had outstanding loans due to ACE and its affiliates of $340 on which the Corporation was charged interest. For the loans outstanding as at December 31, 2005, borrowings in the amount of $90 bear interest at prime plus 3.00%, an amount of $50 bear interest at a fixed interest rate of 10.00%, and the remaining $200 bear interest at a rate per annum equal to the CIBC commercial prime Canadian dollar loans plus 3.00%. The weighted average effective interest rates on these inter-company loans amounted to 9.36% for the period ended November 24, 2006 (8.29% for the year ended December 31, 2005). Management of the Corporation believes that the inter-company debt and the rates thereon are appropriate in the circumstances.

Management of the Corporation believes the assumptions underlying the combined consolidated financial statements, including the allocations described above, are reasonable. These costs and allocations are not necessarily indicative of the costs and allocations that may be reflected in future periods when the Corporation is a stand alone entity.

Excluded Inter-company Investments

Prior to the Air Canada IPO, Air Canada held, for tax planning purposes, certain investments in limited partnerships of which ACE owned directly or indirectly all of the limited partner units. These investments and related income and income tax effects have been excluded from these combined consolidated statements of financial positions and operations of the Corporation, as these activities did not relate to the operations of the Corporation. Certain of these investments were transferred to ACE during 2005 and 2006 in exchange for cash and a note receivable. For purposes of these combined consolidated financial statements, these exchanges of the investments for cash and a note receivable were recorded as related party transactions resulting in a contribution of cash and notes receivable to the Corporation. These contributions of cash have been reflected as financing activities in the combined consolidated statement of cash flows. During 2006 the Corporation received cash from ACE of $673 for the investments in ACTS and $483 for the investments in Jazz (2005 – $1,070 for the investments in Aeroplan).

During 2006, Jazz settled a Note payable outstanding to a subsidiary of ACE of $200 in connection with the initial public offering of Jazz Air Income Fund (Note 19).

C) NATURE OF OPERATIONS

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 as well as the international markets to and from Canada. Certain of the scheduled passenger services are provided by Jazz through the Jazz CPA. Through Air Canada's global route network, virtually every major market throughout the world is served either directly or through the Star Alliance network. In addition, Air Canada provides certain charter services.

Air Canada and Air Canada Cargo provide air cargo services on domestic, US transborder and international flights. Air Canada Cargo is a major domestic and US transborder air cargo carrier and uses the entire cargo capacity on aircraft operated by Air Canada and Jazz on domestic and transborder routes. Air Canada offers cargo services on its international flights and currently uses two chartered all freighter aircraft to supplement Canada-Europe and Canada-Asia services. Air Canada Cargo manages all international cargo and freighter operations on behalf of Air Canada.

Air Canada Ground Handling Services provides passenger handling services to Air Canada, Jazz and other airlines with a primary focus on Canadian stations. Services covered include passenger check-in, gate management, baggage and cargo handling and processing, cabin cleaning, de-icing as well as aircraft ramp services.

Air Canada Vacations is a major Canadian tour operator providing tour operator services and vacation packages which include air transportation supplied by Air Canada, hotel accommodations, car rentals and cruises. Air Canada Vacations also sells surplus seat inventory to travel agents under the trade name Netair.

Jazz is a regional carrier which, pursuant to the Jazz CPA, provides service to Air Canada’s customers in lower density markets and in higher density markets at off-peak times throughout Canada and to certain destinations in the United States. Jazz focuses on flight operations and customer service and Air Canada is responsible for scheduling, marketing, pricing and related commercial activities of the regional operations. Under the Jazz CPA, Jazz records revenues from Air Canada based upon fees relating to flight operations performed, passengers carried and other items covered by the agreement. These inter-company transactions are eliminated in these combined consolidated financial statements. The Air Canada Services segment records the revenue on flights operated under the Jazz CPA in Passenger revenue. However, since all distributions from Jazz are made to its partners, ACE and Jazz Air Income Fund ("Jazz Fund"), all income from Jazz is allocated to the non-controlling interest in the combined consolidated statement of operations. Distributions for the year ended 2006 of $98 are reflected as a reduction of the non-controlling interest on the balance sheet.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A) BASIS OF VALUATION

In accordance with Section 1625 of the CICA Handbook, Comprehensive Revaluation of Assets and Liabilities (“CICA 1625”), Air Canada adopted fresh start reporting on September 30, 2004. As a result of the financial reorganization under CCAA, the assets and liabilities of the combined consolidated entity, excluding goodwill, were comprehensively revalued to fair values. A revaluation adjustment of $4,234 was recorded to shareholders’ equity.

B) PRINCIPLES OF CONSOLIDATION/COMBINATION

These combined consolidated financial statements include the accounts of the operations described in Note 1A above, with provisions for non-controlling interests. The combined consolidated financial statements of the Corporation include the accounts of variable interest entities for which the Corporation is the primary beneficiary. All inter-company and inter-entity balances and transactions are eliminated.

C) USE OF ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

D) PASSENGER AND CARGO REVENUES

Airline passenger and cargo advance sales are deferred and included in current liabilities. Advance sales include the proceeds from the sale of flight tickets to Aeroplan, a subsidiary of ACE that provides loyalty program services to Air Canada and purchases seats from Air Canada under the Commercial Participation and Services Agreement ("CPSA" — refer to Note 2F). Passenger and cargo revenues are recognized when the transportation is provided, except for revenue on unlimited flight passes which is recognized on a straight-line basis over the period during which the travel pass is valid. The Corporation has formed alliances with other airlines encompassing loyalty program participation, code sharing and coordination of services including reservations, baggage handling and flight schedules. Revenues are allocated based upon formulas specified in the agreements and are recognized as transportation is provided.

The Corporation performs regular evaluations on the deferred revenue liability which may result in adjustments being recognized as revenue. 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 relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual results that are different from estimates; however these differences have historically not been material.

E) CAPACITY PURCHASE AGREEMENTS

Air Canada has capacity purchase agreements with certain unaffiliated regional carriers, which are referred to as Tier III carriers, operating aircraft of 18 seats or less. Under these agreements, Air Canada is responsible for the marketing, ticketing and commercial arrangements relating to these flights and records the revenue it earns under passenger revenue. For the year ended December 31, 2006, passenger revenues under capacity purchase agreements with Tier III carriers amounted to $68 ($70 - 2005). Operating expenses under capacity purchase agreements with Tier III carriers are recorded primarily in the aircraft fuel, airport and navigation fees and other operating expense categories.

F) AEROPLAN LOYALTY PROGRAM

Air Canada is an Aeroplan partner providing certain of Air Canada's customers with Aeroplan Miles, which can be redeemed by customers for air travel or other rewards acquired by Aeroplan.

Under the Commercial Participation and Services Agreement ("CPSA") between the Corporation and Aeroplan, Aeroplan purchases passenger tickets from Air Canada to meet its obligation for the redemption of Aeroplan Miles for air travel. The proceeds from the sale of passenger tickets to Aeroplan are included in Advance ticket sales. Revenue related to these passenger tickets is recorded in passenger revenues when transportation is provided.

For Aeroplan Miles earned by Air Canada customers, Air Canada purchases Miles from Aeroplan in accordance with the terms of the CPSA. The cost of purchasing Aeroplan Miles from Aeroplan is accounted for as a sales incentive and charged against passenger revenues when the points are issued, which is upon the qualifying air travel being provided to the customer.

Under the CPSA, for a specified number of Aeroplan Miles issued prior to January 1, 2002, the Corporation is responsible for providing air travel rewards at no charge to Aeroplan. Upon implementation of the Corporation's plan of arrangement under the Companies' Creditors Arrangement Act (the "Plan"), this obligation was recorded at the estimated fair value of air travel rewards expected to be issued to the Aeroplan members (Note 20). On redemption of these Aeroplan Miles, a proportion of the liability is transferred to Advance ticket sales with revenue recorded in passenger revenues when the transportation is provided.

G) OTHER REVENUES

Other revenue includes revenues from the sale of the ground portion of vacation packages, ground handling services and other airline related services, including maintenance services provided by Jazz. Vacation package revenue is recognized as services are provided over the period of the vacation. Other airline related service revenues are recognized as the products are sold to passengers or the services are provided.

The Corporation provides certain services to related parties consisting principally of administrative services in relation to information technology, human resources, finance and accounting, treasury and tax services, corporate real estate, environmental affairs and legal services. Administrative service revenues are recognized as services are provided. Real estate rental revenues are recognized on a straight line basis over the term of the lease.

H) EMPLOYEE FUTURE BENEFITS

The cost of pensions, other post-retirement and post-employment 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 valuation 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 4 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. The average remaining service life for the plans is between 7 and 17 years.

Cumulative unrecognized net actuarial gains and losses in excess of 10% 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.

As described in Note 9, some of the Corporation's employees perform work for ACE, and some are contractually assigned to various subsidiary companies of ACE. These employees are members of the Corporation's sponsored defined benefit pension plans and also participate in the Corporation's sponsored health, life and disability future benefit plans. These combined consolidated financial statements include all of the assets and liabilities of all sponsored plans of the Corporation. Pension expenses are recorded net of costs recovered from related parties pertaining to employees assigned by the Corporation to the related parties based on an agreed upon formula. The cost recovery reduces the Corporation's benefit cost with an offset to inter-company receivable.

I) EMPLOYEE PROFIT SHARING PLAN

The Corporation has an employee profit sharing plan. Payments are calculated annually on full calendar year results and recorded throughout the year as a charge to salary and wage expense based on the estimated annual payment under the plan.

J) STOCK-BASED COMPENSATION PLANS

Certain employees of the Corporation participate in ACE, Air Canada and/or Jazz stock based compensation plans, as described in Note 11.

The fair value of stock options or units granted to Corporation employees is recognized as compensation expense and a credit to contributed surplus on a straight line basis over the applicable vesting period. For a stock option or unit award attributable to an employee who is eligible to retire at the grant date, the fair value of the stock option or unit award is expensed on the grant date. For a stock option or unit award attributable to an employee who will become eligible to retire during the vesting period, the fair value of the stock option or unit award is recognized over the period from the grant date to the date the employee becomes eligible to retire. The amount of compensation cost recognized at any date at least equals the value of the vested portion of the options at that date.

ACE, Air Canada and Jazz maintain employee share and unit purchase plans for shares of ACE, Air Canada and units of Jazz. Under these plans, contributions by the Corporation's employees are matched to a specific percentage by the Corporation. Upon the closing of the Air Canada IPO described in Note 1, Air Canada employees are limited to participating in the Air Canada plan and not the ACE plan. These contributions are included in salaries, wages and benefits expense.

K) MAINTENANCE AND REPAIRS

Maintenance and repair costs are charged to operating expenses as incurred, with the exception of maintenance and repair costs related to return conditions on short-term aircraft leases, which are accrued over the term of the lease.

L) OTHER OPERATING EXPENSES

Included in other operating expenses are expenses related to building rent and maintenance, terminal handling, professional fees and services, crew meals and hotels, advertising and promotion, insurance costs, credit card fees, ground costs for Air Canada Vacations packages, and other expenses. Expenses are recognized as incurred.

M) FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

Under the Corporation's risk management policy, derivative financial instruments are used only for risk management purposes, not for generating trading profits. When the Corporation utilizes derivatives in hedge accounting relationships, the Corporation identifies, designates and documents those transactions and regularly tests the transactions to demonstrate effectiveness in order to continue hedge accounting. To the extent that a derivative financial instrument does not qualify for hedge accounting or for those that are not designated as hedges, the fair value of the derivative financial instrument is recorded in the combined consolidated statement of financial position and changes in its fair value are recorded in income in the period when the change occurs.

Changes in the fair value of foreign currency forward contracts, option agreements and currency swap agreements used for foreign exchange risk management but not designated as hedges for accounting purposes, are recorded in foreign exchange gain (loss). These contracts are included in the combined consolidated statement of financial position at fair value in Accounts receivable and Accounts payable and accrued liabilities.

The Corporation from time to time enters into interest rate swaps to manage the risks associated with interest rate movement on US and Canadian floating rate debt and investments, including anticipated debt transactions. Changes in the fair value of these swap agreements, which are not designated as hedges for accounting purposes, are recognized in income in Other non-operating income and are recorded on the combined consolidated statement of financial position in Other assets and Other long-term liabilities.

Derivatives under the fuel-hedging program are designated as hedges for accounting purposes and hedge accounting is being applied prospectively from October 1, 2005. Under hedge accounting, gains or losses on fuel hedging contracts are recognized as a component of aircraft fuel expense when the underlying jet fuel being hedged is consumed. Premiums paid for option contracts and the excluded time value of the options is deferred as a cost of the hedge in the combined consolidated statement of financial position in Other assets and recognized in Fuel expense at the same time as the hedged jet fuel is consumed. Similarly, the value of the derivatives previously measured at fair value where the Corporation did not apply hedge accounting is also treated as a cost of the hedge and accounted for in the same way. Prior to these derivative instruments being designated as hedges for accounting purposes, gains or losses are recorded in other non-operating expense.

The Corporation will discontinue hedge accounting when the hedge item matures, expires, is sold, terminated, cancelled or exercised, the Corporation terminates its designation of the hedging relationship, the hedging relationship ceases to be effective, or the anticipated transaction is no longer probable.

When a hedging item ceases to exist and is not replaced, any gains, losses, revenues or expenses associated with the hedging item that have been deferred previously as a result of applying hedge accounting are carried forward to be recognized in income in the same period as the corresponding gains, losses, revenues or expenses associated with the hedged item.

When a hedged item ceases to exist or an anticipated transaction is no longer probable, any gains, losses, revenues or expenses associated with the hedging item that had been deferred previously as a result of hedge accounting are realized in the current period's statement of operations.

N) FOREIGN CURRENCY TRANSLATION

Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at rates of exchange in effect at the date of the combined consolidated statement of financial position. Non-monetary assets, non-monetary liabilities, revenues and expenses arising from transactions denominated in foreign currencies, are translated at rates of exchange in effect, which is based on an average for the month. Adjustments to the Canadian dollar equivalent of foreign denominated monetary assets and liabilities due to the impact of exchange rate changes are classified on the combined consolidated statement of operations as a foreign exchange gain or loss.

