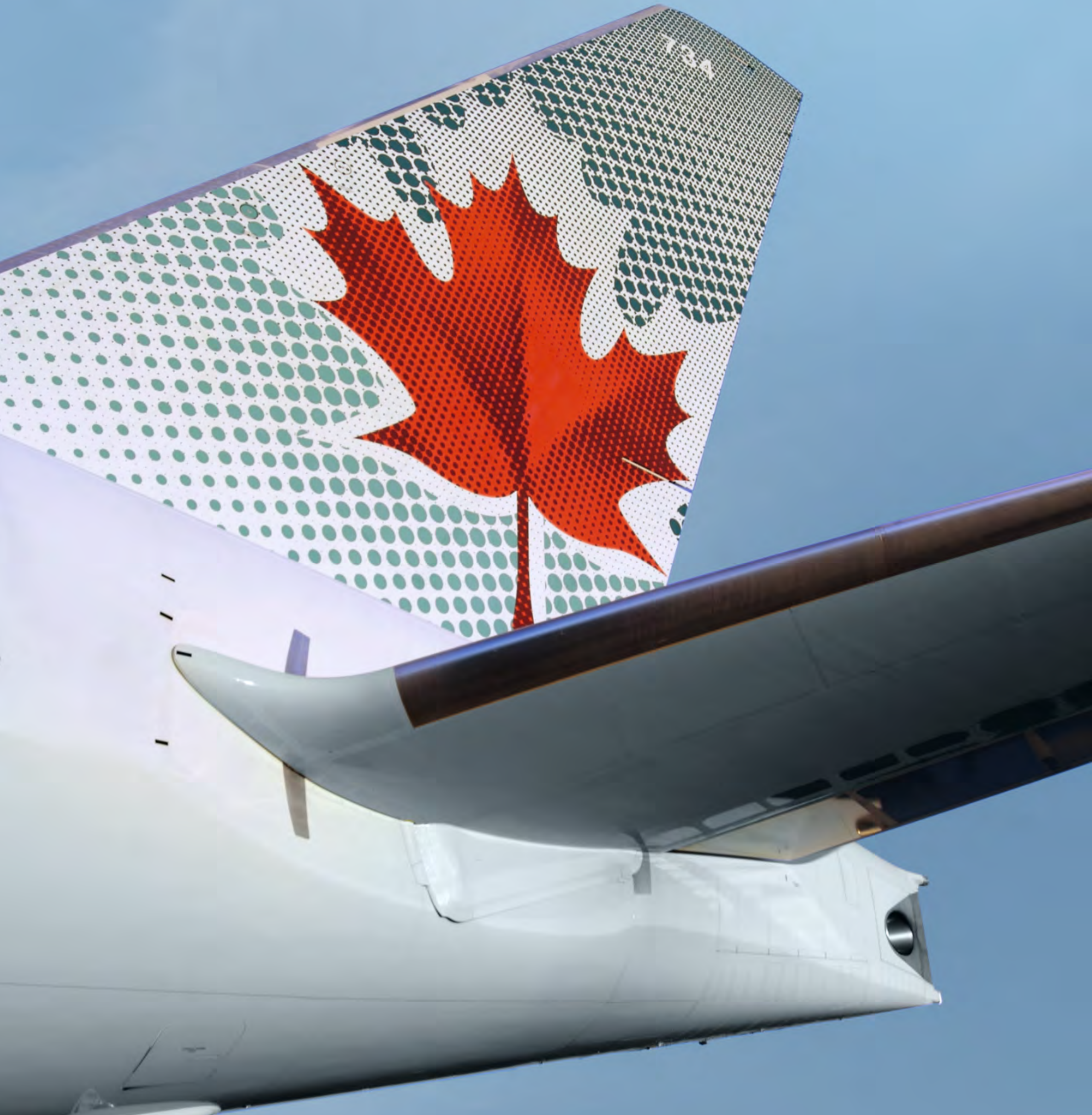
AIR CANADA

ANNUAL REPORT 2009



1. HIGHLIGHTS

The financial and operating highlights for the Corporation of the periods indicated are as follows. Refer to section 2 of the MD&A for additional information.

(Canadian dollars in millions, except per share figures)	Fourth Quarter			Full Year		
	2009	2008	Change $	2009	2008 (1)	Change $
Financial						
Operating revenues	2,348	2,498	(150)	9,739	11,082	(1,343)
Operating loss before a special provision (1)	(83)	(146)	63	(316)	(39)	(277)
Operating loss	(83)	(146)	63	(316)	(164)	(152)
Non-operating expenses	(83)	(44)	(39)	(355)	(170)	(185)
Loss before non-controlling interest, foreign exchange and income taxes	(166)	(190)	24	(671)	(334)	(337)
Loss for the period	(56)	(727)	671	(24)	(1,025)	1,001
Operating margin before a special provision % (1)	-3.5 %	-5.8 %	2.3 pp	-3.2 %	-0.4 %	(2.8) pp
Operating margin %	-3.5 %	-5.8 %	2.3 pp	-3.2 %	-1.5 %	(1.7) pp
EBITDAR before a special provision (1) (2)	167	108	59	679	934	(255)
EBITDAR (2)	167	108	59	679	809	(130)
EBITDAR margin before a special provision % (1) (2)	7.1 %	4.3 %	2.8 pp	7.0 %	8.4 %	(1.4) pp
EBITDAR margin % (2)	7.1 %	4.3 %	2.8 pp	7.0 %	7.3 %	(0.3) pp
Cash, cash equivalents and short-term investments	1,407	1,005	402	1,407	1,005	402
Free cash flow	(52)	(428)	376	(399)	(985)	586
Adjusted debt/equity ratio %	80.1 %	89.6 %	(9.5) pp	80.1 %	89.6 %	(9.5) pp
Loss per share - Basic and diluted	($0.25)	($7.27)	$ 7.02	($0.18)	($10.25)	$ 10.07
Operating Statistics			**Change %**			**Change %**
Revenue passenger miles (millions) (RPM)	10,885	10,845	0.4	47,884	50,519	(5.2)
Available seat miles (millions) (ASM)	13,841	13,571	2.0	59,343	62,074	(4.4)
Passenger load factor %	78.6 %	79.9 %	(1.3) pp	80.7 %	81.4 %	(0.7) pp
Passenger revenue per RPM (cents)	18.6	20.1	(7.3)	17.7	19.2	(7.6)
Passenger revenue per ASM (cents)	14.6	16.0	(8.8)	14.3	15.6	(8.4)
Operating revenue per ASM (cents)	17.0	18.4	(7.8)	16.4	17.9	(8.1)
Operating expense per ASM ("CASM") (cents)	17.6	19.5	(9.8)	16.9	17.9	(5.4)
CASM, excluding fuel expense (cents)	13.2	13.6	(3.2)	12.8	12.4	3.3
Average number of full-time equivalent (FTE) employees (thousands) (3)	22.5	23.6	(4.8)	22.9	24.2	(5.3)
Aircraft in operating fleet at period end (4)	332	333	(0.3)	332	333	(0.3)
Average fleet utilization (hours per day) (5)	8.6	8.8	(2.3)	9.2	9.6	(4.2)
Average aircraft flight length (miles) (5)	823	827	(0.5)	847	863	(1.9)
Fuel price per litre (cents) (6)	72.6	95.8	(24.2)	69.4	90.4	(23.2)
Fuel litres (millions)	825	822	0.4	3,510	3,763	(6.7)

(1) A provision related to investigations and proceedings related to alleged anti-competitive cargo pricing activities of $125 million was recorded in the first quarter of 2008.

(2) See section 21 "Non-GAAP Financial Measures" in the MD&A for a reconciliation of EBITDAR before the provision for cargo investigations and proceedings to operating income (loss) and EBITDAR to operating income (loss).

(3) Reflects FTE employees at Air Canada. Excludes FTE employees at Jazz.

(4) Includes Jazz aircraft covered under the Jazz CPA.

(5) Excludes charter operations. Also excludes third party carriers operating under capacity purchase arrangements, other than Jazz aircraft covered under the Jazz CPA.

(6) Includes fuel handling and is net of fuel hedging results.

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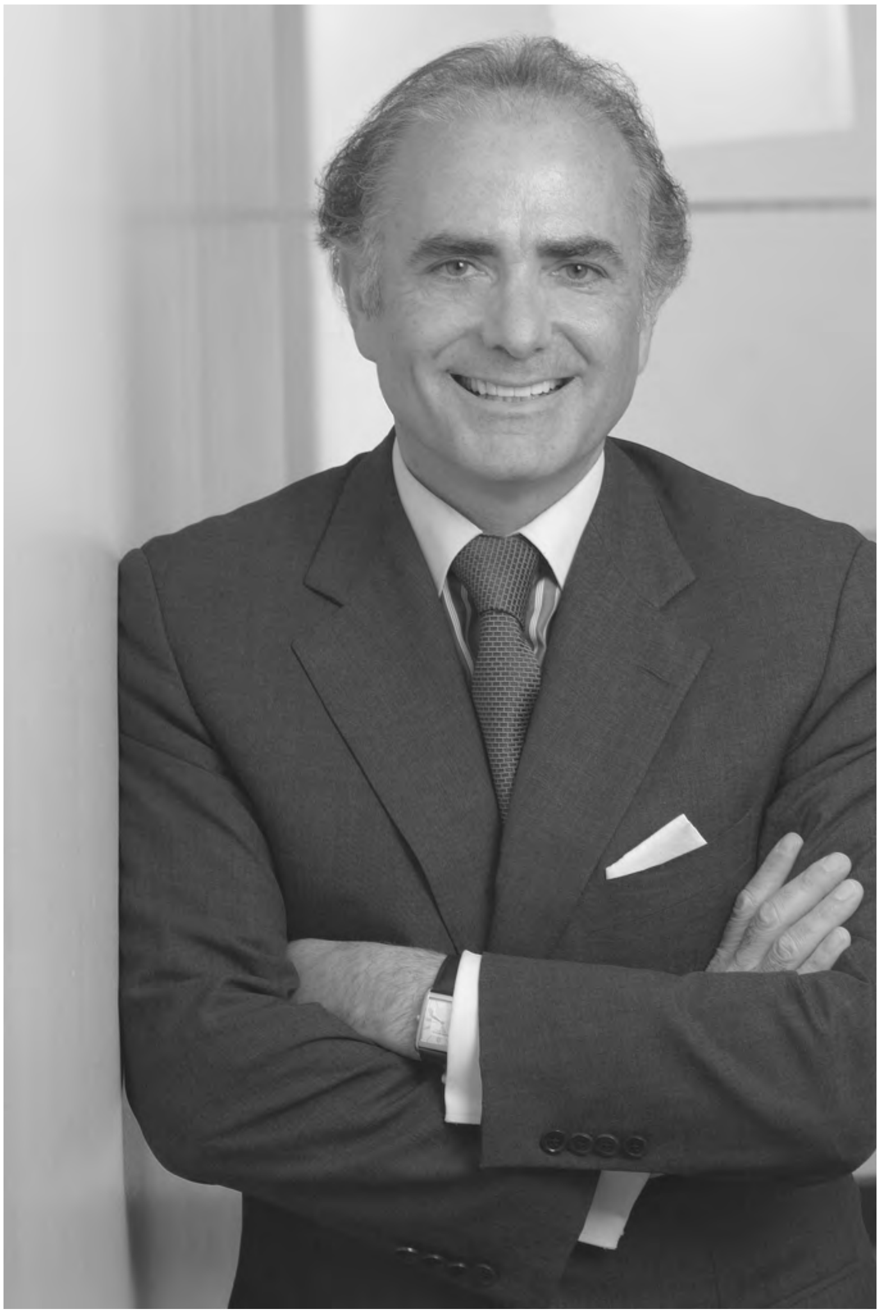
MESSAGE FROM THE PRESIDENT AND CEO OF AIR CANADA



For Air Canada, 2009 was a year of challenges and accomplishments. Along with the rest of the global airline industry, the company encountered an extremely difficult revenue environment owing to the very deep recession encountered last year. Moreover, we faced a set of issues unique to the company that we have now largely addressed, allowing us to be cautiously optimistic about the year ahead.

While delivering on our 2009 adjusted EBITDAR* target, we nonetheless reported an operating loss of $316 million for the year. This reflects a $1.21 billion or 12 per cent decline in passenger revenue, of which more than 33 per cent was attributable to a drop in all-important premium customer revenue. At the same time, unit costs excluding fuel rose 3.3 per cent due mainly to the effects of a weaker Canadian dollar, increased maintenance costs and a capacity reduction that resulted in fewer available seat miles over which to allocate costs.

However, we performed well in comparison with our peers, demonstrating a disciplined approach to both revenue and capacity management. While Air Canada's unit revenue fell 8.4 per cent, this was less than declines experienced by many of our U.S. peers and we flew with an 80.7 per cent load factor versus a global industry average of 75.6 per cent in 2009. We transported almost 31 million passengers and, most importantly, we did so safely and with a better overall operational performance than the previous year.

* Earnings before interest, taxes, depreciation, amortization and aircraft rent

Customers truly appreciated our performance. In late 2009 we received meaningful accolades from two influential business travel magazines. *Business Traveler,* with 500,000 readers and ten editions published globally, gave Air Canada more of its Best in Business Travel Awards than any other airline in the world. These included: Best Flight Attendants in North America; Best In-flight Services in North America; Best Business Class among North American carriers; and the Best North American Airline for International Travel. The annual survey of 25,000 readers of the equally respected *Global Traveler* found Air Canada to be the Best Airline in Canada and Best Airline in North America.

During the year, the company also addressed major structural issues. Foremost among these was the rebuilding of our cash position amid very difficult capital markets. Air Canada raised $1.3 billion in new liquidity – including approximately $260 million in equity through a public share offering – to end 2009 with $1.4 billion in cash, cash equivalents and short term investments. At the beginning of 2010, we raised an additional $100 million to improve unrestricted cash levels to approximately 15 per cent of trailing 12 month revenues, one of our key financial objectives.

Second, Air Canada attained labour stability through agreements with its unionized workforce. The company negotiated cost neutral extensions of its collective agreements lasting until mid-2011 and an accord on a 21-month pension deficit funding moratorium, with capped payments for past service obligations until 2014. While Air Canada aims to preserve its existing defined benefit pension plans and contributed $389 million toward them in 2009, there remains a need for national pension reform to ensure pension plans can be funded on a sustainable basis.

Third, Air Canada struck new and amended agreements during the course of the year with major credit providers, suppliers and vendors to provide greater financial stability. These included a renegotiated Capacity Purchase Agreement with Jazz, amendments to our credit card processing contracts to revise the required levels of unrestricted cash, and an agreement with a key supplier for non-refundable proceeds of $230 million in consideration for various contractual commitments.

Taken together, these and other accomplishments have served to further strengthen the company's foundation so that we can build upon it in anticipation of a general industry rebound. To this end, we have identified four main priorities for 2010 that will further secure and extend these gains, with the objective of transforming Air Canada so that it becomes a profitable company over the long term.

First, Air Canada will expand its international presence by leveraging the geographic advantages of its major hubs, its array of international route authorities and extensive partnerships formed with other carriers through Star Alliance, the world's leading airline network with 26 member carriers. Continental Airlines' entry into Star Alliance in 2009 and the recently-created transatlantic alliance with Continental, Lufthansa and United Airlines will be central to this strategy. Since the start of 2009, Air Canada launched or announced new service to five European gateways – Geneva, Barcelona, Brussels, Copenhagen and Athens – and to 15 U.S. cities. Our renewed and stronger partnership with major Canadian airports, particularly at our central hub in Toronto, will enhance our ability to grow our international network.

Our second priority is to radically transform our cost structure. We have adopted a three-year Cost Transformation Program whose goal is to identify savings and revenue initiatives to generate a minimum of $500 million in annual improvements to our financial results by the end of 2011, on a run-rate basis. In 2009 we exceeded our CTP goal by 40 per cent and are tracking to achieve our accelerated 2010 target of $270 million. Our aim is to achieve permanent gains though a combination of operational process and productivity improvements and revenue enhancements without compromising the passenger experience.

Third, we will re-engage our customers with an added focus on premium revenue passengers. Many of the required elements are already in place with our Maple Leaf Lounges, Concierge Service and new and refurbished fleet, including our long-haul Executive First service featuring lie-flat suites. We intend to drive home these advantages through customer-friendly initiatives such as the introduction of new technologies for added customer convenience and a greater emphasis on service. The awards from *Business Traveler* and *Global Traveler* are evidence we are making significant headway in this area.

Finally, Air Canada is committed to changing its corporate culture by instilling in employees a more customer-centric and entrepreneurial ethic. Given the still difficult economic conditions and unrelenting competitive pressures, it is imperative that employees be empowered to respond appropriately to day-to-day challenges and opportunities so that Air Canada becomes a more nimble, responsive company.

In many respects, it is culture change that will harness together the company's priorities and drive our transformation. While effecting such change is not possible overnight, already there are signs that employees are embracing this new spirit. They readily advanced ideas that we incorporated into our successful winter operations plan. More significantly, they also eagerly joined together to ensure one of the smoothest Olympic and Paralympic operations in memory.

In 2009, the global airline industry faced the most severe drop in traffic since the Second World War and a corresponding decline in revenue. Through operational discipline, focused action on our priorities and by vigorously pursuing solutions, we stabilized the company and began rebuilding in anticipation of an eventual return of economic prosperity. By channeling that same level of determination into our four priorities, we are positioning ourselves to generate income in the current economic cycle in order that we can grow the business profitably on a sustainable basis.

Although well-founded, our optimism is guarded. Achieving this ultimate goal is contingent upon several factors, including the execution of our business priorities, a sensible approach by governments to security, travel infrastructure, and to direct and indirect taxation, the establishment of a rational pension funding regime and an overall improvement in macroeconomic conditions.

In closing, I wish to thank the 26,000 employees of Air Canada for their dedication to safety and customer service and for their unwavering professionalism during a tumultuous year for both our company and our industry. Similarly, I thank all of our stakeholders and customers for their continued support and loyalty. Although the airline industry is highly cyclical and fragile, our company is actively transforming itself to prepare for an upturn in the sector, to be ready to capitalize on opportunities as they emerge

Calin Rovinescu
President and Chief Executive Officer

2. INTRODUCTION

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers to, as the context may require, Air Canada and/or one or more of Air Canada's subsidiaries.

Air Canada's 2009 MD&A provides the reader with a view and analysis, from the perspective of management, of Air Canada's financial results for the fourth quarter of 2009 and for the full year 2009. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2009. All financial information has been prepared in accordance with Generally Accepted Accounting Principles in Canada ("GAAP"), unless indicated otherwise.

Except as otherwise noted, all monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 22 "Glossary". Except as otherwise noted, this MD&A is current as of February 9, 2010.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of the risks relating to Air Canada, see section 19 "Risk Factors" of this MD&A.

The Corporation issued a news release dated February 10, 2010 reporting on its results for the fourth quarter of 2009 and for the full year 2009. This news release is available on SEDAR at **sedar.com** and at **aircanada.com**.

For further information on Air Canada's public disclosure file, including Air Canada's Annual Information Form, consult SEDAR at **sedar.com** or Air Canada's website at **aircanada.com**.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

Air Canada's public communications may include written or oral forward-looking statements within the meaning of applicable securities laws. Such statements are included in this MD&A and may be included in other communications, including filings with regulatory authorities and securities regulators. Forward-looking statements 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. 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, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, industry, market, credit and economic conditions, the ability to reduce operating costs and secure financing, pension issues, energy prices, currency exchange and interest rates, employee and labour relations, competition, war, terrorist acts, epidemic diseases, insurance issues and costs, changes in demand due to the seasonal nature of the business, supply issues, 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 section 19 "Risk Factors" of this MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of the date of this MD&A and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

Assumptions were made by Air Canada in preparing and making forward-looking statements. Air Canada assumes that the North American economy will start to slowly recover in 2010. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C$1.06 per U.S. dollar in the first quarter of 2010 and C$1.04 per U.S. dollar for the full year 2010 and that the price of fuel will average 69 cents per litre in the first quarter of 2010 and for the full year 2010 (both net of fuel hedging positions).

3. ABOUT AIR CANADA

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

In 2009, Air Canada, together with Jazz Air LP ("Jazz"), operated an average of 1,331 scheduled flights daily and carried almost 31 million passengers and provided direct passenger service to 156 destinations and, through commercial agreements with other unaffiliated regional airlines, to an additional 11 destinations, for a total of 167 direct destinations on five continents.

Air Canada enhances its network through a capacity purchase agreement with Jazz (the "Jazz CPA") pursuant to which Air Canada purchases substantially all of Jazz's fleet capacity based on predetermined rates and Air Canada determines the routes and schedule operated by Jazz. Jazz operates small 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 as well as 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 Star Alliance® network currently includes 26 member airlines. Through its membership in the Star Alliance® network, Air Canada is able to offer its customers access to approximately 1,077 destinations in 175 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges.

Air Canada is in the process of concluding arrangements for the implementation of a transatlantic alliance with Continental Airlines, Lufthansa and United Airlines, (which, when concluded, is intended to be effective as of January 1, 2010) and which will enable Air Canada to offer its customers more value, choice and transparency when making their transatlantic travel plans.

Through its long-term relationship with Aeroplan Limited Partnership ("Aeroplan"), Air Canada's frequent flyer program provider, 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 is designed to provide a long-term stable and recurring 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 its cargo services division (doing business as "Air Canada Cargo") and from tour operator services provided by its wholly-owned subsidiary, Touram Limited Partnership (doing business as "Air Canada Vacations").

Air Canada Cargo provides direct cargo services to over 150 Canadian and international destinations and has sales representation in over 50 countries. Air Canada Cargo is Canada's largest provider of air cargo services as measured by cargo capacity. Air cargo services are provided on domestic and U.S. transborder flights and on international cargo services on routes between Canada and major markets in Europe, Asia, South America and Australia.

Air Canada Vacations is one of Canada's leading tour operators. Based in Montreal and Toronto, Air Canada Vacations operates its business in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, South America, and Asia) by developing, marketing and distributing vacation travel packages. Air Canada Vacations also offers cruise packages in the Caribbean, North America and Europe. Air Canada Vacations markets its products through its website (**www.aircanadavacations.com**) and a network of independent travel agencies across Canada.

4. STRATEGY

For Air Canada and the rest of the airline industry, 2009 was a year of tremendous challenges. In the latter part of 2008, Air Canada began adjusting its operations by reducing its capacity and its cost structure to manage through arguably the most challenging economic environment in decades. By mid-year 2009, Air Canada's immediate goal of stabilizing its finances and reducing the risk associated with the expiry of its labour collective agreements in 2009 and the risk associated with the pension solvency deficit as described in section 10.6 of this MD&A was largely realized and strategies had been put in place in an effort to minimize the effects of the weak economic environment.

In 2010, in an effort to improve its ability to generate income and grow its business profitably, Air Canada's priorities, which are further discussed below, include:

- Expanding international operations;
- Generating incremental revenues and achieving significant cost savings through a company-wide cost transformation program (the "CTP");
- Refocusing on customer service and further developing and promoting premium class travel; and
- Fostering culture change throughout the Corporation.

Expanding international operations

Air Canada will seek opportunities to grow its international operations in 2010 by leveraging the advantages of its extensive route rights, its newly refurbished fleet – one of the youngest in North America, its world-class global hub at Toronto, and strong international gateways at Montreal and Vancouver. Air Canada believes it is well positioned to grow its share of traffic between Canada, and Europe and Asia.

Air Canada recently expanded its service to seven additional U.S. cities, fortifying its Toronto hub and strengthening the airline's position as the leading transborder carrier with the most daily flights between Canada and the U.S. of any airline. Air Canada's strategy is to leverage its Toronto hub to make it a global transfer point for domestic, transborder and international travelers. Furthermore, by partnering with leading global carriers, Air Canada's transatlantic joint venture will further enhance the airline's international growth strategy.

In 2009, Air Canada provided scheduled service directly to 54 destinations in Europe, the Middle East, Asia, Australia, the Caribbean, Central America and South America. Air Canada plans on expanding its international network in 2010. This expansion will be fuelled by the addition of routes to Europe and Asia, including Toronto – Montreal – Brussels, Toronto – Barcelona, Montreal – Barcelona, Toronto – Copenhagen, Toronto – Athens, Montreal – Athens, Calgary – Tokyo and St. John's – London, England. Air Canada also expects to grow its capacity to China through increased frequencies and the use of larger aircraft.

Air Canada believes that its investment in new Boeing 777 aircraft and industry-leading on-board product across its fleet, including personal in-flight entertainment systems and in-seat power outlets accessible at virtually every seat, showcase the advantages of flying Air Canada. Air Canada is also one of the most respected brands in Canada and it plans to leverage this strength to attract premium revenue with a concentrated focus on its international service. The mix of types and sizes of aircraft in its fleet is designed to provide the airline with greater flexibility to respond to changing market demand more quickly and efficiently. For additional information on Air Canada's planned fleet for 2010 and beyond, refer to section 9 of this MD&A.

The value of Air Canada's network is enhanced through its Star Alliance network as well as under a newly-formed revenue sharing transatlantic joint venture in the process of being implemented among Air Canada, Lufthansa, Continental and United Airlines. Air Canada's participation in this joint venture is expected to provide the airline's customers with more options between Canada and Europe, Africa, the Middle East, India and the Commonwealth of Independent States (CIS), including western Russia.

In addition, the new Canada-EU air services agreement that came into effect in December 2009 will provide Air Canada with additional traffic right opportunities in the coming years.

Generating incremental revenues and achieving significant cost savings
A key objective of Air Canada's business strategy is to consistently improve unit revenue and cost productivity.

Early in 2009, with the assistance of a leading aviation consultancy firm, Air Canada launched a major company-wide cost transformation program (the "CTP") which is targeting $500 million in annualized revenue gains and cost savings. Through extensive management analysis and benchmarking, over 125 initiatives have been identified to date. Although the vast majority of the initiatives relate to cost savings such as contract renegotiation, operational process improvements and productivity gains, several relate to target revenue optimization. In 2009, Air Canada surpassed its CTP target by $20 million.

As fuel costs constitute the largest percentage of the total operating costs of the airline, Air Canada continues to aggressively focus on managing fuel consumption. Since the implementation of its fuel efficiency program in mid-2006, Air Canada generated cumulative savings of close to $80 million. In 2009, this program generated savings of $12 million and reduced the airline's fuel consumption by 18 million litres, and reduced CO_2 emissions by 45,000 tonnes. Fuel efficiency program initiatives range from simple weight reduction initiatives and flight profile optimization which do not affect on-time performance or passenger connections to more innovative weight savings initiatives such as a potable water management program to reduce the carriage and weight of unnecessary water and a Zero Fuel Weight (ZFW) accuracy program which enables the calculation of accurate flight plans. In 2010, Air Canada's fuel saving initiatives will focus on several programs such as the optimization of all Air Canada's routes to establish the most efficient flight plan. In addition, Air Canada is working together with air traffic control service providers to optimize airspace management and take advantage of new navigation technologies to reduce time and fuel consumption used to approach airports. Moreover, Air Canada is evaluating several new aerodynamic technologies to further improve aircraft fuel efficiency.

Refocusing on customer service and further developing and promoting premium class
Air Canada's success depends on meeting and exceeding the expectations of its customers, attracting new ones and providing all customers with the service they deserve when flying with Air Canada.

Virtually all aircraft operated by Air Canada have new seats with personal in-flight entertainment systems and in-seat power outlets accessible at every seat in the economy, Executive and Executive First cabins. For aircraft that fly international routes (not including U.S. transborder and Caribbean routes), all seats in the Executive First cabin convert to lie-flat beds. The airline also offers its customers a far-reaching network which is enhanced by its strong international Star Alliance partners and will be further enhanced with the implementation of the transatlantic joint venture mentioned earlier. Through its relationship with Aeroplan, one of the premier loyalty programs in the world, Air Canada customers have the ability to earn and redeem points on a worldwide basis.

In 2009, Air Canada was rewarded for the consistent high quality work of its employees and their dedication to offering customers a superior product with the following awards:

- Top honours by readers of Business Traveler's "Best in Business Travel" award program, more first place awards than any other airline in the world in the influential magazine's annual reader survey;

- Voted by the readers of Business Traveler magazine as Best North American Airline for Business Class Service and Best North American Airline for International Travel and as offering Best Flight Attendants in North America; and Best In-Flight Services in North America; and

- Honoured by another influential business travel magazine when Global Traveler named Air Canada the Best Airline in North America and Best Airline in Canada.

Air Canada continues to seek ways to improve the travel experience of its business travelers as this segment of its customer base is an important component in its strategy to drive the airline to sustained profitability. In 2010, the airline will be placing further emphasis on understanding what business travelers value most in enhancements and their travel preferences, and identifying areas where further improvements could be made.

Although one of the airline's objectives is to further develop and promote premium class, providing a good travel experience to every single one of its customers is equally important to Air Canada. As such, Air Canada's goal is to deliver friendly, professional and "best in class" service on a consistent basis to all its customers, including those customers who travel with the airline less frequently. To achieve that, Air Canada has been refocusing its efforts on ensuring it has the appropriate products and services in place.

Although customer satisfaction levels are steadily improving as a result of Air Canada's investment in its fleet and onboard products, its award-winning Maple Leaf Lounges, its concierge program and its loyalty program, Air Canada is continuously working to improve its interaction with customers through policy and procedural changes. Air Canada's objective is to make its policies more simple, efficient and customer-friendly.

Air Canada revised its checked bag policy on January 19, 2010 to permit travelers one free checked bag for travel to the U.S. and Europe, and charge a fee for the second bag of $30 for flights to/from the U.S., and $50 for flights to/from Europe. These revised bag policy changes more closely align Air Canada's policies with those prevailing among international carriers on transatlantic routes and are more generous than those of U.S. carriers on transborder routes, which charge for all checked bags.

Air Canada believes that the elimination of the call centre fee, changes to the "pets in cabin" policy, making more Aeroplan redemption seats available and more generous meal and hotel packages being offered to customers during disrupted operations are helping to improve customer service and thus increasing customer loyalty. In addition, the use of new technologies such as the Air Canada iPhone App, which won the "Best Mobile Application" at the Canadian New Media Awards in 2009, the Blackberry App, as well as the self-service rebooking tool allow the airline to communicate more effectively with customers in times of disrupted operations and provide customers with more choices to plan their travel.

In addition, based on extensive feedback received from customers over the last year, the airline has recently enhanced its frequent flyer program to ensure it remains competitive with other airline offerings and to provide an added incentive for customers to choose Air Canada for their travel needs.

Fostering culture change throughout the Corporation

A key objective of Air Canada's business strategy is to foster a more entrepreneurial corporate culture. The challenging economic environment has highlighted the fact that fundamental culture changes are required for the airline to be better placed to achieve sustained profitability. This corporate culture focuses on leadership, ownership, entrepreneurship and the ability to be more nimble to seize opportunities and react more quickly to challenges. Although this objective may take some time to achieve, Air Canada has begun the change process by communicating to all its employees the type of culture it envisions to allow the airline to prosper. In pursuit of this goal, the airline has taken actions to simplify processes, empower employees and is continually seeking means to actively foster culture change. The recent prestigious industry honours awarded by The Global Traveler and Business Traveler Magazine are an indication that employees are participating in the airline's transformation especially through a renewed focus on customer service.

5. OVERVIEW

Air Canada's results of operations for the fourth quarter of 2009 and the full year 2009 are discussed in section 7 and 8, respectively, of this MD&A.

In summary, Air Canada's results of operations for 2009 compared to 2008 are as follows:

Air Canada recorded a net loss of $24 million or $0.18 per diluted share in 2009 compared to a net loss of $1,025 million or $10.25 per diluted share in 2008. The net loss recorded in 2009 included foreign exchange gains of $657 million which were primarily attributable to a stronger Canadian dollar at December 31, 2009 versus December 31, 2008. The December 31, 2009 noon day exchange rate was US$1 = C$1.0466 while the December 31, 2008 noon day exchange rate was US$1 = C$1.2246.

In 2009, Air Canada recorded an operating loss of $316 million, a deterioration of $277 million from the operating loss (before a provision for cargo investigations and proceedings) of $39 million recorded in 2008. EBITDAR amounted to $679 million in 2009 compared to EBITDAR (before a provision for cargo investigations and proceedings) of $934 million in 2008, a decrease of $255 million.

In 2009, Air Canada recorded operating revenues of $9,739 million, a decrease of $1,343 million or 12% from the operating revenues of $11,082 million recorded in 2008. The decrease in operating revenues was mainly due to a passenger revenue decline of $1,214 million or 12% from 2008. The passenger revenue decrease was due to a lower system yield and reduced traffic. Yield declined 7.6% from 2008. Traffic decreased 5.2% on a capacity reduction of 4.4%, resulting in a passenger load factor decrease of 0.7 percentage points. RASM decreased 8.4% over 2008 due to the yield decline and, to a lesser extent, the decrease in system passenger load factor.

In 2009, Air Canada recorded operating expenses of $10,055 million, a decrease of $1,066 million or 10% from the operating expenses of $11,121 million recorded in 2008. The decrease in operating expenses was achieved in spite of $230 million in additional expenses related to the weaker Canadian dollar versus the U.S. dollar. Reduced fuel expense of $971 million or 28% versus 2008 was the main factor in the year-over-year decrease in operating expenses. Operating expense reductions were recorded in all major line categories with the exception of aircraft maintenance, aircraft rent, capacity purchase fees paid to Jazz and communications and information technology expenses.

In 2009, CASM decreased 5.4% from 2008. Excluding fuel expense, CASM increased 3.3% from 2008. The value of the Canadian dollar versus the U.S. dollar was weaker in the first three quarters of 2009 and stronger in the fourth quarter of 2009 when compared to the same periods in 2008. For the full year 2009, the overall impact of a weaker average Canadian dollar versus the U.S. dollar on U.S. denominated operating expenses accounted for approximately 40% of the CASM increase (excluding fuel expense) year-over-year. Other factors in the CASM increase (excluding fuel expense) included a growth in aircraft maintenance expense, increased Jazz CPA expense, higher unit costs of ownership, and the impact of the capacity reduction. The 3.3% increase in CASM (excluding fuel expense) for 2009 was in line with 3.0% to 3.5% CASM (excluding fuel expense) increase projected in Air Canada's news release dated November 6, 2009.

6. SIGNIFICANT EVENTS IN 2009

In order to strengthen its position to manage through the economic downturn and in an effort to mitigate its liquidity risks, Air Canada entered into the following significant transactions in 2009:

- A public offering for 160,500,000 units at a price of $1.62 per unit with each unit comprised of one Class B voting share or Class A variable voting share and one-half of a warrant which provided net proceeds of $249 million;

- A secured term credit facility (the "Credit Facility") which provided financing proceeds of $600 million, less fees of $20 million. The terms of the Credit Facility permit, on or before the first anniversary and subject to satisfaction of certain conditions, Air Canada to request an increase to the facility by up to an additional $100 million by obtaining new commitments from either the existing or new lenders. The Credit Facility is a five-year facility with the first principal repayment due in August 2010, and bears interest at 12.75%. Air Canada's obligations under the Credit Facility are secured by a first priority security interest and hypothec over substantially all the present and after-acquired property of Air Canada and its subsidiaries. The Credit Facility also provided for warrants entitling the debt holders to acquire up to 10% of the shares of the Corporation, which at the time of the issuance of the warrants represented 10 million shares in the Corporation. As part of the transactions related to the closing of the Credit Facility, existing financing arrangements of $166 million were repaid as follows:

  - A revolving credit facility was repaid in full in the amount of $49 million. The rights of the lender under the revolving credit facility were assigned to the lenders under the Credit Facility;

  - A spare engine financing was partially repaid in the amount of $38 million. This represented the repayment related to 22 engines under a spare engine financing agreement, with 10 engines remaining under the agreement with a loan value of $72 million as at December 31, 2009;

  - A secured loan with Aeroplan Canada Inc. ("Aeroplan") was repaid in full in the amount of $79 million. Aeroplan is a participating lender under the Credit Facility.