O) 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 and liabilities are measured using substantively enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date. Future income tax assets are recognized to the extent that realization is considered more likely than not.

As the income of excluded inter-company investments held by Air Canada (Note 1) has been excluded from these combined consolidated financial statements, the future income tax expense resulting from the utilization of the losses accumulated prior to the implementation of the Plan has been allocated to Shareholders' Equity.

P) CASH AND CASH EQUIVALENTS

Cash includes $1,330 pertaining to investments with original maturities of three months or less at December 31, 2006 (2005 $1,084). Investments include bankers' acceptances, bankers discount notes, and commercial paper, which may be liquidated promptly and have original maturities of three months or less. The weighted average interest rate on investments as at December 31, 2006 is 4.31 % (2005 – 3.39%).

Q) SHORT-TERM INVESTMENTS

Short-term investments, comprised of bankers' acceptances and bankers' discount notes, have original maturities over three months, but not more than one year. The weighted average interest rate on short-term investments as at December 31, 2006 is 4.38% (2005 – 3.15%).

R) RESTRICTED CASH

As at December 31, 2006, the Corporation has recorded $109 (2005 – $86) in restricted cash, under current assets, representing funds held in trust by Air Canada Vacations in accordance with regulatory requirements governing advance ticket sales, recorded under current liabilities, for certain travel related activities.

S) SPARE PARTS, MATERIALS AND SUPPLIES

Spare parts, materials and supplies are valued at the lower of average cost and net realizable value. A provision for the obsolescence of flight equipment spare parts is accumulated over the estimated service lives of the related flight equipment to a 30% residual value.

T) PROPERTY AND EQUIPMENT

Property and equipment is 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. On the application of fresh start accounting effective September 30, 2004, the cost of the Corporation's property and equipment was adjusted to fair value. In addition, the estimated useful lives of certain assets were also adjusted, including buildings where useful lives were extended to periods not exceeding 50 years.

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 leases and variable interest entities are depreciated to estimated residual values over the life of the lease. Aircraft and flight equipment are depreciated over 20 to 30 years, with 10% to 20% estimated residual values. Aircraft reconfiguration costs are amortized over 3 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 40 to 50 years on a straight line basis. 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 5 years. Ground and other equipment is depreciated over 3 to 25 years.

U) INTEREST CAPITALIZED

Interest on funds used to finance the acquisition of new flight equipment and other property and equipment is capitalized for periods preceding the dates that the assets are available for service. Capitalized interest related to the acquisition of new flight equipment and other property and equipment is included in purchase deposits within Property and equipment (refer to Note 3). Capitalized interest also includes financing costs charged by the manufacturer on capital commitments as described in Note 15.

V) DEFERRED FINANCING COSTS

Deferred financing costs are amortized on an effective interest basis over the term of the related obligation.

W) INTANGIBLE ASSETS

As a result of the application of fresh start reporting, intangible assets were recorded at their estimated fair values at September 30, 2004. Indefinite life assets are not amortized while assets with finite lives are amortized to nil over their estimated useful lives.

	Estimated Useful Life
International route rights and slots	Indefinite
Air Canada trade name	Indefinite
Other marketing based trade names	Indefinite
Star Alliance membership	25 years
Other contract and customer based intangible assets	10 to 15 years
Technology based intangible assets	1 to 5 years

X) IMPAIRMENT OF LONG-LIVED ASSETS

Long-lived assets are tested for impairment whenever circumstances indicate that the carrying value may not be recoverable. When events or circumstances indicate that the carrying amount of long-lived assets, other than indefinite life intangibles, are not recoverable, the long-lived assets are tested for impairment 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.

Indefinite life intangible assets are subjected to impairment tests under Canadian GAAP on an annual basis or when events or circumstances indicate a potential impairment. If the carrying value of such assets exceeds the fair values, the assets are written down to fair value.

Y) INVESTMENTS

Investments not subject to significant influence are carried at cost and any declines in value that are determined to be other than temporary are included in earnings. Earnings from such investments are recognized only to the extent received or receivable.

Z) AIRCRAFT LEASE PAYMENTS IN EXCESS OF OR LESS THAN RENT EXPENSE

Total aircraft operating lease rentals over the lease term are amortized to operating expense on a straight-line basis. Included in deferred charges and long-term liabilities is the difference between the straight line aircraft rent expense and the payments as stipulated under the lease agreement.

AA) 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.

BB) RELATED PARTY TRANSACTIONS

Related party transactions not in the normal course of operations are measured at the exchange amount when the change in ownership interest in the item transferred is substantive and the exchange amount is supported by independent evidence; otherwise it is recorded at the carrying amount. Related party transactions in the normal course of operations are measured at the exchange amount.

CC) VARIABLE INTEREST ENTITIES

Aircraft and Engine Leasing Transactions

The Corporation has entered into aircraft and engine leasing transactions with a number of special purpose entities that are variable interest entities (a “VIE”) under Accounting Guideline 15 of the CICA Handbook, Variable Interest Entities (“AcG-15”). As a result of the adoption of AcG-15 and the Corporation being the primary beneficiary of these VIEs, the Corporation consolidates leasing entities covering 51 aircraft and 22 engines.

Fuel Facilities Arrangements

The Corporation participates in fuel facilities arrangements operated through fuel facility corporations (the "Fuel Facility Corporations"), along with other airlines to contract for fuel services at various major Canadian airports. The Fuel Facility Corporations are organizations incorporated under federal or provincial business corporations acts in order to acquire, finance and lease assets used in connection with the fuelling of aircraft and ground support equipment. The Fuel Facilities Corporations operate on a cost recovery basis.

Under AcG-15, the Corporation is the primary beneficiary of three of the Fuel Facilities Corporations in Canada. Five of the Fuel Facility Corporations in which Air Canada participates in Canada that have not been consolidated have assets of approximately $128 and debt of approximately $108, which is the Corporation's maximum exposure to loss without taking into consideration any cost sharing and asset retirement obligations that would occur amongst the other contracting airlines. The Corporation considers this loss potential as remote.

Jazz

Air Canada entered into the Jazz CPA as described further under Note 14 — Segment information. Under the Jazz CPA, Air Canada has provided a minimum daily utilization guarantee and a minimum capacity guarantee to Jazz, pays certain variable costs of operating Jazz aircraft and is obligated to cover the costs of certain aircraft return obligations related to Jazz aircraft covered under the Jazz CPA. Air Canada does not hold any partners units of Jazz. Due to the terms of the Jazz CPA, Air Canada is deemed to have a variable interest in Jazz, as defined under AcG-15. As a result, these combined financial statements consolidate the results of Jazz as a business segment of Air Canada.

DD) FUTURE ACCOUNTING STANDARD CHANGES

The following is an overview of accounting standard changes that the Corporation will be required to adopt in future years:

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 balance sheet 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 the ability for certain unrealized gains and losses arising from changes in fair value to be temporarily recorded outside the income statement 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. The Corporation has evaluated the consequences of the new standards, which may have a material impact on the Corporation's financial statements. See additional disclosure on the impact of the new standards in Note 16.

EE) COMPARATIVES

Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year.

3. PROPERTY AND EQUIPMENT

		2006		2005
Cost				
Flight equipment	$	3,666	$	3,029
Assets under capital leases (a)		1,813		1,758
Buildings and leasehold improvements		662		646
Ground and other equipment		122		118
		6,263		5,551
Accumulated depreciation and amortization				
Flight equipment		476		206
Assets under capital leases (a)		285		142
Buildings and leasehold improvements		95		53
Ground and other equipment		24		18
		880		419
		5,383		**5,132**
Purchase deposits, including capitalized interest (b)		563		319
Property and equipment at net book value (c)	**$**	**5,946**	**$**	**5,451**

(a) Included in capital leases as at December 31, 2006 are 37 aircraft (2005 — 35) with a cost of $1,739 (2005 — $1,684) less accumulated depreciation of $265 (2005 — $130) for a net book value of $1,474 (2005 — $1,554), computer equipment with a cost of $28 (2005 — $28) less accumulated depreciation of $16 (2005 — $9) for a net book value of $12 (2005 — $19) and facilities with a cost of $46 (2005 — $46) less accumulated depreciation $4 (2005 — $3) for a net book value of $42 (2005 — $43).

(b) Includes $287 (2005 — $189) for Boeing B777/787 aircraft, $66 (2005 — $65) for Embraer aircraft, $175 (2005 — $25) for the aircraft interior refurbishment program and $35 (2005 — $40) for equipment purchases and internal projects.

(c) Net book value of Property and equipment includes $1,137 (2005 — $1,224) consolidated for aircraft and engine leasing entities, $111 (2005 — $109) consolidated for fuel facility corporations, and $199 (2005 — $194) consolidated for Jazz; all of which are consolidated under AcG-15.

During 2006:

- The Corporation sold one of its buildings with a carrying value of $35, for proceeds of $40 resulting in a gain on sale of $5.
- The Corporation recorded an impairment loss of $7 on one of its buildings being held for sale, which is to be sold to an affiliate in early 2007, within non-operating expenses of the Air Canada Services segment.

During 2005, the Corporation recorded provisions of $17, including $13 for spare parts, to reflect the excess of the carrying value over fair value.

As at December 31, 2006, flight equipment included 28 aircraft (2005 — 32), that are retired from active service with a net carrying value of $5 (2005 — $10), which approximates fair value.

Interest capitalized during 2006 amounted to $61 (2005 - $14) with $33 at an interest rate of LIBOR plus 3.0% and $28 at an interest rate of 8.05%.

4. DEFERRED CHARGES

		2006		2005
Aircraft lease payments in excess of rent expense – Air Canada Services	$	55	$	75
Financing costs – Air Canada Services		18		17
Aircraft lease payments in excess of rent expense – Jazz		28		30
Financing costs – Jazz		2		5
	$	**103**	**$**	**127**

5. INTANGIBLE ASSETS

	2006	2005
Indefinite life assets		
International route rights and slots	$ 430	$ 653
Air Canada trade name	393	595
Other marketing based trade names	50	84
	873	**1,332**
Finite life assets		
Star Alliance membership	158	239
Other contract and customer based	157	211
Technology based	130	96
	445	546
Accumulated depreciation and amortization		
Star Alliance membership	(22)	(12)
Other contract and customer based	(65)	(36)
Technology based	(37)	(19)
	(124)	(67)
Finite life assets, net	**321**	**479**
	$ 1,194	**$ 1,811**

As a result of recognizing the benefit during the year ended December 31, 2006 of future income tax assets that existed at fresh start, and for which a valuation allowance was recorded, for the year ended December 31, 2006, intangible assets were reduced on a pro-rata basis by $554, including the impact of the reversal of valuation allowance by ACE as described in Note 8 (2005 — $89).

The carrying value of intangible assets includes $5 (2005 — $10) related to Jazz, which is consolidated under AcG-15.

6. DEPOSITS AND OTHER ASSETS

		2006	2005
Aircraft related deposits and derivative instruments		$ 172	$ 167
Collateral under letters of credit and other deposits		133	127
Advances to ACE	note 1	-	186
Other		7	10
		$ 312	**$ 490**

7. LONG-TERM DEBT AND CAPITAL LEASES

	Final Maturity	Stated Interest Rate		2006		2005
Embraer aircraft financing (a)	2017 – 2021	6.89 – 8.49	$	776	$	393
Conditional sales agreements (b)	2019	8.26 – 8.28		184		193
Lufthansa cooperation agreement (c)	2009	6.50		44		59
GE loan (d)	2015	11.12		48		51
Revolving credit facility (e)	2010	-		-		-
Other	2007 – 2010	4.32 – 9.10		5		8
Direct Corporation debt				**1,057**		**704**
Jazz – senior syndicated credit facility (f)	2009	7.09		115		-
Jazz – term loans and credit facilities				-		14
Aircraft and engine leasing entities – debt (g)				1,051		1,125
Fuel facility corporations – debt (h)				59		53
Debt consolidated under AcG-15				**1,225**		**1,192**
Capital lease obligations (i)				**1,281**		**1,365**
Total debt and capital leases				**3,563**		**3,261**
Current portion				(367)		(265)
Long-term debt and capital leases			**$**	**3,196**	**$**	**2,996**

The Stated Interest Rate in the table above is the rate as of December 31, 2006.

Principal repayment requirements as at December 31, 2006 on long-term debt and capital lease obligations, and aircraft, engine and fuel facility debt consolidated as variable interest entities under AcG-15 are as follows:

		2007		2008		2009		2010		2011		Thereafter
Direct Corporation debt	$	67	$	85	$	70	$	55	$	70	$	710
Debt consolidated under AcG-15		120		117		175		118		248		447
Capital lease principal obligation		180		179		92		90		87		653
Total	**$**	**367**	**$**	**381**	**$**	**337**	**$**	**263**	**$**	**405**	**$**	**1,810**

(a) The following table summarizes the loans that Air Canada drew to finance the acquisition of Embraer aircraft that are secured by the delivered aircraft:

	Number of Aircraft	Interest Rate	Maturity		Original US$ Loan Amount		Original CDN$ Loan Amount
2006 Year							
Embraer 175	1	7.34%	2018	$	20	$	23
Embraer 190	15	8.07%	2021		330		374
2005 Year							
Embraer 175	14	7.14%	2017		277		329
Embraer 190	3	7.80%	2020		65		75
Total				**$**	**692**	**$**	**801**

During 2006, the interest rate margins on outstanding financing relating to all EMB 175 aircraft (US$297) were re-priced from 3.25% down to 2.35% and eight loans that bear interest at a floating interest rate were converted to fixed interest rate loans. The Interest Rate above represents the weighted average fixed interest rates as at December 31, 2006 of the loans that Air Canada drew relating to the Embraer aircraft financing (7.81% – weighted average rate of the fixed and floating interest rate loans outstanding as at December 31, 2005).

(b) US$158 principal outstanding on purchases of two A340-500 aircraft financed through conditional sales agreements. Principal and interest is paid quarterly until maturity in 2019. The purchase price installments bear interest at a three month LIBOR rate plus 2.9% (8.27% as at December 31, 2006 and 7.26% as at December 31, 2005).