- The extension or renewal of labour agreements for 21 months with all of the Corporation's Canadian-based unions completed by July 2009 which provide for no increases to wage rates and no changes to group insurance coverage, benefits, or pension benefit levels during the contract extension or renewal periods;

- Pension funding agreements with the Corporation's Canadian-based unions (the "Pension MOUs") and the adoption of the Air Canada Pension Funding Regulations, 2009 (the "Air Canada 2009 Pension Regulations"). The Air Canada 2009 Pension Regulations relieve Air Canada from making any special (past service cost) payments for the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contributions shall equal the lesser of (i) $150 million, $175 million, and $225 million in respect of 2011, 2012, and 2013, respectively and (ii) the maximum past service contributions permitted under the Income Tax Act. Pursuant to the Pension MOUs, on October 26, 2009, the Corporation issued, to a trust, 17,647,059 Class B voting shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of sale of such shares by the trust are to be contributed to the pension plans;

- An agreement with a supplier, in consideration of various contractual commitments, which provided non-refundable proceeds of $230 million. For accounting purposes, the recognition of these proceeds was deferred in order to be applied to reduce the cost of these contractual commitments as they are incurred;

- Amendments to credit card processing agreements with one of its principal credit card processors which revise the levels of unrestricted cash (as defined per the agreement and generally based on the aggregate sums of cash, cash equivalents and short-term investments) required to be maintained;

- An extension of the repayment date of a short-term loan of $78 million (US$75 million) entered into in 2008 which was originally due in 2009, to 2013;

- The sale and leaseback of three Boeing 777 aircraft. The sale and leaseback transactions were substantially completed in November 2009 and provided initial cash proceeds of $95 million (net of deposits). Additional net cash proceeds of $20 million were received in January 2010;

- The sale and leaseback of one Boeing 777 aircraft for aggregate proceeds of $172 million and the requirement repayment of a debt obligation related to the aircraft of $128 million, which included a prepayment fee of $14 million;

- An agreement amending the terms of the Jazz CPA, effective August 1, 2009, which provides for a reduction to rates paid under the agreement;

- Financing arrangements secured by spare parts, spare engines and a Boeing 777 aircraft which provided aggregate proceeds of $267 million, net of fees of $8 million. As discussed above, $38 million of the spare engine financing was repaid on closing of the Credit Facility;

- During 2009, Air Canada entered into various inventory financing arrangements under which it acquired $117 million of spare parts inventories in exchange for the issuance of bills of exchange. Subsequent to the arrangements, Air Canada completed various transactions in relation to certain bills of exchange resulting in gains of $4 million being recorded in non-operating income (expense) in 2009. As at December 31, 2009, the remaining inventory is valued at $43 million which represented its estimated net realizable value. The expected final payment due in 2010 under the financing arrangements is $11 million (US$11 million);

- Repayment of pre-delivery financing of $83 million on a Boeing 777 aircraft received during the first quarter of 2009; and

- In 2009, the net return of collateral deposits on fuel derivatives amounted to $285 million, while the settlement of fuel derivative contracts in favour of counterparties amounted to $280 million.

7. RESULTS OF OPERATIONS – FOURTH QUARTER OF 2009 VERSUS FOURTH QUARTER OF 2008

The following table and discussion compares the results of Air Canada for the fourth quarter of 2009 to its results for the fourth quarter of 2008.

(Canadian dollars in millions, except per share figures)	Fourth Quarter 2009	Fourth Quarter 2008	Change $	Change %
Operating revenues				
Passenger	$ 2,030	$ 2,182	$ (152)	(7)
Cargo	110	113	(3)	(3)
Other	208	203	5	2
	2,348	**2,498**	**(150)**	**(6)**
Operating expenses				
Aircraft fuel	601	792	(191)	(24)
Wages, salaries and benefits	418	444	(26)	(6)
Airport and navigation fees	228	230	(2)	(1)
Capacity purchase with Jazz	227	237	(10)	(4)
Depreciation and amortization	165	174	(9)	(5)
Aircraft maintenance	202	157	45	29
Food, beverages and supplies	69	70	(1)	(1)
Communications and information technology	64	72	(8)	(11)
Aircraft rent	85	80	5	6
Commissions	46	40	6	15
Other	326	348	(22)	(6)
	2,431	**2,644**	**(213)**	**(8)**
Operating loss	**(83)**	**(146)**	**63**	
Non-operating income (expense)				
Interest income	2	11	(9)	
Interest expense	(87)	(88)	1	
Interest capitalized	-	6	(6)	
Loss on assets	(25)	(5)	(20)	
Gain on financial instruments recorded at fair value	22	32	(10)	
Other	5	-	5	
	(83)	(44)	(39)	
Loss before the following items	**(166)**	**(190)**	**24**	
Non-controlling interest	(4)	(4)	-	
Foreign exchange gain (loss)	108	(527)	635	
Recovery of (provision for) income taxes	6	(6)	12	
Loss for the period	**$ (56)**	**$ (727)**	**$ 671**	
EBITDAR (1)	**$ 167**	**$ 108**	**$ 59**	
Loss per share - Basic and diluted	**$ (0.25)**	**$ (7.27)**	**$ 7.02**	

(1) See section 21 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).

System passenger revenues decreased 7.0% from the fourth quarter of 2008

Compared to the fourth quarter of 2008, passenger revenues decreased $152 million or 7.0% to $2,030 million in the fourth quarter of 2009 due to a system yield decrease. In the fourth quarter of 2009, passenger revenues from the premium cabin accounted for 22% of the total decrease in system passenger revenues. The decrease in premium cabin revenues was driven by a 7.2% decline in yield as premium cabin traffic was essentially unchanged from the same period in 2008.

In the fourth quarter of 2009, Air Canada increased its overall capacity by 2.0% from the fourth quarter of 2008. Capacity in the North American market was reduced by 1.0% while capacity in the international market was increased by 5.0%, from the same quarter in 2008. Components of the year-over-year change in fourth quarter system passenger revenues included:

- A system traffic increase of 0.4% on a capacity increase of 2.0%, which resulted in a 1.3 percentage point decline in system passenger load factor compared to the fourth quarter of 2008. The system capacity growth of 2.0% in the fourth quarter of 2009 compared to the fourth quarter of 2008 was in line with the 1.0% to 2.0% ASM capacity increase projected in Air Canada's news release dated November 6, 2009.

- A system yield decline of 7.3% from the fourth quarter of 2008, which was due to a weak economy, greater fare discounting in an effort to stimulate traffic and reduced fuel surcharges year-over-year. This was an improvement from the second and third quarters of 2009 where yield declined 8.9% and 11.2%, respectively, from the corresponding periods in 2008. In the fourth quarter of 2009, the economy cabin reflected a yield decline of 7.6% while the premium cabin reflected a yield decline of 7.2% compared to the same quarter in 2008. All markets reflected yield decreases with the exception of the U.S. transborder market.

- A RASM decrease of 8.8% from the fourth quarter of 2008, which was due to both the yield decline and the decrease in passenger load factor. This was an improvement from the second and third quarters of 2009 where RASM declined 11.3% and 10.2%, respectively, from the corresponding periods in 2008.

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

Fourth Quarter 2009 Versus Fourth Quarter 2008	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	(7.9)	(0.6)	(1.3)	(0.5)	(6.7)	(7.3)
US transborder	(3.7)	(1.8)	(5.0)	(2.5)	1.4	(1.9)
Atlantic	(4.8)	6.7	2.4	(3.3)	(7.0)	(10.8)
Pacific	(9.7)	6.5	4.2	(1.8)	(13.4)	(15.2)
Other	(10.8)	(0.1)	3.3	2.6	(13.7)	(10.7)
System	**(7.0)**	**2.0**	**0.4**	**(1.3)**	**(7.3)**	**(8.8)**

Domestic passenger revenues decreased 7.9% from the fourth quarter of 2008

Domestic passenger revenues of $883 million in the fourth quarter of 2009 decreased $77 million or 7.9% from the fourth quarter of 2008 due to a lower yield and reduced traffic. In the fourth quarter of 2009, Air Canada reduced its domestic capacity by 0.6% from the fourth quarter of 2008. Capacity reductions on transcontinental routes were largely offset by capacity increases on routes to the Maritimes and within central and western Canada. Components of the year-over-year change in fourth quarter domestic passenger revenues included:

- A traffic decline of 1.3% on a capacity reduction of 0.6%, which resulted in a 0.5 percentage point decline in passenger load factor. All major domestic services reflected passenger load factor decreases with the exception of transcontinental routes, linking Toronto, Montreal and Ottawa with major western Canadian cities, including Winnipeg, Calgary, Edmonton and Vancouver.

- A yield decrease of 6.7% from the fourth quarter of 2008, which reflected the continued weak economic environment and greater fare discounting in an effort to stimulate traffic. All major domestic services recorded yield declines with the exception of Rapidair routes, linking Toronto and Montreal/Ottawa.

- A RASM decline of 7.3% from the fourth quarter of 2008, which was mainly due to the lower yield but also to the decrease in passenger load factor.

U.S. transborder passenger revenues decreased 3.7% from the fourth quarter of 2008
U.S. transborder passenger revenues of $405 million in the fourth quarter of 2009 decreased $16 million or 3.7% from the fourth quarter of 2008 due to lower traffic as yield grew 1.4% year-over-year. In the fourth quarter of 2009, U.S. transborder capacity was reduced by 1.8% from the fourth quarter of 2008. Components of the year-over-year change in fourth quarter U.S. transborder passenger revenues included:

- A traffic decline of 5.0% on a capacity reduction of 1.8%, which resulted in a passenger load factor decline of 2.5 percentage points from the fourth quarter of 2008.

- Air Canada's Toronto – Austin and Vancouver – Sacramento routes were suspended in the second half of 2009 while these routes operated in the fourth quarter of 2008. Partly offsetting these capacity decreases was increased capacity to Florida, in order to capitalize on more stable leisure demand, and the introduction of services from Calgary to Portland, as well as services from Calgary to Honolulu and Calgary to Maui and to San Diego.

- A yield increase of 1.4% from the fourth quarter of 2008, which reflected yield improvements on all major U.S. transborder services with the exception of U.S. sun routes and routes from western Canada to western U.S. where additional capacity and aggressive competitive pricing adversely impacted yields. Yield in the economy cabin was unchanged from the same period in 2008 while yield in the premium cabin increased 2.7% year-over-year.

- A RASM decrease of 1.9% from the fourth quarter of 2008, which was due to the passenger load factor decrease.

Atlantic passenger revenues decreased 4.8% from the fourth quarter of 2008
Atlantic passenger revenues of $376 million in the fourth quarter of 2009 decreased $18 million or 4.8% from the fourth quarter of 2008 due to a lower yield as traffic increased 2.4% year-over-year. In the fourth quarter of 2009, Atlantic capacity was increased by 6.7% from the fourth quarter of 2008. Capacity was increased on all major Atlantic services with the exception of Spain and Tel Aviv where capacity was reduced year-over-year. Components of the year-over-year change in fourth quarter Atlantic passenger revenues included:

- A traffic increase of 2.4% on the capacity growth of 6.7%, which resulted in a passenger load factor decrease of 3.3 percentage points from the fourth quarter of 2008.

- The capacity growth in the fourth quarter of 2009 reflected new routes, such as Montreal – Geneva and additional frequencies on Calgary – Frankfurt, which was also partly offset by a suspension earlier in the year of the Toronto – Madrid service for the winter and a reduction in frequencies to Tel Aviv.

- A yield decline of 7.0% from the fourth quarter of 2008, which reflected the continued weak economic environment, increased fare discounting to stimulate traffic and reduced fuel surcharges year-over-year. Additional traffic growth in the fourth quarter was accepted at lower yields in an attempt to fill the capacity growth which resulted in additional pressure placed on yields. Yield declines were reflected on all major Atlantic services with the exception of Spain where yield improved year-over-year.

- A RASM decrease of 10.8% from the fourth quarter of 2008, which was due to both the lower yield and the passenger load factor decrease.

Pacific passenger revenues decreased 9.7% from the fourth quarter of 2008
Pacific passenger revenues of $199 million in the fourth quarter of 2009 decreased $21 million or 9.7% from the fourth quarter of 2008 due to a lower yield as traffic grew 4.2% year-over-year. In the fourth quarter of 2009, capacity was increased by 6.5% from the fourth quarter of 2008 with growth reflected on all major Pacific services with the exception of Korea where capacity was reduced year-over-year. Components of the year-over-year change in fourth quarter Pacific passenger revenues included:

- A traffic increase of 4.2% on the capacity increase of 6.5%, which resulted in passenger load factor decline of 1.8 percentage points from the fourth quarter of 2008. Air Canada increased its capacity in the fourth quarter on the

Pacific with the re-introduction of the Toronto – Narita non-stop service with a Boeing 777 aircraft and additional frequencies from Vancouver to China.

- A yield decline of 13.4% from the fourth quarter of 2008, which reflected the continued weak economic environment, continued fare discounting in an effort to stimulate traffic and significantly reduced fuel surcharges year-over-year. Additional traffic growth in the fourth quarter was accepted at lower yields in an attempt to fill the capacity growth, which resulted in additional pressure placed on yields. Yield decreases were reflected on all major Pacific services.

- A RASM decrease of 15.2% from the fourth quarter of 2008, which was largely due to the decline in yield but also to the decrease in passenger load factor.

Other passenger revenues decreased 10.8% from the fourth quarter of 2008
Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) of $167 million in the fourth quarter of 2009 decreased $20 million or 10.8% from the fourth quarter of 2008 due to reduced yields as overall traffic increased 3.3% year-over-year. Capacity growth on the South Pacific and Caribbean was mostly offset by a capacity reduction on routes to Mexico. Components of the year-over-year change in fourth quarter other passenger revenues included:

- A traffic increase of 3.3% on the capacity reduction of 0.1%, which resulted in a passenger load factor improvement of 2.6 percentage points versus the same period in 2008.

- A yield decline of 13.7% from the fourth quarter of 2008, which reflected a weak economic environment, increased fare discounting to stimulate traffic, continued competitive pricing pressure and reduced fuel surcharges year-over-year. Yield decreases were reflected on all major services.

- A RASM decrease of 10.7% from the fourth quarter of 2008, which was due to the decline in yield.

Cargo revenues decreased 3% from the fourth quarter of 2008
Fourth quarter 2009 cargo revenues amounted to $110 million and were $3 million or 3% below the fourth quarter of 2008. This represented a marked improvement compared to the much greater year-over-year reduction in revenues recorded in the first three quarters of 2009.

Cargo traffic increased by 25% in the fourth quarter compared to the same period last year, on strong traffic growth in Pacific and Atlantic markets. This compared to the first nine months of 2009 where non-freighter traffic declined an average of 15% on a year-over-year basis. In 2008, however, weak economic conditions were already adversely affecting traffic levels during the fourth quarter. System cargo yield per revenue ton mile (RTM) was down 22% versus 2008 mainly due to lower fuel surcharges, increased competitive pressure on rates in certain markets and, to a lesser extent, the unfavourable impact of a stronger Canadian dollar on foreign denominated currencies.

Factors contributing to the year-over-year change in fourth quarter cargo revenues included:

- A decrease in domestic cargo revenues of 13% on a 6% traffic increase and an 18% decline in yield per RTM. Domestic capacity was down 5% versus the fourth quarter of 2008.

- A decrease in Atlantic revenues of 13% on 17% more traffic and a 25% lower yield per RTM. Atlantic capacity was up 7% versus the fourth quarter of 2008.

- An increase in Pacific revenues of 18% on 40% more traffic and a 15% lower yield per RTM. Pacific capacity was up 7% versus the fourth quarter of 2008.

- A stronger Canadian dollar versus the fourth quarter of 2008 which had a negative impact on foreign currency denominated revenues of $4 million in the fourth quarter of 2009.

Other revenues increased 2% from the fourth quarter of 2008

Other revenues of $208 million in the fourth quarter of 2009 increased $5 million or 2% from the fourth quarter of 2008, primarily due to an $18 million increase in third party revenues at Air Canada Vacations, mainly driven by higher passenger volumes. This increase was partly offset by lower aircraft sublease revenues in the quarter largely driven by the unfavourable impact of a stronger Canadian dollar on U.S. denominated aircraft leases and the sale of two Airbus A340-300 aircraft which were subleased to a third party in the fourth quarter of 2008.

CASM decreased 9.8% from the fourth quarter of 2008. Excluding fuel expense, CASM decreased 3.2% from the fourth quarter of 2008

Operating expenses were $2,431 million in the fourth quarter of 2009, a decrease of $213 million or 8% from the fourth quarter of 2008. In the fourth quarter of 2009, a stronger Canadian dollar versus the U.S. dollar compared to the fourth quarter of 2008 reduced operating expenses by $105 million from the fourth quarter of 2008.

Unit cost in the fourth quarter of 2009, as measured by operating expense per available seat mile (CASM), decreased 9.8% over the fourth quarter of 2008. Excluding fuel expense, CASM decreased 3.2% year-over-year. The main contributing factors in the CASM decrease (excluding fuel expense) were the favourable impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for approximately 85% of the CASM decrease (excluding fuel expense), and lower wages, salaries and benefits expense. Partly offsetting these decreases to CASM (excluding fuel expense) was a $45 million year-over-year increase in aircraft maintenance expense from the same period in 2008.

The 3.2% decrease in CASM (excluding fuel expense) for the fourth quarter of 2009 was in line with the 3% to 4% CASM (excluding fuel expense) decrease projected in Air Canada's news release dated November 6, 2009.

The following table compares Air Canada's operating expenses per ASM for the fourth quarter of 2009 to Air Canada's operating expenses per ASM for the corresponding period in 2008.

	Fourth Quarter		Change	
(cents per ASM)	**2009**	**2008**	**cents**	**%**
Wages and salaries	2.61	2.71	(0.10)	(3.7)
Benefits	0.41	0.56	(0.15)	(26.8)
Ownership (DAR) (1)	1.81	1.87	(0.06)	(3.2)
Airport user fees	1.65	1.70	(0.05)	(2.9)
Capacity purchase with Jazz	1.64	1.74	(0.10)	(5.7)
Aircraft maintenance	1.46	1.16	0.30	25.9
Food, beverages and supplies	0.49	0.52	(0.03)	(5.8)
Communications and information technology	0.46	0.53	(0.07)	(13.2)
Commissions	0.33	0.29	0.04	13.8
Other	2.35	2.56	(0.21)	(8.2)
Operating expense, excluding fuel expense (2)	**13.21**	**13.64**	**(0.43)**	**(3.2)**
Aircraft fuel	4.36	5.84	(1.48)	(25.3)
Total operating expense	**17.57**	**19.48**	**(1.91)**	**(9.8)**

(1) DAR refers to the combination of Depreciation and amortization, and Aircraft rent.

(2) Refer to section 21 "Non-GAAP Financial Measures" in this MD&A for additional information.

Fuel expense decreased 24% from the fourth quarter of 2008

Fuel expense amounted to $601 million in the fourth quarter of 2009, a decrease of $191 million or 24% from the fourth quarter of 2008. Factors contributing to the year-over-year change in fourth quarter fuel expense included:

- A lower base fuel price, which accounted for a decrease of $112 million.
- The favourable impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for a decrease of $55 million to fuel expense in the fourth quarter of 2009.

- Fuel hedging losses of $85 million in the fourth quarter of 2009 versus fuel hedging losses of $111 million in the fourth quarter of 2008, a favourable variance of $26 million compared to the fourth quarter of 2008.

The table below provides Air Canada's fuel cost per litre, excluding and including hedging, for the periods indicated.

(Canadian dollars in millions, except where indicated)	Fourth Quarter		Change	
	2009	2008	$	%
Aircraft fuel expense - GAAP (1)	$ 599	$ 788	$ (189)	(24)
Add: Fuel hedging gains (losses) included in aircraft fuel expense	(85)	(111)	26	23
Add: Net cash settlements on maturing fuel derivatives (designated under hedge accounting and economic hedges) (2)	12	91	(79)	(87)
Economic cost of fuel - Non-GAAP (3)	**$ 526**	**$ 768**	**$ (242)**	**(32)**
Fuel consumption (thousands of litres)	824,911	822,011	2,900	-
Fuel costs per litre (cents) - GAAP	72.6	95.8	(23.2)	(24)
Fuel costs per litre (cents) - excluding fuel hedges	62.3	82.2	(19.9)	(24)
Economic fuel costs per litre (cents) - Non-GAAP	63.7	93.2	(29.5)	(32)

(1) Fuel expense excludes fuel related to third party carriers, other than Jazz, operating under capacity purchase agreement.

(2) Excluding early terminated hedging contracts in the fourth quarter of 2009 for $20 million covering 2010 fuel consumption.

(3) The economic cost of fuel is a non-GAAP measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada uses this measure to calculate Air Canada's cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period. It excludes non-cash accounting gains and losses from fuel derivative instruments.

Wages, salaries and benefits expense amounted to $418 million in the fourth quarter of 2009, a decrease of $26 million or 6% from the fourth quarter of 2008

Wages and salaries expense totaled $362 million in the fourth quarter of 2009, a decrease of $7 million or 2% from the fourth quarter of 2008. The decrease in wages and salaries was mainly due to a reduction of an average of 1,131 full-time equivalent ("FTE") employees or 4.8% versus the same period in 2008. Partly offsetting this decrease was an increase in average wages for 0.8% compared to the fourth quarter of 2008. In addition, in the fourth quarter of 2009, Air Canada recorded expenses of $5 million related to a non-unionized staff reduction program. No such expenses were recorded in the same period in 2008.

Employee benefits expense amounted to $56 million in the fourth quarter of 2009, a decrease of $19 million or 29% from the fourth quarter of 2008. The decrease was mainly due to reduced pension and post-employment benefits expenses as a result of revised actuarial assumptions. The actuarial assumptions used for recording pension expense under GAAP differ from those used in determining the solvency deficit. Refer to section 10.6 of this MD&A for a discussion related to Air Canada's pension funding obligations.

Capacity purchase costs with Jazz decreased 4% from the fourth quarter of 2008

Capacity purchase costs with Jazz, pursuant to the Jazz CPA, amounted to $227 million in the fourth quarter of 2009 compared to $237 million in the fourth quarter of 2008, a decrease of $10 million or 4%. This year-over-year decrease in capacity purchase costs was mainly due to the impact of reduced flying which accounted for a decrease of $8 million, the favourable impact of foreign exchange on U.S. denominated Jazz CPA charges paid by Air Canada, which accounted for a decrease of $6 million, and the impact of the reduction to the mark-up on Jazz CPA rates pursuant to an amendment to the Jazz CPA effective August 1, 2009, which accounted for a decrease of $8 million. Partly offsetting these decreases was a year-over-year increase in Jazz CPA rates of $12 million, of which $8 million was related to additional maintenance costs due to the aging of Jazz's fleet.

Ownership costs decreased 2% from the fourth quarter of 2008

Ownership costs, comprised of depreciation and amortization, and aircraft rent expense, of $250 million in the fourth quarter of 2009 decreased $4 million or 2% from the fourth quarter of 2008. Factors contributing to the year-over-year change in the fourth quarter ownership costs included:

- Changes in aircraft residual values, which accounted for a decrease of $9 million to depreciation expense.
- The impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for a decrease of $7 million to aircraft rent expense.

The above-noted decreases were partially offset by the following:

- The addition of new Boeing 777 aircraft to Air Canada's operating fleet, which accounted for an increase of $14 million.

Aircraft maintenance expense increased 29% from the fourth quarter of 2008

In the fourth quarter of 2009, aircraft maintenance expense of $202 million increased $45 million or 29% from the fourth quarter of 2008. Factors contributing to the year-over-year change in fourth quarter aircraft maintenance expense included:

- A net increase of $41 million in airframe maintenance, which was largely due to the timing and scope of airframe events related to the fleets of Airbus A319, A320 and Boeing 767-300 aircraft. In particular, scheduled heavy maintenance was required on the Airbus A319 aircraft which were delivered in the mid-1990s. The impact of cost reduction initiatives resulted in savings of approximately $9 million to maintenance costs in the fourth quarter of 2009.
- A net increase of $19 million in engine maintenance, which was mainly due to an industry campaign for the removal of high pressure turbine blades on the A320 aircraft engine, which resulted in the removal of the blades at an earlier stage than anticipated. A higher volume of engine events related to Boeing 777 and Embraer E175 aircraft also contributed to the increase.
- A net increase of $9 million in component maintenance, which was mainly due to the Boeing 777, Embraer E175 and E190 aircraft requiring maintenance that was no longer covered by warranty. In an effort to lower these costs, Air Canada recently entered into long-term contracts with several vendors pursuant to which Air Canada sold certain of its Boeing 777 component inventory for proceeds of $20 million and obtained more advantageous pricing.

The above-noted increases were partially offset by the following:

- The impact of a stronger Canadian dollar versus the U.S. dollar on U.S. denominated maintenance expenses, mainly engine and component maintenance, which accounted for a decrease of $10 million to aircraft maintenance expense compared to the fourth quarter of 2008.

Food, beverages and supplies expense decreased 1% from the fourth quarter of 2008

In the fourth quarter of 2009, food, beverages and supplies expense of $69 million decreased $1 million or 1% from the fourth quarter of 2008 despite a passenger traffic growth of 0.4%. The impact of cost reduction initiatives including reduced contract rates were factors in this decrease compared to the same period in 2008.

Communications and information technology expense decreased 11% from the fourth quarter of 2008

In the fourth quarter of 2009, communications and information technology expense of $64 million decreased $8 million or 11% from the fourth quarter of 2008 and included the impact of reduced information technology project spend and savings achieved through renegotiation of a major information technology supplier contract.

Commission expense increased 15% from the fourth quarter of 2008

In the fourth quarter of 2009, commission expense of $46 million increased $6 million or 15% from the fourth quarter of 2008, on a passenger revenue decrease of 7%. The impact of higher passenger sales and a change in the commission structure at Air Canada Vacations resulted in additional commission expense of $3 million in the fourth quarter of 2009. The introduction of a 7% commission for Canadian travel agents to sell Tango fares for flights within Canada has resulted in additional commission expense, however, overall, based on management's analysis, the benefits of these initiatives have outweighed the costs by enabling the Corporation to generate increased passenger revenues.

Other operating expenses decreased 6% from the fourth quarter of 2008

Other operating expenses amounted to $326 million in the fourth quarter of 2009, a decrease of $22 million or 6% from the fourth quarter of 2008. The decrease in other operating expenses was mainly driven by favourable rate adjustments on foreign currency transactions.

The following table provides a breakdown of the more significant items included in other expenses:

(Canadian dollars in millions)	Fourth Quarter 2009	Fourth Quarter 2008	Change $	Change %
Air Canada Vacations' land costs	$ 47	$ 49	$ (2)	(4)
Credit card fees	45	44	1	2
Terminal handling	45	45	-	-
Building rent and maintenance	35	35	-	-
Miscellaneous fees and services	33	30	3	10
Crew expenses (meals, transportation and hotels)	29	30	(1)	(3)
Remaining other expenses	92	115	(23)	(20)
	$ 326	**$ 348**	**$ (22)**	**(6)**

Non-operating expense amounted to $83 million in the fourth quarter of 2009

Non-operating expense amounted to $83 million in the fourth quarter of 2009 compared to non-operating expense of $44 million in the fourth quarter of 2008. Factors contributing to the year-over-year change in fourth quarter non-operating expense included:

- Net interest expense increased $14 million from the fourth quarter of 2008 due to:
    - A $9 million decrease in interest income, which was driven by lower rates of interest;
    - A $1 million decrease in interest expense, which was mainly due to the impact of new financing transactions completed in 2009. In addition, in the fourth quarter of 2009, Air Canada recorded a charge of $8 million in interest expense related to the sale and leaseback of three Boeing aircraft. These increases were offset by the impact of lower average interest rates year-over-year, the favourable impact of foreign exchange on interest expense in the fourth quarter of 2009, and by a reduction of interest expense on aircraft pre-delivery payments related to Boeing 777 aircraft versus the same period in 2008;
    - A lower amount of capitalized interest of $6 million compared to 2008.
- In the fourth quarter of 2009, Air Canada recorded a loss on assets of $24 million pertaining to the sale and leaseback of three Boeing 777 aircraft. This compared to a loss on assets of $5 million recorded in the fourth quarter of 2008.
- Gains related to fair value adjustments on derivative instruments amounted to $22 million in the fourth quarter of 2009 versus gains of $32 million in the fourth quarter of 2008. The mark-to-market gains on financial instruments recorded in 2009 were mainly related to the change in the fair value of fuel derivatives.

Gains on foreign exchange amounted to $108 million in the fourth quarter of 2009

Gains on foreign exchange, which were mainly related to U.S. denominated long-term debt, amounted to $108 million in the fourth quarter of 2009 compared to losses of $527 million in the fourth quarter of 2008. The gains in the fourth quarter of 2009 were mainly attributable to a stronger Canadian dollar at December 31, 2009 compared to September 30, 2009. The December 31, 2009 noon day exchange rate was US$1 = C$1.0466 while the September 30, 2009 noon day exchange rate was US$1 = C$1.0722.

Income tax recovery of $6 million in the fourth quarter of 2009

Air Canada recorded an income tax recovery of $6 million on a pre-tax loss of $62 million in the fourth quarter of 2009, which related mainly to an adjustment to current taxes payable.

8. RESULTS OF OPERATIONS – FULL YEAR OF 2009 VERSUS FULL YEAR OF 2008

The following table and discussion compares the results of Air Canada for 2009 to its results for 2008.

(Canadian dollars in millions, except per share figures)	Full Year 2009	Full Year 2008	Change $	Change %
Operating revenues				
Passenger	$ 8,499	$ 9,713	$ (1,214)	(12)
Cargo	358	515	(157)	(30)
Other	882	854	28	3
	9,739	**11,082**	**(1,343)**	**(12)**
Operating expenses				
Aircraft fuel	2,448	3,419	(971)	(28)
Wages, salaries and benefits	1,751	1,877	(126)	(7)
Airport and navigation fees	971	1,001	(30)	(3)
Capacity purchase with Jazz	973	948	25	3
Depreciation and amortization	660	694	(34)	(5)
Aircraft maintenance	759	659	100	15
Food, beverages and supplies	291	314	(23)	(7)
Communications and information technology	293	286	7	3
Aircraft rent	335	279	56	20
Commissions	186	194	(8)	(4)
Other	1,388	1,450	(62)	(4)
	10,055	**11,121**	**(1,066)**	**(10)**
Operating loss before the undernoted item	**(316)**	**(39)**	**(277)**	
Provision for cargo investigations	-	(125)	125	
Operating loss	**(316)**	**(164)**	**(152)**	
Non-operating income (expense)				
Interest income	14	57	(43)	
Interest expense	(373)	(319)	(54)	
Interest capitalized	4	37	(33)	
Loss on assets	(95)	(34)	(61)	
Gain on financial instruments recorded at fair value	95	92	3	
Other	-	(3)	3	
	(355)	(170)	(185)	
Loss before the following items	**(671)**	**(334)**	**(337)**	
Non-controlling interest	(15)	(12)	(3)	
Foreign exchange gain (loss)	657	(655)	1,312	
Recovery of (provision for) income taxes	5	(24)	29	
Loss for the period	**$ (24)**	**$ (1,025)**	**$ 1,001**	
EBITDAR before the provision for cargo investigations (1)	**$ 679**	**$ 934**	**$ (255)**	
EBITDAR (1)	**$ 679**	**$ 809**	**$ (130)**	
Loss per share - Basic and diluted	**$ (0.18)**	**$ (10.25)**	**$ 10.07**	

(1) See section 21 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before the provision for cargo investigations and proceedings to operating income (loss) and EBITDAR to operating income (loss).

System passenger revenues decreased 12.5% from 2008

Compared to 2008, passenger revenues decreased $1,214 million or 12.5% to $8,499 million in 2009 due to lower yield and traffic. A decline in passenger revenues from the premium cabin accounted for $405 million or over 33% of the total decrease in system passenger revenues. In 2009, Air Canada reduced its overall capacity by 4.4%. Capacity in the North American market was reduced by 5.1% while capacity in the international market was reduced by 3.7%, from 2008. Components of the year-over-year change in system passenger revenues included:

- A traffic decline of 5.2% on a capacity reduction of 4.4%, which resulted in a 0.7 percentage point decrease in passenger load factor compared to 2008. The system capacity reduction of 4.4% in 2009 compared to 2008 was in line with the 4.25% to 4.75% ASM capacity reduction projected in Air Canada's news release dated November 6, 2009.

- A system yield decrease of 7.6% from 2008, which was due to a weak economy, reduced high-yield business travel and increased competitive pricing activities. A reduction in fuel surcharges was also a factor in the yield decline year-over-year.

- A weaker Canadian dollar in 2009 versus 2008, which had a positive impact on foreign currency denominated revenues of $184 million in 2009.

- A RASM decrease of 8.4% versus 2008, which was mainly due to the yield decline, but also to the decrease in passenger load factor.

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

Year 2009 Versus Year 2008	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	(12.6)	(3.7)	(4.1)	(0.3)	(8.7)	(9.1)
US transborder	(12.5)	(7.7)	(9.6)	(1.6)	(3.2)	(5.1)
Atlantic	(8.6)	1.4	(0.6)	(1.7)	(8.0)	(9.9)
Pacific	(16.7)	(12.5)	(11.7)	0.8	(5.7)	(4.8)
Other	(15.8)	(1.7)	(2.3)	(0.5)	(13.8)	(14.4)
System	**(12.5)**	**(4.4)**	**(5.2)**	**(0.7)**	**(7.6)**	**(8.4)**

The table below describes year-over-year percentage changes in system passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% change)				
System	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(13.0)	(16.1)	(13.2)	(7.0)	(12.5)
Capacity (ASMs)	(10.3)	(5.4)	(3.3)	2.0	(4.4)
Traffic (RPMs)	(10.9)	(7.9)	(2.1)	0.4	(5.2)
Passenger Load Factor (pp Change)	(0.5)	(2.2)	1.0	(1.3)	(0.7)
Yield	(2.3)	(8.9)	(11.2)	(7.3)	(7.6)
RASM	(3.0)	(11.3)	(10.2)	(8.8)	(8.4)

Domestic passenger revenues decreased 12.6% from 2008

Domestic passenger revenues of $3,591 million in 2009 decreased $517 million or 12.6% from 2008 due to an 8.7% decline in yield and a 4.1% decrease in traffic. In 2009, capacity reductions were reflected on all major services with the exception of routes to the Maritimes and within central and western Canada. Components of the year-over-year change in domestic passenger revenues included:

- A traffic decline of 4.1% on a capacity reduction of 3.7%, which resulted in a 0.3 percentage point decline in passenger load factor. All major domestic services reflected passenger load factor decreases with the exception of transcontinental routes.

- A yield decrease of 8.7% from 2008, which reflected the continued weak economic environment resulting in a decline in higher yielding product bookings and greater fare discounting in an effort to stimulate traffic. All major domestic services recorded yield declines.

- A weaker Canadian dollar in 2009 versus 2008, which had a positive impact on foreign currency denominated revenues of $38 million in 2009.

- A RASM decline of 9.1% from 2008, which was primarily due to the lower yield.

The table below describes year-over-year percentage changes in domestic passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% change)				
Canada	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(11.4)	(17.0)	(13.3)	(7.9)	(12.6)
Capacity (ASMs)	(7.3)	(5.8)	(1.5)	(0.6)	(3.7)
Traffic (RPMs)	(8.3)	(8.2)	0.7	(1.3)	(4.1)
Passenger Load Factor (pp Change)	(1.0)	(2.1)	1.8	(0.5)	(0.3)
Yield	(3.3)	(9.5)	(13.6)	(6.7)	(8.7)
RASM	(4.4)	(11.9)	(11.7)	(7.3)	(9.1)

U.S. transborder passenger revenues decreased 12.5% from 2008

U.S. transborder passenger revenues of $1,641 million in 2009 decreased $235 million or 12.5% from 2008 due to lower traffic and a reduced yield. Capacity was reduced on all major U.S. transborder services with the exception of routes to Florida. Components of the year-over-year change in U.S. transborder passenger revenues included:

- A traffic decline of 9.6% on a capacity reduction of 7.7%, which resulted in a passenger load factor decline of 1.6 percentage points from 2008.

- A yield decrease of 3.2% from 2008, which reflected the continued weak economic environment and greater fare discounting in an effort to stimulate traffic as well as more aggressive pricing as a result of competitive growth on U.S. leisure routes. Yield declines were reflected on all major U.S. transborder services with the exception of U.S. short-haul business routes between Eastern Canada and Northeastern U.S.

- A weaker Canadian dollar in 2009 versus the fourth quarter of 2008, which had a positive impact on foreign currency denominated revenue of $60 million in 2009.

- A RASM decrease of 5.1% from 2008, which was due to both the yield decline and the decrease in passenger load factor.

The table below describes year-over-year percentage changes in U.S. transborder passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% change)				
U.S. transborder	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(17.2)	(14.4)	(13.1)	(3.7)	(12.5)
Capacity (ASMs)	(13.7)	(4.7)	(8.8)	(1.8)	(7.7)
Traffic (RPMs)	(14.4)	(9.5)	(8.0)	(5.0)	(9.6)
Passenger Load Factor (pp Change)	(0.7)	(3.9)	0.7	(2.5)	(1.6)
Yield	(3.4)	(5.4)	(5.4)	1.4	(3.2)
RASM	(4.1)	(10.2)	(4.6)	(1.9)	(5.1)

Atlantic passenger revenues decreased 8.6% from 2008

Atlantic passenger revenues of $1,721 million in 2009 decreased $162 million or 8.6% from 2008 due to a lower yield and, to a lesser extent, a decrease in traffic. In 2009, Atlantic capacity increased 1.4% from 2008. Capacity was increased on all major Atlantic services with the exception of the U.K. and the Tel Aviv markets where capacity was reduced year-over-year. Components of the year-over-year change in Atlantic passenger revenues included:

- A traffic decrease of 0.6% on a capacity growth of 1.4%, which resulted in a passenger load factor decrease of 1.7 percentage points from 2008.
- A yield decline of 8.0% from 2008, which reflected the continued weak economic environment and increased fare discounting to stimulate traffic. The premium cabin reflected a significant yield decrease as pricing actions were taken to offer additional discounted Executive First fares and products in an effort to stimulate premium traffic. Yield declines were reflected on all major Atlantic services.
- A weaker Canadian dollar in 2009 versus 2008, which had a positive impact on foreign currency denominated revenues of $23 million in 2009.
- A RASM decrease of 9.9% from 2008, which was due to both the lower yield and the decrease in passenger load factor.

The table below describes year-over-year percentage changes in Atlantic passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% change)				
Atlantic	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(12.7)	(11.1)	(6.7)	(4.8)	(8.6)
Capacity (ASMs)	(9.7)	(0.1)	6.8	6.7	1.4
Traffic (RPMs)	(12.9)	(1.6)	5.9	2.4	(0.6)
Passenger Load Factor (pp Change)	(2.7)	(1.3)	(0.8)	(3.3)	(1.7)
Yield	0.1	(9.7)	(11.8)	(7.0)	(8.0)
RASM	(3.4)	(11.0)	(12.6)	(10.8)	(9.9)

Pacific passenger revenues decreased 16.7% from 2008

Pacific passenger revenues of $829 million in 2009 decreased $166 million or 16.7% from 2008 due largely to an 11.7% decrease in traffic. In 2009, capacity was reduced by 12.5% from 2008 with reductions reflected on all major Pacific services with the exception of Hong Kong where capacity was increased year-over-year. Components of the year-over-year change in Pacific passenger revenues included:

- A traffic decrease of 11.7% on the capacity reduction of 12.5%, which resulted in passenger load factor improvement of 0.8 percentage points from 2008. Air Canada increased its capacity to Hong Kong through the use of a larger aircraft (from an Airbus A340 to a Boeing 777 aircraft), but reduced frequencies on Korea, including the year-over-year suspension of the Toronto non-stop service, reduced frequencies on Vancouver – China, and suspended Toronto – Narita service in the first quarter of 2009, however, this was partially offset by the re-introduction of Toronto – Narita non-stop service in the fourth quarter of 2009.

- A yield decline of 5.7% from 2008, which reflected the continued weak economic environment, increased fare discounting in an effort to stimulate traffic, concerns over H1N1 predominantly impacting Japan and to a lesser extent China and Korea, as well as reduced fuel surcharges year-over-year. The premium cabin reflected a significant yield decrease as pricing actions were taken to offer additional discounted Executive First fares in an effort to stimulate traffic. Yield decreases were reflected on all major Pacific services.

- A weaker Canadian dollar in 2009 versus 2008, which had a positive impact on foreign currency denominated revenues of $46 million in 2009.

- A RASM decrease of 4.8% from 2008, which was due to the yield decline.

The table below describes year-over-year percentage changes in Pacific passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% change)				
Pacific	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(12.3)	(19.8)	(21.9)	(9.7)	(16.7)
Capacity (ASMs)	(26.0)	(12.6)	(14.8)	6.5	(12.5)
Traffic (RPMs)	(20.5)	(15.7)	(12.6)	4.2	(11.7)
Passenger Load Factor (pp Change)	6.2	(3.1)	2.1	(1.8)	0.8
Yield	10.2	(4.9)	(10.6)	(13.4)	(5.7)
RASM	18.5	(8.3)	(8.4)	(15.2)	(4.8)

Other passenger revenues decreased 15.8% from 2008

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) of $717 million in 2009 decreased $134 million or 15.8% from 2008 due to a lower yield and, to a lesser extent, a decrease in traffic. Components of the year-over-year change in other passenger revenues included:

- A traffic decrease of 2.3% on the capacity reduction of 1.7%, which resulted in a passenger load factor decrease of 0.5 percentage points compared to 2008.

- An overall yield decline of 13.8% from 2008, which reflected a weak economic environment, increased fare discounting to stimulate traffic, competitive pricing actions, especially in South America, South Pacific and on the Caribbean, the impact over H1N1 concerns on traffic to and from Mexico and reduced fuel surcharges year-over-year. Although both the economy and premium cabins reflected yield declines, the premium cabin reflected a more pronounced decrease as pricing actions were taken to offer additional discounted Executive First fares in an effort to stimulate traffic.

- A weaker Canadian dollar in 2009 versus 2008, which had a positive impact on foreign currency denominated revenues of $17 million in 2009.

- A RASM decrease of 14.4% from 2008, which was largely due to the yield decline.

The table below describes year-over-year percentage changes in other passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter and for the full year.

	2009 versus 2008 (% change)				
Other	Q1	Q2	Q3	Q4	Full Year
Passenger Revenue	(11.2)	(23.3)	(20.1)	(10.8)	(15.8)
Capacity (ASMs)	4.2	(6.6)	(7.2)	(0.1)	(1.7)
Traffic (RPMs)	1.4	(8.0)	(7.6)	3.3	(2.3)
Passenger Load Factor (pp Change)	(2.2)	(1.2)	(0.4)	2.6	(0.5)
Yield	(12.4)	(16.7)	(13.5)	(13.7)	(13.8)
RASM	(14.8)	(17.9)	(13.9)	(10.7)	(14.4)

Cargo revenues decreased 30% from 2008

Cargo revenues amounted to $358 million in 2009 and were $157 million or 30% below 2008 on a 7% reduction to cargo capacity. One half of the revenue decline in 2009 was due to significantly reduced fuel surcharge rates and the cancellation, in 2008, of freighter flying. Weak economic conditions, especially in the first nine months of 2009, resulted in reduced traffic volumes and increased competitive pressure on rates which also contributed to the revenue decline.

Freighter revenues declined $29 million as no MD-11 freighter aircraft were operated in 2009 versus one MD-11 freighter which operated to Europe in the first six months of 2008. Freighter operations were terminated in June 2008.

Non-freighter revenues decreased $129 million or 26%, reflecting a 6% system-wide traffic reduction mainly in North American markets. System cargo yield decreased 22% due to significantly lower fuel surcharges and competitive pressure on rates.

Factors contributing to the year-over-year change in cargo revenues included:

- A decrease in domestic cargo revenues of 35% on 29% less traffic and a 9% decline in yield per RTM. The termination of the Canada Post contract in September 2008 accounted for around three quarters of the traffic decrease. Domestic capacity was down 12% versus 2008.
- A decrease in Atlantic non-freighter revenues of 30% on 6% less traffic and a 26% lower yield per RTM.
- A decrease in Pacific revenues of 21% on flat traffic and a 21% lower yield per RTM. Pacific capacity was down 10%.
- A system traffic decline of 11% (including the impact of the freighter termination in June 2008) and a yield per RTM decline of 22%.
- A weaker Canadian dollar versus 2008 had a positive impact on foreign currency denominated revenues of $11 million in 2009.

Other revenues increased 3% from 2008

Other revenues of $882 million in 2009 increased $28 million or 3% from 2008, primarily due to an increase of $46 million in third party revenues at Air Canada Vacations, mainly the result of higher passenger volumes, and an increase of $11 million in aircraft sublease revenues. Various factors, including a decrease in revenues from Aeroplan for services related to information technology, amounting to a net decrease of $28 million partly offset these increases.

CASM decreased 5.4% from 2008. Excluding fuel expense, CASM increased 3.3% from 2008

Operating expenses were $10,055 million in 2009, a decrease of $1,066 million or 10% from 2008. A reduction in fuel expense of $971 million or 28% was a major factor in the year-over-year decrease in operating expenses. This operating expense reduction was achieved in spite of the unfavourable impact of a weaker average Canadian dollar versus the U.S. dollar in 2009 on U.S. denominated operating expenses which resulted in additional operating expenses of $230 million in 2009.

CASM in 2009 decreased 5.4% over 2008. Excluding fuel expense, CASM increased 3.3% year-over-year. The 3.3% increase in CASM (excluding fuel expense) for 2009 was in line with 3.0% to 3.5% CASM (excluding fuel expense) increase projected in Air Canada's news release dated November 6, 2009.

The unfavourable impact of a weaker average Canadian dollar versus the U.S. dollar accounted for approximately 44% of the CASM growth (excluding fuel expense) in 2009. In addition to the impact of foreign exchange, other factors accounting for the CASM growth included: growth in aircraft maintenance expenses, increased Jazz CPA expenses, higher unit costs of ownership, and the impact of the capacity reduction. The capacity reduction impacts CASM (excluding fuel expense) disproportionately as Air Canada's cost structure is such that its fixed costs do not fluctuate proportionately with changes in capacity in the short term. Partly offsetting these increases to CASM (excluding fuel expense) was a reduction in employee benefits expense, the result of revised actuarial assumptions.

The following table compares Air Canada's operating expenses per ASM for 2009 to Air Canada's operating expenses per ASM for 2008.

	Full Year		Change	
(cents per ASM)	**2009**	**2008**	**cents**	**%**
Wages and salaries	2.51	2.46	0.05	2.0
Benefits	0.44	0.56	(0.12)	(21.4)
Ownership (DAR) (1)	1.68	1.57	0.11	7.0
Airport user fees	1.64	1.61	0.03	1.9
Capacity purchase with Jazz	1.64	1.53	0.11	7.2
Aircraft maintenance	1.28	1.06	0.22	20.8
Food, beverages and supplies	0.49	0.51	(0.02)	(3.9)
Communications and information technology	0.49	0.46	0.03	6.5
Commissions	0.31	0.31	-	-
Other	2.34	2.34	-	-
Operating expense, excluding fuel expense (2)	**12.82**	**12.41**	**0.41**	**3.3**
Aircraft fuel	4.13	5.51	(1.38)	(25.0)
Total operating expense	**16.95**	**17.92**	**(0.97)**	**(5.4)**

(1) DAR refers to the combination of Depreciation and amortization, and Aircraft rent.

(2) Refer to section 21 "Non-GAAP Financial Measures" in this MD&A for additional information.

The following summarizes the main factors in the year-over-year change in operating expenses:

Fuel expense decreased 28% from 2008

Fuel expense amounted to $2,448 million in 2009, a decrease of $971 million or 28% from 2008. Factors contributing to the year-over-year change in fuel expense included:

- A lower base fuel price, which accounted for a decrease of $1,362 million.
- A volume-related decrease of $235 million, which included the impact of the termination of freighter flying in June 2008.

The above-noted decreases were partially offset by the following:

- Fuel hedging losses of $419 million in 2009 versus fuel hedging gains of $79 million in 2008, an unfavourable variance of $498 million compared to 2008.
- The unfavourable impact of a weaker average Canadian dollar versus the U.S. dollar, which accounted for an increase of $128 million to fuel expense in 2009.

The table below provides Air Canada's fuel cost per litre, excluding and including hedging, for the periods indicated.

(Canadian dollars in millions, except where indicated)	Full Year		Change	
	2009	2008	$	%
Aircraft fuel expense - GAAP (1)	$ 2,437	$ 3,401	$ (964)	(28)
Add: Fuel hedging gains (losses) included in aircraft fuel expense	(419)	79	(498)	(630)
Add: Net cash settlements on maturing fuel derivatives (designated under hedge accounting and economic hedges) (2)	88	(129)	217	168
Economic cost of fuel - Non-GAAP (3)	**$ 2,106**	**$ 3,351**	**$ (1,245)**	**(37)**
Fuel consumption (thousands of litres)	3,509,918	3,762,698	(252,780)	(7)
Fuel costs per litre (cents) - GAAP	69.4	90.4	(21.0)	(23)
Fuel costs per litre (cents) - excluding fuel hedges	57.5	92.5	(35.0)	(38)
Economic fuel costs per litre (cents) - Non-GAAP	60.0	89.0	(29.0)	(33)

(1) Fuel expense excludes fuel related to third party carriers, other than Jazz, operating under capacity purchase agreement.

(2) Excluding early terminated hedging contracts both in Q1 2009 for $172 million covering 2009 and 2010 fuel consumption and in the fourth quarter of 2009 for $20 million covering 2010 fuel consumption.

(3) Economic cost of fuel is Air Canada's best estimate of the cash cost of fuel. It is a non-GAAP measure used by the Corporation and may not be comparable to measures presented by other public companies.

Wages, salaries and benefits expense amounted to $1,751 million in 2009, a decrease of $126 million or 7% from 2008.
Wages and salaries expense totaled $1,492 million in 2009, a decrease of $36 million or 2% from 2008. Factors contributing to the year-over-year change in wage and salaries expense included:

- A decrease of an average of 1,286 full-time equivalent ("FTE") employees or 5.3%, which was mainly the result of the 4.4% ASM capacity reduction.
- In 2009, Air Canada recorded expenses of $25 million related to the "Sharing our Success" employee profit sharing program versus expenses of $29 million in 2008.

The above-noted decreases were partially offset by the following:

- The impact of a year-over-year increase in average wages of 1.8%, mainly due to contractual progression increases for unionized employees.
- In 2009, Air Canada recorded expenses of $30 million related to staff reduction programs compared to expenses of $21 million in 2008.
- In 2008, Air Canada reversed previously recorded stock-based compensation expense of $5 million. No such reversal occurred in 2009.

Employee benefits expense amounted to $259 million in 2009, a decrease of $90 million or 26% from 2008, mainly due to reduced pension expense and post-employment benefits expenses as a result of revised actuarial assumptions.

Airport and navigation fees decreased 3% from 2008
In 2009, airport and navigation fees of $971 million decreased $30 million or 3% from 2008, on a 3% reduction in aircraft frequencies. Effective January 1, 2010, the Greater Toronto Airports Authority (GTAA) reduced both landing fees and terminal charges by 10% at Toronto Pearson International Airport. Based on current levels of activity, Air Canada estimates that this rate reduction would result in annual savings of $30 million.

Capacity purchase costs with Jazz increased 3% from 2008

Capacity purchase costs with Jazz, pursuant to the Jazz CPA, amounted to $973 million in 2009 compared to $948 million in 2008, an increase of $25 million or 3%. This year-over-year increase in capacity purchase costs was mainly due to the unfavourable impact of foreign exchange on U.S. denominated Jazz CPA charges paid by Air Canada, which accounted for an increase of $30 million, a year-over-year increase in Jazz CPA rates of $42 million, and other costs amounting to $1 million. Partially offsetting these increases was the impact of reduced flying which accounted for a decrease of $34 million, and the impact of the reduction to the mark-up on Jazz CPA rates pursuant to an amendment to the Jazz CPA effective August 1, 2009, which accounted for a decrease of $14 million.

Ownership costs increased 2% from 2008

Ownership costs, comprised of depreciation and amortization, and aircraft rent expense, of $995 million in 2009 increased $22 million or 2% from 2008. Factors contributing to the year-over-year change in ownership costs included:

- The addition of new Boeing 777 aircraft to Air Canada's operating fleet, which accounted for an increase of $49 million.

- The impact of a weaker Canadian dollar versus the U.S. dollar, which accounted for an increase of $25 million to aircraft rent expense.

The above-noted increases were partially offset by the following:

- Changes in aircraft residual values, the result of a weaker Canadian dollar versus the U.S. dollar, which accounted for a decrease of $44 million to depreciation expense.

- A decrease of $10 million to aircraft rent expense as a result of reduced MD-11 freighter flying as no MD-11 freighter aircraft were operated in 2009 versus one MD-11 freighter operated in the first six months of 2008.

Aircraft maintenance expense increased 15% from 2008

In 2009, aircraft maintenance expense of $759 million increased $100 million or 15% from 2008. Factors contributing to the year-over-year change in aircraft maintenance expense included:

- A net increase of $103 million in airframe maintenance, which was largely due to the timing and scope of airframe events related to the fleets of Airbus A319, A320 and Boeing 767-300 aircraft. In particular, scheduled heavy overhaul maintenance was required on the Airbus A319 aircraft which were delivered in the mid-1990s.

- The impact of a weaker Canadian dollar versus the U.S. dollar on U.S. denominated maintenance expenses, mainly engine and component maintenance, which accounted for an increase of $37 million to aircraft maintenance expense compared to 2008.

- A net increase of $7 million in components maintenance, which was largely due to a higher level of components maintenance activity and increased rates year-over-year.

The above-noted increases were partially offset by the following:

- A net decrease of $12 million in engine maintenance, which was largely due to the removal of Airbus A340 aircraft from Air Canada's operating fleet during 2008 and lower aircraft maintenance expense related the Airbus A320 and Boeing 767-300 aircraft. Partly offsetting these decreases was the impact of a higher volume of engine maintenance which was mainly due to an industry campaign for the removal of high pressure turbine blades on the A320 aircraft engine, which resulted in the removal of the blades at an earlier stage than anticipated. Also offsetting these decreases was a higher volume of engine events related to Boeing 777 and Embraer E175 aircraft.

- A net decrease of $17 million due to an overall reduction in maintenance expenses related to the preparation of aircraft for return to lessors or for sublease to third parties.

Food, beverages and supplies expense decreased 7% from 2008

In 2009, food, beverages and supplies expense of $291 million decreased $23 million or 7% from 2008 on a 5.2% decrease in passenger traffic. The impact of cost reduction initiatives and reduced contract rates were factors in the decrease to food, beverage and supplies expense compared to the same period in 2008.

Communications and information technology expense increased 3% from 2008

In 2009, communications and information technology expense of $293 million increased $7 million or 3% from 2008. The unfavourable impact of a weaker Canadian dollar versus the U.S. dollar on U.S. denominated expenses was partly offset by a reduction in information technology project spend and savings achieved through renegotiation of a major information technology supplier contract.

Commission expense decreased 4% from 2008

In 2009, commission expense of $186 million decreased $8 million or 4% from 2008. The impact of a 12.5% passenger revenue decrease versus 2008 was partly offset by the combination of higher passenger sales and a change in commission structure at Air Canada Vacations which resulted in an increase of $8 million to commission expense in 2009. In June 2009, Air Canada introduced a 7% commission for Canadian travel agents to sell Tango fares for flights within Canada. Although these initiatives have resulted in additional commission expense, overall, based on management's analysis, the benefits of these initiatives have outweighed the costs by enabling the Corporation to generate increased passenger revenues.

Other operating expenses decreased 4% from 2008

Other operating expenses amounted to $1,388 million in 2009, a decrease of $62 million or 4% from 2008. Factors contributing to the year-over-year change in other expenses included:

- An increase in expenses related to ground packages at Air Canada Vacations of $27 million compared to 2008, which was mainly due to higher passenger volumes.
- A reduction in credit card fees of $22 million compared to 2008, which was primarily the result of lower passenger sales.
- A decrease in "remaining other expenses" of $75 million, which reflected the impact of various cost reduction initiatives and the impact of the capacity reduction. Favourable rate adjustments on foreign currency transactions accounted for $37 million of the decrease to other operating expenses.

The following table provides a breakdown of the more significant items included in other expenses:

	Full Year		Change	
(Canadian dollars in millions)	**2009**	**2008**	**$**	**%**
Air Canada Vacations' land costs	$ 250	$ 223	$ 27	12
Terminal handling	188	180	8	4
Credit card fees	175	197	(22)	(11)
Building rent and maintenance	131	137	(6)	(4)
Crew expenses (meals, transportation and hotels)	118	117	1	1
Miscellaneous fees and services	117	112	5	4
Remaining other expenses	409	484	(75)	(15)
	$ 1,388	**$ 1,450**	**$ (62)**	**(4)**

Non-operating expense amounted to $355 million in 2009

Non-operating expense amounted to $355 million in 2009 compared to non-operating expense of $170 million in 2008. Factors contributing to the year-over-year change in 2009 non-operating expense included:

- Net interest expense increased $130 million from 2008 due to:

  - A $43 million decrease in interest income which was due to both lower rates of interest and lower cash balances;

  - A $54 million increase in interest expense which was mainly due to the impact of new financing transactions completed in 2009, and the unfavourable impact of foreign exchange on interest expense. These increases were partly offset by the impact of lower average interest rates year-over-year. In addition, in 2009, Air Canada recorded charges amounting to $25 million related to the sale and leaseback transaction of four Boeing 777 aircraft and a charge of $9 million related to the termination of the capital leases of two Airbus A340 aircraft and the subsequent sale of these aircraft. These increases were partly offset by a reduction of interest expense on aircraft pre-delivery payments related to Boeing 777 aircraft versus the same period in 2008;

  - A lower amount of capitalized interest of $33 million compared to 2008.

- In 2009, Air Canada recorded an impairment charge of $68 million related to previously capitalized costs incurred pertaining to the development of a new reservation system, referred to as Polaris. Air Canada is currently working towards the implementation of certain components of the solution such as web and fare technology but has suspended activity relating to the implementation of the reservation system. In addition, Air Canada recorded a loss on assets of $24 million pertaining to the sale and leaseback of three Boeing 777 aircraft.

- In 2008, Air Canada recorded an impairment charge of $38 million relating to the retirement of its fleet of Boeing 767-200 aircraft and gains amounting to $7 million pertaining to the sale of aircraft-related inventory.

- Gains related to fair value adjustments on derivative instruments amounted to $95 million in 2009 versus gains of $92 million in 2008. The mark-to-market gains on financial instruments recorded in 2009 were mainly related to the change in the fair value of fuel derivatives.

Gains on foreign exchange amounted to $657 million in 2009

Gains on foreign exchange, which were mainly related to U.S. denominated long-term debt, amounted to $657 million in 2009 compared to losses of $655 million in 2008. The gains in 2009 were mainly attributable to a stronger Canadian dollar at December 31, 2009 compared to December 31, 2008. The December 31, 2009 noon day exchange rate was US$1 = C$1.0466 while the December 31, 2008 noon day exchange rate was US$1 = C$1.2246.

Income tax recovery of $5 million in 2009

Air Canada recorded an income tax recovery of $5 million on a pre-tax loss of $29 million in 2009, which related mainly to an adjustment to current taxes payable. In 2008, a provision for income taxes of $24 million was recorded on a pre-tax loss of $1,001 million which reflected future income tax being reclassified from other comprehensive income to income for realized gains on fuel derivatives. Potential recovery of future income taxes on the 2008 loss was offset by a valuation allowance.

9. FLEET

The following table provides Air Canada's operating fleet as at December 31, 2009 (excluding aircraft operated by Jazz under the Jazz CPA):

	Total Seats	Number of Operating Aircraft (1)	Average Age	Owned (2)	Capital Lease (2)	Consolidated Under AcG-15 (2)	Operating Lease
Widebody Aircraft							
Boeing 777-300	349	12	1.8	3	1	-	8
Boeing 777-200	270	6	2.1	4	-	-	2
Boeing 767-300	191-213	30	16.3	1	8	6	15
Airbus A330-300	265	8	9.2	-	8	-	-
Narrowbody Aircraft							
Airbus A321	174	10	7.8	-	-	5	5
Airbus A320	146	41	16.7	-	-	-	41
Airbus A319	120	35	12.0	-	17	15	3
EMBRAER 190	93	45	2.8	45	-	-	-
EMBRAER 175	73	15	4.3	15	-	-	-
Total		**202**	**9.7**	**68**	**34**	**26**	**74**

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

(2) Owned aircraft as well as capital leases consolidated under AcG-15 are carried on Air Canada's statement of financial position. Owned aircraft include aircraft financed under conditional sales agreements.

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 progressively introduced 18 Boeing 777 aircraft into its fleet starting in 2007. During 2009, the Corporation took delivery of its last two planned Boeing 777 aircraft, one of which was leased under an operating lease.

In addition to its investment in new aircraft, Air Canada completed a major refurbishment program of its existing aircraft in 2009. All aircraft in its operating fleet were refurbished with the exception of three Boeing 767-300ER aircraft where a light interior renovation was completed. The new fleet-wide amenities include digital quality in-seat monitors with touch-screen controls offering hundreds of hours of audit and video on demand programming, USB ports at every seat, standard in-seat power within reach of every customer and industry leading lie-flat bed suites in Executive First.

At December 31, 2009, pursuant to the Jazz CPA, Jazz operated an operating fleet of 130 aircraft with an average age of 14.6 years comprised of the following aircraft:

- 24 Bombardier CRJ-100 aircraft;
- 30 Bombardier CRJ-200 aircraft;
- 16 Bombardier CRJ-705 aircraft;
- 26 Dash 8-300 aircraft; and
- 34 Dash 8-100 aircraft.

An additional five Bombardier CRJ-200 aircraft and two Bombardier CRJ-100 aircraft are planned to be removed from the Jazz fleet during 2010, reducing Jazz's operating fleet to 123 by May 2010.

The following table provides the existing and planned fleet changes to Air Canada's operating fleet (excluding aircraft operated by Jazz under the Jazz CPA):

	Actual			Planned			
Fleet Plan	**December 31, 2008**	**New Deliveries**	**December 31, 2009**	**2010 Fleet Changes**	**December 31, 2010**	**2011 fleet changes**	**December 31, 2011**
Boeing 777-300	**10**	2	**12**	-	**12**	-	**12**
Boeing 777-200	**6**	-	**6**	-	**6**	-	**6**
Boeing 767-300	**30**	-	**30**	-	**30**	(3)	**27**
Airbus A330-300	**8**	-	**8**	-	**8**	-	**8**
Airbus A321	**10**	-	**10**	-	**10**	-	**10**
Airbus A320	**41**	-	**41**	-	**41**	-	**41**
Airbus A319	**35**	-	**35**	-	**35**	-	**35**
EMBRAER 190	**45**	-	**45**	-	**45**	-	**45**
EMBRAER 175	**15**	-	**15**	-	**15**	-	**15**
Total	**200**	2	**202**	-	**202**	(3)	**199**
Average age (years)	**8.8**		**9.7**		**10.7**		**11.6**

10. FINANCIAL AND CAPITAL MANAGEMENT

10.1 FINANCIAL POSITION

The following table provides a condensed statement of financial position of Air Canada as at December 31, 2009 and as at December 31, 2008.

(Canadian dollars in millions)	December 31, 2009	December 31, 2008
Assets		
Cash, cash equivalents and short-term investments	$ 1,407	$ 1,005
Other current assets	1,244	1,398
Current assets	2,651	2,403
Property and equipment	6,369	7,469
Intangible assets	916	997
Deposits and other assets	470	495
	$ 10,406	**$ 11,364**
Liabilities		
Current liabilities	$ 3,002	$ 3,678
Long-term debt and capital leases	4,054	4,691
Pension and other benefits liabilities	1,163	1,585
Other long-term liabilities	540	458
	8,759	**10,412**
Non-controlling interest	**201**	**190**
Shareholders' equity	**1,446**	**762**
	$ 10,406	**$ 11,364**

Movements in current assets and liabilities are described below under "Working Capital".

Property and equipment amounted to $6,369 million at December 31, 2009, a reduction of $1,100 million from December 31, 2008. The reduction was mainly due to the impact of depreciation expense of $602 million in 2009, the sale of two Airbus A340 aircraft and the sale and leaseback of three Boeing 777 aircraft partly offset by additions to capital assets.

Long-term debt and capital leases, including the current portion, amounted to $4,522 million at December 31, 2009, a decrease of $832 million from December 31, 2008. The decrease in long-term debt and capital leases from December 31, 2008 was mainly due to the appreciation of the Canadian dollar and the resulting favourable impact of $702 million on Air Canada's U.S. dollar debt and capital leases. Borrowings of $926 million, including those under the Credit Facility described in section 6 of this MD&A, were more than offset by long-term debt and capital lease repayments of $1,237 million. In addition, the sale and leaseback of a Boeing 777 aircraft was accounted for as a capital lease which resulted in an increase to total long-term debt of $158 million.

The decline in pension and other benefits liabilities of $422 million from December 31, 2008 was primarily due to pension funding of $389 million in 2009. Refer to section 10.6 of this MD&A for a discussion related to Air Canada's pension funding obligations.

Shareholders' equity increased by $684 million due mainly to comprehensive income of $422 million and the equity offering completed in October 2009, which raised net proceeds of $249 million.

10.2 ADJUSTED NET DEBT

The table reflects Air Canada's adjusted net debt balances and net debt to net debt plus equity ratio as at December 31, 2009 and as at December 31, 2008.

(Canadian dollars in millions)	December 31, 2009	December 31, 2008	Change $
Total long-term debt and capital leases	$ 4,054	$ 4,691	$ (637)
Current portion of long-term debt and capital leases	468	663	(195)
Total long-term debt and capital leases including current portion	4,522	5,354	(832)
Non-controlling interest	201	190	11
Less cash, cash equivalents and short-term investments	(1,407)	(1,005)	(402)
Net debt and non-controlling interest	**3,316**	**4,539**	**(1,223)**
Capitalized operating leases (1)	2,513	2,093	420
Adjusted net debt and non-controlling interest	**5,829**	**6,632**	**(803)**
Less pre-delivery (PDP) financing included in long-term debt	-	(81)	81
Adjusted net debt and non-controlling interest, excluding PDP financing	**$ 5,829**	**$ 6,551**	**$ (722)**
Shareholders' equity	**$ 1,446**	**$ 762**	**$ 684**
Adjusted net debt to net debt plus equity ratio, excluding PDP financing	**80.1 %**	**89.6 %**	**(9.5) pp**

(1) Adjusted net debt is a non-GAAP measure used by the Corporation and may not be comparable to measures presented by other public companies. The Corporation includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7.5. This definition of capital is used by the Corporation and may not be comparable to similar measures presented by other public companies. Aircraft rent was $335 million for the twelve months ended December 31, 2009 and $279 million for the twelve months ended December 31, 2008. Aircraft rent expense includes aircraft rent associated with aircraft subleased to third parties. The sublease revenue associated with these aircraft leases is included in Other revenues on Air Canada's consolidated statement of operations.

At December 31, 2009, adjusted net debt and non-controlling interest, including capitalized operating leases and excluding PDP financing, decreased $722 million from December 31, 2008. The value of capitalized operating leases increased by $420 million primarily as a result of an increase in aircraft rent expense, mainly due to the impact of a weaker average Canadian dollar during 2009 versus 2008, and the sale and leaseback transactions of Boeing 777 aircraft completed in 2009. This was more than offset by a decrease in net debt of $1,223 million. Net debt declined mainly due to the impact of a stronger Canadian dollar as at December 31, 2009 versus the exchange rate as at December 31, 2008, which accounted for $702 million, and the impact of certain transactions to increase liquidity completed in 2009. For additional information related to these transactions, refer to section 6 of this MD&A.

The adjusted net debt to net debt plus equity ratio for Air Canada decreased to 80.1% at December 31, 2009 from 89.6% at December 31, 2008.

Shareholders' equity was favourably impacted by comprehensive income of $422 million recorded in 2009, which included foreign exchange gains of $657 million, and net proceeds of $249 million from the equity offering completed in 2009, which is further described in section 6 of this MD&A.

10.3 LIQUIDITY

At December 31, 2009, cash, cash equivalents and short-term investments amounted to $1,407 million, or 14% of 2009 operating revenues. Refer to section 13 of this MD&A for a discussion on Air Canada's liquidity risks.

Working capital

The following table provides additional information on Air Canada's working capital balances at December 31, 2009 as compared to December 31, 2008.

(Canadian dollars in millions)	December 31, 2009	December 31, 2008	Change $
Cash and short-term investments	$ 1,407	$ 1,005	$ 402
Accounts receivable	701	702	(1)
Collateral deposits for fuel derivatives	43	328	(285)
Other current assets	500	368	132
Accounts payable and accrued liabilities	(1,215)	(1,262)	47
Fuel derivatives in current liabilities	(31)	(420)	389
Advance ticket sales	(1,288)	(1,333)	45
Current portion of long-term debt and capital leases	(468)	(663)	195
	$ (351)	**$ (1,275)**	**$ 924**

The working capital deficiency of $351 million has improved by $924 million from December 31, 2008, largely due to the financing activities undertaken by Air Canada, as described in section 6 of this MD&A and working capital generated from operating activities which amounted to approximately $450 million. This was partly offset by pension funding payments of $389 million and the impact of capital expenditures of $232 million in 2009.

Collateral deposits for fuel derivatives

The Corporation currently holds, within its derivative portfolio, swaps and put option contracts which could expose the Corporation to the potential of posting cash collateral deposits. Once the fair value in favour of the counterparties of certain fuel derivatives exceeds certain agreed credit thresholds with those counterparties, the Corporation is responsible for extending collateral to the counterparties to cover their exposure.

As at January 31, 2010, the total cash collateral deposits held by counterparties amounted to $55 million ($43 million at December 31, 2009 and $328 million at December 31, 2008). If oil prices remain at their current levels for 2010, the collateral extended would cover the expected losses on existing fuel hedging contracts maturing in 2010 and would not generate additional cash outflows to the Corporation. Refer to section 13 of this MD&A for a discussion on fuel price risk.

At December 31, 2009, Air Canada's sensitivity on cash collateral deposits was approximately US$2.5 million for every US$1 change in commodity prices (with increases to commodity prices benefiting the Corporation by lowering cash collateral deposit requirements and decreases having the reverse impact).