(c) US$38 principal outstanding to mature in 2009, with semi annual repayments, at a fixed interest rate of 4.495% plus an annual 2.0% guarantee fee.

(d) US$41 principal outstanding to mature in 2015, with quarterly repayments, at a floating interest rate equal to the six month LIBOR rate plus 5.75% pre-payable on any interest payment date after December 23, 2007 secured by certain flight training equipment with a current carrying value of $55.

(e) Upon closing of the Air Canada IPO and satisfaction of certain customary conditions, the revolving credit facility was amended and restated. The amended agreement established a $400 million senior secured revolving credit facility (the "Amended Credit Facility") with a three-year term. The Amended Credit Facility has a three year term that can be extended at Air Canada's option for additional one-year periods on each anniversary of the closing of the Air Canada IPO, subject to prior approval of Lenders holding no less than two thirds of the total commitments under the Amended Credit Facility. The total amount available for borrowing under the Amended Credit Facility is subject to a borrowing base restriction based on certain percentages of the values of eligible accounts receivable and eligible real estate. The Amended Credit Facility is secured by a first priority security interest and hypothec over the present and after-acquired personal property of Air Canada, subject to certain exclusions and permitted liens, and by a first priority charge and hypothec over certain owned and leased real property of Air Canada. Air Canada's obligations are guaranteed by 1209265 Alberta Ltd., a subsidiary of Air Canada, which provides a first priority security interest over its present and after-acquired personal property, subject to certain exclusions and permitted liens, as security for its guarantee obligations. The Amended Credit Facility contains customary representations and warranties and is subject to customary terms and conditions (including negative covenants, financial covenants and events of default). The interest rate margin ranges from LIBOR plus 2.25% to 3.25% or prime plus 1.25% to 2.25% (based on Air Canada's earnings before interest, taxes, depreciation, amortization and obsolescence and aircraft rent). As at December 31, 2006, no amount was drawn under this facility.

(f) In connection with the initial public offering of the Jazz Air Income Fund ("Jazz IPO"), Jazz arranged for a senior secured syndicated credit facility in the amount of $150. On closing of the Jazz IPO, $115 was drawn under the credit facility ($113 net of fees). The facility bears interest at floating rates and has a three year term maturing in 2009. The outstanding credit facility is secured by substantially all the present and future assets of Jazz. Jazz entered into swap agreements with third parties with a notional value of $115 to receive floating rates and pay fixed rates of 7.09%. Subsequent to December 31, 2006, the original term of this facility was extended to 2010.

(g) The Corporation has entered into aircraft and engine lease transactions with several special purpose entities that qualify as VIEs. The debt has a weighted average effective interest rate of approximately 8%. The aircraft are charged as collateral against the debt by the owners thereof. The creditors under these leasing arrangements have recourse to the Corporation, as lessee, in the event of default or early termination of the lease. Aircraft related debt amounting to US$902 ($1,051) [2005 — US$965 ($1,125)] is summarized as follows:

	Final Maturity	**2006**	**2005**
Canadian Regional Jet	2007 – 2011	$ 316	$ 329
Boeing 767-300	2011 – 2016	211	231
Engines	2008	71	78
Airbus 319	2011 – 2014	304	331
Airbus 321	2017	149	156
		$ 1,051	**$ 1,125**

(h) Under AcG-15, the Corporation is the primary beneficiary of certain of the Fuel Facility Corporations in Canada. The debt is secured by a general security agreement covering all assets of the Fuel Facility Corporations.

(i) Capital lease obligations, related to computer equipment, facilities and 37 aircraft, total $1,281 ($80 and US$1,030) [2005 total $1,365 ($87 and US$1,096)]. The debt has a weighted average effective interest rate of approximately 8% and final maturities range from 2008 to 2027. During 2006 the Corporation recorded interest expense on capital lease obligations of $101 (2005 – $119).

As at December 31, 2006, obligations under capital leases for future minimum lease payments are as follows:

2007	$	275
2008		260
2009		161
2010		152
2011		142
Thereafter		829
Total minimum lease payments		1,819
Less amount representing interest		(538)
Total obligation under capital leases	**$**	**1,281**

Certain aircraft lease agreements contain a fair value test, beginning on July 1, 2009, and annually thereafter until lease expiry. This test relates to 38 aircraft under lease of which 37 are accounted for as capital leases. Under the test, the Corporation may be required to prepay certain lease amounts, based on aircraft fair values, as of the date of the test. Any amounts prepaid are recoverable to the extent that aircraft fair values exceed certain thresholds and to the extent the Corporation has obtained residual value support on lease expiry. The maximum amount payable on July 1, 2009, assuming the related aircraft are worth nil, is US$871. This amount declines over time to nil upon lease expiry.

Interest paid on long-term debt and capital lease obligations in 2006 by the Corporation was $251 (2005 – $227).

8. FUTURE INCOME TAXES

The following income tax related amounts appear in the Corporation's combined consolidated statement of financial position:

		2006		2005
Future income tax asset recorded in current assets (a)	$	345	$	-
Current taxes payable (a)	$	(345)	$	-
Future income tax liability (c)	$	(134)	$	(217)

a) Current Taxes Payable

As part of a tax loss utilization strategy that was planned in conjunction with the initial public offering of Air Canada and corporate restructuring, a current tax payable of $345 was created. This tax payable arose upon a transaction to transfer tax assets from Air Canada to ACE. This tax payable will be recoverable from future income tax assets of Air Canada. The recovery is expected to settle within twelve months.

b) Valuation Allowance

The Corporation has determined that it is more likely than not that future income tax assets of $1,169 are not recoverable and have been offset by a valuation allowance. However, the future tax deductions underlying the future tax assets remain available for use in the future to reduce taxable income.

Prior to the completion of the Air Canada IPO, it was determined that a portion of valuation allowance recorded by ACE should be reversed as it was more likely than not that certain future income tax assets of $504, which a valuation allowance had been recorded against at the time of fresh start reporting, would be realized. Consistent with the income tax accounting policy of Air Canada while it was wholly owned by ACE, the reversal of the valuation allowance by ACE results in a reduction of Air Canada's intangible assets (on a pro-rata basis) of $374.

The benefit of future income tax assets that existed at fresh start, including the benefit recognized by affiliates of the Corporation, and for which the valuation allowance has been reversed, are recognized on a pro rata basis as a reduction of intangible assets of the Corporation and a debit or credit to shareholders' equity. The pro rata allocation of the reversal of the valuation allowance has been based on the aggregate carrying value of intangible assets of the Corporation and other entities of ACE on the basis that under the Plan, these intangible assets were transferred to the other entities from Air Canada. The accumulated credit to shareholders' equity as at December 31, 2006 is $340, as disclosed in Note 12 (2005 – $49).

As described in Note 1, the income of certain inter-company investments held by Air Canada are excluded from these combined consolidated financial statements. The income from these investments resulted in the utilization of non-capital losses carried forward of Air Canada and, as a result, the related future income tax expense has been charged to shareholders' equity. The accumulated debit to shareholders' equity as at December 31, 2006 is $177, as disclosed in Note 12 (2005 - $105).

Subsequent to the completion of the Air Canada IPO, the future income tax accounting of Air Canada is independent from ACE, and as such, Air Canada's intangible assets and shareholders' equity are not expected to be affected by accounting events from ACE.

c) Future Income Tax Liability

It has been assumed that certain intangibles and other assets with no underlying tax cost and a carrying value of approximately $836, have indefinite lives and accordingly, the associated future income tax liability of $134 is not expected to reverse until the assets are disposed of or become amortizable, resulting in the reporting of a future income tax liability of $134.

	December 31 2006	December 31 2005
Future tax assets		
Non-capital loss carry forward	$ 10	$ 334
Post-employment obligations	685	805
Accounting provisions not currently deductible for tax	180	184
Tax basis of capital over book basis	316	413
Eligible capital expenditures	10	7
Unearned revenues	355	32
Net other	34	63
Total future tax assets	1,590	1,838
Future tax liabilities		
Intangible assets	210	361
Net future tax assets	1,380	1,477
Less valuation allowance	1,169	1,694
Net recorded future income tax asset (liability)	**$ 211**	**$ (217)**

The reconciliation of income tax attributable to continuing operations, computed at the statutory tax rates, to income tax expense (recovery) is as follows:

	December 31 2006	December 31 2005
Provision (recovery) based on combined federal and provincial rates	$ (25)	$ -
Non-taxable portion of capital gains	1	(2)
Large corporations tax	-	10
Non-deductible expenses	14	12
Effect of tax rate changes on future income taxes	2	-
Effect of statutory tax rates substantially enacted during the year	64	(17)
Other	2	-
	58	3
Valuation allowance	(61)	18
(Recovery of) provision for income taxes	**$ (3)**	**$ 21**

Significant components of the provision for income taxes attributable to continuing operations are as follows:

	December 31 2006	December 31 2005
Current tax expense	$ -	$ 10
Future income tax expense relating to temporary difference	(6)	10
Future income tax recovery from tax rate changes	64	(17)
Valuation allowance	(61)	18
(Recovery of) provision for income taxes	**$ (3)**	**$ 21**

No income taxes were paid in 2005 and 2006 by the Corporation.

The balances of tax attributes as at December 31, 2006, namely the balances of non-capital loss carry forwards, vary amongst different taxing jurisdictions. The following are the Federal tax loss expiry dates:

	Tax losses
2010	$ 9
2014	16
	$ 25

9. PENSION AND OTHER BENEFIT LIABILITIES

The Corporation maintains several defined benefit and defined contribution plans providing pension, other retirement and post-employment benefits to its employees, including those employees of the Corporation who are contractually assigned to ACTS and Aeroplan.

The Corporation is the administrator and sponsoring employer of ten Domestic Registered Plans ("Domestic Registered Plans") under the Pension Benefits Standard Act, 1985 (Canada). The US plan, UK plan and Japan plan are international plans covering employees in those countries. In addition, the Corporation maintains a number of supplementary pension plans, which are not registered. The defined benefit pension plans provide benefits upon retirement, termination or death based on the member's years of service and final average earnings for a specified period.

The other employee benefits consist of health, life and disability. These benefits consist of both post-employment and post-retirement benefits. The post-employment benefits relate to disability benefits available to eligible active employees, while the post-retirement benefits are comprised of health care and life insurance benefits available to eligible retired employees.

Certain Corporation employees perform work for ACE and others are contractually assigned to ACTS and Aeroplan. These employees are members of Corporation sponsored defined benefit pension plans and also participate in Corporation-sponsored health, life and disability future benefit plans. These combined consolidated financial statements include all of the assets and liabilities of all Corporation sponsored plans. The employee benefit expense in these combined consolidated financial statements includes the expenses for all employees participating in the plans less a cost recovery which is charged to the related parties for those employees assigned. The cost recovery related to pension and other benefit liabilities amounted to $56 for the year ended December 31, 2006 (2005 - $51).

In 2005, the measurement date used for financial reporting of the pension and other benefit obligations was revised to November 30 from December 31.

Benefit Obligation and Plan Assets

The following tables present financial information related to the change in the pension and other post-employment benefits plans:

	Pension Benefits		Other Employee Future Benefits	
	2006	2005	2006	2005
Change in benefit obligation				
Benefit obligation at beginning of year	$ 12,921	$ 11,207	$ 940	$ 842
Current service cost	254	202	77	85
Interest cost	640	650	48	50
Employees' contributions	89	80	-	-
Benefits paid	(627)	(592)	(60)	(63)
Actuarial (gain) loss	(74)	1,419	(38)	31
Foreign exchange	32	(45)	(1)	(5)
	13,235	12,921	966	940
Change in plan assets				
Fair value of plan assets at beginning of year	10,421	9,673	14	10
Actual return on plan assets	1,493	1,016	1	1
Employer contributions	455	284	47	54
Employees' contributions	89	80	-	-
Benefits paid	(627)	(592)	(54)	(51)
Foreign exchange	27	(40)	-	-
	11,858	10,421	8	14
Deficit at end of year	**1,377**	**2,500**	**958**	**926**
Employer contributions after measurement date	(7)	(6)	(6)	(5)
Unrecognized past service cost	-	-	-	-
Unrecognized net actuarial gain (loss)	(221)	(1,061)	46	21
Net benefit obligation	**$ 1,149**	**$ 1,433**	**$ 998**	**$ 942**
Weighted average assumptions used to determine the accrued benefit liability				
Discount rate	5.00%	5.00%	5.00 – 5.50%	4.50 – 5.75%
Rate of compensation increase (a)	2.50%	4.00%		

(a) As a result of pay awards during 2006, a rate of compensation increase of 1.75% was used for years 2006 to 2008 in determining the net benefit obligation for the pension plan and 2.5% for the remaining years.

The pension benefit deficit at the end of the year by plan is as follows:

	2006	2005
Domestic registered plans (a)	$ 556	$ 1,657
US, UK and Japan	55	76
Supplementary plans	766	767
	$ 1,377	**$ 2,500**

(a) Includes $19 (2005 — $17) related to Jazz, which is consolidated under AcG-15.

The deficit, on an accounting basis, at December 31, 2006 for pension benefits was $1,377 compared to $2,500 at December 31, 2005. The decrease in the accounting deficit is mainly the result of a return on plan assets of approximately 13.8% for the year and funding of past service employer contributions of $261. The decrease in the net plan deficit during the year is expected to result in decreased employer contributions for 2007 as described below under Pension Plan Cash Funding Obligations.

The net benefit obligation recorded in the statement of financial position is as follows:

	2006	2005
Pension benefits	$ 1,149	$ 1,433
Other employee future benefits	998	942
Net benefit obligation	**2,147**	**2,375**
Current portion	(271)	(221)
Pension and other benefits liability	**$ 1,876**	**$ 2,154**

The current portion of Pension benefits represents past service contributions for the Domestic Registered Plans, scheduled to be paid during 2007 while the current portion of Other employee future benefits is an estimate of the claims to be incurred during 2007. The current portion is included in Accounts payable and accrued liabilities.

Total cash payments for 2006, consisting of cash contributed by the Corporation to its defined benefit plans, cash payments to beneficiaries for post-employment and post-retirement plans, and cash contributed to its defined contribution plans were $520 (2005 – $355).

Pension and Other Employee Future Benefit Expense

The Corporation has recorded net defined benefit pension and other employee future benefits expense as follows:

	Pension Benefits		Other Employee Future Benefits	
	2006	2005	2006	2005
Components of Net Periodic Pension Cost				
Current service cost	$ 254	$ 202	$ 77	$ 85
Interest cost	640	650	48	50
Actual return on plan assets	(1,515)	(973)	(1)	(1)
Actuarial (gain) loss on benefit obligation	(47)	1,362	(43)	19
Costs arising in the year	(668)	1,241	81	153
Differences between costs arising in the year and costs recognized in the year in respect of:				
Return on plan assets	774	281	-	-
Actuarial loss (gain)	65	(1,362)	26	(23)
	839	(1,081)	26	(23)
Net periodic benefit cost of plans	171	160	107	130
Amount charged to affiliates	(33)	(28)	(23)	(24)
Net defined benefit pension and other employee benefits expense (a)	**$ 138**	**$ 132**	**$ 84**	**$ 106**
Weighted average assumptions used to determine the accrued benefit cost				
Discount rate	5.00%	5.75%	5.00 – 5.50%	4.50 – 5.75%
Expected long-term rate of return on plan assets	7.50%	7.50%	7.50%	7.50%
Rate of compensation increase (b)	4.00%	4.00%		

(a) Includes $10 of Pension Benefits related to Jazz (2005 — $5), which is consolidated under AcG-15.

(b) A rate of compensation increase of 0% in 2005 and 2% in 2006 was used in determining the net benefit pension expense and 4% for the remaining years.

Other Benefits — Sensitivity Analysis

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 9.75% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2006 (2005 – 10%). The rate is assumed to decrease gradually to 5% by 2013. A one percentage point increase in assumed health care trend rates would have increased the service and interest costs by $1 and the obligation by $17. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by $1 and the obligation by $16.

Pension Plan Cash Funding Obligations

As at December 31, 2006 and based on the January 1, 2006 solvency valuation, the table below provides projections for the Corporation's cash pension plan funding obligations for 2007. The final funding obligation for 2007 will be determined based on the January 1, 2007 valuation.

		2007
Past service domestic registered plans (a)	$	250
Current service domestic registered plans		162
Other pension arrangements		86
	$	**498**

(a) Includes $2 for past service and $7 for current service, related to Jazz, which is consolidated under AcG-15.

The most recent actuarial valuation is as at January 1, 2006 and the effective date of the next required actuarial valuation is January 1, 2007. For domestic registered pension plans, the funding requirements are based on the minimum past service contributions disclosed in the January 1, 2006 actuarial valuations plus a projection of the current service contributions based upon the January 1, 2006 actuarial valuation used for the purpose. Based on a funding outlook, the solvency deficit on the registered pension plans at January 1, 2007 is expected to decrease significantly compared January 1, 2006 and, as a result, employer contributions determined in accordance with regulations, are expected to decline by approximately $90 in 2007.

On August 9, 2004, the Government of Canada adopted the Air Canada Pension Plan Solvency Deficiency Funding Regulations (the "Pension Regulations"). The Pension Regulations allow Air Canada to fund the solvency deficiencies in its Domestic Registered Plans as of January 1, 2004 over ten years, rather than the five years required under the ordinary rules, and to pay down such deficiencies by way of an agreed schedule of variable annual contributions rather than by way of equal annual contributions as required under the ordinary rules. The Pension Regulations came into force upon Air Canada's emergence from CCAA protection on September 30, 2004, on which date Air Canada issued subordinated secured promissory Notes in an aggregate amount of approximately $347 in favour of the pension plan trustee. Such Notes will be reduced as the principal amount of the solvency deficiencies is paid down, and will only be called on the occurrence of certain specified events of default. The amount of secured promissory Notes outstanding as at December 31, 2006 is $219 (2005 – $329. The effect of the issuance of the subordinated security promissory Notes is included within the fair value of the obligation for pension benefits as reflected in the Corporation's balance sheet.

The composition of the Domestic Registered Plan assets and the target allocation consist of the following:

	November 30 2006	November 30 2005	Target Allocation
Equity securities	59.1%	62.3%	59.0%
Bonds and mortgages	34.7%	32.1%	41.0%
Real estate	0.0%	0.1%	0.0%
Short-term and other	6.2%	5.5%	0.0%
	100.0%	100.0%	100.0%

Domestic Registered Plans

For the Domestic Registered Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Master Trust Fund. The investment return objective of the fund is to achieve a total annualized rate of return that exceeds inflation by at least 3.75% 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 37% to 43% 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 40% of the total return of the Scotia Capital Universe Bond Index and 60% of the total return of the Scotia Capital Long Term Bond Index.

Similar investment policies are established for the other pension plans sponsored by the Corporation.

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 reviewed anticipated future long-term performance of individual asset categories and considered 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.

Defined Contribution Plans

The Corporation's management, administrative and certain unionized employees may participate in defined contribution plans. The employees' contributions range from 3% to 6% of earnings with the Corporation contributing an equal amount. The Corporation’s expense for defined contribution plans amounted to $7 for the year ended December 31, 2006 (2005 – $6).

10. OTHER LONG-TERM LIABILITIES

		2006		2005
Aeroplan miles obligations (a)	$	105	$	80
Unfavourable contract liability on aircraft leases (b)		77		107
Aircraft rent in excess of lease payments (c)		121		126
Long-term employee liabilities (d)		54		86
Workplace safety and insurance board liability		45		53
Other		70		44
	$	**472**	**$**	**496**

(a) Air Canada has a liability related to Aeroplan Miles which were issued by Air Canada prior to January 1, 2002. Refer to Note 20 for a description of the Special charge for Aeroplan Miles which adjusted the original estimate of Aeroplan Miles. As of December 31, 2006 a liability for approximately 15 billion Miles, or $163, remains in Air Canada, of which $58 is included in current liabilities (total liability of 14 billion Miles, or $169, as at December 31, 2005). The amount of the additional liability was determined by valuing the incremental Miles at the current fair value.

(b) The unfavourable contract liability on aircraft leases represents the net present value of lease payments in excess of estimated market rents related to lease arrangements that existed on fresh start reporting.

(c) Included in this balance is $59 as at December 31, 2006 (2005 — $53) related to Jazz, which is consolidated under AcG-15.

(d) The following table outlines the changes to labour related provisions which are included in long-term employee liabilities for balances that existed upon the implementation of fresh start reporting on September 30, 2004:

		2006		2005
Beginning of year	$	121	$	157
Charges recorded in salaries, wages and benefits		-		5
Interest accretion		8		12
Amounts disbursed		(52)		(53)
End of year		77		121
Current portion		(32)		(40)
	$	**45**	**$**	**81**

The following table outlines the changes to labour related provisions which are included in long-term employee liabilities for balances that have been created subsequent to the implementation of fresh start reporting on September 30, 2004:

		2006		2005
Beginning of year	$	13	$	12
Special charge for labour restructuring				
Initial provision		28		-
Adjustment to provision		(8)		-
Charges recorded in salaries, wages and benefits		7		5
Amounts disbursed		(11)		(4)
End of year		29		13
Current portion		(20)		(8)
	$	**9**	**$**	**5**

The current portion is included in Accounts payable and accrued liabilities.

Special charge for labour restructuring

A workforce reduction plan was announced in February 2006 to reduce non-unionized employee levels by 20 percent. A special charge of $28 was recorded in the Air Canada Services segment in Quarter 1 2006 relating to this program. During Quarter 4 2006, the estimated cost of this plan was revised due to the favourable impact of attrition and other factors which reduced the cost of achieving the target. As a result, the Air Canada Services segment recorded a reduction of $8 in Quarter 4 2006 to the special charge for labour restructuring.

The Corporation offers certain severance programs to certain employees from time to time. The cost of these programs is recorded within operating expenses. The Corporation does not have any continuing obligation to offer these programs.

11. STOCK-BASED COMPENSATION

ACE Stock Option Plan

Certain of the Corporation's employees participate in the ACE stock option plan. Plan participation is limited to employees holding positions that, in ACE Board's view (or a committee selected by the Board), have a significant impact on ACE's long term results. The stock option plan provides that the options will have an exercise price of not less than 100% of the market price of the underlying shares at the time of grant. Fifty percent of all options vest over four years. The remaining options vest upon performance conditions that are based on net income targets established by the ACE Board over the same time period. All options expire after seven years. The terms of ACE's stock option plan specify that upon the retirement of the employee, options granted to that employee may be exercised as the options vest.

The number of ACE stock options granted to employees, the related compensation expense recorded and the assumptions used to determine stock-based compensation expense, using the Black-Scholes option valuation model were as follows:

	2006	2005
Compensation expense ($ millions)	$ 3	$ 2
Number of stock options granted to Air Canada employees	186,006	320,000
Weighted average fair value per option granted ($)	$ 10.39	$ 9.76
Aggregated fair value of options granted ($ millions)	$ 2	$ 3
Weighted average assumptions:		
Risk-free interest rate	4.02%	3.40%
Expected volatility	35%	35%
Dividend yield	0%	0%
Expected option life (years)	4.5	4.5

A summary of the activity related to Corporation employees participating in the ACE stock options' plan is as follows:

	2006		2005	
	Options (000)	Weighted Average Exercise Price/Share	Options (000)	Weighted Average Exercise Price/Share
Beginning of year	1,550	$ 24.37	1,460	$ 20.00
Granted	26	34.78	320	41.15
Exercised	(80)	20.00	(142)	20.00
Forfeited	(30)	20.00	(88)	20.00
Outstanding options, prior to special distribution	1,466	24.88	1,550	24.37
Adjustment – ACE special distribution (a)	101		n/a	
Outstanding options, after special distribution (a)	1,567	23.26		
Granted	160	32.08		
Exercised	(96)	19.07		
Forfeited	(21)	20.73		
Outstanding options, end of year	1,610	$ 24.42	1,550	$ 24.37
Options exercisable, end of year	291	$ 24.27	233	$ 22.90

(a) In accordance with the terms of the ACE stock option plan, the special distribution by ACE in March 2006 triggered an adjustment to the weighted average exercise price of options and the number of options outstanding. Effective March 22, 2006, the adjustment was applied to all unexercised ACE stock options as of March 1, 2006, whether vested or not. As at the adjustment date, the weighted average option exercise price and number of options outstanding had been amended from $24.88 and 1,465,480 options to $23.26 and 1,567,612 options.

		2006 Outstanding Options			2006 Exercisable Options	
Range of Exercise Prices	Expiry Dates	Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
$18.70	2011	1,085,803	5	$18.70	210,742	$18.70
$31.89 - $38.91	2012	339,604	6	38.52	80,220	38.91
$30.61 - $33.89	2013	184,734	7	32.14	-	-
		1,610,141		$24.42	290,962	$24.27

		2005 Outstanding Options			2005 Exercisable Options	
Range of Exercise Prices	Expiry Dates	Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
$20.00	2011	1,229,622	6	$20.00	201,372	$20.00
$34.11 - $41.62	2012	320,000	7	41.15	31,250	41.62
		1,549,622		$24.37	232,622	$22.90

Air Canada Long-Term Incentive Plan

As approved by the Board of Directors, concurrent with the Air Canada IPO described in Note 1, certain of the Corporation's employees participate in the Air Canada Long-term Incentive Plan (the "Long-term Incentive Plan") administered by the Board of Directors of Air Canada. The Long-term Incentive Plan provides for the grant of options and performance share units to senior management and officers of Air Canada.

The options to purchase shares granted under the Long-term Incentive Plan have a maximum term of 10 years and an exercise price based on the fair market value of the shares at the time of the grant of the options. Options granted under the Long-term Incentive Plan will vest over four years and will incorporate performance vesting features. The performance vesting conditions are based on net income targets established by the Air Canada Board over the same time period. The terms of the Long-term Incentive Plan specify that upon the retirement of the employee, options granted may be exercised as the rights to exercise accrue within three years from the retirement date.

The number of Air Canada stock options granted to employees, the related compensation expense recorded and the assumptions used to determine stock-based compensation expense, using the Black-Scholes option valuation model were as follows:

	2006	2005
Compensation expense ($ millions)	$ 3	$ -
Number of stock options granted	1,699,678	-
Weighted average fair value per option granted ($)	$ 5.40	$ -
Aggregated fair value of options granted ($ millions)	$ 9	$ -
Weighted average assumptions:		
Risk-free interest rate	4.07%	-
Expected volatility	35%	-
Dividend yield	0%	-
Expected option life (years)	4.5	-

A summary of the activity related to Corporation employees participating in the Air Canada Long-term Incentive Plan is as follows:

	2006		2005	
	Options (000)	Weighted Average Exercise Price/Share (b)	Options (000)	Weighted Average Exercise Price/Share
Beginning of year	-	$ -	-	$ -
Granted	1,700	21.00	-	-
Exercised	-	-	-	-
Forfeited	-	-	-	-
Outstanding options, end of year	1,700	$ 21.00	-	$ -
Options exercisable, end of year	-	$ -	-	$ -

		2006 Outstanding Options			2006 Exercisable Options	
Range of Exercise Prices	Expiry Dates	Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	Number of Exercisable Options	Weighted Average Exercise Price/Share
$21.00	2016	1,699,678	10	$21.00	-	-

Approximately 346,000 performance share units were also granted under the Long-term Incentive Plan. The performance share units have a maximum term of three years and a grant price based on fair market value of the shares at the time of the grant. Performance share units granted under the Long-term Incentive Plan will vest over three years commencing January 1, 2007 and will incorporate performance vesting features. The terms of the Long-term Incentive Plan specify that upon the retirement of the employee, performance share units granted will be prorated at the end of the vested term based on the total number of completed months of active service during the term of the performance share units.