Consolidated cash flow movements

The following table provides the cash flow movements for Air Canada for the periods indicated:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	2009	2008	Change $	2009	2008	Change $
Net cash from operating activities	$ 43	$ 25	$ 18	$ 188	$ 559	$ (371)
Fuel hedge collateral deposits, net	62	(322)	384	268	(322)	590
Pension funding	(60)	(116)	56	(389)	(456)	67
Changes in non-cash working capital	(55)	135	(190)	(234)	117	(351)
Cash flows used for operating activities	(10)	(278)	268	(167)	(102)	(65)
Additions to capital assets	(42)	(150)	108	(232)	(883)	651
Free cash flow (1)	**(52)**	**(428)**	**376**	**(399)**	**(985)**	**586**
Proceeds from contractual commitment	-	-	-	230	-	230
Proceeds from sale of assets	7	11	(4)	103	38	65
Proceeds from sale and leaseback transactions	380	-	380	552	708	(156)
Funding of Aveos letter of credit	-	40	(40)	-	59	(59)
Short-term investments	(125)	111	(236)	214	206	8
Other	(8)	(3)	(5)	(29)	62	(91)
Cash flows from investing activities (excluding additions to capital assets)	**254**	**159**	**95**	**1,070**	**1,073**	**(3)**
Borrowings	3	558	(555)	926	871	55
Issue of common shares & warrants	249	-	249	256	-	256
Reduction of long-term debt and capital lease obligations	(381)	(284)	(97)	(1,237)	(992)	(245)
Other	-	(3)	3	-	5	(5)
Cash flows from (used for) financing activities	**(129)**	**271**	**(400)**	**(55)**	**(116)**	**61**
Net increase (decrease) in cash and cash equivalents	73	2	71	616	(28)	644
Net increase (decrease) in short-term investments	125	(111)	236	(214)	(206)	(8)
Net increase (decrease) in cash, cash equivalents and short-term investments	**$ 198**	**$ (109)**	**$ 307**	**$ 402**	**$ (234)**	**$ 636**

(1) Free cash flow is a non-GAAP measure used by the Corporation and may not be comparable to measures presented by other public companies. Air Canada considers free cash flow to be an indicator of the financial strength and performance of its business because it shows how much cash is available to repay debt, meet ongoing financial obligations and reinvest in the Corporation.

Air Canada's free cash flow improved $376 million from the fourth quarter of 2008 and $586 million when compared to the full year 2008. The improvement in free cash flow was mainly due to the impact of reduced capital expenditures, a reduction in fuel hedge collateral deposits requirements, improved cash operating results and the impact of lower past service cost contributions as a result of the adoption of new pension funding regulations in July 2009. Partly offsetting these favourable changes was unfavourable changes in non-cash working capital balances. Working capital in 2009 was negatively impacted by the decrease in advance ticket sales and passenger revenues; however this trend improved during the fourth quarter of 2009. Also negatively impacting working capital in 2009 was the expiry of the Aeroplan accelerated payment agreement, reached in 2008.

10.4 CAPITAL EXPENDITURES AND RELATED FINANCING ARRANGEMENTS

Air Canada has 37 firm orders for Boeing 787 aircraft with The Boeing Company ("Boeing"). Air Canada also holds purchase options for 13 Boeing 787 aircraft and purchase rights for 10 Boeing 787 aircraft and 18 Boeing 777 aircraft. Air Canada's first Boeing 787 aircraft is scheduled for delivery in the second half of 2013.

For the firm aircraft orders, the Corporation has financing commitments from Boeing and the engine manufacturer covering 31 of the 37 Boeing 787 aircraft. The financing terms for 28 out of the 31 covered aircraft is for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments. For the remaining three out of the 31 covered aircraft, the financing under the commitment covers up to 90% of the capital expenditure and the term to maturity is 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.

The table below provides Air Canada's current projected, planned and committed capital expenditures for 2010, for the next four years and after 2014.

(Canadian dollars in millions)	2010	2011	2012	2013	2014	Thereafter
Projected committed expenditures	$ 74	$ 47	$ 121	$ 731	$ 979	$ 2,860
Projected planned but uncommitted expenditures	60	93	112	118	50	
Total projected expenditures (1) (2)	134	140	233	849	1,029	
Projected financing on committed expenditures	-	-	-	(566)	(775)	
Total projected expenditures, net of financing	**$ 134**	**$ 140**	**$ 233**	**$ 283**	**$ 254**	

(1) U.S. dollar amounts are converted using the December 31, 2009 noon day exchange rate of US$1 = C$1.0466. Final aircraft delivery prices include estimated escalation and interest on deferred delivery payments.

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

10.5 CONTRACTUAL OBLIGATIONS

The table below provides Air Canada's current contractual obligations for 2010, for the next four years and after 2014.

(Canadian dollars in millions)	2010	2011	2012	2013	2014	Thereafter	Total
Long-term debt, capital leases and interest repayment obligations (1)	$ 761	$ 1,004	$ 734	$ 773	$ 593	$ 2,025	$ 5,890
Operating lease obligations (2)	419	375	355	322	257	902	2,630
Committed capital expenditures (3)	74	47	121	731	979	2,860	4,812
Total contractual obligations (4) (5)	**$ 1,254**	**$ 1,426**	**$ 1,210**	**$ 1,826**	**$ 1,829**	**$ 5,787**	**$ 13,332**

(1) The interest repayment obligations relate to long-term debt, debt consolidated under AcG-15 and capital leases.

(2) The operating lease obligations above mainly relate to U.S. dollar aircraft operating leases.

(3) The committed capital expenditures above mainly relate to U.S. dollar aircraft-related expenditures. These expenditures also include purchases relating to system development costs, facilities and leasehold improvements.

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

(5) The table above excludes the future minimum non-cancelable commitment under the capacity purchase agreement with Jazz of $732 million for 2010 and the minimum annual commitment to purchase Aeroplan® Miles from Aeroplan of $211 million for 2010. Future commitments for 2011 and beyond are not yet determinable.

Fair value test

Certain aircraft lease agreements contain a fair value test, beginning on July 1, 2009, and annually thereafter until lease expiry. This test relates to 24 aircraft under lease of which 23 are accounted for as capital leases and the remainder relate to leasing entities that are consolidated under AcG-15. Under the test, the Corporation may be required to prepay certain lease amounts or to provide additional collateral, based on aircraft fair values, as of the date of the test. Any amounts prepaid would be recorded as a reduction of the lease obligation. The Corporation contracts with certain third parties to provide residual value support for certain aircraft. If the Corporation is required to prepay lease obligations as a result of value tests, these amounts would be recoverable from the third party residual value support provider upon lease expiry to the extent that the adjusted obligation taking into account prepayments is less than the residual value support. The maximum amount payable on July 1, 2010, assuming the related tests establish an aircraft value of nil, is $599 million (US$572 million). The maximum payable amount declines over time to nil upon lease expiry. In July 2009, additional collateral of $8 million in the form of cash deposits were made under the fair value test. As the Corporation does not expect to have to prepay or provide additional collateral in any significant amounts based upon expectations of aircraft fair values into the future, the amortized cost of these capital lease obligations reflects the scheduled payments over the term to final maturity. However, there can be no assurance that aircraft fair values will not decrease in the future such that the Corporation would be required to prepay significant amounts.

10.6 PENSION FUNDING OBLIGATIONS

The Corporation maintains several defined benefit pension plans as described in section 16 of this MD&A. As at January 1, 2009, based on the actuarial valuations which were used to determine certain pension funding requirements in 2009, the aggregate solvency deficit in the registered pension plans was $2,835 million. Based on preliminary actuarial valuations as at January 1, 2010, the preliminary estimate of the aggregate solvency deficit in the registered plans is estimated to be between $2,500 million and $2,700 million. This preliminary estimate of the solvency deficit range includes the impact of the actual return on plan assets partially offset by a decrease in the discount rate used to value the benefit obligation which has the effect of increasing the benefit obligation. The final actuarial valuations for January 1, 2010 will be completed in the first half of 2010 but, as described below, they will not impact the 2010 pension funding obligations.

In July 2009, the Government of Canada adopted the Air Canada 2009 Pension Regulations. The Air Canada 2009 Pension Regulations relieve the Corporation from making any special (past service cost) payments in respect of the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contribution shall equal the lesser of (i) $150 million, $175 million, and $225 million in respect of 2011, 2012, and 2013, respectively and (ii) the maximum past service contribution permitted under the Income Tax Act.

The Air Canada 2009 Pension Regulations were adopted in coordination with the Pension MOUs identified in section 6 of this MD&A. Pursuant to the Pension MOUs, on October 26, 2009, Air Canada issued to a trust, 17,647,059 Class B voting shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of sale of such shares by the trust are to be contributed to the pension plans. For so long as the trust continues to hold at least 2% of Air Canada's issued and outstanding shares of Air Canada, the trustee will have the right to designate one nominee (who shall not be a member or officer of any of Air Canada's Canadian-based unions) to Air Canada's board of directors, subject to completion of Air Canada's usual governance process for selection and confirmation of director nominees. Current service contributions will continue to be made in the normal course while the Air Canada 2009 Pension Regulations are in effect.

After consideration of the effect of the Air Canada 2009 Pension Regulations, as outlined above, employer pension funding contributions amounted to $389 million in 2009.

(Canadian dollars in millions)	2009 Contributions	2008 Contributions
Past service cost for registered pension plans	$ 140	$ 189
Current service cost for registered pension plans	185	165
Other pension arrangements (1)	64	102
Total contributions	**$ 389**	**$ 456**

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

The following table provides indicative figures of Air Canada's pension funding obligations, on a cash basis, for 2010 and for the next three years. Actual funding obligations are dependant on a number of factors, including the Air Canada 2009 Pension Regulations described above for past service, the assumptions used in the last filed actuarial valuation reports for current service (including a discount rate of 6.25%), the plan demographics at the valuation date, the existing plan provisions, existing pension legislation and changes in the economic conditions, mainly the return on fund assets and changes in interest rates. Actual contributions which are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition to changes in plan demographics and experience, actuarial assumptions and methods may be changed from one valuation to the next including by reason of changes in plan experience, financial markets, future expectations, changes in legislation and other factors. As of 2014, the Air Canada 2009 Pension Regulations will cease to have effect and Air Canada's pension funding obligations may vary significantly based on a wide variety of factors, including regulatory developments, assumptions and methods used and changes in the economic conditions, mainly the return on fund assets and changes in interest rates.

(Canadian dollars in millions)	2010	2011	2012	2013
Past service domestic registered plans	$ -	$ 138	$ 173	$ 221
Current service domestic registered plans	161	165	170	175
Other pension arrangements (1)	78	79	81	83
Projected pension funding obligations	**$ 239**	**$ 382**	**$ 424**	**$ 479**

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

The net deficit, on an accounting basis, at December 31, 2009 for pension benefits was $1,186 million ($1,012 million in 2008). The increase in the accounting deficit is mainly the result of an increase to the accrued benefit obligation resulting from a decrease in the discount rate largely offset by a higher than expected return on plan assets.

10.7 SHARE INFORMATION

An aggregate of 278,147,059 Class A variable voting shares and Class B voting shares in the capital of Air Canada are issued and outstanding. The issued and outstanding shares of Air Canada, along with shares potentially issuable, are as follows:

	Number of shares at	
	January 31, 2010	December 31, 2008
Issued and outstanding shares		
Class A variable voting shares	59,341,968	15,475,659
Class B voting shares	218,805,091	84,524,341
Total issued and outstanding shares	**278,147,059**	**100,000,000**
Class A variable voting and Class B voting shares potentially issuable		
Warrants	90,250,000	-
Stock options	3,963,474	1,701,447
Performance share units	561,846	559,885
Total shares potentially issuable	**94,775,320**	**2,261,332**
Total outstanding and potentially issuable shares	**372,922,379**	**102,261,332**

Under the Credit Facility identified in section 6 of this MD&A, Air Canada issued to the lenders, concurrently with the first drawdown, warrants for the purchase of five million of Air Canada's Class A variable voting shares or Class B voting shares representing an aggregate of 5% of the total issued and outstanding shares as at the closing date of the Credit Facility, allocated among the lenders based on their pro-rata lending commitments under the Credit Facility. These initial warrants have an exercise price of $1.51 per share, are exercisable at any time and expire four years after the date of issuance. In the event that Air Canada did not grant additional security over certain assets within 90 days of closing, Air Canada was required to issue to the lenders additional warrants representing up to an additional five million shares or 5% of the total issued and outstanding shares (determined at the time of issuance of such additional warrants) with an average exercise price established based on a volume weighted average price over the five days before issuance, exercisable at any time and expiring four years after the date of issuance. These additional warrants were issued on October 19, 2009 and have an exercise price of $1.44 per share.

Pursuant to the Pension MOUs, on October 26, 2009, Air Canada issued to a trust, 17,647,059 Class B voting shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of sale of such shares by the trust are to be contributed to the pension plans. For so long as the trust continues to hold at least 2% of the issued and outstanding shares of Air Canada, the trustee will have the right to designate one nominee (who shall not be a member or officer of any of Air Canada's Canadian-based unions) to Air Canada's board of directors, subject to completion of Air Canada's usual governance process for selection and confirmation of director nominees.

On October 27, 2009 Air Canada completed a previously announced bought deal public offering pursuant to which it sold to an underwriting syndicate 160,500,000 units (the "Units") of Air Canada at a price of $1.62 per Unit for aggregate gross proceeds to Air Canada of $260 million (net proceeds of $249 million after expenses and underwriter fees). Each Unit was comprised of one Class A variable voting share (the "Variable Voting Shares") or one Class B voting share (the "Voting Shares", and, together with the Variable Voting Shares, the "Shares") of Air Canada, and one-half of one share purchase warrant. Each whole share purchase warrant is defined as a "Warrant". Each Warrant will entitle the holder thereof to acquire one Variable Voting Share or one Voting Share (each, a "Warrant Share") at an exercise price of $2.20 per Warrant Share, at any time prior to 36 months following October 27, 2009. In the event that, prior to the time of expiry of the Warrants, the 20-day volume weighted average trading price of the Variable Voting Shares on the Toronto Stock Exchange ("TSX") is equal to or greater than $4.00 or the 20-day volume weighted average trading price of the Voting Shares on the TSX is equal to or greater than $4.00 (each, an "Acceleration Event"), Air Canada shall have the right, at its option, within 10 business days after the Acceleration Event, to accelerate the time of expiry of the Warrants.

11. QUARTERLY FINANCIAL DATA

The following table summarizes quarterly financial results and major operating statistics for Air Canada for the last eight quarters.

(Canadian dollars in millions, except per share figures)	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009
Operating revenues	**$ 2,727**	**$ 2,782**	**$ 3,075**	**$ 2,498**	**$ 2,391**	**$ 2,330**	**$ 2,670**	**$ 2,348**
Aircraft fuel	715	848	1,064	792	593	572	682	601
Ownership (DAR) (1)	234	242	243	254	245	248	252	250
Other operating expenses	1,790	1,685	1,656	1,598	1,741	1,623	1,668	1,580
Operating expenses	**2,739**	**2,775**	**2,963**	**2,644**	**2,579**	**2,443**	**2,602**	**2,431**
Operating income (loss) before the undernoted item	**(12)**	**7**	**112**	**(146)**	**(188)**	**(113)**	**68**	**(83)**
Provision for cargo investigations (2)	(125)	-	-	-	-	-	-	-
Operating income (loss)	**(137)**	**7**	**112**	**(146)**	**(188)**	**(113)**	**68**	**(83)**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(151)	115	(244)	(581)	(212)	268	209	27
Net income (loss)	**$ (288)**	**$ 122**	**$ (132)**	**$ (727)**	**$ (400)**	**$ 155**	**$ 277**	**$ (56)**
Revenue passenger miles (millions)	12,331	12,884	14,458	10,845	10,984	11,862	14,153	10,885
Available seat miles (millions)	15,407	15,581	17,515	13,571	13,821	14,735	16,946	13,841
Passenger load factor (%)	80.0	82.7	82.5	79.9	79.5	80.5	83.5	78.6
RASM (cents)	15.0	15.7	15.7	16.0	14.5	13.9	14.1	14.6
CASM (cents)	17.8	17.8	16.9	19.5	18.7	16.6	15.4	17.6
CASM, excluding fuel expense (cents)	13.1	12.4	10.8	13.6	14.4	12.7	11.3	13.2
Fuel price per litres (cents) (3)	75.2	89.2	101.0	95.8	71.4	65.4	68.6	72.6
EBITDAR before the provision for cargo investigations (4)	**$ 222**	**$ 249**	**$ 355**	**$ 108**	**$ 57**	**$ 135**	**$ 320**	**$ 167**
EBITDAR (4)	**$ 97**	**$ 249**	**$ 355**	**$ 108**	**$ 57**	**$ 135**	**$ 320**	**$ 167**
Earning (loss) per share								
- Basic	**$ (2.88)**	**$ 1.22**	**$ (1.32)**	**$ (7.27)**	**$ (4.00)**	**$ 1.55**	**$ 2.77**	**$ (0.25)**
- Diluted	**$ (2.88)**	**$ 1.22**	**$ (1.32)**	**$ (7.27)**	**$ (4.00)**	**$ 1.55**	**$ 2.44**	**$ (0.25)**

(1) DAR refers to the combination of Depreciation and amortization, and Aircraft rent expenses.

(2) A provision for cargo investigations and proceedings of $125 million was recorded in the first quarter of 2008.

(3) Includes fuel handling and is net of fuel hedging results.

(4) See section 21 "Non-GAAP Financial Measures" in this MD&A for additional information.

12. SELECTED ANNUAL INFORMATION

The following table provides selected annual information for Air Canada for the years 2007 through to 2009.

(Canadian dollars in millions, except per share figures)	2009	2008	2007
Operating revenues	$ 9,739	$ 11,082	$ 10,646
Operating expenses	10,055	11,121	10,213
Operating income (loss) before the provision for cargo investigations	**(316)**	**(39)**	**433**
Provision for cargo investigations	-	(125)	-
Operating income (loss)	**(316)**	**(164)**	**433**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	292	(861)	(4)
Net income (loss)	**$ (24)**	**$ (1,025)**	**$ 429**
EBITDAR	$ 679	$ 934	$ 1,263
EBITDAR excluding the provision for cargo investigations	$ 679	$ 809	$ 1,263
Earning (loss) per share			
- Basic	$ (0.18)	$ (10.25)	$ 4.29
- Diluted	$ (0.18)	$ (10.25)	$ 4.27
Cash, cash equivalents and short-term investments	$ 1,407	$ 1,005	$ 1,239
Total assets	$ 10,406	$ 11,364	$ 11,820
Total long-term liabilities (1)	$ 6,140	$ 7,309	$ 6,579
Total liabilities	$ 8,759	$ 10,412	$ 9,193
Shareholders' equity	$ 1,446	$ 762	$ 2,443

(1) Total long-term liabilities include long-term debt (including current portion) and capital leases, pension and other benefit liabilities and other long-term liabilities.

13. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Risk management

Under its risk management policy, the Corporation manages its interest rate risk, foreign exchange risk, and market risk through the use of various interest rate, foreign exchange, and fuel derivative financial instruments. The Corporation uses derivative financial instruments only for risk management purposes, not for generating trading profit.

The Corporation engages in derivative hedging to mitigate various risks. The derivative fair values represent the amount of the consideration that could be exchanged in an arm's length transaction between willing parties who are under no compulsion to act. Fair value of these derivatives is determined using active markets, where available. When no such market is available, valuation techniques are applied such as discounted cash flow analysis. Where practical, the valuation technique incorporates all factors that would be considered in setting a price, including the Corporation's own credit risk and the credit risk of the counterparty.

Interest rate risk

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

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

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in the Corporation's capital structure and is based upon a long term objective of 60% fixed and 40% floating. The ratio at December 31, 2009 is 59% fixed and 41% floating, including the effects of interest rate swap positions (58% and 42%, respectively, as at December 31, 2008).

The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded during 2009:

- In 2009, the Corporation entered into an interest rate swap agreement, with a term to November 2011, relating to the Credit Facility, with an original notional value of $600 million systematically declining as payments are made to $450 million by the end of its two-year term. This swap converts the Credit Facility's bankers' acceptance rate setting from "in advance" to "in arrears minus 0.2%". The fair value of this contract as at December 31, 2009 was $1 million in favour of the counterparty. This derivative instrument has not been designated as a hedge for accounting purposes and is recorded at fair value. During 2009, a loss of $1 million was recorded in gain on financial instruments recorded at fair value related to this derivative.

- As at December 31, 2009, the Corporation had two interest rate swap agreements in place with terms to July 2022 and January 2024 relating to two Boeing 767 aircraft financing agreements with an aggregate notional value of $92 million (US$88 million) (2008 - $118 million (US$96 million)). These swaps convert the lease payments on the two aircraft leases from fixed to floating rates. The fair value of these contracts as at December 31, 2009 was $12 million in favour of the Corporation ($21 million in favour of the Corporation in 2008). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2009, a loss of $9 million was recorded in gain on financial instruments recorded at fair value related to these derivatives (a gain of $14 million in 2008).

Interest income includes $10 million ($47 million in 2008) related to cash and cash equivalents, short-term investments, and collateral deposits for fuel derivatives, which are classified as held for trading. Interest expense reflected on Air Canada's consolidated statement of operations relates to financial liabilities recorded at amortized cost.

Foreign exchange risk

Foreign exchange risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. The Corporation's risk management objective is to reduce cash flow risk related to foreign denominated cash flows.

The Corporation's cash inflows are primarily in Canadian dollars, while a large portion of its outflows are in U.S. dollars. This unbalanced mix results in a U.S. dollar shortfall from operations annually. In order to mitigate this imbalance, the Corporation has adopted the practice of converting excess revenues from offshore currencies into US dollars. In 2009, this conversion generated coverage of approximately 29% of the imbalance. The remaining 71% was covered through the use of a variety of foreign exchange derivatives, including spot transactions and U.S. dollar investments, which had maturity dates corresponding to the forecasted shortfall dates. The level of foreign exchange derivatives expiring at any one point in time is dependent upon a number of factors, which include the amount of foreign revenue conversion available, U.S. dollar net cash flows, as well as the amount attributed to aircraft and debt payments.

The following are the current derivatives employed in foreign exchange risk management activities and the adjustments recorded in 2009:

As at December 31, 2009, the Corporation had outstanding foreign currency option agreements converting U.S. dollars into Canadian dollars on $99 million (US$95 million) which mature in 2010 and ($632 million (US$516 million) in 2008) $5 million (€3 million) which mature in 2010 (2008 - $632 million (US$516 million) and $5 million (€3 million)). The fair value of these foreign currency contracts as at December 31, 2009 was $4 million in favour of the counterparties ($64 million in 2008 in favour of the Corporation). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2009, a loss of $7 million was recorded in foreign exchange gain (loss) related to these derivatives ($327 million gain in 2008).

Fuel price risk

In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, the Corporation enters into derivative contracts with financial intermediaries. The Corporation uses derivative contracts on jet fuel and other crude oil-based commodities, heating oil and crude oil. Heating oil and crude oil commodities are used due to the relative limited liquidity of jet fuel derivative instruments on a medium to long-term horizon since jet fuel is not traded on an organized futures exchange. The Corporation's policy permits hedging of up to 75% of the projected jet fuel purchases for the next 12 months, 50% for the next 13 to 24 months and 25% for the next 25 to 36 months. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. There are regular reviews to adjust the strategy in light of market conditions. The Corporation does not purchase or hold any derivative financial instrument for speculative purposes.

In 2009, the Corporation purchased crude oil call options. The premium related to these contracts was $6 million.

At January 31, 2010, approximately 21% of the Corporation's anticipated purchases of jet fuel for the remainder of 2010 is hedged at an average West Texas Intermediate ("WTI") capped price of USD$93 per barrel, and approximately 10% is subject to an average floor price of US$96 per barrel. The Corporation's contracts to hedge anticipated jet fuel purchases over the 2010 period is comprised of jet fuel and crude-oil based contracts.

The following table outlines the notional volumes per barrel outstanding at January 31, 2010, along with the WTI-weighted average floor and capped price for each year currently hedged by type of derivative instruments.

Outstanding at January 31, 2010				
Derivative Instruments	Term	Volume (BBLs)	WTI-weighted Average Floor Price (US$ per barrel)	WTI-weighted Average Capped Price (US$ per barrel)
Call Options (1)	2010	2,345,000	n/a	90
Swaps (1)	2010	975,000	99	99
Collars (1)	2010	1,055,000	93	95

(1) Air Canada is expected to generate fuel hedging gains if oil prices increase above the average capped price and is exposed to fuel hedging losses if oil prices decrease below the average floor price.

In 2009, fuel derivative contracts cash settled with a fair value of $88 million in favour of the counterparties ($129 million in favour of the Corporation in 2008).

After considering the costs and benefits specific to the application of cash flow hedge accounting, the Corporation elected to discontinue hedge accounting for all fuel derivatives effective the third quarter of 2009. Therefore as of July 1, 2009, all fuel hedging contracts were considered "economic hedges" and the periodic change in their fair market value was recorded in other non-operating income under gain (loss) on financial instruments recorded at fair value. A fair value gain of $102 million was recognized in 2009 (a loss of $9 million in 2008).

While applying hedge accounting, the Corporation had recorded losses under accumulated other comprehensive loss ("AOCL") which will be recognized under fuel expense in the period where the derivative is schedule to mature. Throughout 2009, $419 million has been recognized into fuel expense. As at December 31, 2009, the net amount of existing losses reporting in AOCL that is expected to be reclassified to operating income (loss) during the following 12 months is $183 million before tax (Q1: $58 million, Q2 $52 million, Q3: $42 million, Q4: $31 million). Due to the discontinuation of hedge accounting, the AOCL balance related to fuel hedging contracts will be completely depleted as of December 31, 2010.

In 2009, the Corporation modified its fuel hedge portfolio with the termination of swap and put option contracts for $192 million in favour of the counterparties. The collateral held by the counterparties covered the majority of the settlement amount, therefore minimal additional cash outflows resulted. Certain of these contracts were previously designated under hedge accounting. The value of the AOCL balance recognized in connection with these derivatives while designated under hedge accounting will be taken into fuel expense in the period where the derivative was scheduled to mature.

The types of derivative instruments used by the Corporation within its hedging program, such as swaps and put options within collar structures, expose the Corporation to the potential of providing collateral deposits to its counterparties. When fuel prices decrease causing the Corporation's derivative position to be in a liability position below the set credit thresholds with counterparties, the Corporation is responsible for extending collateral to the counterparties. As at December 31, 2009, the Corporation had extended $43 million of collateral to counterparties ($328 million as at December 31, 2008).

Below is a table summarizing the impact of fuel derivatives on the Corporation's consolidated statement of operations, consolidated statement of comprehensive loss and consolidated statement of financial position.

		Fourth Quarter		Full Year	
(Canadian dollars in millions)		2009	2008	2009	2008
Consolidated Statement of Operations					
Operating expense					
Aircraft fuel	Realized effective gain (loss) – derivatives designated under hedge accounting	$ (85)	$ (111)	$ (419)	$ 79
Non-operating income (expense)					
Gain (loss) on financial instruments recorded at fair value	Ineffective gain (loss) – derivatives designated under hedge accounting	n/a	$ 59	$ -	$ 83
	Fair market value gain (loss) – economic hedges	$ 24	$ (40)	$ 102	$ (9)
Consolidated Statement of Comprehensive Income (Loss)					
	Effective gain (loss) – derivatives designated under hedge accounting	n/a	$ (678)	$ (1)	$ (605)
	Tax expense on effective gain	$ -	$ 44	$ -	$ -
	Reclassification of net realized (gain) loss on fuel derivatives designated under hedge accounting to aircraft fuel expense	$ 85	$ 111	$ 419	$ (79)
	Tax on reclassification	$ -	$ (39)	$ 4	$ 22

(Canadian dollars in millions)		December 31, 2009	December 31, 2008
Consolidated Statement of Financial Position			
Current assets	Collateral deposits for fuel derivatives	$ 43	$ 328
Current liabilities[(1)]	Fair market value of fuel derivatives designated under hedge accounting	n/a	$ (405)
	Fair market value of fuel derivatives – economic hedges	$ (31)	$ (15)
Shareholders' equity (AOCL)	Net loss from fuel derivatives designated under hedge accounting (net of tax in 2009 - $1 million and 2008 - $5 million)	$ (184)	$ (606)

(1) The balance is reflected within current liabilities on Air Canada's Consolidated Statement of Financial Position due to the counterparty's ability to terminate the derivatives at fair value at any time prior to maturity.

Summary of gain on financial instruments recorded at fair value

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

	Fourth Quarter		Full Year	
(Canadian dollars in millions)	2009	2008	2009	2008
Ineffective portion of fuel hedges	$ -	$ 59	$ -	$ 83
Fuel derivatives not under hedge accounting	24	(40)	102	(9)
Cross-currency interest rate swaps	-	(2)	-	4
Other	(2)	15	(7)	14
Gain on financial instruments recorded at fair value	**$ 22**	**$ 32**	**$ 95**	**$ 92**

Liquidity risk

Liquidity risk is the risk that the Corporation will encounter difficulty in meeting obligations associated with its financial liabilities and other contractual obligations. The Corporation monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. The Corporation's principal objective in managing liquidity risk is to maintain a minimum unrestricted cash balance in excess of a target liquidity level of 15% of annual operating revenues. As at December 31, 2009, Air Canada had cash, cash equivalents and short-term investments of $1,407 million which represented 14% of 2009 operating revenues.

Management believes that the significant events as described in section 6 of this MD&A improve the Corporation's current liquidity position. However, certain risks remain such as those related to the current economic environment, including risks related to market volatility in the price of fuel, foreign exchange and interest rates and increased competitive pressures as well as risks relating to restrictive terms under the Corporation's financing, credit card processing and other arrangements and other risks as identified below.

The H1N1 influenza virus may also continue to impact demand for air travel. The Corporation is continuing to monitor the H1N1 influenza virus risk. While the Corporation has developed contingency plans related to the H1N1 influenza virus risk, it is unable to predict the likelihood of this risk materializing or the impact on the Corporation to the extent this risk does materialize. The Corporation is also monitoring the impact on the demand for air travel of the new security measures imposed in December 2009 by Canadian and U.S. government authorities on flights from Canada to the U.S.

Pension funding obligations

Refer to section 10.6 of this MD&A for a discussion on Air Canada's pension funding obligations.

Covenants in credit card agreements

The Corporation has various agreements that process customer credit card transactions. Approximately 85% of the Corporation's sales are processed using credit cards, with remaining sales processed through cash-based transactions. The Corporation receives payment for a credit card sale generally in advance of when the passenger transportation is provided.

As at December 31, 2008, under the terms of certain credit card processing agreements with one of its principal credit card processors, the processor was entitled to withhold payment of funds to Air Canada upon the occurrence of certain events ("triggering events"), which included unrestricted cash (as defined per the agreements and generally based on the aggregate sums of cash and cash equivalents and short-term investments) being less than $900 million as at the end of any month and operating losses in excess of certain amounts. During 2009, the Corporation entered into amendments with this processor to amend certain credit card processing agreements under which the triggering events related to operating losses were removed, the levels of unrestricted cash required to be maintained by Air Canada were reduced to $800 million and Air Canada provides the processor with deposits, to be accumulated over time, and security. The agreements provide that should Air Canada maintain unrestricted cash of more than $1,200 million for two consecutive months, the unrestricted cash requirement increases to $1,100 million at which time the processor will return to Air Canada all deposits and security previously provided by Air Canada. This occurred during the third quarter of 2009, and as a result, no deposit was provided under these processing agreements as at December 31, 2009. As long as unrestricted cash remains at or above $1,100 million at each month-end, Air Canada has no obligation to provide deposits or security to the processor. In addition, should the Corporation's unrestricted cash be less than $1,100 million at any month-end, its obligation to provide deposits to the processor would be capped at an amount not to exceed $75 million, provided unrestricted cash is not less than $800 million. The current agreements with this credit card processor expire in May 2010.

Cargo investigations and proceedings

The Corporation is exposed to potential liabilities related to the proceedings and investigations of alleged anti-competitive cargo pricing activities, as described in section 19 of this MD&A. The preliminary estimate recorded by the Corporation during 2008 is based upon the current status of the investigations and proceedings and the Corporation's assessment as to the potential outcome for certain of them. This provision does not address the proceedings in all jurisdictions, but only where there is sufficient information to do so. Management has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings. Additional material provisions may be required. Amounts could become payable within the year and may be materially different than management's preliminary estimate.

Credit risk

Credit risk is the risk of loss due to a counterparty's inability to meet its obligations. As at December 31, 2009, the Corporation's credit risk exposure consists mainly of the carrying amounts of cash and cash equivalents, short-term investments and accounts receivable as well as collateral deposits for fuel derivatives extended to counterparties. Cash, cash equivalents and short-term investments are in place with major financial institutions, the Canadian government, and major corporations. Accounts receivable are generally the result of sales of tickets to individuals, often through the use of major credit cards, through geographically dispersed travel agents, corporate outlets, or other airlines. Credit rating guidelines are used in determining counterparties for fuel hedging. In order to manage its exposure to credit risk and assess credit quality, the Corporation reviews counterparty credit ratings on a regular basis and sets credit limits when deemed necessary.

At January 31, 2010, the Corporation has $55 million in collateral deposits extended to fuel hedge counterparties. Credit risk related to these deposits is offset against the related liability to the counterparty under the fuel derivative.

Refer to the "Asset Backed Commercial Paper" section below for information on credit risks.

Market risks

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: foreign exchange risk; interest rate risk; and other price risk, which includes commodity price risk.

The Corporation uses derivative instruments to reduce market exposures from changes in foreign currency rates, interest rates, and fuel prices. The Corporation uses derivative instruments only for risk management purposes and not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows related to the risk being hedged.

Asset Backed Commercial Paper ("ABCP")

The Corporation has $37 million ($29 million net of a fair value adjustment) in non-bank sponsored ABCP which has been recorded in Deposits and other assets. The carrying value as at December 31, 2009 is based on a number of assumptions as to the fair value of the investments including factors such as estimated cash flow scenarios and risk adjusted discount rates. The assumptions used in estimating the fair value of the investments are subject to change, which may result in further adjustments to non-operating results in the future. No adjustments to the carrying value were recorded during 2009.

14. OFF-BALANCE SHEET ARRANGEMENTS

The following is a summary of Air Canada's more significant off-balance sheet arrangements.

Guarantees

Performance obligations relating to aircraft leasing agreements

With respect to 45 Air Canada aircraft leases, the difference between the amended rents as a result of the implementation of the Plan of Reorganization, Compromise and Arrangement (the "Plan") under the Companies' Creditors Arrangement Act ("CCAA") on September 30, 2004 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

Air Canada participates in fuel facility arrangements operated through fuel facility corporations (the "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 Air Canada under Accounting Guideline 15 – Consolidated of Variable Interest Entities ("AcG-15") was approximately $162 million as at December 31, 2009 ($127 million as at December 31, 2008), which is Air Canada's maximum exposure to loss without taking into consideration any cost sharing that would occur amongst the other contracting airlines. Air Canada 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.

Indemnification agreements

Air Canada enters into real estate leases or operating agreements, which grant a license to Air Canada to use certain premises, in substantially all cities that it serves. It is common in such commercial lease transactions for Air Canada, as the lessee, to agree to indemnify the lessor and other related third parties for tort or similar extra-contractual 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, Air Canada 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, Air Canada 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, Air Canada typically provides indemnities in respect of various tax consequences including in relation to the leased or financed aircraft, the use, possession, operation, maintenance, leasing, subleasing, repair, insurance, delivery, import, export of such aircraft, the lease or finance arrangements entered in connection therewith, changes of law and certain income, commodity and withholding tax consequences.