Jazz Long-Term Incentive Plan

Jazz has an Initial Long-Term Incentive Plan (“Jazz Initial LTIP”) that grants Jazz Fund Units to key employees as a one-time special award. A total of 603,903 Jazz Fund Units were granted. Under the terms of the plan, 50% of the units granted are subject to vesting conditions based on Jazz’s performance and 50% vest on December 31, 2008. The Jazz segment recorded compensation expense of $2 during 2006 for this plan and the total estimated future commitment under this plan is $6.

Employee Ownership Plans

Employee ownership plans have been established for shares or units of ACE, Air Canada or Jazz under which eligible employees are allowed to invest up to 6% of their base salary for the purchase of shares or units on the secondary market. Air Canada and Jazz will match 33.3% of the investments made by the employee. During 2006, the Corporation recorded compensation expense of $2 in the Air Canada Services segment and $2 in the Jazz segment for the employee ownership plans.

12. SHAREHOLDERS' EQUITY

Share capital as at December 31, 2006 (net of issue costs) consists of the following:

	2006	2005
Share capital		
Common shares (a)	$ 562	$ -
Special common shares	-	325
	562	325
Adjustment to shareholders' equity (b)	(288)	(303)
	$ 274	**$ 22**

(a) The net proceeds from the Treasury offering by Air Canada in 2006 resulted in an increase to shareholders' equity of $187 (after $13 of expenses). The carrying value of outstanding common shares as at December 31, 2005 represents the net proceeds received by Air Canada from shares issued to ACE as at September 30, 2004.

(b) Under fresh start reporting, the balance in shareholders' equity after a comprehensive revaluation is adjusted to the net value of identifiable assets and liabilities. Section 1625 of the CICA Handbook, 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 Quarter 4 2006, as a result of a review of outstanding provisions, it was determined that a portion of the provision amounting to $15 would no longer be required. The amount reversed has been applied against Share capital as these amounts related to provisions established before the application of fresh start reporting.

As a result of the transactions related to the Air Canada IPO as described in Note 1, Air Canada became the parent company of the entities included in the Air Canada Services segment within these combined consolidated financial statements. In accordance with Emerging Issues Committee Abstract 89 of the CICA Handbook, Exchanges of Ownership Interests Between Enterprises Under Common Control – Wholly and Partially-Owned Subsidiaries, shareholders' equity has been restated for all periods presented to reflect the shareholders' equity of Air Canada as if the companies had been combined since their inception.

The following table describes the continuity of Air Canada's share capital during the year:

Outstanding shares (in thousands)	Common Shares	Special Common Shares	Special Preferred Shares	Exchangeable Distress Preferred Shares	Class A Non-Voting Shares	Non-Voting Shares
2006						
Beginning of year	-	50,000	50,000	-	-	-
Changes during the year:				-	-	-
Transfer of investments from ACE (c)	1	1	-	-	-	-
Conversion for IPO (c)	90,475	(50,001)	(50,000)	-	-	-
Initial public offering	9,524	-	-	-	-	-
End of year	**100,000**	**-**	**-**	**-**	**-**	**-**
2005						
Beginning of year	15,158	-	-	23,647	3	22,646
Changes during the year:						
Conversion to common	46,254	-	-	(23,647)	(3)	(22,646)
Conversion to special common and preferred	(61,412)	50,000	50,000	-	-	-
End of year	**-**	**50,000**	**50,000**	**-**	**-**	**-**

(c) In connection with the Air Canada IPO as described in Note 1, ACE transferred to Air Canada all of its interests in Air Canada Ground Handling, all of its interests in Air Canada Cargo and 51% of its interests in

Touram Limited Partnership (“Air Canada Vacations”) in consideration for the issuance to ACE of common shares of Air Canada and special common shares, which were converted into common shares prior to the Air Canada IPO. In addition, ACE exchanged all the preferred shares it held in Air Canada for common shares of Air Canada at an exchange ratio equal to the price of shares sold in the Air Canada IPO resulting in the issuance of additional common shares.

Common Shares

As at December 31, 2006, the common shares issuable by Air Canada consist of an unlimited number of Class A Variable Voting Shares (“Variable Voting Shares”) and an unlimited number of Class B Voting Shares (“Voting Shares”). The two classes of common shares have equivalent rights as common shareholders except for voting rights. Holders of Variable Voting Shares are entitled to one vote per share unless the aggregate number of Variable Voting Shares outstanding, as a percentage of the total number of votes attaching to all issued and outstanding voting shares of Air Canada exceeds 25% or the total number of votes cast by or on behalf of holders of Variable Voting Shares at any meeting exceeds 25% of the total number of votes that may be cast at such meeting. If the 25% threshold would be surpassed, the votes attaching to the Variable Voting Shares would be proportionately reduced. Variable Voting Shares will be automatically converted to Voting Shares if the shares become held, beneficially owned and controlled, directly or indirectly, by a Canadian. Voting Shares will be automatically converted to Variable Voting Shares if the shares become held, beneficially owned or controlled, directly or indirectly, by a party that is not a qualified Canadian.

The issued and outstanding common shares of Air Canada as at December 31, 2006, along with the potential common shares, are as follows:

Outstanding common shares (in millions)	**2006**
Issued and outstanding	
Class A variable voting shares	18
Class B voting shares	82
Total issued and outstanding	100
Potential common shares	
Stock options	2

During 2005, a nominal number of common shares were issued to ACE in consideration for the acquisition of the assets of Destina.

Special Common Shares and Special Preferred Shares

During the period from January 1, 2006 to the date of the Air Canada IPO:

- 1,000 special common shares were issued to ACE in consideration for the acquisition of ACGHS and certain other general partners as described in Note 1.

- 50,001,101 special common shares and 50,000,000 special preferred shares were converted into 90,475,190 common shares. The carrying value of the special preferred share liability of $50 was reclassified to share capital and the number of common shares deemed to be issued for the special preferred shares is 2,380,952. ACE received a special common share in consideration for the accrued interest on the special preferred share liability.

During 2005, all issued and outstanding common shares were cancelled in exchange for 50,000,000 special common shares and 50,000,000 special preferred shares. As at December 31, 2005, the share capital of Air Canada consisted of 50 million special common shares held by ACE.

Based on the characteristics of the special preferred shares, the 50 million special preferred shares held by a wholly owned subsidiary of ACE as at December 31, 2005 were classified as a liability in these combined consolidated financial statements.

Special Common Shares

Each holder of special common shares was entitled to one vote per special common share held and each special common share had liquidation rights in preference to other common shares of $0.01 per share.

Special Preferred Shares

Each holder of special preferred shares was not entitled to voting rights in respect to the special preferred shares held. The holder of the special preferred shares was entitled to receive cumulative dividends at a fixed rate of 8% per annum payable in money, property or by the issue of fully paid shares of any class of the share capital of Air Canada. A holder of special preferred shares shall be entitled to require the Corporation to redeem at any time all, or from time to time part, of the special preferred shares at $1 per share.

Exchangeable Distressed Preferred Shares

Each holder of exchangeable distressed preferred ("EDP") shares was not entitled to voting rights in respect to the EDP shares held. The holders of EDP shares were entitled to receive an aggregate amount of $5 by way of reduction of the stated capital of the EDP shares over a period of 5 years. Each EDP share was convertible at any time at the option of the holder into one fully paid and non-assessable common share. During 2005, 23,646,547 EDP shares with a nil carrying value were exchanged into common shares.

Class A Non-voting and Non-voting Shares

Each holder of class A non-voting and non-voting shares was not entitled to voting rights in respect to the class A non-voting or non-voting shares held. During 2005 these shares were converted into common shares.

Contributed Surplus

The changes during the years presented to Contributed surplus are as follows:

	2006	2005
Contributed surplus, beginning of year	$ 1,037	$ -
Allocation of corporate expenses (Note 1)	11	21
Fair value of stock options issued to Corporation employees recognized as compensation expense (Note 11)		
ACE plan	3	2
Air Canada plan	3	-
Allocation of reduction to intangible assets (Note 8)	(340)	49
Utilization of future income tax assets (Note 8)	(177)	(105)
Contribution from ACE on transfer of investments (Note 1)	1,156	1,070
Contributed surplus, end of year	**$ 1,693**	**$ 1,037**

13. EARNINGS PER SHARE

The following table outlines the calculation of basic and diluted earnings per share:

(in millions, except per share amounts)	2006	2005
Numerator:		
Numerator for basic earnings per share:		
Loss for the year	$ (74)	$ (20)
Effect of potential dilutive securities:		
Stock options	-	-
Adjusted numerator for diluted earnings per share	**$ (74)**	**$ (20)**
Denominator:		
Denominator for basic earnings per share:		
Weighted-average shares (a)	**89**	**82**
Effect of potential dilutive securities:		
Stock options	-	-
Adjusted denominator for diluted earnings per share	**89**	**82**
Basic loss per share	**$ (0.83)**	**$ (0.25)**
Diluted loss per share	**$ (0.83)**	**$ (0.25)**

The calculation of earnings per share is based on whole dollars and not on rounded millions. As a result, the above amounts may not be recalculated to the per share amount disclosed above.

(a) The weighted average shares outstanding used in the above calculations of basic and diluted earnings per share for 2006 and 2005 have taken into consideration the impact of the exchanges of different share types within share capital in deriving the outstanding common shares of Air Canada at the time of the Air Canada IPO (Note 12). These exchanges have been treated as stock splits and reverse stock splits in these financial statements and the weighted average number of common shares for the purpose of computing per share amounts has been retroactively restated.

The dilutive effect of outstanding stock options on earnings per share is based on the application of the treasury stock method. Under this method, the proceeds from the exercise of such securities are assumed to be used to purchase Class B Voting Shares.

Excluded from the calculation of diluted earnings per share were 1,699,678 outstanding options as the option's exercise price was greater than the average market price of the common shares for the year (2005 – nil).

At December 31, 2006, approximately 346,000 performance share units of Air Canada were outstanding and commence vesting on January 1, 2007. These units are excluded from the calculation of diluted earnings per share above.

14. SEGMENT INFORMATION

A reconciliation of the total amounts reported by each business segment and geographic region to the applicable amounts in the combined consolidated statements follows:

				2006
	Air Canada Services	**Jazz**	**Elimination**	**Consolidated Total**
Passenger revenue	$ 8,887	$ -	$ -	$ 8,887
Cargo revenue	629	-	-	629
Other revenue	644	7	-	651
External revenue	10,160	7	-	10,167
Inter-segment revenue	79	1,374	(1,453)	-
	10,239	**1,381**	**(1,453)**	**10,167**
Special charge for Aeroplan Miles	(102)	-	-	(102)
Total revenues	**10,137**	**1,381**	**(1,453)**	**10,065**
Salaries, wages, and benefits	1,816	311	-	2,127
Aircraft fuel	2,544	285	(284)	2,545
Aircraft rent	314	134	(7)	441
Airport user fees	982	178	(178)	982
Aircraft maintenance materials and supplies	768	98	(11)	855
Depreciation of property and equipment	437	21	-	458
Amortization of intangible assets	54	-	-	54
Obsolescence provisions	2	-	-	2
Commissions	237	-	-	237
Capacity purchase fees paid to Jazz	871	-	(871)	-
Special charge for labour restructuring	20	-	-	20
Other operating expenses	1,978	210	(103)	2,085
Total operating expenses	**10,023**	**1,237**	**(1,454)**	**9,806**
Operating income	**114**	**144**	**1**	**259**
Interest income	82	6	(1)	87
Interest expense	(313)	(8)	-	(321)
Interest capitalized	62	(1)	-	61
Loss on sale of and provisions on assets	(6)	-	-	(6)
Other non-operating expense	(16)	(1)	-	(17)
Non-controlling interest	(12)	-	(140)	(152)
Foreign exchange gain	12	-	-	12
Recovery of income taxes	3	-	-	3
Segment results / income (loss)	**$ (74)**	**$ 140**	**$ (140)**	**$ (74)**

				2005
	Air Canada Services	Jazz	Elimination	Consolidated Total
Passenger revenue	$ 8,197	$ 2	$ -	$ 8,199
Cargo revenue	625	-	-	625
Other revenue	626	8	-	634
External revenue	9,448	10	-	9,458
Inter-segment revenue	61	1,013	(1,074)	-
Total revenues	**9,509**	**1,023**	**(1,074)**	**9,458**
Salaries, wages, and benefits	1,857	265	-	2,122
Aircraft fuel	2,197	177	(177)	2,197
Aircraft rent	341	80	(4)	417
Airport user fees	924	124	(124)	924
Aircraft maintenance materials and supplies	693	68	(10)	751
Depreciation of property and equipment	346	18	-	364
Amortization of intangible assets	56	-	-	56
Obsolescence provisions	2	-	-	2
Commissions	253	-	-	253
Capacity purchase fees paid to Jazz	693	-	(693)	-
Other operating expenses	1,956	162	(64)	2,054
Total operating expenses	**9,318**	**894**	**(1,072)**	**9,140**
Operating income (loss)	**191**	**129**	**(2)**	**318**
Interest income	48	1	(1)	48
Interest expense	(270)	(16)	2	(284)
Interest capitalized	14	-	-	14
Loss on sale of and provisions on assets	(31)	4	-	(27)
Other non-operating income (expense)	15	-	1	16
Non-controlling interest	(13)	-	(118)	(131)
Foreign exchange gain	47	-	-	47
Provision for income taxes	(21)	-	-	(21)
Segment results / income (loss)	**$ (20)**	**$ 118**	**$ (118)**	**$ (20)**

Geographic Information

Passenger revenues	**2006**	**2005**
Canada	$ 3,680	$ 3,420
US Transborder	1,825	1,557
Atlantic	1,795	1,712
Pacific	946	924
Other	641	586
	$ 8,887	**$ 8,199**

Cargo revenues	**2006**	**2005**
Canada	$ 119	$ 129
US Transborder	28	33
Atlantic	225	228
Pacific	215	189
Other	42	46
	$ 629	**$ 625**

Passenger and cargo revenues are based on the actual flown revenue for flights with an origin and destination in a specific country or region. Atlantic refers to flights that cross the Atlantic Ocean with origin and destinations principally in Europe. Pacific refers to flights that cross the Pacific Ocean with origin and destinations principally in Asia. Other revenues are principally provided to customers located in Canada.