When Air Canada, as a customer, enters into technical service agreements with service providers, primarily service providers who operate an airline as their main business, Air Canada 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 and pursuant to contractual agreements between the Corporation and each of its officers and directors, Air Canada 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 Air Canada.

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

15. RELATED PARTY TRANSACTIONS

At December 31, 2009, ACE Aviation Holdings Inc. ("ACE") held a 27% ownership interest in Air Canada. Air Canada has various related party transactions with Aveos Fleet Performance Inc. ("Aveos") and ACE.

Summary of Significant Related Party Agreements

The Relationship between the Corporation and Aveos

Refer to the "Aveos Restructuring Plan" section below for a description of a restructuring plan announced by Aveos on January 26, 2010. Closing of Aveos' restructuring transactions is expected to occur during the first quarter of 2010 and is dependant on completion of formal documentation and certain conditions. This restructuring would modify the terms of certain commercial agreements between Air Canada and Aveos, including terms of the Pension and Benefits Agreement and the Agreement with Aveos on Revised payment terms described below.

Pension and Benefits Agreement

The Corporation, ACTS and Aveos entered into a Pension and Benefits Agreement effective as of October 16, 2007, as amended ("Pension and Benefits Agreement"), relating to pension and benefits arrangements pertaining to (i) the non-unionized employees of Air Canada who were previously assigned to the ACTS operation and who became employees of Aveos on October 16, 2007 and (ii) those unionized employees of Air Canada who were assigned to ACTS Aero operation pursuant to general services agreements between Air Canada and ACTS for the assignment of unionized employees from Air Canada to ACTS (these agreements were assigned to ACTS Aero (i.e. Aveos) in 2007). Under the Pension and Benefits Agreement, Aveos is required to establish new defined benefit and defined contribution pension plans as well as other employee and retiree benefit arrangements (including health, life and disability) (the "ACTS Benefit Arrangements").

Upon receipt of regulatory approval where required and based upon valuations of the relevant pension and benefit arrangements of Air Canada (the "Air Canada Benefit Arrangements") as at October 16, 2007, the assets and obligations under the Air Canada Benefit Arrangements pertaining to the transferring non-unionized employees are to be transferred to Aveos or the ACTS Benefit Arrangements, as applicable. Amounts with a present value equal to the solvency deficiency in the defined benefit pension plans as at October 16, 2007 related to transferring non-unionized employees will be paid by Air Canada through quarterly payments to Aveos until 2014. Amounts with a present value equal to the accounting liability as at October 16, 2007 in respect of retiree and disability benefits related to transferring non-unionized employees are to be paid by Air Canada through quarterly payments to Aveos until 2012. The present value of these quarterly payments is also referred to as the compensation amount. Until such future time as the assets and obligations under the Air Canada Benefit Arrangements pertaining to non-unionized employees are to be transferred to Aveos, the current service pension cost and the current service and interest costs for other employee benefits are expensed by Air Canada with a full offset recorded as an amount charged to affiliates (Aveos).

In addition, the Pension and Benefits Agreement contemplates similar asset and liability transfer and compensation arrangements in respect of unionized employees, which arrangements would take effect at such future time as those unionized employees may commence employment with Aveos pursuant to the Transition Memorandum of Agreement ("the Transition MOA"), as described further below. However, the solvency deficiencies in respect of transferring unionized employees for which the future quarterly compensation payments would be made are determined as at October 16, 2007, subject to certain adjustments, and the discount rate used to compute the accounting liability for the unionized employees' retiree and disability benefits is fixed as at October 16, 2007. The compensation payments in respect of these solvency deficiencies and accounting liabilities will be made quarterly during the five years beginning after the unionized employees are transferred to Aveos, but only if such a transfer occurs. Until such future time as the assets and obligations under the Air Canada Benefit Arrangement pertaining to unionized employees may be transferred to Aveos, the current service pension cost and the current service and interest costs for other employee benefits in respect of Air Canada employees providing services to Aveos are charged by Air Canada to Aveos.

The Pension and Benefits Agreement also required that Air Canada provide letters of credit to Aveos on October 16, 2007, to secure the above-described payment obligations in respect of the solvency deficiencies of the defined benefit pension plans and accounting liabilities for other retiree and disability benefit arrangements. The letters of credit initially totaled $101 million, subject to adjustment once the exact amounts of the relevant solvency deficiencies and accounting liabilities as at October 16, 2007 were determined by actuarial valuations. The face amount of the letter of credit in respect of the unionized solvency deficiency is also adjusted annually to recognize past service costs paid by Air Canada to the plan in respect of unionized employees assigned to Aveos. The face amount of the letters of credit decreases as the related quarterly funding payments described above are made. During 2008, as described below under "Agreement with Aveos on Revised Payment Terms", the Corporation and Aveos also agreed to temporarily cancel certain letters of credit in the amount of $40 million. Aveos may call the letters of credit in whole or in part, in the event of a default as defined in the Pension and Benefits Agreement. Collateral equal to the amount of the letters of credit was paid in cash with the asset recorded in deposits and other assets. Refer to the "Aveos Restructuring Plan" section below for a description of amendments which would be made to this agreement pursuant to the restructuring.

In 2008, Air Canada, Aveos, and the union representing the employees assigned to Aveos continued discussions regarding the options under which certain unionized employees would commence employment directly with Aveos and the creation of a separate bargaining unit for those employees at Aveos. On January 8, 2009, these same parties entered into the Transition MOA in order to resolve certain remaining issues and in order to (i) facilitate the orderly transition of certain Air Canada employees to Aveos and (ii) to establish terms and conditions of employment that will apply to those Air Canada employees who elect to become employees of Aveos. In relation to the Transition MOA, the Corporation and Aveos also entered into certain ancillary agreements (the "Ancillary Transition Agreements") to address commercial issues relating to the transition of employees contemplated by the Transition MOA. On March 5, 2009, the Corporation received the decision of the arbitrator seized with resolving five issues which remained outstanding following the execution of the Transition MOA. The Corporation and the IAMAW subsequently amended the Transition MOA, by establishing timelines for the steps for the transition and by providing for a date on which the employees who will transition to Aveos will become employees of Aveos, namely, April 1, 2011.

Non-Compete and Repair Schemes Transfer Agreement

Aveos and Air Canada are parties to a Non-Compete and Repair Schemes Transfer Agreement, effective as of October 16, 2007. Generally described, repair schemes are processes and methods which may be used in the maintenance and repair of aircraft and related equipment. The Non-Compete and Repair Schemes Transfer Agreement confirmed an arrangement and provides for the sale from Air Canada to ACTS Aero (as successor to ACTS LP) of an undivided joint ownership interest in repair schemes owned by Air Canada or approved under Air Canada's airworthiness engineering organization as well as the sale from Aveos to Air Canada of an undivided joint ownership interest in the repair schemes owned or developed by Aveos and applicable to airframe heavy maintenance services provided by ACTS to Air Canada under the parties' airframe heavy maintenance services agreement. However, in September 2004 as part of the implementation of the Corporation's plan of arrangement under the CCAA, the Corporation had already granted ACTS full and exclusive right to these schemes on a royalty free basis.

The Non-Compete and Repair Schemes Transfer Agreement also restricts Air Canada's ability to own any equity interest in an entity (other than entities in which Air Canada previously held interests), or to carry on a business activity, related to the following commercial maintenance, repair and overhaul services in the airline industry, namely, airframe heavy maintenance and paint services, engine and auxiliary power unit ("APU") overhaul maintenance services, and component maintenance services. The applicable non-compete periods are as follows:

- With respect to airframe heavy maintenance services and paint services, the non-compete period ends one year after the current heavy maintenance services agreement is terminated or expires (the current term of the heavy maintenance services agreement expires October 1, 2011);
- With respect to engine and APU overhaul maintenance services, the non-compete period ends on October 1, 2015; and
- With respect to component maintenance services, the non-compete period ends on October 1, 2016.

The Non-Compete and Repair Schemes Transfer Agreement does not restrict Air Canada from holding interests in any entities in which it held interests at the time of concluding the agreement nor does it limit Air Canada's line maintenance activities which it continues to operate.

Agreement with Aveos on Revised Payment Terms

Air Canada and Aveos entered into an agreement dated October 28, 2008 pursuant to which Air Canada has agreed to temporarily extend payment terms to Aveos under certain related party agreements. In exchange for the extended payment terms, certain letters of credit related to the Pension and Benefits Agreement, as described above, were cancelled. The cancellation of the letters of credit provided cash to Air Canada of approximately $40 million and was offset by the impact of extended payment terms to Aveos of $22 million, for a net cash flow benefit of $18 million to the Corporation. The extended payment terms to Aveos were originally scheduled to begin reducing in May 2009 with a corresponding return of the letters of credit to Aveos.

As a result of amendments, the payment terms were extended. The extended payment terms to Aveos will be reduced starting in February 2010, with the expiration of the extended terms to be completed over the following six months. By July 2010, following expiration of the extended payment terms, the letters of credit would be reinstated to the levels then required under the Pension and Benefits Agreement between the two parties. Refer to the "Aveos Restructuring Plan" section below for a description of amendments which would be made to this agreement pursuant to the restructuring.

Maintenance Agreements

Aveos and Air Canada are parties to a general terms and related services agreements effective October 1, 2006, pursuant to which Aveos provides technical services to the Corporation including engine and auxiliary power unit maintenance services, aircraft heavy maintenance services (excluding line and cabin maintenance services which are provided by the Corporation) and component maintenance. Aveos serves as the Corporation'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. The services agreement relating to aircraft heavy maintenance services, which expires in October 2011, will be extended to June 2013 conditional upon the issuance of an order of the Canada Industrial Relations Board establishing that Aveos is a distinct employer, bound by separate collective agreements and providing for the transition of employees from Air Canada to Aveos which are fully within the scope of the Transition MOA and the Ancillary Transition Agreements mentioned above. The services agreement relating to engine maintenance expires in October 2013, except in respect of certain engine types, for which the parties have agreed to extend the term to December 31, 2018. Each of the other maintenance agreements referred to above expire in October 2013.

Master Services Agreement (MSA)

Aveos and Air Canada are parties to an amended and restated master services agreement (the "Aveos MSA"), effective January 1, 2007, pursuant to which the Corporation provides Aveos with services including infrastructure support and services which are mostly administrative in nature, including information technology, human resources, finance and accounting services in return for fees paid by Aveos to the Corporation. Aveos may elect to terminate any services under the Aveos MSA or the entire Aveos MSA upon six months' prior written notice, with the exception of services relating to information technology which Aveos cannot terminate prior to the expiry of the Aveos MSA. Air Canada may elect to terminate any services under the Aveos MSA or the entire Aveos MSA upon 18 months' prior written notice. These amounts are recorded in the table below summarizing related party revenues and expenses under "Revenues from corporate services and other to ACE and Aveos".

General Services Agreements

Aveos and Air Canada are parties to an amended and restated general services agreement (the "Aveos GSA"), effective as of June 22, 2007, pursuant to which the Corporation provides Aveos with the services of a group of unionized employees for which the Corporation is reimbursed by Aveos for all costs, including salary and benefits, on a fully allocated basis. The Aveos GSA may be terminated by either party at any time upon 30 days' prior written notice.

Real Estate Agreements

Aveos and Air Canada are parties to a master lease agreement, effective as of October 1, 2006, pursuant to which Aveos leases space from the Corporation at the Vancouver, Winnipeg, Toronto and Montreal airports.

Aveos Restructuring Plan
On January 26, 2010, Aveos reached an agreement with its lenders and equity holders on the terms of a consensual restructuring plan to recapitalize the company. As part of this recapitalization, Air Canada and Aveos entered into a preliminary agreement to settle certain issues and modify the terms of certain contractual arrangements in exchange for Air Canada receiving a minority equity interest in Aveos. The modified terms relating to the maintenance agreements are not expected to have a material impact on maintenance expense over their terms.

Closing of Aveos' recapitalization, including the related transactions between Air Canada and Aveos, is subject to completion of formal documentation and other conditions and is expected to occur during the first quarter of 2010. As part of these agreements, the Corporation would also agree to extend repayment terms on $22 million of receivables (described above under "Agreement with Aveos on Revised Payment Terms"), due in 2010, over six years with annual repayments on a non-interest bearing basis, with such payments subject to satisfaction of certain conditions.

The terms of the Pension and Benefits Agreement (described above) would also be modified to defer the determination of pension assets and related solvency deficiencies of transferring unionized employees performing airframe maintenance services to April 2011. This would have the result of Air Canada assuming changes in the solvency deficiency for those affected employees from the date of the Pension and Benefits Agreement to the date of their transfer to Aveos, scheduled for April 2011. As part of the amendment, all letters of credit issued under the Pension and Benefits Agreement would be cancelled and a new letter of credit in a maximum amount of $20 million would be issued by Air Canada in favour of Aveos to secure the payment of all compensation payments owing by Air Canada to Aveos in respect of pension, disability, and retiree liabilities for which Air Canada is liable under the Pension and Benefits Agreement. This modification would result in a reduction to the outstanding deposit under Air Canada's letter of credit facility of approximately $20 million in the first quarter of 2010.

The accounting for the above agreements will be determined upon closing.

The Relationship between the Corporation and ACE

Credit Facility
ACE is a participant lender in the Credit Facility as described in section 6 of this MD&A. ACE's participation in the Credit Facility represents $150 million of the outstanding loan of $600 million as at December 31, 2009. The participant lenders participate on a pro-rata basis with respect to any warrants and principal and interest payments. ACE's pro-rata share of interest expense reported in 2009 amounted to $8 million and its pro-rata share of the warrants as reported in contributed surplus is approximately $2 million.

Master Services Agreement
Air Canada provides certain accounting and administrative services to ACE in return for a fee. ACE terminated the majority of these service agreements in 2009.

The related party balances resulting from the payment obligations in respect of the application of the related party agreements were as follows:

(Canadian dollars in millions)	December 31, 2009		December 31, 2008	
Accounts receivable				
ACE	$	-	$	2
Aveos		135		120
	$	**135**	**$**	**122**
Prepaid Maintenance				
Aveos	$	9	$	5
	$	**9**	**$**	**5**
Accounts payable and accrued liabilities				
ACE	$	3	$	-
Aveos		92		99
	$	**95**	**$**	**99**
Long-term debt including current portion and value of warrants				
ACE	$	150	$	-
	$	**150**	**$**	**-**

Revenues and expenses with related parties are summarized as follows:

	Full Year			
(Canadian dollars in millions)	2009		2008	
Revenues				
Property rental revenues from ACE and Aveos	$	31	$	29
Revenues from information technology services to Aveos		6		15
Revenues from corporate services and other to ACE and Aveos		9		15
	$	**46**	**$**	**59**
Expenses				
Maintenance expense for services from Aveos	$	514	$	478
Recovery of wages, salary and benefit expense for employees assigned to ACE and Aveos		(228)		(277)
Interest expense for ACE's participation in the Credit Facility		8		-
Other Expenses		-		1
	$	**294**	**$**	**202**

16. 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 consolidated financial statements:

Passenger and cargo revenues

Airline passenger and cargo advance sales are deferred and included in current liabilities. Advance sales also include the proceeds from the sale of flight tickets to Aeroplan, a corporation that provides loyalty program services to the Corporation and purchases seats from Air Canada pursuant to the Aeroplan Commercial Participation and Services Agreement between Aeroplan and Air Canada (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. Air Canada 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.

Employee future benefits

Air Canada maintains several defined benefit and defined contribution plans providing pension, other retirement and post-employment benefits to its employees. Certain Corporation employees perform work for ACE and Aveos and are members of Corporation-sponsored defined benefit pension plans and also participate in Corporation-sponsored health, life and disability benefit plans. Other Corporation employees performed work for Aeroplan until the date of transition to employment at Aeroplan and then ceased to accrue benefits under the Corporation-sponsored defined benefit pension plans and under the Corporation-sponsored health, life and disability benefit plans. The Corporation's audited consolidated financial statements for 2009 include all of the assets and liabilities of all the sponsored plans of the Corporation. Employee benefits expense includes the expenses for all employees participating in the plans less a cost recovery which is charged to ACE, Aveos, and Aeroplan for those employees contractually assigned. The cost recovery includes current service costs for pensions, past service costs to Aeroplan for pensions and a portion of post-employment and post-retirement benefits to ACE and Aveos, based on the actuarial calculation for their specific employee group. The cost recovery amounted to $32 million for the year ended December 31, 2009 ($40 million for the year ended December 31, 2008).

In May 2009, Air Canada and Aeroplan reached an agreement with the Canadian Auto Workers (CAW) Local 2002 providing for a process for the approximately 750 Air Canada employees then assigned to and working in the Aeroplan contact centres to choose to transition to employment at Aeroplan, effective June 1, 2009, or to remain employees of Air Canada. Employees at Air Canada work locations who became surplus to Air Canada's needs due to employees who were senior to them and then working at Aeroplan contact centres choosing to remain employees of Air Canada were given the option to transition to employment at Aeroplan. Effective October 4, 2009, all affected employees had completed the transition to Aeroplan. For those employees who transferred to Aeroplan, their service, which largely determines benefit levels under the Air Canada pension and other employee benefit plans, ceased to accrue as of the date of employment with Aeroplan. Air Canada and Aeroplan continue to discuss the terms surrounding the transfer of pension benefits and certain implications relating to same remain to be resolved. Air Canada continues to retain plan assets and report liabilities for services accrued for the transferred Aeroplan employees as at December 31, 2009, pending final determination of this matter. Aeroplan is now contributing current service costs in their pension plan for service accruing with Aeroplan.

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

	December 31, 2009	December 31, 2008
Weighted average assumptions used to determine the accrued benefit liability		
Discount rate	6.40 %	7.35 %
Rate of compensation increase (1)	2.50 %	2.50 %
Weighted average assumptions used to determine the accrued benefit cost		
Discount rate	7.35 %	5.75 %
Expected long-term rate	7.15 %	7.15 %
Rate of compensation increase (2)	2.50 %	2.50 %

(1) As a result of the pay awards, a rate of compensation increase of 0% plus merit was used for years 2009 and 2010 in determining the net benefit obligation for the pension plan and 2.50% plus merit for the remaining years.

(2) A rate of compensation increase of 0% plus merit was used in 2009 and in 2010 in determining the net benefit pension expense and 2.50% plus merit 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. An increase in the discount rate of 0.25% results in a decrease of $346 million to the pension obligation and $28 million to the pension expense. A decrease in the discount rate of 0.25% results in an increase of $346 million to the pension obligation and $25 million to the pension expense.

Expected return on assets assumption

Air Canada's expected long-term rate of return on assets assumption is selected based on the facts and circumstances that existed as of the measurement date and the specific portfolio mix of plan assets. Air Canada's management, in conjunction with its actuaries, reviews anticipated future long-term performance of individual asset categories and considers the asset allocation strategy adopted by Air Canada, 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. The determination of the long-term rate considers recent fund performance, including the significant drop in the value of plan assets during 2008 and the partial recovery in 2009, and historical returns, to the extent that the past is indicative of the expected long-term, prospective rate. There can be no assurance that any of the plans will earn the expected rate of return. A sensitivity analysis on pension expense assuming a change in the expected return on plan assets is provided below.

Composition of pension plan assets

The composition of the domestic registered plan assets and the target allocation are the following:

	2009	2008	Target allocation (1)
Non-matched assets (mainly equities)	55.9 %	52.9 %	54.4 %
Matched assets (mainly Canadian bonds)	43.4 %	43.5 %	45.6 %
Cash and temporary investments	0.7 %	3.6 %	0.0 %
Total	**100.0 %**	**100.0 %**	**100.0 %**

(1) Weighted average of the Master Trust Fund target allocation (99% of Domestic Registered Plan assets) and the Bond Fund target allocation. The Bond Fund serves the purpose of altering the asset mix of some of the participating plans. These plans exhibit characteristics that differ from the majority of the participating plans, which are solely invested in the Master Trust.

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") as amended during 2008. The investment return objective of the Fund is to achieve a total annualized rate of return that exceeds by a minimum of 1.0% before investment fees on average over the long term (i.e. 10 years) the total annualized return that could have been earned by passively managing the Liability Benchmark. The Liability Benchmark, which is referenced to widely used Canadian fixed income performance benchmarks ("DEX"), is composed of a mix of the DEX Universe Provincial Bond Index, DEX Long Term Provincial Bond Index and DEX Real Return Bond Index that closely matches the characteristics of the pension liabilities.

In addition to the broad asset allocation, as summarized in the asset allocation section above, the following policies apply to individual asset classes:

- Non-matched assets are mainly equities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 31% to 37% of the total market value of the Master Trust Fund. Limitations are placed on the overall allocation to any individual security at both cost and market value. Investments in non-publicly traded securities and in non-traditional asset classes are allowed up to 10% of the total market value of the Master Trust Fund.

- Matched assets are mainly Canadian bonds, oriented toward long term investment grade securities rated "BBB" 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, these investments are required to be diversified among individual securities and sectors.

Derivatives are permitted provided that they are used for hedging a particular risk (including interest rate risk related to pension liabilities) or to create exposures to given markets and currencies and that counterparties have a minimum credit rating of A. As of December 31, 2009, an additional 5% derivatives exposure to matched assets is in place to hedge interest rate risk related to pension liabilities.

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

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.

Sensitivity analysis

Sensitivity analysis on the 2009 pension expense based on different actuarial assumptions with respect to discount rate and expected return on plan assets is as follows:

	0.25 percentage point	
Impact on 2009 pension expense (Canadian dollars in millions)	**Decrease**	**Increase**
Discount rate on obligation assumption	$ 25	$ (28)
Long-term rate of return on plan assets assumption	$ 30	$ (29)

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. An 8.25% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2009 (8.25% was assumed for 2008). The rate is assumed to decrease gradually to 5% by 2015. 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 $18 million. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by $2 million and the obligation by $23 million.

Income taxes

The Corporation utilizes the assets and 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.

Cash tax projections

As at December 31, 2009, Air Canada has substantial tax attributes largely in the form of loss carry forwards and other tax attributes to shelter future taxable income. 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 and recorded in the period. Recoverability is assessed relative to undiscounted cash flows from the direct use and disposition of the asset or group of assets.

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 discount rates to be applied in the analysis and future cash flows to be generated by the assets, including the estimated useful life of the assets. Discount rates are determined with reference to estimated risk adjusted market rates of return for similar cash flows. The Corporation performs sensitivity analysis on the discount rates applied. The discount rates used are subject to measurement uncertainty.

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.

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 within variable interest entities are depreciated to estimated residual values over the life of the lease. Air Canada's aircraft and flight equipment, including spare engines and related parts ("rotables"), are depreciated over 20 to 25 years, with 10 to 20% estimated residual values. Aircraft reconfiguration costs are amortized over three to five years. Betterments to owned aircraft are capitalized and amortized over the remaining service life of the aircraft. Betterments to aircraft on operating leases are amortized over the term of the lease.

Buildings are depreciated over their useful lives not exceeding 50 years on a straight-line basis. An exception to this is where the useful life of the building is greater than the term of the land lease. In these circumstances, the building is depreciated over the life of the lease. Leasehold improvements are amortized over the lesser of the lease term or five years. Ground and other equipment is depreciated over three 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 upon emergence from CCAA. Since that time, the intangible assets have been reduced by a tax allocation of $914 million. 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.

17. ACCOUNTING POLICIES

17.1 CHANGES IN ACCOUNTING POLICIES

Stock-based compensation plans

The Corporation changed its accounting policy for awards of stock-based compensation granted to Corporation employees with a graded vesting schedule. Prior to January 1, 2009, the fair value of stock options with a graded vesting schedule was recognized as compensation expense and a credit to contributed surplus on a straight-line basis over the applicable vesting period. Effective January 1, 2009, the fair value of stock options with a graded vesting schedule is determined based on different expected lives for the options that vest each year, as it would be if the award were viewed as several separate awards, each with a different vesting date, and it is accounted for on that basis. The new accounting policy provides more reliable and relevant information about the effects of the transactions.

The impact of the change in accounting policy for awards granted to Corporation employees with a graded vesting schedule was immaterial to any prior period and therefore no adjustments were made to such prior periods.

Goodwill and intangible assets

Effective January 1, 2009, the Corporation adopted new Canadian Institute of Chartered Accountants ("CICA") accounting standard section 3064, Goodwill and Intangible Assets, which provides guidance on the recognition, measurement, presentation and disclosure for goodwill and intangible assets, other than the initial recognition of goodwill or intangible assets acquired in a business combination. The Corporation's accounting policy for intangible assets is consistent with the new standard and, as a result, no adjustment was recorded on transition.

Credit risk and the fair value of financial assets and financial liabilities

Effective January 1, 2009, the Corporation adopted the recommendations of the Emerging Issues Committee ("EIC") of the CICA relating to Abstract EIC-173 Credit Risk and the Fair Value of Financial Assets and Financial Liabilities. Under this Abstract, the Corporation's own credit risk and the credit risk of the counterparty are taken into consideration in determining the fair value of financial assets and liabilities, including derivative instruments. The adoption of this guidance had no significant impact on the Corporation's consolidated financial statements as collateral deposits with fuel derivative counterparties and master netting arrangements are considered in determining whether a credit risk adjustment is required on the valuation of the derivatives.

Financials instruments – Disclosures

Effective January 1, 2009, the Corporation has adopted the enhanced disclosure requirements of amended CICA section 3862 Financial Instruments – Disclosures. Under these requirements, a classification of fair value measurements recognized in Air Canada's Consolidated Statement of Financial Position is presented using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

17.2 FUTURE ACCOUNTING STANDARD CHANGES

Business Combinations, Consolidated Financial Statements and Non-controlling Interests

The CICA issued three new accounting standards in January 2009: section 1582, Business Combinations, section 1601, Consolidated Financial Statements, and section 1602, Non-controlling Interests. These new standards will be effective for fiscal years beginning on or after January 1, 2011. The Corporation is in the process of evaluating the requirements of these new standards.

Section 1582 replaces section 1581, and establishes standards for the accounting for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard IFRS 3 – Business Combinations. The section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011.

Sections 1601 and 1602 together replace section 1600 – Consolidated Financial Statements. Section 1601 establishes standards for the preparation of consolidated financial statements. Section 1601 applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of International Financial Reporting Standard IAS 27 - Consolidated and Separate Financial Statements and applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011.

International Financial Reporting Standards

The Canadian Accounting Standards Board has confirmed January 1, 2011 as the changeover date for Canadian publicly accountable enterprises to start using International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences in recognition, measurement and disclosures.

As a result, the Corporation has developed a plan to convert its consolidated financial statements to IFRS establishing a cross-functional IFRS team represented by managers in the areas of Accounting, Taxation, IT and Data Systems, Internal Control and Processes, Planning, Compensation, Treasury, Investor Relations and Legal. Updates regarding the progress of the conversion plan are provided to the Corporation's Audit, Finance and Risk Committee on a quarterly basis.

The Corporation has identified the following major differences between its current accounting policies and those required or expected to apply in preparing IFRS financial statements.

Passenger and cargo revenues

<u>Current accounting policy</u>

Airline passenger and cargo advance sales are deferred and included in current liabilities. Advance sales also include the proceeds from the sale of flight tickets to Aeroplan, a corporation that provides loyalty program services to Air Canada 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.

<u>Expected IFRS accounting policy</u>

No significant changes have been identified from the Corporation's current accounting policy.

Employee future benefits

Current accounting policy

The cost of pensions, other post-retirement and post-employment benefits earned by employees is actuarially determined annually as at December 31. The cost is 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 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 four years.

Past service costs arising from plan amendments are amortized on a straight-line basis over the expected average remaining service period of employees active at the date of amendment. This period does not exceed the expected average remaining service period of such employees up to the full eligibility date. The expected average remaining service period of active employees (or expected average remaining life expectancy of retired members for a plan with no active members) is between 7 and 16 years for pension plans and between 10 and 11 years for post retirement and post employment benefit plans.

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 expected remaining service life of active employees.

Expected IFRS accounting policy

Defined benefit plans

Actuarial gains and losses

Under IAS 19 Employee benefits ("IAS19"), actuarial gains and losses may either be:

- Deferred up to a maximum, with any excess amortised in profit or loss (the 'corridor approach'),
- Recognised immediately in profit or loss, or
- Recognised immediately in other comprehensive income without subsequent recycling to income.

Under the corridor approach under IAS 19, cumulative actuarial gains and losses in excess of 10% of the greater of the obligation and the fair value of plan assets at the beginning of the period are amortized in profit or loss over the average remaining working lives of the employees. Under current Canadian GAAP, the corridor approach is used and cumulative actuarial gains and losses in excess of 10% of the greater of the obligation and market-related value of plan assets at the beginning of the period is amortized in profit or loss.

The Corporation has not finalized its decision with respect to the accounting for actuarial gains and losses.

Fair value of plan assets vs market-related value of plan assets

Under IAS 19, a market-related valuation method can not be used to value plan assets. Under current Canadian GAAP, a market-related value of assets whereby the difference between actual and expected return is gradually recognized over four years is used.

The Corporation will use the fair value of plan assets under IAS 19.

The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction

In July 2007, the IASB issued IFRIC 14 IAS 19 – The Limit of a Defined Benefit Asset, Minimum Funding Requirements and their Interaction ("IFRIC 14"). The Interpretation addresses the application of paragraph 58 of IAS 19 which limits the measurement of a defined benefit asset to "the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan" plus cumulative unrecognised net losses and past service cost. Questions have arisen about when refunds or reductions in future contributions should be regarded as available, particularly when a minimum funding requirement exists. Further, minimum funding requirements may give rise to a liability if the required contributions will not be available to the entity once they have been paid.

IFRIC 14 provides guidance regarding (a) when refunds or reductions in future contributions should be regarded as available in accordance with paragraph 58 of IAS 19, (b) how a minimum funding requirement might affect the availability of reductions in future contributions and (c) when a minimum funding requirement might give rise to a liability. This is a detailed piece of guidance for which there is no Canadian-specific equivalent. In addition, there is some lack of clarity around how the requirements of the IFRIC are to be interpreted in a Canadian environment.

The Corporation has not finalized the impact of IFRIC 14 with respect to the accounting for the limits of any defined benefit assets.

Other long-term employee benefits

Under Canadian GAAP, there is no separate category for other long-term employee benefits. IFRS takes the approach that the introduction of, or changes to, other long-term employee benefits rarely causes a material amount of past service cost. For these reasons, IAS 19 requires a simplified method of accounting for other long-term employee benefits. This method differs from the accounting required for post-employment benefits as follows:

- actuarial gains and losses are recognised immediately and no 'corridor' is applied; and
- all past service cost is recognised immediately.

The Corporation will adopt this revised accounting policy on transition to IFRS for other long-term employee benefits.

Income taxes

Current accounting policy

The Corporation utilizes the assets and 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.

Expected IFRS accounting policy

The Corporation has not finalized analyzing the impact of IAS 12 Income taxes with respect to the accounting for income taxes.

Impairment of long-lived assets

Current accounting policy

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 and recorded in the period. 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 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.

Expected IFRS accounting policy

Impairment testing of long-term assets is based on a two-step approach under current Canadian GAAP, while it is based on comparing the carrying amount to the recoverable amount under IAS 36 Impairment of Assets ("IAS 36"). In addition, IAS 36 requires, under certain circumstances, the reversal of impairment losses, which is not allowed under current Canadian GAAP.

The Corporation will adopt this revised accounting policy on transition to IFRS.

Property and equipment

Current accounting policy

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

Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Property and equipment under capital leases and within variable interest entities are depreciated to estimated residual values over the life of the lease. Aircraft and flight equipment, including spare engines and related parts ("rotables") are depreciated over 20 to 25 years, with 10% to 20% estimated residual values. Aircraft reconfiguration costs are amortized over three to five years. Betterments to owned aircraft are capitalized and amortized over the remaining service life of the aircraft. Betterments to aircraft on operating leases are amortized over the term of the lease.

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

Maintenance and repair costs for both leased and owned aircraft, including line maintenance, component overhaul and repair, and maintenance checks, 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. Line maintenance consists of routine daily and weekly scheduled maintenance inspections and checks, overhaul and repair involves the inspection or replacements of major parts, and maintenance checks consist of more complex inspections and servicing of the aircraft.

Expected IFRS accounting policy

Componentization

IAS 16 Property, plant and equipment ("IAS 16") reinforces the requirement under Canadian GAAP that requires that each part of property, plant and equipment that has a cost that is significant in relation to the overall cost of the item should be depreciated separately.

The Corporation will adopt this revised accounting policy with respect to componentization of property, plant and equipment on transition to IFRS.

Capitalization of major engine and airframe overhaul

In addition, IAS 16 provides guidance that would require major engine and airframe overhaul be treated as separate components of an aircraft with the overhaul cost capitalised and depreciated over the period to the next major overhaul.

The Corporation will adopt this revised accounting policy with respect to capitalization of major maintenance on transition to IFRS.

Leases

Under IAS 17 Leases, a lease is classified as either a finance lease or an operating lease. Lease classification depends on whether substantially all of the risks and rewards incidental to ownership of a leased asset have been transferred from the lessor to the lessee, and is made at inception of the lease. A number of indicators are used to assist in lease classification however, quantitative thresholds are not offered as an indicator as under current Canadian GAAP.

The Corporation has developed internal indicators to assist in lease classification under IFRS.

Intangible assets

Current accounting policy

Intangible assets are initially recorded at cost. Indefinite life assets are not amortized while assets with finite lives are amortized on a straight-line basis to nil over their estimated useful lives.

Expected IFRS accounting policy

No significant changes have been identified from the Corporation's current accounting policy.

IFRS transition

With regards to IFRS transition, the Corporation has thoroughly analyzed the optional exemptions available under IFRS 1 First-time Adoption of International Financial Reporting Standards ("IFRS 1"). The decisions about the optional exemptions available under IFRS 1 are preliminary at this time. The decisions about accounting policy choices available under IFRS 1 and other individual IFRS standards will be disclosed throughout 2010 as they are reviewed by the Audit, Finance and Risk Committee and finalized. The Audit, Finance and Risk Committee Audit, Finance and Risk Committee will consider the appropriateness of the accounting policies applied under IFRS both at the time of transition and following transition.

Summary of the IFRS changeover plan

The plan addresses the impact of IFRS on Accounting policies and implementation decisions, Infrastructure, Business activities and Control activities. A summary status of the key elements of the changeover plan is as follows:

	Key activities	Status
Accounting policies and implementation decisions	Identification of differences in Canadian GAAP and IFRS accounting policies; Selection of the Corporation's ongoing IFRS policies; Selection of the Corporation's IFRS 1 First-time Adoption of International Financial Reporting Standards ("IFRS 1") choices; Development of financial statement format; Quantification of effects of change in initial IFRS 1 disclosures and 2010 financial statements.	The Corporation has identified differences between accounting policies under Canadian GAAP and accounting policy choices under IFRS, both on an ongoing basis and with respect to certain choices available on conversion, made in accordance with IFRS 1; The Corporation will continue to progress towards the quantification of the identified differences and choices throughout 2010.
Infrastructure Financial reporting expertise	Development of IFRS expertise.	The Corporation has provided training for key employees and stakeholders. Additional training will be ongoing until full adoption in 2011.
Infrastructure Information technology and data systems	Development of systems solution for transition period and post-convergence period.	The Corporation has determined system requirements and solutions. The impact with respect to Information technology and data systems is due to the change in accounting for property, plant and equipment. These changes have largely been implemented at nominal cost.
Business activities Financial covenants	Identification of impact on financial covenants and business practices; Completion of any required renegotiations/changes by the third quarter of 2010.	The Corporation is in the process of analyzing the contractual implications of IFRS on any financing relationships and other arrangements.
Business activities Compensation arrangements	Identification of impact on compensation arrangements; Assessment of required changes by the third quarter of 2010.	The Corporation is in the process of analyzing any compensation policies that rely on indicators derived from the financial statements.
Control activities Internal control over financial reporting	For all accounting policy changes identified, assessment of Internal Controls over Financial Reporting ("ICFR") design and effectiveness implications; Implementation of appropriate changes by the second quarter of 2010.	The Corporation is in the process of analyzing any issues with respect to ICFR.
Control activities Disclosure controls and procedures	For all accounting policy changes identified, assessment of Disclosure Controls and Procedures ("DC&P") design and effectiveness implications; Implementation of appropriate changes by the second quarter of 2010.	The Corporation is in the process of analyzing any issues with respect to DC&P.