Segment Asset Information

					2006
	Air Canada Services	Jazz	Elimination	Consolidated Total
Cash and cash equivalents	$ 1,312	$ 135	$ -	$ 1,447
Short-term investments	798	-	-	798
	$ 2,110	$ 135	$ -	$ 2,245
Additions to capital assets	$ 863	$ 25	$ -	$ 888
Total assets	**$ 11,388**	**$ 483**	**$ (122)**	**$ 11,749**

				2005
	Air Canada Services	Jazz	Elimination	Consolidated Total
Cash and cash equivalents	$ 1,000	$ 34	$ -	$ 1,034
Short-term investments	302	-	-	302
	$ 1,302	$ 34	$ -	$ 1,336
Additions to capital assets	$ 852	$ 16	$ -	$ 868
Total assets	**$ 9,995**	**$ 504**	**$ (237)**	**$ 10,262**

The Corporation is a domestic and international carrier and for the purposes of segment reporting, flight equipment is attributed to Canada. As a result, substantially all of the Corporation's property and equipment are related to operations in Canada.

Relationship between Air Canada and Jazz

Air Canada has no ownership interests in Jazz. Jazz is consolidated in these combined consolidated financial statements under AcG-15. Air Canada has been determined to be the primary beneficiary. Air Canada and Jazz negotiate transactions between each other as if they were unrelated parties on an arm's length basis.

The Air Canada Services segment is comprised of the passenger and cargo transportation services business operated by Air Canada and related ancillary services.

The Jazz segment is Jazz Air LP operating under the capacity purchase agreement ("Jazz CPA") with Air Canada as described in Note 1C.

Under the Jazz CPA, Jazz is reimbursed for all pass-through costs (as described below) and Jazz is paid fees by Air Canada on a variety of different metrics based on an estimate of all costs and expenses to be incurred and paid by Jazz for the applicable period with respect to flights operated by Jazz pursuant to the Jazz CPA and other services to aircraft, other than Jazz's pass-through costs marked-up by a specified percentage. The fees include both a variable component that is dependent on Jazz aircraft utilization and a fixed component. The fees charged by Jazz to the Air Canada Services segment are payable on a monthly basis and are broken down between aircraft rent and other operating expenses in the segmented results.

Pass-through costs, which are reimbursed to Jazz, include fuel, airport and navigations fees and other, are recorded within the Other operating expenses in the segment results of Air Canada Services.

The accounting policies for these two segments are as described in Note 2. In addition, Jazz recognizes its revenue under the Jazz CPA as the services are provided to the Air Canada Services segment.

15. COMMITMENTS

In 2004, Air Canada signed definitive purchase agreements with Embraer — Empresa Brasileira de Aeronautica S.A. ("Embraer") for the acquisition of regional jet aircraft. In November 2005, Air Canada also concluded agreements with The Boeing Company ("Boeing") for the acquisition of Boeing 777 and Boeing 787 aircraft.

Embraer

The agreement with Embraer covers firm orders for 15 Embraer 175 series aircraft as well as 45 Embraer 190 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. As at December 31, 2006, 49 options remain exercisable.

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% financed by a third party as described in Note 7.

The Embraer 190 series deliveries commenced in December 2005 and at December 31, 2006, 18 of the Embraer 190 series firm aircraft orders have been completed. For the first 18 firm Embraer 190 deliveries, all of which have been delivered, Air Canada received loans from a syndicate of banks and the manufacturer covering 80% of the capital expenditure as described in Note 7.

Certain aircraft deliveries which were planned to be completed by November 2007 have been delayed with the last delivery expected by January 2008 and the impact of these delays has been reflected in the projected committed capital expenditures table below. These projections are based on estimates using information currently available and are subject to change.

Air Canada also received loan commitments from a third party for an additional 18 Embraer 190 series firm aircraft covering approximately 80% of the capital expenditure to be repaid in quarterly installments for a 12-year term. Financing for a maximum of five of these aircraft may be based on fixed rates while the remaining 13 aircraft will be based on floating rates. The borrowings bear interest at the 90-day US LIBOR plus 1.90% or the fixed rate equivalent.

Air Canada also received loan commitments from a syndicate of banks for the remaining nine Embraer 190 series firm aircraft to cover approximately 80% of the capital expenditure and to be repaid in quarterly installments for a 12-year term. The borrowings bear interest either at the 90-day US LIBOR plus 1.70% or the fixed rate equivalent.

Boeing

In November 2005, Air Canada concluded agreements with Boeing for the acquisition of up to 36 Boeing 777 aircraft and up to 60 Boeing 787 aircraft.

The order for the 36 Boeing 777 aircraft is comprised of firm orders for 18 aircraft plus purchase rights for 18 more, in a yet-to-be determined mix of the 777 family's newest models. As of December 31, 2006, Air Canada has confirmed with Boeing the delivery of eight Boeing 777-300ER aircraft and six Boeing 777-200LR aircraft. The models of the remaining four Boeing aircraft are yet to be determined. Delivery of the first Boeing 777 aircraft is scheduled for March 2007.

The order for the 60 Boeing 787 aircraft is comprised of firm orders for 14 aircraft plus options and purchase rights for an additional 46 aircraft. Air Canada's first Boeing 787 aircraft is scheduled for delivery in 2010.

Air Canada has received financing commitments from Boeing and the engine manufacturer for all firm aircraft orders covering approximately 90 percent of the capital expenditure. This available financing would be at an interest rate of 9.86 percent, based on interest rates as at December 31, 2006. The term to maturity would be 15 years with principal payments made on a mortgage style basis resulting in equal installment payments of principal and interest over the term to maturity. In November 2006, Air Canada made an application for loan guarantee support from the Export-Import Bank of the United States for the first seven Boeing 777 aircraft deliveries in 2007. The loan guarantee, if provided, would cover a 12-year loan term for 85% of the capital expenditure at an interest rate of approximately 5.36%, based on interest rates as at December 31, 2006.

Air Canada has signed a 10-year lease for one Boeing 777-300ER from International Lease Finance Corporation ("ILFC"), which is scheduled to be delivered in May 2007.

Aircraft Interior Refurbishment Program

In addition to acquiring new aircraft, Air Canada commenced a major refurbishment of the interior of its existing aircraft in April 2006. All existing aircraft, except for the Airbus A340 aircraft, will have refurbished interiors. The aircraft refurbishment program is scheduled to be completed by the middle of 2008. The capital expenditure associated with this program will be amortized over a five-year period.

Capital Commitments

As at December 31, 2006, the estimated aggregate cost of the future firm deliveries as well as other capital purchase commitments approximates $5,861 (of which $4,745 is subject to firm commitment financing). US dollar amounts are converted using the December 31, 2006 noon day rate of CDN$1.1653. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day LIBOR rate at December 31, 2006. Committed payments are as follows:

		2006
Year ending December 31, 2007	$	2,151
Year ending December 31, 2008		1,458
Year ending December 31, 2009		448
Year ending December 31, 2010		933
Year ending December 31, 2011		868
Thereafter		3
	$	**5,861**

Operating Lease Commitments

As at December 31, 2006 the future minimum lease payments under existing operating leases of aircraft and other property amount to $2,957 (December 31, 2005 — $3,416) using year end exchange rates.

	2006 Operating lease commitments					
		Aircraft		Other property		Total
Year ending December 31, 2007	$	406	$	66	$	472
Year ending December 31, 2008		335		58		393
Year ending December 31, 2009		305		43		348
Year ending December 31, 2010		270		34		304
Year ending December 31, 2011		200		25		225
Thereafter		1,072		143		1,215
	$	**2,588**	**$**	**369**	**$**	**2,957**

Lease payments for aircraft classified as capital leases and variable interest entities for accounting purposes are disclosed in Note 7 "Long-Term Debt and Capital Lease Obligations".

As at December 31, 2006, the future minimum non-cancellable commitments for the next 12 months under the capacity purchase agreements with unaffiliated regional carriers is $14.

16. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

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.

Interest Rate Risk Management

The Corporation enters into forward interest rate agreements to manage the risks associated with interest rate movement on US dollar and Canadian dollar floating rate debt and investments. During 2006 the Corporation entered into 19 interest rate swaps with a notional value of US$414 to receive floating rates and pay a weighted average fixed rate of 5.81% for the debt to be arranged in relation to the financing of Embraer 190 aircraft between June 2006 and November 2007. The swaps have 15 year terms from the expected delivery date of the aircraft and their maturities range from June 2021 to December 2022. The Corporation intends on settling the interest rate swaps upon delivery of the related aircraft. The Corporation did not apply hedge accounting to these derivative instruments. Before December 31, 2006, 7 of these swaps were settled at net loss of $4. As at December 31, 2006, the fair value of the remaining 12 swaps is $13 in favour of the counterparty and is recorded in Other long-term liabilities on the combined consolidated statement of financial position. The Corporation has recognized a net loss of $17 since inception of these swaps in Quarter 2 2006.

During 2005, the Corporation reached a settlement with a third party related to interest rate swaps that were terminated as a result of Air Canada's filing for CCAA on April 1, 2003. A dispute had arisen 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 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 had a fair value of $9 in favour of the Corporation on inception. As a result of these transactions, the Corporation recorded a gain of $17 net of transaction fees of $3, which has been included in Deposits and other assets. The swaps have a term to January 2024 and convert lease payments related to two B767 aircraft leases consolidated under AcG-15, from fixed to floating rates. These have not been designated as hedges for accounting purposes. As at December 31, 2006, these two swaps have a fair value of $4 in favour of the Corporation (December 31, 2005 — $7 in favour of the Corporation).

During 2006, Jazz entered into interest rate swaps to hedge its exposure to changes in interest rates on its outstanding senior secured credit facility (Note 7). The interest rate swap is with third parties with a notional value of $115, which has effectively resulted in a fixed interest rate of 7.09% for the term of the senior secured credit facility until February 2, 2009. Effective February 2, 2006, the Corporation is applying hedge accounting to these financial instruments and no amount is recorded in these combined consolidated financial statements. As at December 31, 2006, the fair value of these swaps was less than $1 in favour of the counterparty.

Foreign Exchange Risk Management

The Corporation enters into certain foreign exchange forward contracts or currency swaps to manage the risks associated with foreign currency exchange rates. As at December 31, 2006, the Corporation had entered into foreign currency forward contracts and option agreements on US$503 of future purchases in 2007. The fair value of these foreign currency contracts as at December 31, 2006 is $25 in favour of the Corporation (December 31, 2005 — $1 in favour of third parties on US$521 of future purchases in 2006). These derivative instruments have not been designated as hedges for accounting purposes. The unrealized gain has been recorded in foreign exchange.

The Corporation has entered into currency swap agreements for 16 Canadair Regional Jet (CRJ) operating leases until lease terminations between 2007 and 2011. Currency swaps for five CRJ operating leases, with third parties, were put in place on the inception of the leases and have a fair value at December 31, 2006 of $10 in favour of the third parties (December 31, 2005 — $13 in favour of the third parties), taking into account foreign exchange rates in effect at that time. Currency swaps for 11 CRJ operating leases with third parties have a fair value at December 31, 2006 of $3 in favour of the Corporation (December 31, 2005 — $3 in favour of the Corporation). These have not been designated as hedges for hedge accounting purposes. The unrealized changes in fair value have been recorded in Foreign exchange gain or loss.

Fuel Price Risk Management

The Corporation enters into contracts with financial intermediaries to manage its exposure to jet fuel price volatility. As of December 31, 2006, the Corporation had collar option and swap structures in place to hedge a portion of its anticipated jet fuel requirements over the 2007 to 2008 period. Since jet fuel is not traded on an organized futures exchange, liquidity for hedging this commodity is mostly limited to a shorter time horizon. Crude oil and heating oil contracts are effective commodities for hedging jet fuel and the Corporation mainly uses these commodities for medium to longer term hedges.

As of December 31, 2006, approximately 39% of the Corporation's anticipated purchases of jet fuel for 2007 were hedged. The Corporation's contracts to hedge anticipated jet fuel purchases over the 2007 period comprised of jet fuel, heating oil and crude-oil based contract. The Corporation's contracts to hedge anticipated purchases over the 2008 period are all crude oil-based and covered 8% of the first quarter of 2008 anticipated jet fuel purchase requirements.

Hedge accounting was applied prospectively from October 1, 2005. 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 the commencement of the Corporation's hedge accounting being applied, an unrealized gain of $2 was recorded in other non-operating expense during the nine months ended September 30, 2005.

For the year ended December 31, 2006, the Corporation recognized a net loss of $43 as a component of fuel expense on the combined consolidated statement of operations (net loss of $3 for the year ended December 31, 2005) on the settlement of matured contracts and amortization of deferred costs. The fair value of the Corporation’s fuel hedging contracts as at December 31, 2006 was $24 (US$21) in favour of counterparties (2005 – $3 in favour of third parties).

During 2006, the Corporation entered into two three-way collar option structures which are composed of one short put option, one long call option and one short call option. This structure creates a ceiling on the potential benefits to be realized by the Corporation if commodity prices increase above the threshold of the short call strike price. Due to the ceiling in these derivative instruments, this type of derivative does not qualify as a hedging instrument under GAAP. As at December 31, 2006, one of the three-way collar option structures remains outstanding, the fair value of this derivative instrument is $1 in favour of the counterparty and is recorded in Accounts payable and accrued liabilities on the combined consolidated statement of financial position.

During 2005, the Corporation de-designated one contract previously under hedge accounting that was combined into a new net-written option. The net-written option has a fair value less then zero at the time of inception and so it does not qualify as a hedging instrument under GAAP. As at December 31, 2006, the fair value of the net written option was $2 in favour of the counterparty (2005 – less than $1 in favour of the counterparty) and is recorded in Accounts payable and accrued liabilities on the combined consolidated statement of financial position.

The Corporation has recognized a net loss of $3 in non-operating expense during the year ended 2006 for these derivative instruments which do not qualify as hedge accounting instruments.

Concentration of Credit Risk

The Corporation does not believe it is subject to any significant concentration of credit risk. Cash and short-term investments are in place with major financial institutions, Canadian governments and major corporations. Accounts receivable are generally the result of sales of tickets to individuals through geographically dispersed travel agents, corporate outlets, or other airlines, often through the use of major credit cards.