18. SENSITIVITY OF RESULTS

Air Canada's financial results are subject to many different internal and external factors which can have a significant impact on operating results. In order to provide a general guideline, the following table describes, on an indicative basis, the financial impact that changes in certain assumptions would generally have had on Air Canada's operating results. These guidelines were derived from 2009 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 Air Canada. Conversely, an opposite change in the sensitivity factor would have had the opposite effect on operating income.

Key Variable	2009 Measure		Sensitivity Factor	Favourable / (Unfavourable) Estimated Operating Income Impact	
Revenue Measures					
Passenger yield (cents)	System	17.7	1% increase in yield	$	80
	Canada	23.0		$	34
Traffic (RPMs) (millions)	System	47,884	1% increase in traffic	$	76
	Canada	15,544		$	32
Passenger load factor (%)	System	80.7	1 percentage point increase	$	94
RASM (cents)	System	14.3	1% increase in RASM	$	78
Cost Measures					
Labour and benefits expenses ($ millions)		1,751	1% increase	$	(18)
Fuel – WTI price (US$/barrel) (1)		59.2	US$1/barrel increase to WTI	$	(25)
Fuel – jet fuel price (CAD cents/litre) (1)		57.2	1% increase	$	(20)
Cost per ASM (cents)		16.9	1% increase in CASM	$	(101)
Currency Exchange					
Cdn$ to US$	1US$ = Cdn$1.09		1 cent increase (e.g. $1.09 to $1.08)	$	23

(1) Excludes the impact of fuel surcharges and fuel hedging. Refer to section 13 of this MD&A for information on Air Canada's fuel derivative instruments.

Key Variable	2009 Measure	Sensitivity Factor	Favourable / (Unfavourable) Estimated Pre-Tax Income Impact(1)	
Currency Exchange				
Cdn$ to US$	1US$ = Cdn$1.09	1 cent increase (e.g. $1.09 to $1.08)	$	57

(1) Excludes the impact of foreign exchange forward contracts and currency swaps.

19. RISK FACTORS

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

Risks relating to Air Canada

Operating Results

Prior to emergence from its restructuring under the Companies Creditors Arrangement Act, as amended ("CCAA") on September 30, 2004, Air Canada had sustained significant losses and Air Canada may sustain significant losses in the future. In 2008, Air Canada recorded an operating loss before a provision for cargo investigations and proceedings of $39 million. During 2009, Air Canada recorded an operating loss of $316 million. Current economic conditions may result in significant losses for Air Canada. Despite ongoing business initiatives and efforts at securing cost reductions, revenue improvements and additional sources of financing, Air Canada may not be able to successfully achieve positive net profitability or realize the objectives of any or all of its initiatives, including those which seek to improve yield or offset or mitigate risks facing Air Canada, including those relating to economic conditions, liquidity, pension funding, unexpected volatility in fuel costs and other expenses.

Leverage

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

The ability of Air Canada to make scheduled payments under its indebtedness will depend on, among other things, its future operating performance and its ability to refinance its indebtedness, if necessary. In addition, as Air Canada incurs indebtedness which bears interest at fluctuating interest rates, to the extent these interest rates increase, its interest expense will increase. There can be no assurance that Air Canada will be able to generate sufficient cash from its operations to pay its debts and lease obligations. Each of these factors is, to a large extent, subject to economic, financial, competitive, regulatory, operational and other factors, many of which are beyond Air Canada's control.

Need for Additional Capital and Liquidity

Air Canada faces a number of challenges in its business, including in relation to economic conditions, pension plan funding, volatile fuel prices, contractual covenants which could require Air Canada to deposit cash collateral with third parties, foreign exchange rates and increased competition from international, transborder and low-cost domestic carriers. Air Canada's liquidity levels may be adversely impacted by these as well as by other factors and risks identified in this MD&A. As part of Air Canada's efforts to meet such challenges and to support Air Canada's business strategy, significant liquidity and significant operating and capital expenditures are, and will in the future be, required. There can be no assurance that Air Canada will continue to be able to obtain on a timely basis sufficient funds on terms acceptable to Air Canada to provide adequate liquidity and to finance the operating and capital expenditures necessary to overcome challenges and 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, could require Air Canada to delay or abandon some or all of its anticipated expenditures or to modify its business strategy and could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Furthermore, competitors with greater liquidity or their ability to raise money more easily and on less onerous terms could create a competitive disadvantage for Air Canada.

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

Economic and Geopolitical Conditions

Airline operating results are sensitive to economic and geopolitical conditions which can have a significant impact on Air Canada. For example, economic and geopolitical conditions may impact demand for air transportation in general or to or from certain destinations, as well as Air Canada's operating costs, pension plan contributions and costs and availability of capital and supplies required by Air Canada. Especially in light of Air Canada's substantial fixed cost structure, any prolonged or significant impact arising from economic and geopolitical conditions, including weakness of the Canadian, U.S. or world economies could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Airline fares and passenger demand have fluctuated significantly in the past and are likely to fluctuate significantly in the future. Air Canada is not able to predict with certainty market conditions and the fares that Air Canada may be able to charge. Customer expectations can change rapidly and the demand for lower fares may limit revenue opportunities. Travel, especially leisure travel, is a discretionary consumer expense. Depressed economic conditions in North America and other areas served by Air Canada, as well as geopolitical instability in various areas of the world, concerns about the environmental impacts of air travel and tendencies towards "green" travel initiatives where consumers reduce their travel activities, could have the effect of reducing demand for air travel in Canada and abroad and could materially adversely impact Air Canada's profitability.

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).

Pension plan solvency valuations are influenced primarily by long-term interest rates and by the investment return on plan assets, which in turn may be dependent on a variety of factors, including economic conditions. 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. Deteriorating economic conditions may result in significant increases in Air Canada's funding obligations, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Refer to section 10.6 of this MD&A for additional information relating to Air Canada's pension funding obligations. In particular, as of 2014, the Air Canada 2009 Pension Regulations will cease to have effect and Air Canada's pension funding obligations may vary significantly based on several factors, including regulatory developments, assumptions and methods used and changes in the economic conditions (mainly the return on fund assets and changes in interest rates). Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its registered pension plans could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Fuel Costs

Fuel costs constituted the largest percentage of the total operating costs of Air Canada in 2009. 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 2006, 2007 and 2008, fuel prices increased and fluctuated near or at historically high levels. Should fuel prices fluctuate significantly or increase significantly above current levels, fuel costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Due to the competitive nature of the airline industry, Air Canada may not be able to pass on increases in fuel prices to its customers by increasing its fares. Based on 2009 volumes, management estimates that a US$1 per barrel movement in the average price of WTI crude oil would have resulted in an approximate $25 million change in 2009 fuel expense for Air Canada (excluding any impact of fuel surcharges, foreign exchange rates and fuel hedging), assuming flying capacity remained unchanged and that refining spreads between WTI crude oil and jet fuel as well as foreign exchange rates remained constant.

Foreign Exchange

Air Canada's financial results are sensitive to the fluctuating value of the Canadian dollar. In particular, Air Canada 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 2009, a $0.01 increase in the Cdn/U.S. dollar exchange rate (i.e., $1.09 to $1.08 per U.S. dollar) would have had an estimated $23 million favourable impact on operating income and a $57 million favourable impact on pre-tax income. Conversely, an opposite change in the exchange rate would have had the opposite effect. Air Canada incurs significant expenses in U.S. dollars for such items as fuel, aircraft rental and maintenance 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 Air Canada relative to its U.S. competitors and could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, Air Canada may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

Labour Costs and Labour Relations

Labour costs constitute one of Air Canada's largest operating cost items. There can be no assurance that Air Canada will be able to maintain such costs at levels 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 Air Canada's expectations or comparable to agreements entered into by Air Canada'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 Air Canada, its business, results from operations and financial condition.

Most of Air Canada's employees are unionized. The collective agreements representing the majority of the unionized workforce were renewed or extended in 2009 and will now expire in 2011. No strikes or lock-outs may lawfully occur during the term of the collective agreements, nor during the negotiations of their renewal until a number of pre-conditions, in respect of the unions for Canadian-based employees, prescribed by the Canada Labour Code, have been satisfied. There can be no assurance that collective agreements will be further renewed without labour conflict or action or that there will not be a labour conflict that could lead to a dispute or to an interruption or stoppage in Air Canada's service or otherwise adversely affect the ability of Air Canada to conduct its operations, any of which could have a material adverse effect on Air Canada, 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 would also likely be a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, labour conflicts at Star Alliance® partners could result in lower demand for connecting traffic with Air Canada and, ultimately, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Airline Industry Characterized by Low Gross Profit Margins and High Fixed Costs

The airline industry is 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 would have a significant effect on Air Canada'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 Air Canada, its business, results from operations and financial condition. Air Canada incurs substantial fixed costs which do not meaningfully fluctuate with overall capacity. As a result, should Air Canada be required to reduce its overall capacity or the number of flights operated, it may not be able to successfully reduce certain fixed costs in the short term and may be required to incur important termination or other restructuring costs, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Competition

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

Canadian low-cost and other carriers have entered and/or expanded or announced their intention to compete in many of Air Canada's key domestic markets and, along with some U.S. carriers have also entered and/or expanded their operations in the U.S. transborder and leisure-oriented markets. Carriers against which Air Canada may compete, including U.S. carriers, may undergo (and some of whom who have undergone) substantial reorganizations (including by way of merger with or acquisition by another carrier), creating reduced levels of indebtedness and lower operating costs and may be in a position to more effectively compete with Air Canada. Air Canada 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 and other carriers are successful in entering or expanding into Air Canada's domestic and the U.S. transborder markets, if additional U.S. or other carriers against which Air Canada competes are successful in entering Air Canada's transborder market or if carriers are successful in their expansion in international markets of Air Canada, Air Canada's business results from operations and financial condition could be materially adversely affected.

Air Canada also encounters substantial price competition. The expansion of low-cost carriers in recent years, along with the advent of Internet travel websites and other travel products distribution channels, has resulted in a substantial increase in discounted and promotional fares initiated by Air Canada'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 Air Canada, its business, results from operations and financial condition. Furthermore, Air Canada's ability to reduce its fares in order to effectively compete with other carriers is dependent on Air Canada's ability to achieve acceptable operating margins and may also be limited by government policies to encourage competition. Likewise, competitors continue to pursue commission/incentive actions and, in many cases, increase these payments. The decision to modify Air Canada's current programs in order to remain competitive and maintain passenger traffic could result in increased costs to Air Canada's business.

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 Air Canada which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Limitations Due to Restrictive Covenants

Some of the financing and other major agreements to which Air Canada is a party contain restrictive, financial (including in relation to liquidity, minimum EBITDAR, fixed charge coverage ratio and debt coverage ratios) and other covenants which affect and, in some cases, significantly limit or prohibit, among other things, the manner in which Air Canada may structure or operate its business, including by reducing Air Canada's liquidity, limiting Air Canada's ability to incur indebtedness, create liens, sell assets, pay dividends, make capital expenditures, and engage in acquisitions, mergers or restructurings or a change of control. Future financing and other major agreements 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 ability to operate its business and its profitability.

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

Refer to section 13 of this MD&A for a description of restrictive covenants relating to one of Air Canada's credit card processing agreements.

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

Strategic, Business, Technology and Other Important Initiatives

In order to operate its business, achieve its goals and remain competitive, Air Canada 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, business process initiatives, information technology initiatives and others. These initiatives, including activities relating to their development and implementation, may be adversely impacted by a wide range of factors, many of which are beyond Air Canada's control. Such factors include the performance of third parties, including suppliers, the implementation and integration of such initiatives into Air Canada's other activities and processes as well as the adoption and acceptance of initiatives by Air Canada'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 Air Canada's ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

For instance, a key component of Air Canada's business plan is the completion of Air Canada's fleet restructuring program through the acquisition of new and more efficient Boeing 787 aircraft. A delay or failure in the completion of Air Canada's fleet restructuring, including further delays by the manufacturers in the delivery of the 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 Air Canada's business plan which may, in turn, have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Dependence on Technology

Air Canada relies heavily on technology, 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 Air Canada'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 third party suppliers' acts or omissions, natural disasters, terrorist attacks, telecommunications failures, power failures, computer viruses, unauthorized or fraudulent users, and other operational and security issues. While Air Canada 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, interruption or misuse could materially and adversely affect Air Canada's operations and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key Supplies and Suppliers

The Corporation is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and Air Canada is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services in a timely manner, including those available at airports or from airport authorities or otherwise required for Air Canada's operations such as fuel, aircraft and related parts and aircraft maintenance services (including maintenance services obtained from Aveos). In certain cases, Air Canada may only be able to access goods and services from a limited number of suppliers and transition to new suppliers may take significant amounts of time and require significant resources. A failure, refusal or inability of a supplier may arise as a result of a wide range of causes, many of which are beyond Air Canada's control. In addition, in the context of the current economic climate, there can be no assurance as to the continued viability of any of Air Canada's suppliers. Any failure or inability of Air Canada 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 Air Canada, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Aeroplan

Through its commercial agreement with Aeroplan LP ("Aeroplan"), Air Canada 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 Air Canada under the Aeroplan Commercial Participation and Services Agreement and in connection with the Aeroplan program®, or other unexpected interruptions of Aeroplan services which are beyond Air Canada's control, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Jazz

Under the CPA, Jazz provides Air Canada'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 Air Canada's mainline routes. Pursuant to the terms of the Jazz CPA, Air Canada pays Jazz a number of fees which are determined based upon certain costs incurred by Jazz. Air Canada also 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 Air Canada under the Jazz CPA, or other unexpected interruptions or cessation of Jazz's services which are beyond Air Canada's control could have a material adverse effect on Air Canada, its 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 Air Canada make certain minimum payments to Jazz regardless of the amount of flying done on its behalf by Jazz.

Star Alliance®

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

Interruptions or Disruptions in Service

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

Current Legal Proceedings

The European Commission, the United States Department of Justice and the Competition Bureau in Canada are investigating alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including Air Canada. Competition authorities have sought or requested information from Air Canada as part of their investigations. Air Canada is cooperating with these investigations, which are likely to lead, or have led, to proceedings against Air Canada and a number of airlines and other cargo operators in certain jurisdictions including in the European Union where all formal procedural steps preceding a decision have been completed. Air Canada 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.

During 2008, Air Canada recorded a provision of $125 million as a preliminary estimate. This is only an estimate based upon the current status of the investigations and proceedings and Air Canada's assessment as to the potential outcome for certain of them. This provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Management has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings and investigations. Additional material provisions may be required and such provisions could have a material adverse effect on Air Canada's financial position.

In February 2006, Jazz commenced proceedings before the Ontario Superior Court of Justice against Porter Airlines Inc. ("Porter") and other defendants (collectively the "Porter Defendants") after Jazz became aware that it would be excluded from operating flights from Toronto City Centre (Island) Airport (the "TCCA"). On October 26, 2007, the Porter Defendants counter-claimed against Jazz and Air Canada alleging various violations of competition law, including that Jazz and Air Canada's commercial relationship contravenes Canadian competition laws, and claiming $850 million in damages. Concurrently with the Ontario

Superior Court of Justice proceedings, Jazz commenced judicial review proceedings against the Toronto Port Authority ("TPA") before the Federal Court of Canada relating to Jazz's access to the TCCA. The Porter Defendants were granted intervener and party status in these proceedings. In January of 2008, Porter filed a defence and counterclaim against Jazz and Air Canada making allegations and seeking conclusions similar to those in the Ontario Superior Court counterclaim. On October 16, 2009, Jazz discontinued its suit in the Ontario Superior Court against Porter. However, Jazz is continuing its proceedings in the Federal Court of Canada against the TPA, to which Porter intervened. The counterclaim filed by Porter in the Ontario Court against Jazz and Air Canada has been stayed pending the outcome of the mirror counterclaim in the Federal Court. Management views Porter's counterclaims in both jurisdictions as being without merit.

The Canadian Union of Public Employees ("CUPE"), which represents Air Canada's flight attendants, has filed a complaint 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 complaint dates from 1991 but has 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 complaint. On March 16, 2007, the Canadian Human Rights Commission referred the complaint against Air Canada for investigation. Air Canada considers that any investigation will show that it is complying with the equal pay provisions of the Canadian Human Rights Act, however, Management has determined that it is not possible at this time to predict with any degree of certainty the final outcome of the Commission's investigation.

Air Canada is engaged in a number of proceedings involving challenges to the mandatory retirement provisions of certain of its collective agreements, including the Air Canada-Air Canada Pilots Association collective agreement which incorporate provisions of the pension plan terms and conditions applicable to pilots requiring them to retire at age 60. Air Canada is defending these challenges. At this time, it is not possible to determine with any degree of certainty the extent of any financial liability that may arise from Air Canada being unsuccessful in its defense of these proceedings, though any such financial liability, if imposed, would not be expected to be material.

Future Legal Proceedings
Airlines are susceptible to various claims and litigation, including class action claims, in the course of operating their business or with respect to the interpretation of existing agreements. Any future claims or litigation could also have a material adverse effect on Air Canada, its business and results from operations.

Key Personnel
Air Canada 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 airline industry

Terrorist Attacks and Security Measures
The September 11, 2001 terrorist attacks and subsequent terrorist activity, notably in the Middle East, Southeast Asia, Europe and the U.S., causes uncertainty in the minds of the traveling public. The occurrence of a terrorist attack (or attempted attacks) (whether domestic or international and whether involving Air Canada or another carrier or no carrier at all) and increasingly restrictive security measures, such as current restrictions on the content of carry-on baggage, current or proposed passenger identification document requirements, and passenger screening procedures could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada's flights. It could also lead to a substantial increase in insurance, 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 Air Canada, its business, results from operations and financial condition.

Epidemic Diseases (Severe Acute Respiratory Syndrome (SARS), H1N1 Influenza or Other Epidemic Diseases)

The international outbreaks of Severe Acute Respiratory Syndrome (SARS) in 2003 and the resulting actions tabled by the World Health Organization (the "WHO"), including a travel advisory against non-essential travel to Toronto, Canada, had a significant adverse effect on passenger demand for air travel in Air Canada's markets and resulted in a major negative impact on traffic on the entire network. Air Canada is continuing to monitor the H1N1 influenza virus risk. While Air Canada has developed contingency plans related to the H1N1 influenza virus risk, it is unable to predict the likelihood of this risk materializing or the impact on its operations to the extent this risk does materialize. An outbreak of influenza, SARS, H1N1 influenza virus or of another epidemic disease (whether domestic or international) or any WHO travel advisories (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. Any resulting reduction in traffic in the markets served by Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Casualty Losses

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

Seasonal Nature of the Business, Other Factors and Prior Performance

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

As described elsewhere, demand for and cost of air travel is also affected by factors such as geopolitical and 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, privacy, licensing, competition, environment (including noise levels and carbon emissions) and, in some measure, pricing.

For example, new and proposed legislation have been considered or adopted concerning carbon emissions emanating from the aviation industry; such legislative initiatives include, for example, market-based mechanisms called emissions trading systems which are being proposed and implemented to reduce the amount of carbon emissions through the setting of emissions allowances and charging aircraft operators for a certain percentage of these allowances. The implementation of additional regulations or decisions, including those relating to carbon emissions, and others, whether by Transport Canada, the Competition Bureau and/or the Competition Tribunal, the Canadian Transportation Agency or other domestic or foreign governmental entities, may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

The European Union passed legislation for an Emissions Trading System which will include carbon emissions from aviation commencing in January 2012, including for flights operated between Canada and countries within the European Union. The legislation would require aircraft operators to monitor and report on fuel use and emissions data. While this legislation would be expected to result in increased costs relating to the purchase of emissions allowances, the net financial impact would, in part, depend upon how much of such cost, if any, would be recoverable in the form of higher passenger and cargo fares.

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 Air Canada, its international operations.

Air Canada is subject to domestic and foreign laws regarding privacy of passenger and employee data, including advance passenger information and access to airline reservation systems, which are not consistent in all countries in which Air Canada operates. The need to comply with these regulatory regimes is expected to result in additional operating costs and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

There can be no assurances that new laws, regulations or revisions to same, or decisions, will not be adopted or rendered, from time to time, and these could impose additional requirements or restrictions, which may adversely impact Air Canada's business, results from operations and financial condition.

Increased Insurance Costs

Since September 11, 2001 the aviation insurance industry has been continually re-evaluating the terrorism risks that it covers, and this activity may adversely affect some of Air Canada's existing insurance carriers or Air Canada's ability to obtain future insurance coverage. To the extent that Air Canada's existing insurance carriers are unable or unwilling to provide it with insurance coverage, and in the absence of measures by the Government of Canada to provide the required coverage, Air Canada's insurance costs may increase further and may result in Air Canada being in breach of regulatory requirements or contractual arrangements requiring that specific insurance be maintained, which may have a material adverse effect on Air Canada, its 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 Air Canada 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, Air Canada and other industry participants would have to turn to the commercial insurance market to seek such coverage. Air Canada estimates that such coverage would cost Air Canada approximately $5 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.

Risks related to the Corporation's relationship with ACE

Control of Air Canada and Related Party Relationship

As at September 30, 2009, ACE owned Class B voting shares representing 75% of the shares issued and outstanding. This voting control enabled ACE to determine substantially all matters requiring security holder approval as a result of its voting interest in Air Canada. Accordingly, ACE would have been able to exercise control over corporate transactions that must be submitted to Air Canada's security holders for approval and effectively has sufficient voting power to effect or prevent a change in control of Air Canada. Following completion of the offering, as described in section 6 of this MD&A, and the issuance of shares under the Pension MOUs, ACE's ownership is reported to represent 27% of the shares issued and outstanding, however, ACE remains the largest shareholder of Air Canada. The extent of ACE's shareholdings in Air Canada may discourage transactions involving shares in 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. The exercise, if any, by lenders other than ACE of the initial warrants and additional warrants under the Credit Agreement would further dilute ACE's shareholdings in Air Canada.

Future Sales of Shares by or for ACE

ACE generally has the right at any time to spin-off the Air Canada shares that it owns or to sell a significant interest in Air Canada to a third party, in either case without the approval of the public shareholders of Air Canada and without providing for a purchase of such shareholders' shares of Air Canada, subject to compliance with applicable securities laws. Sales of substantial amounts of Air Canada's shares by ACE (including through a distribution of Air Canada's shares to ACE shareholders), or the perception or possibility of those sales by ACE, could adversely affect the market price of the shares and/or impede Air Canada's ability to raise capital through the issuance of equity securities.

ACE has no contractual obligation to retain any of its Air Canada shares. The Registration Rights Agreement that Air Canada entered into with ACE concurrently with its initial public offering granted 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.

20. CONTROLS AND PROCEDURES

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

Internal controls over financial reporting have been designed by management, with the participation of the Corporation's President and Chief Executive Officer ("CEO") and the Executive Vice President and Chief Financial Officer ("CFO"), to provide reasonable assurance regarding the reliability of the Corporation's financial reporting and its preparation of financial statements for external purposes in accordance with GAAP.

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

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

Management's report on disclosure controls and procedures
Management, with the participation of the Corporation's CEO and CFO, assessed the effectiveness of the Corporation's disclosure controls and processes and concluded, as at December 31, 2009, that such disclosure controls and processes were effective to provide reasonable assurance that:

(i) material information relating to the Corporation was made known to its Disclosure Policy Committee by others; and

(ii) information required to be disclosed by the Corporation in its annual filings, interim filings and other reports filed or submitted by the Corporation under securities legislation was recorded, processed, summarized and reported within the time periods specified in securities legislation.

Management's report on internal controls over financial reporting
Management, with the participation of the Corporation's CEO and CFO, assessed the effectiveness of the Corporation's internal controls over financial reporting. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control - Integrated Framework. Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2009, the Corporation's internal controls over financial reporting were effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. This evaluation took into consideration the Corporation's Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee.

Changes in internal controls over financial reporting
There have been no changes to the Corporation's internal controls over financial reporting during the year ended December 31, 2009 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

21. NON-GAAP FINANCIAL MEASURES

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation and amortization, and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation and amortization, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Air Canada presents EBITDAR before and after the provision for cargo investigations and proceedings as this item could potentially distort the analysis of trends in business performance. 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 before the provision for cargo investigations and proceedings and EBITDAR for Air Canada are reconciled to operating income (loss) as follows:

(Canadian dollars in millions)	Fourth Quarter			Full Year		
	2009	2008	Change $	2009	2008	Change $
GAAP operating loss before the provision for cargo investigations	$ (83)	$ (146)	$ 63	$ (316)	$ (39)	$ (277)
Add back:						
Aircraft rent	85	80	5	335	279	56
Depreciation and amortization	165	174	(9)	660	694	(34)
EBITDAR before the provision for cargo investigations	**167**	**108**	**59**	**679**	**934**	**(255)**
Add back:						
Provision for cargo investigations	-	-	-	-	(125)	125
EBITDAR	**$ 167**	**$ 108**	**$ 59**	**$ 679**	**$ 809**	**$ (130)**

Operating expense excluding fuel expense

Air Canada uses operating expense excluding fuel expense to assess the operating performance of its ongoing business without the effects of fuel expense as it could potentially distort the analysis of trends in business performance. Fuel expense fluctuates widely depending on many factors including international market conditions, geopolitical events and the Canada/U.S. exchange rate, and excluding this expense from GAAP results analysis allows Air Canada to compare its operating performance on a consistent basis. 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 expense, excluding fuel expense, for Air Canada is reconciled to operating expense as follows:

(Canadian dollars in millions)	Fourth Quarter			Full Year		
	2009	2008	Change $	2009	2008	Change $
GAAP operating expense	$ 2,431	$ 2,644	$ (213)	$ 10,055	$ 11,121	$ (1,066)
Remove:						
Aircraft fuel	(601)	(792)	191	(2,448)	(3,419)	971
Operating expense, excluding fuel expense	**$ 1,830**	**$ 1,852**	**$ (22)**	**$ 7,607**	**$ 7,702**	**$ (95)**

22. 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 and amortization, and aircraft rent and is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation and amortization, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Refer to section 21 of this MD&A for additional information.

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.

Yield — Average passenger revenue per RPM.

MANAGEMENT'S REPORT

The consolidated financial statements have been prepared by management. Management is responsible for the fair presentation of the consolidated financial statements 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 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 over the safeguarding of assets and over the completeness, fairness and accuracy of the 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 consolidated financial statements, management's discussion and analysis and annual report disclosures prior to their release. The Audit, Finance and Risk Committee meets 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 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 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.

Michael Rousseau
Executive Vice President &
Chief Financial Officer

Calin Rovinescu
President &
Chief Executive Officer

AUDITORS' REPORT

TO THE SHAREHOLDERS OF AIR CANADA

We have audited the consolidated statements of financial position of Air Canada as at December 31, 2009 and December 31, 2008 and the consolidated statements of operations, changes in shareholders' equity, comprehensive income (loss) and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Corporation as at December 31, 2009 and December 31, 2008 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 [1]

Chartered Accountants
Montreal, Quebec
February 9, 2010

[1] Chartered accountant auditor permit No. 18144

"PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP/s .r.l./s.e.n.c.r.l., an Ontario limited liability partnership, or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

CONSOLIDATED STATEMENT OF OPERATIONS

For the year ended December 31 (Canadian dollars in millions except per share figures)		2009	2008
Operating revenues			
Passenger		$ 8,499	$ 9,713
Cargo		358	515
Other		882	854
		9,739	11,082
Operating expenses			
Aircraft fuel		2,448	3,419
Wages, salaries and benefits		1,751	1,877
Airport and navigation fees		971	1,001
Capacity purchase with Jazz	Note 2D	973	948
Depreciation and amortization	Notes 3 &4	660	694
Aircraft maintenance		759	659
Food, beverages and supplies		291	314
Communications and information technology		293	286
Aircraft rent		335	279
Commissions		186	194
Other		1,388	1,450
		10,055	11,121
Operating loss before under noted item		**(316)**	**(39)**
Provision for cargo investigations	Note 17	–	(125)
Operating loss		**(316)**	**(164)**
Non-operating income (expense)			
Interest income		14	57
Interest expense		(373)	(319)
Interest capitalized		4	37
Loss on assets	Note 3	(95)	(34)
Gain on financial instruments recorded at fair value	Note 15	95	92
Other		–	(3)
		(355)	(170)
Loss before the following items		**(671)**	**(334)**
Non-controlling interest		(15)	(12)
Foreign exchange gain (loss)		657	(655)
Recovery of (provision for) income taxes			
Current	Note 7	7	(1)
Future	Note 7	(2)	(23)
Loss for the year		**$ (24)**	**$ (1,025)**
Loss per share			
Basic and diluted	Note 12	$ (0.18)	$ (10.25)

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

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

As at December 31 (Canadian dollars in millions)		2009	2008
ASSETS			
Current			
Cash and cash equivalents	Note 2O	$ 1,115	$ 499
Short-term investments	Note 2P	292	506
		1,407	1,005
Restricted cash	Note 2Q	78	45
Accounts receivable	Note 18	701	702
Aircraft fuel inventory		63	97
Spare parts and supplies	Note 1C	64	20
Collateral deposits for fuel derivatives	Note 15	43	328
Prepaid expenses and other current assets	Note 18	295	206
		2,651	2,403
Property and equipment	Note 3	6,369	7,469
Intangible assets	Note 4	916	997
Deposits and other assets	Note 5	470	495
		$ 10,406	**$ 11,364**
LIABILITIES			
Current			
Accounts payable and accrued liabilities	Note 18	$ 1,215	$ 1,262
Fuel derivatives	Note 15	31	420
Advance ticket sales		1,288	1,333
Current portion of long-term debt and capital leases	Note 6	468	663
		3,002	3,678
Long-term debt and capital leases	Note 6	4,054	4,691
Future income taxes	Note 7	85	88
Pension and other benefit liabilities	Note 8	1,163	1,585
Other long-term liabilities	Note 9	455	370
		8,759	10,412
Non-controlling interest		201	190
SHAREHOLDERS' EQUITY			
Share capital	Note 11	532	274
Contributed surplus		1,825	1,797
Deficit		(727)	(703)
Accumulated other comprehensive loss	Notes 2L &15	(184)	(606)
		1,446	762
		$ 10,406	**$ 11,364**

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

Commitments (Note 14); Contingencies, Guarantees, and Indemnities (Note 17)

On behalf of the Board of Directors:

Signed
David I. Richardson
Chairman

Signed
Michael M. Green
Chair of the Audit, Finance and Risk Committee

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

For the year ended December 31 (Canadian dollars in millions)		2009	2008
Share Capital			
Common shares, beginning of year		$ 274	$ 274
Shares issued under the pension MOUs	Note 8	28	-
Shares issued under the public offering	Note 11	230	-
Total share capital		532	274
Contributed surplus			
Balance, beginning of year		1,797	1,791
Fair value of stock-based compensation issued to employees recognized as compensation expense (recovery)	Note 10	2	(5)
Warrants issued under the credit facility	Note 6	7	-
Warrants issued under the public offering	Note 11	19	-
Proceeds from intercompany agreements	Note 18	-	11
Total contributed surplus		1,825	1,797
Retained earnings (deficit)			
Balance, beginning of year		(703)	322
Loss for the year		(24)	(1,025)
Deficit		(727)	(703)
Accumulated other comprehensive income (loss)			
Balance, beginning of year		(606)	56
Other comprehensive income (loss)		422	(662)
Total accumulated other comprehensive loss		(184)	(606)
Total deficit and accumulated other comprehensive loss		(911)	(1,309)
Total shareholders' equity		**$ 1,446**	**$ 762**

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS)

For the year ended December 31 (Canadian dollars in millions)		2009	2008
Comprehensive income (loss)			
Loss for the year		$ (24)	$ (1,025)
Other comprehensive income (loss), net of taxes:			
Net losses on fuel derivatives under hedge accounting, net of taxes	Note 15	(1)	(605)
Reclassification of net realized losses (gains) on fuel derivatives to income, net of taxes	Note 15	423	(57)
		422	(662)
Total comprehensive income (loss)		**$ 398**	**$ (1,687)**

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

CONSOLIDATED STATEMENT OF CASH FLOW

For the year ended December 31 (Canadian dollars in millions)		2009	2008
Cash flows from (used for)			
Operating			
Loss for the year		$ (24)	$ (1,025)
Adjustments to reconcile to net cash from operations			
Depreciation and amortization		660	694
Loss on assets		95	34
Foreign exchange (gain) loss		(633)	822
Future income taxes		2	23
Excess of employee future benefit funding over expense		(368)	(316)
Provision for cargo investigations	Note 17	-	125
Non-controlling interest		15	12
Fuel and other derivatives	Note 15	41	(208)
Fuel hedge collateral deposits, net	Note 15	268	(322)
Changes in non-cash working capital balances		(234)	117
Other		11	(58)
		(167)	**(102)**
Financing			
Borrowings	Note 6	926	871
Shares issued under the public offering	Note 11	230	-
Warrants issued under the public offering and credit facility	Notes 6 & 11	26	-
Reduction of long-term debt and capital lease obligations		(1,237)	(992)
Other		-	5
		(55)	**(116)**
Investing			
Short-term investments		214	206
Additions to capital assets		(232)	(883)
Proceeds from contractual commitments	Note 1C	230	-
Proceeds from sale of assets	Note 3	103	38
Proceeds from sale-leaseback transactions	Note 3	552	708
Funding of Aveos letter of credit	Note 18	-	59
Other		(29)	62
		838	**190**
Increase (decrease) in cash and cash equivalents		**616**	**(28)**
Cash and cash equivalents, beginning of year		499	527
Cash and cash equivalents, end of year		**$ 1,115**	**$ 499**

Cash and cash equivalents exclude Short-term investments of $292 as at December 31, 2009 (2008 - $506).

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

For the Years Ended December 31, 2009 and 2008 (Currencies in millions – Canadian dollars)

1. BASIS OF PRESENTATION, NATURE OF OPERATIONS AND SIGNIFICANT EVENTS

A) BASIS OF PRESENTATION

The accompanying consolidated financial statements are of Air Canada (the "Corporation"). ACE Aviation Holdings Inc. ("ACE") holds a 27% ownership interest in the Corporation as at December 31, 2009. The term "Corporation" refers to, as the context may require, Air Canada and/or one or more of Air Canada's subsidiaries.

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

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

B) NATURE OF OPERATIONS

The consolidated financial statements of Air Canada include wholly-owned subsidiaries of Air Canada, including Air Canada Cargo Limited Partnership ("Air Canada Cargo") up to and including November 30, 2009, ACGHS Limited Partnership ("Air Canada Ground Handling Services" or "ACGHS") up to and including November 30, 2009 and Touram Limited Partnership ("Air Canada Vacations"). These consolidated financial statements also include certain aircraft and engine leasing entities and fuel facility corporations, which are consolidated under Accounting Guideline 15 – Consolidation of Variable Interest Entities (Note 2Z).

Effective December 1, 2009, the operations of Air Canada Cargo and Air Canada Ground Handling Services, previously operated by wholly-owned subsidiaries of Air Canada, were wound up into Air Canada and are now operated as divisions of Air Canada. These wind-ups had no impact on the consolidated financial statements.

Air Canada is Canada's largest domestic and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-US transborder market as well as the international markets to and from Canada. Certain of the scheduled passenger services offered on domestic and Canada-US transborder routes are provided by Jazz Air LP ("Jazz") through a capacity purchase agreement between Air Canada and Jazz (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 passenger charter services.

Air Canada offers air cargo services on domestic and US transborder routes using cargo capacity on aircraft operated by Air Canada and Jazz. (Prior to December 1, 2009, these services were provided by Air Canada Cargo). Air Canada offers international cargo services on routes between Canada and major markets in Europe, Asia, South America and Australia using cargo capacity on Boeing 777 and other wide body aircraft operated by Air Canada.

Air Canada Ground Handling Services provided passenger handling services to Air Canada, Jazz and other airlines with a primary focus on Canadian stations. Services covered included passenger check-in, gate management, baggage and cargo handling and processing, cabin cleaning, de-icing as well as aircraft ramp services. Effective December 1, 2009 with the wind-up of ACGHS, Air Canada offers these services directly.

Air Canada Vacations is one of Canada's leading tour operators. Based in Montreal and Toronto, it operates its business in the outgoing leisure travel market (Caribbean, Mexico, USA, Europe, South America and Asia) by developing, marketing and distributing vacation travel packages and services through a network of independent travel agencies in Canada as well as through the Air Canada Vacations website, aircanadavacations.com.

Air Canada is managed as one reportable segment based on how financial information is produced internally for the purposes of making operating decisions.

C) SIGNIFICANT EVENTS

During 2009, the Corporation entered into the following transactions in an effort to mitigate the Corporation's liquidity risks as described in Note 15 (refer to Notes 3, 6 and 11 for additional detail on these financing activities):

During the fourth quarter of 2009

- Completed a share and warrant public offering for net proceeds of $249 (refer to Note 11 for further details).

During the third quarter of 2009

- Completed a secured term credit facility (the "Credit Facility") for financing proceeds of $600, less fees of $20. The Credit Facility is a five-year facility, with the first principal repayment due in August 2010, and currently bears interest at 12.75%. Under the Credit Facility, 10 million warrants were issued which entitle the debt holders to acquire up to 10 million shares in the Corporation, as further described in Note 6. As part of the transactions related to the closing of the Credit Facility, existing financing arrangements of $166 were repaid as follows:
    - The revolving credit facility, as further described in Note 6L, was repaid in the amount of $49. The rights of the lender under the revolving credit facility were assigned to the lenders under the Credit Facility;
    - The spare engine financing agreement, as further described in Note 6J, was partially repaid in the amount of $38. This represented the repayment related to 22 engines under a spare engine financing agreement, with 10 engines remaining under the agreement with a loan value of $72 as at December 31, 2009;
    - The Aeroplan Canada Inc. ("Aeroplan") loan, as further described below, was repaid in the amount of $79. Aeroplan is a participating lender under the Credit Facility.
- Extended or renewed labour agreements for 21 months with all of the Corporation's Canadian-based unions were completed by July 2009. The agreements provide for no increases to wage rates, no changes to group insurance coverage or benefits, or pension benefit levels during the contract extension or renewal periods;
- Pension funding agreements with all of the Corporation's Canadian-based unions (the "Pension MOUs") and the adoption of the Air Canada Pension Funding Regulations, 2009 (the "Air Canada 2009 Pension Regulations"). The Air Canada 2009 Pension Regulations relieve the Corporation from making any special (past service cost) payments for the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contributions shall equal the lesser of (i) $150, $175, and $225 in respect of 2011, 2012, and 2013, respectively and (ii) the maximum past service contributions permitted under the Income Tax Act. Pursuant to the Pension MOUs, on October 26, 2009 the Corporation issued, to a trust, 17,647,059 Class B Voting Shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of the sale of such shares held by the trust are to be contributed to the pension plans;
- An agreement with a supplier for non-refundable proceeds of $230 in consideration of various contractual commitments. For accounting purposes, the recognition of these proceeds was deferred in order to be applied to reduce the cost of these contractual commitments as they are incurred;
- Amendments to credit card processing agreements with one of its principal credit card processors to revise the levels of unrestricted cash (as defined per the agreement and generally based on the aggregate sums of Cash and cash equivalents and Short-term investments) required to be maintained as described further in Note 15;
- An extension of the repayment date of a short-term loan of $78 (US$75) entered into in 2008, which was originally due in 2009, to 2013. This loan is described in Note 6F;

- A memorandum of understanding with GE Capital Aviation Services (the "GECAS MOU") for the sale and leaseback of three Boeing 777 aircraft. The sale and leaseback transactions were substantially completed in early November 2009 and provided initial net cash proceeds of $95 (net of deposits), with additional net proceeds of $20 received in January 2010 upon completion of the remaining part of the transaction; and

- An agreement amending the terms of the Jazz CPA, effective August 1, 2009, which provides for a reduction to rates paid under the agreement.

During the second quarter of 2009

- A secured loan with Aeroplan for net proceeds of $79. This loan, as described above, was terminated in July 2009 pursuant to the transactions relating to the Credit Facility.

During the first quarter of 2009

- Financing arrangements secured by spare parts, spare engines and a Boeing 777 aircraft for aggregate proceeds of $267, net of fees of $8. The spare engine financing was partially repaid in July 2009, as described above;

- Sale-leaseback of a Boeing 777 aircraft for aggregate proceeds of $172 and the required repayment of a debt obligation related to the aircraft of $128, which included a prepayment fee of $14;

- Repayment of pre-delivery financing of $83 on the Boeing 777 aircraft received during the first quarter; and;

During 2009, Air Canada entered into various inventory financing arrangements under which it acquired $117 of spare parts inventories in exchange for the issuance of bills of exchange. Subsequent to the arrangements, Air Canada completed various transactions in relation to certain bills of exchange resulting in gains of $4 being recorded in non-operating income (expense) in 2009. As at December 31, 2009, the remaining inventory is valued at $43 which represents its estimated net realizable value and the expected final payment due in 2010 under the financing arrangements is $11 (US$11).

In addition, during the year, the net return of collateral deposits on fuel derivatives amounted to $285, while the settlement of fuel derivative contracts in favour of counterparties amounted to $280 (refer to Note 15 for additional information on fuel price risk management activities).

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A) PRINCIPLES OF CONSOLIDATION

These consolidated financial statements include the accounts of all entities controlled by Air Canada, with adjustments for non-controlling interests. The consolidated financial statements of the Corporation include the accounts of variable interest entities for which the Corporation is the primary beneficiary. All inter-company balances and transactions are eliminated.

B) 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 consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Significant estimates made in the preparation of the consolidated financial statements include those used in accounting for employee future benefits (Note 8), accounting for income taxes (Note 7), the determination of passenger revenues, the determination of amortization period for long-lived assets, the impairment considerations on long-lived assets and the carrying value of financial instruments recorded at fair value.

C) PASSENGER AND CARGO REVENUES

Airline passenger and cargo advance sales are deferred and included in Current liabilities. Advance sales also include the proceeds from the sale of flight tickets to Aeroplan, a corporation that provides loyalty program services to Air Canada and purchases seats from Air Canada pursuant to the Commercial Participation and Services Agreement between Aeroplan and Air Canada (the “CPSA”) (Note 14). 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.

D) CAPACITY PURCHASE AGREEMENTS – JAZZ & TIER III CARRIERS

Air Canada has capacity purchase agreements with Jazz and certain other regional carriers, which are referred to as Tier III carriers, operating aircraft of 18 seats or less. Under these agreements, Air Canada markets, tickets and enters into other commercial arrangements relating to these flights and records the revenue it earns under Passenger revenue. Operating expenses under capacity purchase agreements include the capacity purchase fees, which, under the Jazz CPA, include a variable component that is dependent on Jazz aircraft utilization, a fixed component and pass-through costs. Pass-through costs are non-marked-up costs charged to the Corporation and include fuel, airport and user fees and other costs. These expenses are recorded in the applicable category within Operating expenses.

The following table outlines expenses and pass through costs under the Jazz CPA for the last two years:

	2009	2008
Expenses from Jazz CPA	$ 973	$ 948
Pass through fuel expense from Jazz CPA	253	427
Pass through airport expense from Jazz CPA	196	201
Pass through other expense from Jazz CPA	35	38
	$ 1,457	**$ 1,614**

Due to terms of the Jazz CPA, Jazz is deemed to be a variable interest entity. Notwithstanding that Air Canada is not the primary beneficiary of Jazz, Air Canada holds a significant variable interest in Jazz through the contractual arrangements with Jazz as described in Note 14.

As discussed in Note 1C, the Corporation entered into an agreement amending the terms of the Jazz CPA effective August 1, 2009. This amending agreement provides for (i) a reduction to rates paid under the Jazz CPA based on a reduction in the mark-up rate paid to Jazz on the first 375,000 block hours of annual flying from 16.7% to 12.5% and from 16.7% to 5% on annual block hours above 375,000; (ii) a reduction in Air Canada's commitment to Jazz's minimum fleet from 133 to 125 aircraft; (iii) a contract term extension of five years (from January 1, 2016 to December 31, 2020), during which the rates will be subject to a benchmarking review; and (iv) a commitment to work together on Jazz's turboprop fleet renewal strategy over the term of the contract.

E) 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 CPSA, 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 occurs upon the qualifying air travel being provided to the customer.

F) OTHER REVENUES

Other revenue includes revenues from the sale of the ground portion of vacation packages, ground handling services and other airline related services. 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.

Other revenue also includes revenue related to the lease or sublease of aircraft to third parties. Lease or sublease revenues are recognized on a straight line basis over the term of the lease or sublease. Rental revenue from operating leases and subleases amounted to $126 in 2009 (2008 - $115).

In certain subleases of aircraft to Jazz, the Corporation reports the sublease revenues net against aircraft rent expense as the terms of the sublease match the terms of the Corporation's lease. The Corporation acts as lessee and sublessor in these matters. Refer to Note 14 for the lease commitments under these arrangements.

The Corporation provides certain services to related parties, namely ACE and Aveos Fleet Performance Inc. ("Aveos"), and former related parties consisting principally of administrative services in relation to information technology, human resources, finance and accounting, treasury and tax services, corporate real estate, and environmental affairs. 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.

G) EMPLOYEE FUTURE BENEFITS

The cost of pensions, other post-retirement and post-employment benefits earned by employees is actuarially determined annually as at December 31. The cost is 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 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 four years.

Past service costs arising from plan amendments are amortized on a straight-line basis over the expected average remaining service period of employees active at the date of amendment. This period does not exceed the expected average remaining service period of such employees up to the full eligibility date. The expected average remaining service period of active employees (or expected average remaining life expectancy of retired members for a plan with no active members) is between 7 and 16 years for pension plans and between 10 and 11 years for post retirement and post employment benefit plans.

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 expected remaining service life of active employees.

As described in Note 8, certain Corporation employees perform work for ACE and Aveos and are members of Corporation-sponsored defined benefit pension plans and also participate in Corporation-sponsored health, life and disability benefit plans. Other Corporation employees performed work for Aeroplan until the date of transition to employment at Aeroplan and then ceased to accrue benefits under the Corporation-sponsored defined benefit pension plans and under the Corporation-sponsored health, life and disability benefit plans. These consolidated financial statements include all of the assets and liabilities of all sponsored plans of the Corporation. Pension and other employee benefits expenses are recorded net of costs recovered from these entities pertaining to employees contractually assigned by the Corporation to these entities based on an agreed upon formula. The cost recovery reduces the Corporation's benefit cost.

H) EMPLOYEE PROFIT SHARING PLAN

The Corporation has an employee profit sharing plan. Expenses 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.

I) STOCK-BASED COMPENSATION PLANS

Certain employees of the Corporation participate in Air Canada's Long-Term Incentive Plan, which provide for the grant of stock options and Performance Share Units ("PSUs"), as further described in Note 10.

The Corporation changed its accounting policy for awards of stock based compensation granted to Corporation employees with a graded vesting schedule. Prior to January 1, 2009, the fair value of stock options with a graded vesting schedule was recognized as compensation expense and a credit to Contributed surplus on a straight line basis over the applicable vesting period. Effective January 1, 2009, the fair value of stock options with a graded vesting schedule is determined based on different expected lives for the options that vest each year, as it would be if the award were viewed as several separate awards, each with a different vesting date, and it is accounted for on that basis. The new accounting policy provides more reliable and relevant information about the effects of the transactions. For a stock option award attributable to an employee who is eligible to retire at the grant date, the fair value of the stock option award is expensed on the grant date. For a stock option award attributable to an employee who will become eligible to retire during the vesting period, the fair value of the stock option 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 options at that date.

The impact of the change in accounting policy for awards granted to Corporation employees with a graded vesting schedule was immaterial to any prior period and therefore no adjustments were made to such prior periods.

For grants of PSUs that are accounted for as equity settled instruments, the Corporation recognizes Compensation expense offset by Contributed surplus equal to the market value of an Air Canada common share at the date of grant on a straight line basis over the applicable vesting period. Compensation expense is adjusted for subsequent changes in management's estimate of the number of PSUs that are expected to vest. For grants of PSUs that are accounted for as cash settled instruments, the Corporation recognizes Compensation expense offset by Other long-term liabilities equal to the market value of an Air Canada common share at the date of grant on a straight line basis over the applicable vesting period. Compensation expense is adjusted for subsequent changes in the market value of Air Canada common shares and management's estimate of the number of PSUs that are expected to vest.

Air Canada also maintains an employee share purchase plan. Under this plan, contributions by the Corporation's employees are matched to a specific percentage by the Corporation. Employees must remain with the Corporation until March 31 of the subsequent year for vesting of the Corporation's contributions. These contributions are included in Wages, salaries, and benefits expense as earned.

J) MAINTENANCE AND REPAIRS

Maintenance and repair costs for both leased and owned aircraft, including line maintenance, component overhaul and repair, and maintenance checks, 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. Line maintenance consists of routine daily and weekly scheduled maintenance inspections and checks, overhaul and repair involves the inspection or replacements of major parts, and maintenance checks consist of more complex inspections and servicing of the aircraft.

K) 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.

L) FINANCIAL INSTRUMENTS AND HEDGE ACCOUNTING

Under the Corporation's risk management policy derivative financial instruments are used only for risk management purposes and not for generating trading profits.

Financial assets and financial liabilities, including derivatives, are recognized on the Consolidated Statement of Financial Position when the Corporation becomes a party to the contractual provisions of the financial instrument or non-financial derivative contract. All financial instruments are required to be measured at fair value on initial recognition except for certain related party transactions. Effective January 1, 2009, the Corporation adopted the recommendations of the Emerging Issues Committee of the CICA relating to Abstract EIC-173 *Credit Risk and the Fair Value of Financial Assets and Financial Liabilities*. Under this Abstract, the Corporation's own credit risk and the credit risk of the counterparty are taken into consideration in determining the fair value of financial assets and financial liabilities, including derivative instruments. The adoption of this guidance had no significant impact on the Corporation's consolidated financial statements as collateral deposits with fuel derivative counterparties and master netting arrangements are considered in determining whether a credit risk adjustment is required on the valuation of the derivatives. Measurement in subsequent periods is dependent upon the classification of the financial instrument as held-for-trading, held-to-maturity, available-for-sale, loans and receivables, or other financial liabilities. The held-for-trading classification is applied when an entity is "trading" in an instrument or alternatively the standard permits that any financial instrument be irrevocably designated as held-for-trading. The held-to-maturity classification is applied only if the asset has specified characteristics and the entity has the ability and intent to hold the asset until maturity. For financial instruments classified as other than held-for-trading, transaction costs are added to the initial fair value of the related financial instrument.

Financial assets and financial liabilities classified as held-for-trading are measured at fair value with changes in those fair values recognized in Non-operating income (expense). Financial assets classified as held-to-maturity, loans and receivables, or other financial liabilities are measured at amortized cost using the effective interest method of amortization.

The Corporation enters into interest rate, foreign currency, and fuel derivatives to manage the associated risks. Derivative instruments are recorded on the Consolidated Statement of Financial Position at fair value, including those derivatives that are embedded in financial or non-financial contracts. Changes in the fair value of derivative instruments are recognized in Non-operating income (expense) with the exception of foreign exchange risk management contracts, which are recorded in Foreign exchange gain (loss), and fuel derivatives designated as effective cash flow hedges, as further described below. These contracts are included in the Consolidated Statement of Financial Position at fair value in Prepaid expenses and other current assets, Deposits and other assets, Accounts payable and accrued liabilities, or Other long-term liabilities based on the terms of the contractual agreements. All cash flows associated with purchasing and selling derivatives are classified as operating cash flows in the Consolidated Statement of Cash Flow.

For financial instruments measured at amortized cost, transaction costs or fees, premiums or discounts earned or incurred are recorded, at inception, net against the fair value of the financial instrument. Interest expense is recorded using the effective interest method. For any guarantee issued that meets the definition of a guarantee pursuant to Accounting Guideline 14, *Disclosure of Guarantees*, the inception fair value of the obligation relating to the guarantee is recognized and amortized over the term of the guarantee. It is the Corporation's policy to not re-measure the fair value of the financial guarantee unless it qualifies as a derivative.

The Corporation has implemented the following classifications:

- Cash and cash equivalents and Short-term investments are classified as held-for-trading and any period change in fair value is recorded through interest income.

- Restricted cash is classified as held-for-trading.

- Aircraft related and other deposits are classified as held-to-maturity investments and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.

- Accounts receivable are classified as loans and receivables and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.

- Accounts payable, credit facilities, and bank loans are classified as other financial liabilities and are measured at amortized cost using the effective interest rate method. Interest income is recorded in net income, as applicable.

Effective January 1, 2009, the Corporation has adopted the enhanced disclosure requirements of amended CICA section 3862 *Financial Instruments – Disclosures*. Refer to Note 15 for a classification of fair value measurements recognized in the Consolidated Statement of Financial Position using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

Fuel Derivatives Under Hedge Accounting

Prior to the Corporation discontinuing hedge accounting for all fuel derivatives effective the third quarter of 2009 as described below, it had designated certain of its fuel derivatives as cash flow hedges. In a cash flow hedging relationship, the effective portion of the change in the fair value of the hedging derivative is recognized in Other comprehensive income ("OCI") while the ineffective portion is recognized in Non-operating income (expense). Upon maturity of the fuel derivatives, the effective gains and losses previously recognized in Accumulated OCI ("AOCI") are recorded in fuel expense.

Hedge accounting is discontinued prospectively when the derivative no longer qualifies as an effective hedge, or the derivative is terminated or sold, or upon the sale or early termination of the hedged item. The amounts previously recognized in AOCI are reclassified to fuel expense during the periods when the derivative matures. Refer to Note 15 for the impact of fuel derivatives during the year.

After considering the costs and benefits specific to the application of cash flow hedge accounting, the Corporation elected to discontinue hedge accounting for all fuel derivatives effective the third quarter of 2009. The derivative instruments will continue to be recorded at fair value in each period with both realized and unrealized changes in fair value recognized immediately in earnings in non-operating income (expense). Amounts deferred to AOCI for derivatives previously designated under hedge accounting will be taken into fuel expense in the period in which the derivative was originally scheduled to mature.

M) 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 Consolidated Statement of Financial Position. Non-monetary assets and liabilities, revenues and expenses arising from transactions denominated in foreign currencies, are translated at the historical exchange rate or the average exchange rate during the period, as applicable. Adjustments to the Canadian dollar equivalent of foreign denominated monetary assets and liabilities due to the impact of exchange rate changes are recognized in Foreign exchange gain (loss).

N) INCOME TAXES

The Corporation utilizes the asset and 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. Income taxes are recognized in the income statement except to the extent that it relates to items charged or credited to Shareholders' equity, in which case the taxes are netted with such items. The effect on future income tax assets and liabilities of a change in tax rates is recognized in earnings in the period when the change is substantively enacted. Future income tax assets are recognized to the extent that realization is considered more likely than not. The Corporation applied fresh start reporting on September 30, 2004 under which the assets and liabilities of the Corporation were comprehensively revalued, excluding goodwill ("fresh start"). The benefit of future income tax assets that existed at fresh start, and for which a valuation allowance is recorded, will be recognized first to reduce to nil any remaining intangible assets (on a pro-rata basis) that were recorded upon fresh start reporting with any remaining amount as a credit to Shareholders' equity. The benefit of future income tax assets that arise after fresh start will be recognized in the Consolidated Statement of Operations.

O) CASH AND CASH EQUIVALENTS

Cash includes $323 pertaining to investments with original maturities of three months or less at December 31, 2009 (2008 - $416). Investments include bankers' acceptances and bankers' discount notes, 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, 2009 is 0.29% (2008 - 2.06%).

P) 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, 2009 is 0.53% (2008 - 2.90%).

Q) RESTRICTED CASH

The Corporation has recorded $78 (2008 - $45) 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.

Restricted cash with maturities greater than one year from the balance sheet date is recorded in Deposits and other assets. This restricted cash relates to funds on deposit with various financial institutions as collateral for letters of credit and other items.

R) AIRCRAFT FUEL INVENTORY AND SPARE PARTS INVENTORY

Inventories of aircraft fuel and spare parts and supplies are measured at the lower of cost and net realizable value, with cost being determined using a weighted average formula.

The Corporation did not recognize any write-downs on inventories or reversals of any previous write-downs during the periods presented. Included in aircraft maintenance is $74 related to spare parts and supplies consumed during the year.

S) PROPERTY AND EQUIPMENT

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

Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Property and equipment under capital leases and within variable interest entities are depreciated to estimated residual values over the life of the lease. Aircraft and flight equipment, including spare engines and related parts ("rotables") are depreciated over 20 to 25 years, with 10% to 20% estimated residual values. Aircraft reconfiguration costs are amortized over 3 to 5 years. Betterments to owned aircraft are capitalized and amortized over the remaining service life of the aircraft. Betterments to aircraft on operating leases are amortized over the term of the lease.

Buildings are depreciated over their useful lives not exceeding 50 years on a straight line basis. 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.

T) 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 (Note 3) using the effective interest rate method. Capitalized interest also includes financing costs charged by the manufacturer on capital commitments as described in Note 14.

U) INTANGIBLE ASSETS

Effective January 1, 2009 the Corporation adopted the new CICA accounting standard section 3064, *Goodwill and Intangible Assets* which provides guidance on the recognition, measurement, presentation and disclosure for goodwill and intangible assets, other than the initial recognition of goodwill or intangible assets acquired in a business combination. The Corporation's accounting policy for intangible assets is consistent with the new standard and as a result, no adjustment was recorded on transition.

As a result of the application of fresh start reporting, intangible assets were recorded at their estimated fair values at September 30, 2004. For periods subsequent to September 30, 2004, intangible assets are initially recorded at cost. Indefinite life assets are not amortized while assets with finite lives are amortized on a straight line basis 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

V) 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 and recorded in the period. 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 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.

W) 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 Deposits and other assets and Other long-term liabilities are the differences between the straight line aircraft rent expense and the payments as stipulated under the lease agreement.

X) 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 through charges to income and any changes in the amount of the underlying cash flows through increases or decreases to the asset retirement obligation and related asset. A gain or loss may be incurred upon settlement of the liability.

Y) 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.

Z) VARIABLE INTEREST ENTITIES

Aircraft Leasing Transactions
The Corporation has aircraft 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 Corporation being the primary beneficiary of these VIEs, the Corporation consolidates leasing entities covering 44 aircraft.

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 Facility 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 \$181 and debt of approximately \$162, 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.

AA) FUTURE ACCOUNTING STANDARD CHANGES

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

Business Combinations, Consolidated Financial Statements and Non-controlling Interests
The CICA issued three new accounting standards in January 2009: section 1582, *Business Combinations*, section 1601, *Consolidated Financial Statements*, and section 1602, *Non-controlling interests*. These new standards will be effective for fiscal years beginning on or after January 1, 2011. The Corporation is in the process of evaluating the requirements of these new standards.

Section 1582 replaces section 1581, and establishes standards for the accounting for a business combination. It provides the Canadian equivalent to International Financial Reporting Standard IFRS 3 – *Business Combinations*. The section applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011.

Sections 1601 and 1602 together replace section 1600 – *Consolidated Financial Statements*. Section 1601, establishes standards for the preparation of consolidated financial statements. Section 1601 applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011. Section 1602 establishes standards for accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. It is equivalent to the corresponding provisions of International Financial Reporting Standard IAS 27 - *Consolidated and Separate Financial Statements* and applies to interim and annual consolidated financial statements relating to fiscal years beginning on or after January 1, 2011.

3. PROPERTY AND EQUIPMENT

	2009	2008
Cost		
Flight equipment, including spare engines (a)	$ 5,866	$ 6,235
Assets under capital leases (b)	1,959	1,940
Buildings, including leasehold improvements	688	643
Ground and other equipment	157	160
	8,670	8,978
Accumulated depreciation and amortization		
Flight equipment, including spare engines (a)	1,407	1,101
Assets under capital leases (b)	683	562
Buildings, including leasehold improvements	187	148
Ground and other equipment	62	49
	2,339	1,860
	6,331	**7,118**
Purchase deposits, including capitalized interest (c)	38	351
Property and equipment at net book value (d)	**$ 6,369**	**$ 7,469**

(a) Included in flight equipment as at December 31, 2009 are rotable parts, including spare engines with a cost of $821 (2008 - $798) less accumulated depreciation of $327 (2008 - $279) for a net book value of $494 (2008 - $519). Also included in flight equipment are 25 aircraft (2008 – 30 aircraft and 1 engine) which are leased to Jazz (Note 14) and third parties with a cost of $630 (2008 - $942) less accumulated depreciation of $253 (2008 - $289) for a net book value of $377 (2008 - $653).

(b) Included in capital leases as at December 31, 2009 are 40 aircraft (2008 - 41) with a cost of $1,893 (2008 - $1,874) less accumulated depreciation of $672 (2008 - $554) for a net book value of $1,221 (2008 - $1,320) and facilities with a cost of $66 (2008 - $66) less accumulated depreciation $11 (2008 - $8) for a net book value of $55 (2008 - $58).

(c) Includes $17 (2008 - $259) for Boeing B777/787 aircraft, $21 (2008 - $34) for equipment purchases and internal projects and nil (2008 - $58) for the aircraft interior refurbishment program. Refer to Note 6K relating to the financing of Boeing pre-delivery payments

(d) Net book value of Property and equipment includes $798 (2008 - $836) consolidated for aircraft leasing entities and $165 (2008 - $150) consolidated for fuel facility corporations, both of which are consolidated under AcG-15.

As at December 31, 2009, flight equipment included 17 aircraft (2008 - 21) that are retired from active service with a net carrying value of $22 (2008 - $33).

Interest capitalized during 2009 amounted to $4 at an interest rate of 7.38% (2008 - $37 with $10 at an interest rate of 1 month US LIBOR plus 1.14%, $6 at an interest rate of 3 month US LIBOR plus 3.00%, $17 at an interest rate of 7.72%, and $4 of fees).

Depreciation of property and equipment in 2009 amounted to $602 (2008 - $646).

During 2009:

- The Corporation took delivery of one Boeing 777 aircraft. The aircraft was financed with guarantee support from the Export-Import Bank of the United States ("EXIM").

- The Corporation entered into a sale-leaseback transaction which closed during Quarter 1 2009 for a Boeing 777 aircraft, which was originally delivered in 2007 and debt financed. The proceeds from the transaction of $172 were used to repay the outstanding loan of $114. The Corporation recorded a charge of $17 in interest expense for this transaction including a prepayment fee of $14. The gain on sale of the aircraft of $26 has been deferred and will be recognized in Depreciation and amortization over the term of the lease. The lease is accounted for as a capital lease with a 12 year term, with monthly lease payments.

- The Corporation sold two A340 aircraft for proceeds of $91 with a book value of $93, resulting in a loss on sale of $2. The Corporation made a repayment of $82 for the associated debt.

- The Corporation entered into a sale-leaseback transaction which closed during Quarter 4 2009 for three Boeing 777 aircraft, which were originally delivered in 2007 and debt financed. The proceeds from the transaction of $380 were used to repay the outstanding principal of $273. The Corporation recorded a charge of $8 in interest expense for this transaction and a loss on sale of the aircraft of $24. The leases are accounted for as operating leases with a 12 year term, with monthly lease payments.

During 2008:

- The Corporation received delivery of eight Boeing 777 aircraft. Three aircraft were financed with guarantee support from EXIM (Note 6). Five of the aircraft were financed under sale-leaseback transactions with proceeds of $708. The resulting gain on sale of $81 was deferred and is being recognized as a reduction to Aircraft rent expense over the term of the leases. The leases are accounted for as operating leases with 12 year terms, paid monthly.

- The Corporation recorded an impairment charge of $38 on its fleet of B767-200 aircraft due to the revised retirement date of the aircraft.

- The Corporation sold six Dash-8 aircraft for proceeds of $10 with a book value of $8, resulting in a gain on sale of $2.

- The Corporation sold an A319 aircraft for proceeds of $23 with a book value of $21, resulting in a gain on sale of $2.

4. INTANGIBLE ASSETS

	2009	2008
Indefinite life assets		
International route rights and slots	$ 329	$ 327
Air Canada trade name	298	298
Other marketing based trade names	31	31
	658	**656**
Finite life assets		
Star Alliance membership	131	131
Other contract and customer based	144	144
Technology based	254	279
	529	554
Accumulated depreciation and amortization		
Star Alliance membership	(37)	(32)
Other contract and customer based	(110)	(99)
Technology based	(124)	(82)
	(271)	(213)
Finite life assets, net	**258**	**341**
	$ 916	**$ 997**

The amortization of intangible assets in 2009 amounted to $58 (2008 - $48).

During 2009, the Corporation recorded an impairment charge of $68 related to previously capitalized costs incurred pertaining to the development of a new reservation system, referred to as POLARIS, which was recorded in Technology based intangible assets. The Corporation is currently working towards the implementation of certain components of the solution such as web and fare technology but has suspended activity relating to the implementation of the reservation system.

5. DEPOSITS AND OTHER ASSETS

		2009	2008
Aircraft related deposits (a)		$ 189	$ 203
Restricted cash		121	65
Deposit related to the Pension and Benefits Agreement	Note 18	43	42
Asset backed commercial paper (b)		29	29
Aircraft lease payments in excess of rent expense	Note 2W	51	49
Other deposits		24	78
Other		13	29
		$ 470	**$ 495**

(a) Represents the amount of deposits with lessors for the lease of aircraft and flight simulators.

(b) The Corporation has $37 ($29 net of a fair value adjustment) in non-bank sponsored ABCP. The carrying value as at December 31, 2009 is based on a number of assumptions as to the fair value of the investments including factors such as estimated cash flow scenarios and risk adjusted discount rates. The assumptions used in estimating the fair value of the investments are subject to change, which may result in further adjustments to non-operating results in the future. No adjustments to the carrying value were recorded during 2009.

6. LONG-TERM DEBT AND CAPITAL LEASES

		Base Currency	Final Maturity	Actual Interest Rate %	2009	2008
Embraer aircraft financing (a)		USD	2017 - 2021	2.15 - 8.49	$ 1,150	$ 1,425
Boeing aircraft financing (b)		USD	2019 - 2021	0.25 - 5.69	436	871
Boeing aircraft financing (c)		JPY	2020	0.46 - 0.47	205	270
Term Credit Facility (d)		CDN	2014	12.75	573	-
Aircraft leasing entities - debt (e)	Note 2Z				662	828
Term loan due 2013 (f)		USD	2013	6.21	78	190
Conditional sales agreements (g)		USD	2019	3.15 - 3.31	140	175
Fuel facility corporations - debt (h)	Note 2Z				136	125
Spare parts financing (i)		USD	2014	5.73	132	97
Spare engine financing (j)		USD	2013	3.65	72	95
Boeing pre-delivery payments (k)	Note 2Z	USD	2009		-	81
Revolving credit facility (l)		CDN			-	50
Canadian Regional Jet (m)		CDN	2012	2.13	17	25
GE loan (n)		USD	2015	3.19	17	24
Lufthansa cooperation agreement (o)		USD	2009		-	16
Long-term debt					**3,618**	**4,272**
Capital lease obligations (p)					904	1,082
Total debt and capital leases					**4,522**	**5,354**
Current portion					(468)	(663)
Long-term debt and capital leases					**$ 4,054**	**$ 4,691**

The Interest Rate in the table above is the actual rate as of December 31, 2009

Amounts reported below are before any transaction costs or fees recorded net against the value of the debt.

(a) Embraer aircraft financing amounts to US$1,112 as at December 31, 2009 (US$1,163 as at December 31, 2008). Principal and interest is repaid quarterly until maturity and the financing has both fixed and variable interest rates. The fixed rate financing of US$847 bears interest at rates ranging from 6.39% to 8.49% and the variable rate financing of US$265 bears interest at a three month US LIBOR plus 1.9% (2.15% to 2.18%). The financing can be repaid at any time, in whole or in part, with the payment of applicable fees. The financing is secured by the 60 delivered Embraer aircraft, with a carrying value of $1,591.

(b) Boeing aircraft financing amounts to US$430 as at December 31, 2009 (US$711 as at December 31, 2008), which is financed under loan guarantee support provided by EXIM. Principal and interest is repaid quarterly until maturity and the financing has both fixed and variable interest rates. The fixed rate financing of US$155 bears interest at rates ranging from 5.41% to 5.69% and the variable rate financing of US$275 bears interest at a three month US LIBOR (0.25% to 0.28%). The financing can be repaid at any time, in whole, with the payment of applicable fees. The financing is secured primarily by the 5 delivered aircraft with a carrying value of $632.

(c) Boeing aircraft financing amounts to JPY18,671 as at December 31, 2009 (JPY19,995 as at December 31, 2008), which is financed under loan guarantee support provided by the EXIM. Principal and interest is repaid quarterly until maturity and the financing bears interest at a three month JPY LIBOR (0.46% to 0.47%). The financing can be repaid at any time, in whole, with the payment of applicable fees. The financing is secured primarily by the 2 delivered aircraft with a carrying value of $234.

(d) In July 2009, the Corporation received financing proceeds of $600, less financing fees of $20, under a secured term credit facility (the "Credit Facility") pursuant to which the Corporation also issued warrants for the purchase of Air Canada's Class A Variable Voting Shares or Class B Voting Shares as further described below. The terms of the Credit Facility permit, on or before the first anniversary and subject to satisfaction of certain conditions, Air Canada to request an increase to the facility by up to an additional $100 by obtaining new commitments from either the existing or new lenders. The Credit Facility is repayable in 16 consecutive quarterly instalments commencing in

August 2010 of $30 with the final instalment of $120 due in July 2014. Any increase to the facility would increase, on a pro rata basis, the scheduled repayments, including the final payment.

The Credit Facility bears interest at a rate based upon the greater of the bankers' acceptance rate or 3.00% plus 9.75% (12.75% as at December 31, 2009). The Credit Facility can be repaid at any time, in whole or in part, with the payment of applicable fees, subject to a minimum repayment of $10.

Air Canada's obligations under the Credit Facility are secured by a first priority security interest and hypothec over substantially all the present and after-acquired property of Air Canada and its subsidiaries, subject to certain exclusions and permitted liens. The Credit Facility contains customary representations and warranties and is subject to customary terms and conditions (including negative covenants, financial covenants and events of default). Financial covenants require the Corporation to maintain, as of the last business day of each month, unrestricted cash (as defined per the Credit Facility and generally based upon the aggregate sums of Cash and cash equivalents and Short-term investments) of $800 and a minimum EBITDAR (earnings before interest, income taxes, depreciation, amortization, aircraft rentals, certain non-operating income (expense) and special items) and an interest coverage ratio test determined as at the end of each fiscal quarter.