Statement of Combined Consolidated Financial Position Financial Instruments — Fair Values

The carrying amounts reported in the combined consolidated statement of financial position for cash and short-term investments, accounts receivable and accounts payable approximate fair values due to the immediate or short-term maturities of these financial instruments.

The fair value of long-term debt and capital lease obligations as at December 31, 2006 and December 31, 2005 approximates its carrying value.

Proposed Accounting Policies

The Canadian Institute of Chartered Accountants Accounting Standards Board issued CICA 3855, Financial Instruments – Recognition and Measurement, CICA 3865, Hedges, and CICA 1530, Comprehensive Income, which will be applied by the Corporation for its fiscal years beginning on January 1, 2007. CICA 3855 prescribes when a financial asset, financial liability or non-financial derivative is to be recognized on the balance sheet and the measurement of such amount. It also specifies how financial instrument gains and losses are to be presented. CICA 3865 is applicable for designated hedging relationships and builds on existing Canadian GAAP guidance by specifying how hedge accounting is applied and what disclosures are necessary when it is applied. CICA 1530 introduces new standards for the presentation and disclosure of components of comprehensive income. Comprehensive income is defined as the change in net assets of an enterprise during a reporting period from transactions and other events and circumstances from non-owner sources. It includes all changes in net assets during a period except those resulting from investments by owners and distributions to owners.

When the Corporation adopts the new requirements on January 1, 2007, a new section of shareholders' equity called other comprehensive income will be presented. The new section will include gains and losses related to the mark-to-market of investment securities and cash flow hedges.

The impact of measuring fuel hedging derivatives at fair value on January 1, 2007 will be recognized in opening accumulated other comprehensive income.

The impact of measuring investment securities at fair value on January 1, 2007 will be recognized in opening accumulated other comprehensive income.

Deferred financing costs within deferred charges will be adjusted to the carrying amount of the related long-term debt and after initial recognition the related long-term debt will be amortized using an effective interest method.

The Corporation is currently considering further impacts related to the adoption of such standards on the consolidated financial statements. Prior periods will not be restated for the impact of these new standards.

17. CONTINGENCIES, GUARANTEES AND INDEMNITIES

Contingencies

Investigation by Competition Authorities Relating to Cargo

The European Commission, the United States Department of Justice and the Competition Bureau in Canada, among other competition authorities, are investigating alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges of a number of airlines and cargo operators, including the Corporation. Competition authorities have sought or requested information from the Corporation as part of their investigations. The Corporation is cooperating fully with these investigations. The Corporation is also named as a defendant in a number of class action lawsuits that have been filed before the United States District Court and in Canada in connection with these allegations. It is not possible at this time to predict with any degree of certainty the outcome of these proceedings. It is the Corporation's policy to conduct its business in full compliance with all applicable competition laws.

Pay Equity

Complaints filed in 1991 and 1992 with the Canadian Human Rights Commission against Air Canada and the former Canadian Airlines International on behalf of flight attendants at the two airlines alleging discrimination in negotiated wages were referred to the Canadian Human Rights Tribunal in 1996 for inquiry. By agreement of all parties, the inquiry before the Tribunal was limited to whether flight attendants at each airline were in the same establishment as pilots and technical operations personnel. Under the applicable legislation, a complaint can only compare the value of employees work and their wages if they work in the same establishment. In December 1998 the Tribunal found that pilots, flight attendants and technical operations personnel were in different establishments at each airline. This decision was upheld on judicial review by the Federal Court Trial Division, but overturned by the Federal Court of Appeal in 2004. The Supreme Court of Canada in January 2006 dismissed Air Canada's appeal from this latter decision and has remitted the complaints to the Commission for investigation. The parties are awaiting instructions from the Commission on how to proceed with the complaints. The value of each employee's work will be assessed on the basis of the skill, effort and responsibility it demands as well as the conditions under which it is performed. 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. Air Canada, upon consultation with legal counsel, considers that any investigation will show that it is complying with the equal pay provisions of the Canadian Human Rights Act; however, management is not able to determine the final outcome of the Commission's investigation.

Claim by the Air Canada Pilots Association

In October 2006, the Air Canada Pilots Association ("ACPA") commenced proceedings before the Ontario Superior Court of Justice against Air Canada, ACE and certain members of the board of directors of Air Canada alleging that certain past and future actions are oppressive to them. A variety of remedies were sought against the parties including an injunction to impose, among other things, limits on corporate distributions including those contemplated under the ACE plan of arrangement which became effective on October 10, 2006. Following a hearing in December, 2006, Mr. Justice Cumming of the Ontario Superior Court of Justice dismissed ACPA's application for an injunction and granted Air Canada's motion to dismiss ACPA's claim. ACPA has not appealed the dismissal of the injunction application but has appealed the order dismissing its claim.

Other

Various other lawsuits and claims, including claims filed by various labour groups of Air Canada and Jazz, are pending by and against the Corporation and provisions have been recorded where appropriate. It is the opinion of management that final determination of these claims will not have a significant material adverse effect on the financial position or the results of the Corporation.

Guarantees

With respect to 45 aircraft leases, the difference between the amended rents from the restructuring arrangements and amounts due under the original lease contracts will be forgiven at the expiry date of the leases if no material defaults have occurred. If a material default occurs, this difference plus interest will become due and payable and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements and any liability would be recorded only at the time management believes the amount is likely to occur.

Guarantees in Fuel Facilities Arrangements

The Corporation participates in fuel facility arrangements operated through fuel facility corporations ("Fuel Facility Corporations"), along with other airlines that contract for fuel services at various major airports in Canada. The Fuel Facility Corporations operate on a cost recovery basis. The purpose of the Fuel Facility Corporations is to own and finance the system that distributes the fuel to the contracting airlines, including leasing the Land Rights under the land lease. The aggregate debt of the five Fuel Facility Corporations in Canada that have not been consolidated by the Corporation under AcG-15 is approximately $108 as at December 31, 2006 (2005 $87), which is the Corporation's maximum exposure to loss without taking into consideration any cost sharing that would occur amongst the other contracting airlines. The Corporation views this loss potential as remote. Each contracting airline participating in a Fuel Facility Corporation shares pro rata, based on system usage, in the guarantee of this debt.

Under the terms of their respective land leases, the Fuel Facility Corporations have an obligation to restore the land to vacant condition at the end of the lease and to rectify any environmental damage for which it is responsible. If it was found that the Fuel Facility Corporations had to contribute to any remediation costs, each contracting airline would share pro rata, based on system usage, in the costs. For Fuel Facility Corporations that are consolidated, the Corporation has recorded an obligation of $2 ($12 undiscounted) representing the present value of the estimated decommissioning and remediation obligations at the end of the lease using an 8% discount rate, with lease term expiry dates ranging from 2032 to 2039. This estimate is based on numerous assumptions including the overall cost of decommissioning and remediation and the selection of alternative decommissioning and remediation approaches. For Fuel Facilities Corporations that are not consolidated, the Corporation will also be responsible for any remediation costs that may be incurred. No amount has been accrued in these financial statements for these future costs.

Guarantees of Related Parties

The Corporation is jointly and severally liable for its own obligations and those of a related party subject to common control by ACE, pursuant to a merchant services agreement entered into with First Data Loan Company, Canada, in the event that such entities were unable to fulfill their obligations related to airline and tour tickets sold in advance and charged to the credit cards processed under the agreement. The maximum exposure related to this guarantee as at December 31, 2006 was estimated to be $10 million ($8 million as at December 31, 2005)

Indemnification Agreements

The Corporation enters into real estate leases or operating agreements, which grant a license to the Corporation to use certain premises, in substantially all cities that it serves. It is common in such commercial lease transactions for the Corporation as the lessee to agree to indemnify the lessor and other related third parties for tort liabilities that arise out of or relate to the Corporation's use or occupancy of the leased or licensed premises. Exceptionally, this indemnity extends to related liabilities arising from the negligence of the indemnified parties, but usually excludes any liabilities caused by their gross negligence or willful misconduct. Additionally, the Corporation typically indemnifies such parties for any environmental liability that arises out of or relates to its use or occupancy of the leased or licensed premises.

In aircraft financing or leasing agreements, the Corporation typically indemnifies the financing parties, trustees acting on their behalf and other related parties and/or lessors against liabilities that arise from the manufacture, design, ownership, financing, use, operation and maintenance of the aircraft and for tort liability, whether or not these liabilities arise out of or relate to the negligence of these indemnified parties, except for their gross negligence or willful misconduct. In addition, in aircraft financing or leasing transactions, including those structured as leveraged leases, the Corporation typically provides indemnities in respect of certain tax consequences.

When the Corporation, as a customer, enters into technical service agreements with service providers, primarily service providers who operate an airline as their main business, the Corporation has from time to time agreed to indemnify the service provider against liabilities that arise from third party claims, whether or not these liabilities arise out of or relate to the negligence of the service provider, but excluding liabilities that arise from the service provider's gross negligence or willful misconduct.

Under its general by-laws, the Corporation has indemnification obligations to its directors and officers. Pursuant to such obligations, the Corporation indemnifies these individuals, to the extent permitted by law, against any and all claims or losses (including amounts paid in settlement of claims) incurred as a result of their service to the Corporation.

The maximum amount payable under the foregoing indemnities cannot be reasonably estimated. The Corporation expects that it would be covered by insurance for most tort liabilities and certain related contractual indemnities described above.

18. RELATED PARTY TRANSACTIONS

ACE has a 75% ownership interest in Air Canada and a 79.7% ownership interest in Jazz. The Corporation has various related party transactions with ACE and other entities under common control, including, Aeroplan and ACTS. These transactions are recorded at the exchange amount.

Related party trade balances arise from the provision of services, as outlined in the table below, the allocation of employee related costs, as further described in Note 9, the allocation of corporate expenses, as described in Note 1, and centralized cash management activities as described below.

The related party balances resulting from the application of the commercial and contractual practices were as follows:

	2006	2005
Accounts receivable		
ACE	$ -	$ 57
Aeroplan	6	5
ACTS	97	75
	$ 103	**$ 137**
Accounts payable and accrued liabilities		
ACE	$ 12	$ 7
ACTS	111	96
	$ 123	**$ 103**

Revenues and expenses with related parties are summarized as follows:

	2006	2005
Revenues		
Revenues from Aeroplan related to Aeroplan rewards	$ 358	$ 307
Cost of Aeroplan Miles purchased from Aeroplan	(243)	(204)
Property rental revenues from related parties	46	44
Revenues from information technology services to related parties	27	28
Revenues from corporate services and other	14	13
Cargo revenues from related parties	4	5
	$ 206	**$ 193**
Expenses		
Maintenance expenses from ACTS	$ 614	$ 562
Call centre management and marketing fees from Aeroplan	10	13
Other expenses	39	25
Recovery of salary, wages and benefit expense for employees assigned to Aeroplan and ACTS	(413)	(374)
	$ 250	**$ 226**
Net interest expense from related parties	**$ 6**	**$ 21**

Air Canada held certain investments in Aeroplan, Jazz and ACTS. As described in Note 1, certain cash payments and notes received from ACE on transfer of these investments to ACE have been included in these combined consolidated financial statements as a contribution from ACE to Shareholders' Equity (Note 12).

Summary of significant related party agreements

The Relationship between the Corporation and Aeroplan

Aeroplan is a subsidiary of ACE in which ACE has a 75.3% interest at December 31, 2006 (50.3% after January 10, 2007). Aeroplan operates a loyalty program which provides loyalty marketing services to its customers.

The transactions between Air Canada and Aeroplan described below are recorded at the exchange amount and, commencing June 29, 2005, are settled by netting amounts payable against amounts receivable in accordance with the inter-company agreements with any outstanding balance paid in the subsequent period. Accordingly, as at December 31, 2006 and December 31, 2005, the amounts have been presented on a net basis as the parties intend to settle on a net basis.

Aeroplan Commercial Participation and Services Agreement (CPSA)

Pursuant to the Aeroplan CPSA, Air Canada allocates fixed seat capacity to Aeroplan on Air Canada Flights ("AC Flights"). Such allocation of seat capacity consists of a total of 15% of the seat capacity on AC Flights, 8% of which is at a fixed redemption cost and the balance of 7% is at a higher fixed redemption cost. The rates charged for such seat capacity are fixed through the end of 2007. Thereafter, any upwards or downwards adjustments to such rates must maintain aggregate discounts at least as favourable to Aeroplan as those set out in the current rates. These amounts are included in the above table summarizing related party revenue and expenses under Revenues from Aeroplan related to Aeroplan Rewards.

Air Canada pays a fee to participate in the Aeroplan Program, which fee is based on the Aeroplan Miles awarded to Air Canada customers who travel on AC Flights. Aeroplan is required to purchase annually a minimum number of reward travel seats on AC Flights, which number is a function of Aeroplan's consumption of seats in the three preceding calendar years. Moreover, Air Canada is required to purchase a minimum number of Aeroplan Miles annually (2006 — $170). This fee is included in the above table summarizing related party revenue and expenses under Revenue offset from purchase of Aeroplan Miles.

The Aeroplan CPSA also provides that Aeroplan shall, in return for a service fee, manage Air Canada's frequent flyer tier membership program for Air Canada Super Elite(TM), Elite(TM) and Prestige(TM) customers, as well as perform certain marketing and promotion services for Air Canada, including call centre services for the frequent flyer tier membership program. These amounts are included in the above table summarizing related party revenue and expenses under Call Centre management and marketing fees from Aeroplan.

Unless otherwise agreed to between Air Canada and Aeroplan, all amounts due and owing by either party to the other pursuant to the CPSA are payable within thirty days of the invoice date.

Aeroplan Database Agreement

Pursuant to the Aeroplan Database Agreement, Aeroplan manages Air Canada's passenger information database. The Aeroplan Database Agreement allows Aeroplan to access and use the Air Canada database information for statistical purposes, as well as for revenue generating and general marketing purposes by using such information to conduct market research for other Aeroplan partners who are not in direct competition with Air Canada. Air Canada is entitled to access and use the Aeroplan database information for certain purposes, including pre-approved targeted marketing activities. The access and usage by each of Aeroplan and Air Canada is subject to adherence with any applicable confidentiality and privacy restrictions and is subject to pre-established fees based on the information access or use, which fees are invoiced on a quarterly basis and are subject to revision annually.

Aeroplan Master Services Agreement (MSA)

Pursuant to the Aeroplan MSA, Air Canada has agreed to provide certain services to Aeroplan in return for a fee based on Air Canada's fully allocated cost of providing such services to Aeroplan plus a mark-up to reflect overhead and administrative costs. Pursuant to the Aeroplan MSA, Air Canada provides Aeroplan with infrastructure support which is mostly administrative in nature, including information technology, human resources, finance and accounting, and legal services. Amounts related to the MSA are included in the above table summarizing related party revenues and expenses under Revenues from corporate services and other.

Aeroplan General Services Agreement (GSA)

Pursuant to the Aeroplan GSA, Air Canada provides Aeroplan with the services of a group of call centre employees of Air Canada. Aeroplan must reimburse Air Canada for all costs, including salary and benefits, related to the call centre employees on a fully allocated basis. With regard to the shortfall in the pension plan maintained by Air Canada which covers, among others, these call centre employees, Aeroplan has agreed to pay an amount not to exceed $16.1 million over the next eight years to compensate Air Canada for call centre employees' share of the unfunded Air Canada pension liability. Amounts related to GSA are recorded in the above table summarizing related party revenues and expenses under Recovery of salary, wages, and benefit expense for employees assigned to Aeroplan, ACTS, and ACE.

Trademark License Agreement

Air Canada and Aeroplan LP have granted each other reciprocal royalty-free, non-exclusive, non-sublicensable, non-assignable rights to use certain of each other's trademarks around the world which incorporate their names or logos, solely in association with the Aeroplan Program.

The Relationship between the Corporation and ACTS

ACTS is a wholly owned subsidiary of ACE that provides full-service maintenance, repair and overhaul services to a wide range of customers.

ACTS Maintenance Agreements

Pursuant to the ACTS Maintenance Agreements and other maintenance agreements with Jazz, ACTS has agreed to provide the following services to Air Canada and Jazz: engine and auxiliary power unit maintenance services, aircraft heavy maintenance services (excluding line and cabin maintenance services which are provided by Air Canada), component maintenance services, training services, supply chain management services and other ancillary services. ACTS serves as Air Canada's exclusive repair agency to provide certain of these services and Jazz's exclusive repair agency related to component repair and overall work on parts which can be removed from Jazz aircraft. Jazz performs certain of its own aircraft heavy maintenance. The amounts related to the ACTS Maintenance Agreements and other maintenance agreements with Jazz are recorded in the above table summarizing related party revenues and expenses under Maintenance expense from ACTS.

ACTS Master Services Agreement (MSA)

Pursuant to the master services agreement between Air Canada and ACTS (the "ACTS MSA"), Air Canada has agreed to provide ACTS with services including infrastructure support and services which are mostly administrative in nature, including information technology, human resources, finance and accounting, and legal services in return for fees to be paid by ACTS to Air Canada.

These amounts are recorded in the above table summarizing related party revenues and expenses under Revenues from corporate services and other.

ACTS Trademark License Agreement

Air Canada has granted ACTS a royalty-free, non-exclusive, non-assignable right to use certain trademarks registered by Air Canada which incorporate the Air Canada name, and/or Air Canada's roundel design, solely in association with the provision of heavy maintenance, component maintenance and supply chain business services in Canada and the United States.

General Services Agreements

Pursuant to general services agreements between Air Canada and ACTS (the "ACTS GSAs"), Air Canada provides ACTS with the services of a group of unionized and non-unionized employees of certain departments/divisions of Air Canada. ACTS must reimburse Air Canada for all costs, including salary and benefits, related to these employees on a fully allocated basis. These amounts are recorded in the above table summarizing related party revenues and expenses under Recovery of salary, wages, and benefits expense for employees assigned to ACTS.

Unless otherwise agreed to between Air Canada and ACTS, all amounts due and owing by either party to the other are payable within thirty days of the invoice date.

Building Sale to ACTS

Air Canada and ACTS are finalizing the sale of a building from Air Canada to ACTS that is expected to be executed in Quarter 1 2007. As a result of the anticipated sale, Air Canada recorded an impairment loss on the building in 2006 as described in Note 3. Upon execution of the agreement, the building will be sold to ACTS at the carrying value of $28.

The Relationship between Corporation and ACE

Master Services Agreement

Air Canada provides certain administrative services to ACE in return for a fee. Such services relate to finance and accounting, information technology, human resources and other administrative services.

Cash Management System

Air Canada manages the cash for certain related parties, including Aeroplan up to June 2005, Jazz up to February 2006 and ACTS during all periods presented in these combined consolidated financial statements. All cash collected from billings and sources other than Air Canada is recorded by Air Canada on a daily basis. Any payments to pay obligations related to operating and financing costs and capital expenditures other than obligations to Air Canada and other ACE affiliates were made through the Air Canada cash management system. In addition, certain inter-company transactions for services were not settled within the terms set out in the above noted agreements. Inter-company accounts receivable and payable include any excess cash, (cash proceeds greater than cash expenditures), cash deficiencies (cash expenditures greater than proceeds) or deferrals of receipts of payments. The combined consolidated statement of cash flows reflects the receipt and repayment of excess cash as a financing activity and the disbursement and repayment of cash deficiencies as investing activities.

19. JAZZ IPO

On February 2, 2006, Jazz Air Income Fund ("Jazz Fund") completed an initial public offering of its fund units. The Jazz Fund is an unincorporated, open-ended trust. With the proceeds of the initial public offering, the Jazz Fund subscribed for 23.5 million units of Jazz at a price of $10.00 per unit for net proceeds of $218, net of offering costs of $17 that were paid during Quarter 1 2006. Concurrent with the closing of the initial public offering, Jazz received proceeds of $113, net of fees of $2, representing the drawing under a new term credit facility (refer to Note 3).

On February 27, 2006, following the exercise of the over-allotment option by the underwriters, the Jazz Fund issued an additional 1.5 million units at a price of $10.00 per unit for additional net proceeds of approximately $14. The proceeds of the over allotment were used to acquire 1,500,000 partnership units from ACE.

As of December 31, 2006, the Jazz Fund indirectly holds 20.3% of the outstanding limited partnership units of Jazz. ACE holds the remaining 79.7% of the outstanding limited partnership units of Jazz.

In connection with the initial public offering, Jazz Air Limited Partnership transferred substantially all of its assets and liabilities to the new Jazz Air LP that was wholly owned by ACE. In consideration ACE received 99,365,143 units of the Jazz Air LP partnership and an acquisition promissory note of $424. The acquisition promissory note was repaid by Jazz Air LP to ACE from proceeds it received from the offering, a drawdown under its new term credit facility (Note 7) and out of the working capital of Jazz Air LP.

20. SPECIAL CHARGE FOR AEROPLAN MILES

In 2001, Air Canada established Aeroplan Limited Partnership as a limited partnership wholly owned by Air Canada. The Aeroplan loyalty program was previously a division of Air Canada.

Under the Commercial Participation and Services Agreement (CPSA) between Air Canada and Aeroplan, Air Canada retained responsibility for the 103 billion Miles to be redeemed from accumulations up to December 31, 2001. Aeroplan assumed responsibility for all Miles issued beginning January 1, 2002. On December 31, 2001, there were 171 billion Miles outstanding of which, after considering breakage, management estimated that 103 billion Miles would be redeemed.

With the assistance of independent actuaries, management of Air Canada and Aeroplan re-estimated the number of Miles expected to be redeemed from accumulations up to December 31, 2001. Management now expects that 112 billion Miles will be redeemed compared to the original estimate of 103 billion. Pursuant to the terms of the CPSA, dated June 9, 2004, as amended, the management of Air Canada and Aeroplan have agreed to further amend the terms of the CPSA. Effective October 13, 2006, by amendment, Air Canada has assumed responsibility for the redemption of up to 112 billion Miles and, as a result, recorded a special charge of $102 for the incremental 9 billion Miles against Operating revenues in the year ended December 31, 2006 and increased Aeroplan deferred revenues. This amendment to the CPSA represents full and final settlement with Aeroplan of Air Canada's obligations for the redemption of pre-2002 Miles. Aeroplan is responsible for any redemption of Miles in excess of the re-estimated 112 billion Miles. The amount of the additional liability was determined by valuing the incremental Miles at the current fair value.

Officers and Directors

Officers

Robert Milton	Chairman
Montie Brewer	President and Chief Executive Officer
Joshua Koshy	Executive Vice President and Chief Financial Officer
Sean Menke	Executive Vice President and Chief Commercial Officer
Rob Reid	Executive Vice President and Chief Operating Officer
Lise Fournel	Senior Vice President, E-Commerce and Chief Information Officer
Kevin Howlett	Senior Vice President, Employees Relations
Alan Butterfield	Vice President, Air Canada Maintenance and Engineering
Yves Dufresne	Vice President, International, Alliances and Regulatory Affairs
Julie Laviolette	Vice President, Procurement and Corporate Real Estate
David Legge	Vice President, Flight Operations
Charlie McKee	Vice President, Marketing
Scott Morey	Vice President, Labour Relations
Marc Rosenberg	Vice President, Sales and Product Distribution
David Shapiro	Vice President and General Counsel
Daniel Shurz	Vice President, Network Planning
Susan Welscheid	Vice President, Customer Experience - In-Flight Service
Carolyn Hadrovic	Corporate Secretary
Chris Isford	Controller
Chantal Baril	President and Chief Executive Officer, ACGHS
Claude Morin	President and Chief Executive Officer, Air Canada Cargo
Benjamin Smith	President and Chief Executive Officer, Air Canada Vacations

Directors

Robert A. Milton	Chairman, Air Canada and Chairman, President and Chief Executive Officer of ACE Aviation Holdings Inc., Chairman Aeroplan Holding GP Inc., Jazz Air Holding GP Inc. and ACTS Technical Services Inc., Westmount, Quebec
Bernard Attali	Country Advisor, Texas Pacific Group France, Paris, France
Montie Brewer	President and Chief Executive Officer, Air Canada, Hudson, Quebec
Brian Dunne	Executive Vice President and Chief Financial Officer, ACE Aviation Holdings Inc., Westmount, Quebec
Pierre Marc Johnson	Senior Counsel, Heenan Blaikie L.L.P., Montreal, Quebec
Richard H. McCoy	Corporate Director, Toronto, Ontario
John T. McLennan	Corporate Director, Mahone Bay, Nova Scotia
Arthur T. Porter	Director General and Chief Executive Officer, McGill University Health Center, Montreal, Quebec
David I. Richardson	Corporate Director, Grafton, Ontario
Vagn Sørensen	Corporate Director, Holte, Denmark
Marvin Yontef	Senior Partner, Stikeman Elliott L.L.P., Toronto, Ontario

Investor and Shareholder Information

Price Range and Trading Volume of Air Canada Variable Voting Shares (AC.A)

2006	High	Low	Volume Traded
4th Quarter	$ 21.00	$ 15.65	29,061,039

Price Range and Trading Volume of Air Canada Voting Shares (AC.B)

2006	High	Low	Volume Traded
4th Quarter	$ 21.05	$ 15.63	8,976,738

Duplicate Communication

Shareholders receiving more than one copy are requested to call 1-800-387-0825 or write to the Transfer Agent and Registrar, CIBC Mellon Trust Company at the following address:
2001 University Street, Suite 1600, Montreal, Quebec H3A 2A6

Inquiries may be submitted by electronic mail to inquiries@cibcmellon.com

Restrictions on Voting Securities

The Air Canada Public Participation Act and the articles of Air Canada limit ownership of the airline's voting interests by all non-residents of Canada to a maximum of 25%. The Canada Transportation Act (CTA) also requires that Canadians own and control at least 75% of the voting interests of licensed Canadian carriers. Since Air Canada is a licence holder, Air Canada's articles contain restrictions to ensure that it remains "Canadian" as defined under the CTA. The restrictions in Air Canada's articles provide that non-Canadians can only hold variable voting shares of Air Canada, that such variable voting shares will not carry more than 25% of the aggregate votes attached to all issued and outstanding voting shares and that the total number of votes cast by the holders of such variable voting shares at any meeting will not exceed 25% of the votes that may be cast at such meeting.

Glossary of Terms

Revenue Passenger Miles (RPMs)
Total number of revenue passengers carried multiplied by the miles they are carried.

Available Seat Miles (ASMs)
A measure of passenger capacity calculated by multiplying the total number of seats available for revenue traffic by the miles flown.

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

Revenue Ton Miles (RTMs)
Total number of cargo tons carried multiplied by the miles they are carried.

Yield per RPM
Average revenue per revenue passenger mile.

For Further Information

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Air Canada complies with the guidelines adopted by the Toronto Stock Exchange.

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AIR CANADA

Corporate Profile

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 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 2006, represented 87% of its total operating revenues.

Air Canada and Jazz, the Corporation's regional carrier, operate an extensive domestic, transborder and international network. During 2006, Air Canada and Jazz operated, on average, approximately 1,300 scheduled flights each day and carried over 32 million passengers. In 2006, Air Canada and Jazz provided direct passenger air transportation to 161 destinations and, through commercial agreements with other unaffiliated regional airlines referred to as tier III carriers, to an additional 15 destinations, for a total of 176 direct destinations on five continents. The Corporation's primary hubs are located in Toronto, Montreal, Vancouver and Calgary.

Air Canada also operates an extensive global network in conjunction with its international partners. Air Canada is a founding member of the Star Alliance, the world's largest airline alliance group. The Star Alliance has grown, since its inception, to include 17 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 855 destinations in 155 countries, with reciprocal participation in frequent flyer programs and use of airport lounges.

The Corporation holds a 51% interest in Touram LP, which provides tour operator services and leisure vacation packages. The Corporation also provides Cargo Services through Air Canada and AC Cargo LP and Groundhandling Services through ACGHS LP.

aircanada.com