A requirement of the Credit Facility is that the Corporation maintain at all times unrestricted cash in accounts subject to securities control agreements equal to or greater than the lesser of (a) $800 and (b) 80% of unencumbered cash subject to a minimum of $500. The securities in such accounts would become restricted if the Corporation defaults on certain terms of the Credit Facility as described above.

Under the Credit Facility, Air Canada issued to the lenders, concurrently with the first drawdown, warrants for the purchase of Air Canada's Class A Variable Voting Shares or Class B Voting Shares representing an aggregate of 5% or 5 million of the total issued and outstanding shares as at the closing date of the Credit Facility, allocated among the lenders based on their pro rata lending commitments under the Credit Facility. These initial 5% warrants have an exercise price of $1.51 per share, are exercisable at any time and expire four years after the date of issuance. In the event that Air Canada did not grant additional security over certain assets within 90 days of closing, Air Canada was required to issue to the lenders additional warrants representing up to an additional 5% or 5 million of the total issued and outstanding shares (determined at the time of issuance of such additional warrants) with an average exercise price established based on a volume weighted average price over the 5 days before issuance, exercisable at any time and expiring four years after the date of issuance. These additional warrants were issued on October 19, 2009 and have an exercise price of $1.44 per share. The ascribed value of both the initial and additional warrants, totalling 10 million warrants, have been included in Contributed surplus on the Consolidated Statement of Financial Position as at December 31, 2009 in the amount of $7.

(e) The Corporation has aircraft lease transactions with several special purpose entities that qualify as VIEs. The debt has a weighted average effective interest rate of approximately 8% (2008 - 8%). These aircraft have a carrying value of $798 (2008 - $836) and 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$633 ($662) (US$676 ($828) as at December 31, 2008) is summarized as follows (in Canadian dollars):

	Final Maturity	2009	2008
Canadian Regional Jet	2010 - 2011	$ 211	$ 257
Boeing 767-300	2011 - 2016	141	185
Airbus 319	2011 - 2014	192	242
Airbus 321	2017	118	144
Total		**$ 662**	**$ 828**

(f) During 2008, the Corporation arranged for and received financing amounting to $190 (US$155). The first payment of US$80 matured and was repaid in January 2009. In July 2009, the maturity of the Term Loan due 2009 was extended to December 2013. The financing bears interest at one month LIBOR plus 5.98% (6.21% as at December 31, 2009 and 6.45% as at December 31, 2008) and is secured by a security interest and a movable hypothec in the principal amount of $400. The financing can be repaid at any time prior to maturity, in whole or in part, without the payment of applicable fees.

(g) US$133 principal outstanding (US$142 as at December 31, 2008) on acquisitions of two A340-500 aircraft financed through conditional sales agreements. Principal and interest is paid quarterly until maturity in 2019. The purchase price instalments bear interest at a three month LIBOR rate plus 2.9% (3.15% - 3.31% as at December 31, 2009 and 4.37% - 6.44% as at December 31, 2008). The financing can be repaid at any time, in whole, with the payment of applicable fees. The carrying value of the two A340-500 aircraft provided as security under the conditional sales agreements is $212 as at December 31, 2009.

(h) The Corporation is the primary beneficiary of certain Fuel Facility Corporations in Canada. The debts bear interest at rates ranging from 2.15% to 5.09%. Of the total debts of $136, $104 relates to a bond payable at a fixed rate of interest of 5.09% which matures in 2032 with equal semi-annual payments of principal and interest. The remaining debts have varying maturities. The debts are secured by a general security agreement covering all assets of the Fuel Facility Corporations. The carrying value of the assets of the fuel facilities is $165 as at December 31, 2009.

(i) US$132 principal outstanding to mature in 2014 (US$80 as at December 31, 2008), with quarterly repayments, at a floating interest rate equal to the three month LIBOR rate plus the lender's incremental cost of funds rate and a margin of 3.00%. The financing can be repaid subsequent to the 36th monthly anniversary of the initial funding date, in whole or in part, with the payment of applicable fees. The loan is secured by spare parts and other assets with a carrying value of $265. The loan agreement contains a collateral value test, performed on a monthly basis. This test relates to all inventory collateral and the Corporation may be required to provide additional inventory collateral, cash collateral, letters of credit, prepay some of the loan or any combination of the above based on appraised values, as of the date of the test. Any amounts prepaid would be recorded as a reduction of the loan. This amount declines over time to nil upon the loan expiry. In January 2009 an additional $92 (US$75) principal was added under the original agreement with the same terms as described above. Financing fees totaling $6 were recorded in 2009 for these additional borrowings.

(j) US$70 principal outstanding to mature in 2013 (US$78 as at December 31, 2008), with quarterly repayments and a final payment at maturity of 50% of the original principal, at a floating interest rate equal to the three month LIBOR rate plus 3.40% as at December 31, 2009 (2008 – 5.13%). The financing can be repaid at any time, in whole, with the payment of applicable fees. The loan is secured by 10 spare engines with a carrying value of $113.

The loan agreement contains a current market value test, beginning on the first anniversary of the facility, and annually thereafter until expiry. This test relates to 10 engines and under the test, the Corporation may be required to provide additional collateral or prepay certain facility amounts, based on engine current market values, as of the date of the test. Any amounts prepaid would be recorded as a reduction of the loan. The maximum amount payable in December 2010 on the next anniversary, assuming the engines are worth nil and no additional collateral has been provided, is $65 (US$63). This amount declines over time to fifty percent of the original principal upon the loan expiry. In January 2009 an additional $46 (US$37) principal and 22 engines were added under the original agreement with the same terms as described above. Financing fees totaling $2 were recorded in 2009 for these additional borrowings. As discussed in Note 1C, the outstanding balance related to the additional financing was repaid in 2009.

(k) On October 30, 2007, the Corporation entered into an agreement with a syndicate of banks for the financing of pre-delivery payments ("PDP") for 10 of the 16 Boeing B777 aircraft contemplated in the Boeing Purchase Agreement. The PDP financing was a series of loans that are aircraft specific with a maximum aggregate commitment of up to $568 (US$575). The PDP loans had a term of five years, but could be prepaid upon the delivery of the aircraft without penalty. During 2009, the Corporation drew nil (2008 - $39 (US$39)) and prepaid $83 (US$66) towards 1 aircraft ($516 ($US501) towards 8 aircraft during 2008). This was the final repayment on the pre-delivery financing. At year-end 2009, the balance outstanding on the PDP loans was nil ($81 (US$66) as at December 31, 2008). The 2009 capitalized interest relating to this financing was nil (2008 - $10) at an interest rate of 30 day LIBOR plus 1.14% (1.61% as at December 31, 2008).

(l) As at December 31, 2008, the Corporation was a party to a $100 senior secured revolving credit facility (the "Revolving Credit Facility"). The Revolving Credit Facility had a one year term that could be extended at Air Canada's request for additional one-year periods on each anniversary of the closing, subject to prior approval of the lenders. The total amount available for borrowing under the Revolving Credit Facility was subject to a borrowing base restriction based on certain percentages of the values of eligible accounts receivable and eligible real property. As at December 31, 2008, the funds available under the Revolving Credit Facility were $50. The Revolving Credit Facility was 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 were guaranteed by 1209265 Alberta Ltd., a subsidiary of Air Canada, which provided 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 Revolving Credit Facility contained customary representations and warranties and was subject to customary terms and conditions (including negative covenants, financial covenants and events of default). Financial covenants required the Corporation to maintain, as of the last business day of each month, a minimum liquidity level of $900, which included the unused and available commitment under the facility, and an interest coverage ratio test determined as at the end of each fiscal quarter. During the second quarter, the financial covenant that required the Corporation to maintain as of the last business day of each month a minimum cash level of $900 including the unused and available commitment under the facility was reduced to $800. The interest rate margin for drawn amounts was, at the option of Air Canada, prime plus 13.00% or bankers' acceptances plus 14.00%. As discussed in Note 1C, in connection with the entering into of the Credit Facility described in (d), the Revolving Credit Facility was repaid in full in the amount of $49 during 2009. The rights of the lender under this Revolving Credit Facility were assigned to the lenders under the Credit Facility.

(m) As at December 31, 2009, the principal outstanding is $17 on four CRJ aircraft ($25 as at December 31, 2008). Principal and interest are paid quarterly to maturity in 2012. The financing bears interest at a floating rate of the 3 month Canadian bankers' acceptance rate plus 1.7%. The financing can be repaid at any time, in whole or in part, with the payment of applicable fees. The loan is secured by the aircraft with a carrying value of $23.

(n) US$16 principal outstanding to mature in 2015 (US$20 as at December 31, 2008), with quarterly repayments, at a floating interest rate equal to the six month LIBOR rate plus 2.75% pre-payable on any interest payment date after September 21, 2009, without the payment of applicable fees. The next interest payment date is March 20, 2010. The debt is secured primarily by certain flight training equipment with a current carrying value of $33.

(o) As at December 31, 2008, US$13 principal outstanding which matured in 2009, with semi-annual repayments, at a fixed interest rate of 4.50% plus an annual 2.0% guarantee fee.

(p) Capital leases, related to facilities and 40 aircraft, total $904 ($83 and US$784) ($1,082 ($84 and US$815) as at December 31, 2008). The debt has a weighted average effective interest rate of approximately 8% and final maturities range from 2010 to 2033. During 2009, the Corporation recorded interest expense on capital lease obligations of $102 (2008 - $94).

Certain aircraft lease agreements contain a fair value test, beginning on July 1, 2009, and annually thereafter until lease expiry. This test relates to 24 aircraft under lease of which 23 are accounted for as capital leases and the remainder relates to leasing entities that are consolidated under AcG-15. Under the test, the Corporation may be required to prepay certain lease amounts or to provide additional collateral, based on aircraft fair values, as of the date of the test. Any amounts prepaid would be recorded as a reduction of the lease obligation. The Corporation contracts with certain third parties to provide residual value support for certain aircraft. If the Corporation is required under the loan to value test to prepay lease obligations, these amounts are recoverable from the third party residual value support provider upon lease expiry to the extent that the adjusted obligation taking into account prepayments is less than the residual value support. The maximum amount payable on July 1, 2010, assuming the related aircraft are worth nil, is $599 (US$572). The maximum payable amount declines over time to nil upon lease expiry. In July 2009 additional collateral of $8 in the form of cash deposits were made under the fair value test. As the Corporation does not expect to have to prepay any significant amounts based upon expectations of aircraft fair values into the future, the amortized cost of these capital lease obligations reflects the scheduled payments over the term to final maturity.

Interest paid on Long-term debt and capital leases in 2009 by the Corporation was $326 (2008 - $293).

Refer to Note 14 for the Corporation's 5 year principal and interest repayment requirements as at December 31, 2009.

7. FUTURE INCOME TAXES

The following income tax related amounts appear in the Corporation's Consolidated Statement of Financial Position:

	2009	2008
Liability		
Tax payable (a)	$ (10)	$ (10)
Future income tax liability (c)	(85)	(88)
	$ (95)	**$ (98)**

(a) Taxes Payable

During 2007, Air Canada recorded a current income tax expense of $10 resulting from the Federal and Ontario harmonization of corporate taxes. Air Canada will have a cash tax payable of $10 that will be payable over a five year period beginning in 2010. The estimated amount payable in 2010 of $4 is included in Accounts payable and accrued liabilities and the remainder is recorded in Other long-term liabilities.

(b) Valuation Allowance

The Corporation has determined that it is more likely than not that future income tax assets of $1,043 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. The benefit of future income tax assets that existed at fresh start, and for which a valuation allowance is recorded, is recognized first to reduce to nil any remaining intangible assets (on a pro-rata basis) that were recorded upon fresh start reporting with any remaining amount as a credit to Shareholders' equity. The benefit of future income tax assets that arise after fresh start are recognized in the Consolidated Statement of Operations.

(c) Future Income Tax Liability

It has been assumed that certain intangibles and other assets with nominal tax cost and a carrying value of approximately $658, have indefinite lives and accordingly, the associated future income tax liability 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 $85.

The future income tax assets and liabilities are as follows:

	2009	2008
Future tax assets		
Loss carry forwards	$ 689	$ 588
Post-employment obligations	322	466
Accounting provisions not currently deductible for tax	144	261
Deferred gains	24	40
Other	91	95
Total future tax assets	**1,270**	**1,450**
Future tax liabilities		
Book basis of capital over tax basis	153	217
Intangible assets	120	126
Other	39	38
Total future tax liabilities	**312**	**381**
Net future tax assets	**958**	**1,069**
Less valuation allowance (b)	1,043	1,157
Net recorded future income tax liability	**$ (85)**	**$ (88)**

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

	2009	2008
Recovery based on combined federal and provincial rates	$ (9)	$ (319)
Non-taxable portion of capital (gains) losses	(105)	68
Non-deductible expenses	7	53
Effect of tax rate changes on future income taxes	76	51
Other	(15)	23
	(46)	(124)
Valuation allowance (refer to (b) above)	41	148
Provision for (recovery of) income taxes	**$ (5)**	**$ 24**

Significant components of the Provision for (recovery of) income taxes attributable to continuing operations are as follows:

	2009	2008
Current tax expense (recovery)	$ (7)	$ 1
Future income tax recovery relating to temporary differences	(115)	(176)
Future income tax expense from tax rate changes	76	51
Valuation allowance (refer to (b) above)	41	148
Provision for (recovery of) income taxes	**$ (5)**	**$ 24**

Refer to Note 15 for future income taxes recorded in other comprehensive income related to fuel derivatives designated under fuel hedge accounting.

Income taxes recovered in 2009 by the Corporation were $5 (2008 – payments of less than $1).

The balances of tax attributes as at December 31, 2009, 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
2014	$ 18
2026	3
2027	1,354
2028	1,093
2029	391
	$ 2,859

There are no net capital losses (2008 - nil).

8. PENSION AND OTHER BENEFIT LIABILITIES

The Corporation maintains several defined benefit and defined contribution plans providing pension, other post-retirement and post-employment benefits to its employees, including those employees of the Corporation who are contractually assigned to Aveos and were contractually assigned to 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 Aveos and are members of Corporation-sponsored defined benefit pension plans and also participate in Corporation-sponsored health, life and disability benefit plans. Other Corporation employees performed work for Aeroplan until the date of transition to employment at Aeroplan and then ceased to accrue benefits under the Corporation-sponsored defined benefit pension plans and under the Corporation-sponsored health, life and disability benefit plans. These consolidated financial statements include all of the assets and liabilities of all Corporation-sponsored plans. The employee benefit expense in these consolidated financial statements includes the expenses for all employees participating in the plans less a cost recovery which is charged to ACE, Aveos, and Aeroplan for those employees contractually assigned. The cost recovery includes current service costs for pensions, past service cost to Aeroplan for pensions and a portion of post-employment and post-retirement benefits to ACE and Aveos, based on actuarial calculation for their specific employee group. This cost recovery amounted to $32 for the year ended December 31, 2009 (2008 - $40).

In May 2009, Air Canada and Aeroplan reached an agreement with the Canadian Auto Workers (CAW) Local 2002 providing for a process for the approximately 750 Air Canada employees then assigned to and working in the Aeroplan contact centres to choose to transition to employment at Aeroplan, effective June 1, 2009, or to remain employees of Air Canada. Employees at Air Canada work locations who became surplus to Air Canada's needs due to employees who were senior to them and then working at Aeroplan contact centres choosing to remain employees of Air Canada were given the option to transition to employment at Aeroplan. Effective October 4, 2009, all affected employees had completed the transition to Aeroplan. For those employees who transferred to Aeroplan, their service, which largely determines benefit levels under the Air Canada pension and other employee benefit plans, ceased to accrue as of the date of employment with Aeroplan. Air Canada and Aeroplan continue to discuss the terms surrounding the transfer of pension benefits. and certain implications relating to same remain to be resolved. Air Canada continues to retain plan assets and report liabilities for services accrued for the transferred Aeroplan employees as at December 31, 2009, pending final determination of this matter. Aeroplan is now contributing current service costs in their pension plan for service accruing with Aeroplan.

As described in Note 18, Air Canada and Aveos are parties to a Pension and Benefits Agreement covering the future transfer of certain pension and benefit assets and obligations to Aveos.

As described in Note 2, the accounting for pensions requires management to make significant estimates including estimates as to the discount rate applicable to the benefit obligation and the expected rate of return on plan assets.

Pension Plan Cash Funding Obligations

As at January 1, 2009, based on the actuarial valuations which were used to determine certain pension funding requirements in 2009, the aggregate solvency deficit in the registered pension plans was $2,835. Based on preliminary actuarial valuations, as at January 1, 2010, the aggregate solvency deficit in the registered plans is estimated to be between $2,500 and $2,700. This preliminary estimated solvency deficit range includes the impact of the actual return on plan assets as shown below partially offset by a decrease in the discount rate used to value the benefit obligation which has the effect of increasing the benefit obligation. The final actuarial valuations for January 1, 2010 will be completed in the first half of 2010, but as described below, they will not impact the 2010 pension funding obligations.

In July 2009, the Government of Canada adopted the Air Canada 2009 Pension Regulations. The Air Canada 2009 Pension Regulations relieve Air Canada from making any past service contributions (i.e. special payments to amortize the plan deficits) to its ten domestic defined benefit registered pension plans in respect of the period beginning April 1, 2009 and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contribution shall equal the lesser of (i) $150, $175, and $225 in respect of 2011, 2012, and 2013, respectively, on an accrued basis, and (ii) the maximum past service contribution permitted under the Tax Act.

The Air Canada 2009 Pension Regulations were adopted in coordination with the Pension MOUs identified in Note 1C. Pursuant to the Pension MOUs, on October 26, 2009, Air Canada issued to a trust, 17,647,059 Class B Voting Shares. This number of shares represented 15% of the shares of Air Canada issued and outstanding as at the date of the Pension MOUs and the date of issuance (in both cases after taking into account such issuance). All net proceeds of sale of such shares by the trust are to be contributed to the pension plans. On October 26, 2009, upon the issuance of the shares to the trust, the Corporation recorded a decrease to its Pension and other benefit liabilities in the amount of $28 and an increase to Share capital in the amount of $28. For so long as the trust continues to hold at least 2% of the issued and outstanding shares of Air Canada, the trustee will have the right to designate one nominee (who shall not be a member or officer of any of Air Canada's Canadian-based unions) to Air Canada's board of directors, subject to completion of Air Canada's usual governance process for selection and confirmation of director nominees. Current service contributions will continue to be made in the normal course while the Air Canada 2009 Pension Regulations are in effect.

After consideration of the effect of the Air Canada 2009 Pension Regulations as outlined above, employer pension funding contributions during 2009 amounted to $389.

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. An increase in the discount rate of 0.25% results in a decrease of $346 to the pension obligation and $28 to the pension expense. A decrease in the discount rate of 0.25% results in an increase of $346 to the pension obligation and $25 to the pension expense.

Expected Return on Assets Assumption

The 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. Air Canada's management, in conjunction with its actuaries, reviews anticipated future long-term performance of individual asset categories and considers the asset allocation strategy adopted by Air Canada, 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. The determination of the long term rate considers recent fund performance, including the significant drop in the value of plan assets during 2008 and the partial recovery in 2009, and historical returns, to the extent that the past is indicative of the expected long-term, prospective rate. There can be no assurance that any of the plans will earn the expected rate of return.

Benefit Obligation and Plan Assets

The following table presents financial information related to the changes in the pension and other post-employment benefits plans:

	Pension Benefits		Other Employee Future Benefits	
	2009	2008	2009	2008
Change in benefit obligation				
Benefit obligation at beginning of year	$ 10,729	$ 12,150	$ 790	$ 899
Current service cost	123	203	50	62
Interest cost	760	706	54	52
Employees' contributions	78	83	-	-
Benefits paid	(724)	(677)	(58)	(57)
Plan amendments	-	2	-	-
Actuarial loss (gain)	1,015	(1,738)	33	(189)
Foreign exchange gain (loss)	(44)	-	(18)	23
	11,937	10,729	851	790
Change in plan assets				
Fair value of plan assets at beginning of year	9,717	11,747	-	-
Actual return (loss) on plan assets	1,296	(1,879)	-	-
Employer contributions	389	456	58	57
Employees' contributions	78	83	-	-
Pension MOUs share contribution	28	-	-	-
Benefits paid	(724)	(677)	(58)	(57)
Foreign exchange gain (loss)	(33)	(13)	-	-
	10,751	9,717	-	-
Deficit at end of year	**1,186**	**1,012**	**851**	**790**
Unrecognized past service costs	(2)	(2)	-	-
Unrecognized net actuarial gain (loss)	(1,079)	(479)	258	321
Valuation allowance against accrued benefit	15	9	-	-
Net benefit obligation	**$ 120**	**$ 540**	**$ 1,109**	**$ 1,111**
Weighted average assumptions used to determine the accrued benefit liability				
Discount rate	6.40 %	7.35 %	4.75 - 6.40 %	6.25 - 7.35 %
Rate of compensation increase (a)	2.50 %	2.50 %		

(a) As a result of pay awards, a rate of compensation increase of 0% plus merit was used for years 2009 and 2010 in determining the net benefit obligation for the pension plan and 2.50% plus merit for the remaining years.

Under the terms of the domestic registered and supplementary plans, there is no indexation provided after January 1, 2007.

The pension benefit deficit of only those plans that are not fully funded at the end of the year is as follows:

	2009	2008
Domestic registered plans	$ 496	$ 383
US, UK, and Japan	78	83
Supplementary plans	653	606
	$ 1,227	**$ 1,072**

The net deficit, on an accounting basis, at December 31, 2009 for pension benefits was $1,186 (2008 - $1,012). The increase in the accounting deficit is mainly the result of the increase to the accrued benefit obligation resulting from the decrease in the discount rate largely offset by the higher than expected returns on plan assets.

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

	2009	2008
Pension benefits	$ 120	$ 540
Other employee future benefits	1,109	1.111
Net benefit obligation	**1,229**	**1,651**
Current portion	(66)	(66)
Pension and other benefit liabilities	**$ 1,163**	**$ 1,585**

The current portion of the net benefit obligation represents an estimate of other employee future benefits claims to be incurred during 2010. The current portion is included in Accounts payable and accrued liabilities.

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	
	2009	2008	2009	2008
Components of Net Periodic Pension Cost				
Current service cost	$ 123	$ 203	$ 50	$ 62
Interest cost	760	706	54	52
Actual loss (return) on plan assets	(1,296)	1,879	-	-
Actuarial loss (gain)	1,015	(1,738)	33	(189)
Plan amendments	-	2	-	-
Costs arising in the year	**602**	**1,052**	**137**	**(75)**
Differences between costs arising in the year and costs recognized in the year in respect of:				
Loss (return) on plan assets	460	(2,711)	-	-
Actuarial loss (gain)	(1,068)	1,742	(62)	172
Plan amendments	-	(2)	-	-
Increase in valuation allowance provided against accrued benefit asset	6	8	-	-
Net periodic benefit cost of plans	**-**	**89**	**75**	**97**
Amount charged to ACE, Aveos, and Aeroplan	(20)	(24)	(12)	(16)
Net defined benefit pension and other employee benefits expense	**$ (20)**	**$ 65**	**$ 63**	**$ 81**
Weighted average assumptions used to determine the accrued benefit cost				
Discount rate	7.35 %	5.75 %	6.25 - 7.35 %	5.75 - 6.00 %
Expected long-term rate of return on plan assets	7.15 %	7.15 %	n/a	n/a
Rate of compensation increase (1)	2.50 %	2.50 %		

(1) A rate of compensation increase of 0% plus merit in 2009 and in 2010 was used in determining the net benefit pension expense and 2.50% plus merit 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. An 8.25% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2009 (2008 - 8.25%). The rate is assumed to decrease gradually to 5% by 2015. 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 $18. A one percentage point decrease in assumed health care trend rates would have decreased the service and interest costs by $2 and the obligation by $23.

Composition of Pension Plan Assets

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

	2009	2008	Target Allocation (1)
Non-matched assets (mainly equities)	55.9%	52.9 %	54.4 %
Matched assets (mainly Canadian bonds)	43.4 %	43.5 %	45.6 %
Cash and temporary investments	0.7 %	3.6 %	0.0 %
	100.0 %	**100.0 %**	**100.0 %**

(1) Weighted average of the Master Trust Fund target allocation (99% of Domestic Registered Plan assets) and the Bond Fund target allocation. The Bond Fund serves the purpose of altering the asset mix of some of the participating plans. These plans exhibit characteristics that differ from the majority of the participating plans, which are solely invested in the Master Trust.

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, as amended during 2009. The investment return objective is to achieve a total annualized rate of return that exceeds by a minimum of 1.0% before investment fees on average over the long term (i.e., 10 years) the total annualized return that could have been earned by passively managing the Liability Benchmark. The Liability Benchmark, which is referenced to widely used Canadian fixed income performance benchmarks (DEX), is composed of a mix of the DEX Universe Provincial Bond Index, DEX Long Term Provincial Bond Index and DEX Real Return Bond Index that closely matches the characteristics of the pension liabilities.

In addition to the broad asset allocation, as summarized in the asset allocation section above, the following policies apply to individual asset classes:

- Non-matched assets are mainly equities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 31% to 37% of the total market value of the Master Trust Fund. Limitations are placed on the overall allocation to any individual security at both cost and market value. Investments in non-publicly traded securities and in non-traditional asset classes are allowed up to 10% of the total market value of the Master Trust Fund.

- Matched assets are mainly Canadian bonds, oriented toward long term investment grade securities rated “BBB” 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, these investments are required to be diversified among individual securities and sectors.

Derivatives are permitted provided that they are used for hedging a particular risk (including interest rate risk related to pension liabilities) or to create exposures to given markets and currencies and that counterparties have a minimum credit rating of A. As of December 31, 2009, an additional 5% derivatives exposure to matched assets is in place to hedge interest rate risk related to pension liabilities.

Defined Contribution Plans

The Corporation's management, administrative and certain unionized employees may participate in defined contribution plans. Contributions range from 3% to 6% of annual pay for those employees in Canada and 3% to 7% of annual pay for those participants in the United Kingdom. The Corporation contributes an equal amount. The Corporation's expense for defined contribution plans amounted to $1 for the year ended December 31, 2009 (2008 - $1).

9. OTHER LONG-TERM LIABILITIES

		2009		2008	
Unfavourable contract liability on aircraft leases (a)		$	31	$	37
Proceeds from contractual commitments (b)	Note 1C		107		-
Aircraft rent in excess of lease payments	Note 2W		41		56
Long-term employee liabilities (c)			33		35
Workplace safety and insurance board liabilities			40		37
Deferred gains on aircraft sale- leasebacks			69		76
Other (d)			134		129
		$	**455**	**$**	**370**

(a) 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.

(b) Proceeds from contractual commitments represent non-refundable proceeds received, net of related costs and deposits, in consideration of various contractual commitments and will be recognized as reductions in the cost of those contractual commitments when incurred.

(c) The following table outlines the changes to labour related provisions which are included in long-term employee liabilities:

	2009		2008	
Beginning of year	$	54	$	66
Interest accretion		3		4
Charges recorded in Wages, salaries and benefits		30		21
Amounts disbursed		(26)		(37)
End of year		61		54
Current portion in Accounts payable and accrued liabilities		(28)		(19)
	$	**33**	**$**	**35**

The Corporation offers certain severance programs to certain employees from time to time. The cost of these programs is recorded within Operating expenses.

(d) "Other" includes asset retirement obligations of the Corporation. Under the terms of their respective land leases, each Fuel Facility Corporation has 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 were 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 all asset retirement obligations including all Fuel Facility Corporations in Canada in which the Corporation participates, the Corporation has recorded an obligation of $9 ($40 undiscounted) (2008 - $8 ($40 undiscounted)) representing the present value of the estimated decommissioning and remediation obligations at the end of the lease using an 8% (2008 - 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.

10. STOCK-BASED COMPENSATION

Air Canada Long-Term Incentive Plan

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. Five million shares are authorized for issuance under the Long-term Incentive Plan in the form of stock options or performance share units.

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. Fifty percent of all options vest over four years. The remaining options will vest based upon performance conditions. The performance vesting conditions are based on operating margin (operating income over operating revenues) and 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 are as follows:

	2009	2008
Compensation expense ($ millions)	$ 2	$ (3)
Number of stock options granted to Air Canada employees	2,330,000	11,000
Weighted average fair value per option granted ($)	$ 1.06	$ 1.99
Aggregated fair value of options granted ($ millions)	$ 2	$ -
Weighted average assumptions:		
Risk-free interest rate	1.73 - 3.14 %	3.29 %
Expected volatility	83.0 - 84.7 %	34 %
Dividend yield	0 %	0 %
Expected option life (years)	4.50	4.50

During 2008, previously recorded stock-based compensation expense, related to stock options, of $3 was reversed as management had determined that the performance vesting criteria would not be met.

A summary of the Long-term Incentive Plan option activity is as follows:

	2009		2008	
	Options	Weighted Average Exercise Price/Share	Options	Weighted Average Exercise Price/Share
Beginning of year	1,701,447	$ 19.14	1,720,092	$ 19.24
Granted	2,330,000	1.32	11,000	8.51
Forfeited	(67,973)	19.44	(29,645)	21.00
Outstanding options, end of year	**3,963,474**	**$ 8.66**	**1,701,447**	**$ 19.14**
Options exercisable, end of year	**551,544**	**$ 19.60**	**362,253**	**$ 19.96**

Range of Exercise Prices	Expiry Dates	2009 Outstanding Options: Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	2009 Exercisable Options: Number of Exercisable Options	Weighted Average Exercise Price/Share
$ 21.00	2013	1,146,400	4	$ 21.00	429,900	$ 21.00
$ 11.08 - $ 18.60	2014	481,074	5	14.73	120,269	14.73
$ 8.51	2015	11,000	6	8.51	1,375	8.51
$ 0.97 - $ 1.59	2016	2,325,000	7	1.32	-	-
		3,963,474		**$ 8.66**	**551,544**	**$ 19.60**

Range of Exercise Prices	Expiry Dates	2008 Outstanding Options: Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/Share	2008 Exercisable Options: Number of Exercisable Options	Weighted Average Exercise Price/Share
$ 21.00	2013	1,207,577	5	$ 21.00	301,894	$ 21.00
$ 11.08 - $ 18.60	2014	482.870	6	14.74	60,359	14.74
$ 8.51	2015	11,000	7	8.51	-	-
		1,701,447		**$ 19.14**	**362,253**	**$ 19.96**

Performance Share Units

The Long-term Incentive Plan also includes Performance Share Units ("PSUs"). The vesting term of PSUs is three years, generally commencing on January 1 of the year following granting, and incorporate performance vesting features based upon achieving earnings targets established over the vesting period. Subject to vesting and other conditions, each PSU entitles the employee to receive a payment in the form of one common share, cash in the amount equal to market value of one common share, or a combination thereof, at the discretion of the Board of Directors. The terms of the plan specify that upon the retirement of an employee, the number of PSUs that vest are prorated based on the total number of completed months of active service during the PSU vesting term. Certain PSUs previously granted may only be redeemed for Air Canada shares purchased on the secondary market and/or equivalent cash. As outlined above, the remaining PSUs may be redeemed for Air Canada shares issued from treasury or purchased on the secondary market and/or equivalent cash at the discretion of the Corporation.

The compensation expense related to PSUs in 2009 was less than $1. In 2008, previously recorded stock based compensation expense, related to PSUs, of $2 was reversed as management had determined that the performance vesting criteria would not be met.

A summary of the Long-term Incentive Plan performance share unit activity is as follows:

	2009	2008
Beginning of year	1,671,068	551,251
Granted	11,591	1,125,092
Forfeited	(29,595)	(5,275)
Outstanding PSUs, end of year (1)	**1,653,064**	**1,671,068**

(1) As at December 31, 2009, all PSUs remain non-vested. Included in the total number of PSUs outstanding, 1,091,218 PSUs will entitle the employee to receive, at the discretion of the Corporation, Air Canada shares purchased on the secondary market and/or equivalent cash (2008 - 1,111,183). As at December 31, 2009, the liability related to these PSUs is less than $1.

Employee Share Purchase Plans

Eligible employees can participate in the employee share purchase plan under which employees can invest up to 6% of their base salary for the purchase of shares on the secondary market. Air Canada will match 33.3% of the investments made by the employee. During 2009, the Corporation recorded compensation expense of less than $1 (2008 - $1).

11. SHAREHOLDERS' EQUITY

The issued and outstanding common shares of Air Canada, along with the potential common shares, were as follows:

As at December 31 Outstanding shares	2009	2008
Issued and outstanding		
Class A variable voting shares	56,586,112	15,475,659
Class B voting shares	221,560,947	84,524,341
Total issued and outstanding	**278,147,059**	**100,000,000**
Potential common shares		
Warrants (refer to note below)	90,250,000	-
Stock options	3,963,474	1,701,447
Performance share units	561,846	559,885
Total potential common shares	**94,775,320**	**2,261,332**

The changes during 2009 in the number of issued and outstanding shares and their recorded value, net of issue costs, were as follows:

For the year ended December 31, 2009 Outstanding shares		Number of shares	Value
Issued, beginning of year		100,000,000	$ 274
Shares issued under the pension MOUs	Note 8	17,647,059	28
Shares issued under the share and warrant public offering (refer to note below)		160,500,000	230
Issued, end of year		**278,147,059**	**$ 532**

Common Shares

As at December 31, 2009, 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 (i) the number of Variable Voting Shares outstanding, as a percentage of the total number of voting shares of Air Canada exceeds 25% or (ii) 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 either of the above noted thresholds would otherwise be surpassed at any time, the vote attached to each Variable Voting Share will decrease proportionately such that (i) the Variable Voting Shares as a class do not carry more than 25% of the aggregate votes attached to all issued and outstanding voting shares of Air Canada and (ii) the total number of votes cast by or on behalf of holders of Variable Voting Shares at any meeting do not exceed 25% of the votes that may be cast at such meeting.

Variable Voting Shares may only be held, beneficially owned or controlled, directly or indirectly, by persons who are not Canadians (within the meaning of the *Canada Transportation Act*). An issued and outstanding Variable Voting Share shall be converted into one Voting Share automatically and without any further act of Air Canada or the holder, if such Variable Voting Share becomes held, beneficially owned and controlled, directly or indirectly, otherwise than by way of security only, by a Canadian, as defined in the *Canada Transportation Act*.

Voting Shares may only be held, beneficially owned and controlled, directly or indirectly, by Canadians. An issued and outstanding Voting Share shall be converted into one Variable Voting Share automatically and without any further act of Air Canada or the holder, if such Voting Share becomes held, beneficially owned or controlled, directly or indirectly, otherwise than by way of security only, by a person who is not a Canadian.

Warrants

A summary of warrants outstanding as at December 31, 2009 is as follows:

Grant date	Number of Warrants Outstanding	Exercise Prices	Expiry Dates	Remaining Life (Years)
30-Jul-09	5,000,000	$ 1.51	30-Jul-13	3.6
19-Oct-09	5,000,000	1.44	19-Oct-13	3.8
27-Oct-09	80,250,000	2.20	27-Oct-12	2.8
	90,250,000			

During 2009, a total of 90,250,000 warrants were issued, of which 10,000,000 were issued in conjunction with the Credit Facility as described in Note 6D and 80,250,000 were issued in conjunction with the Share and Warrant Public Offering as described below.

Share and Warrant Public Offering

On October 27, 2009 Air Canada completed a bought deal public offering pursuant to which it sold to an underwriting syndicate 160,500,000 units (the "Units") of Air Canada at a price of $1.62 per Unit for aggregate gross proceeds to Air Canada of $260 (net proceeds of $249 after expenses and underwriter fees).

Each Unit is comprised of one Class A variable voting share (the "Variable Voting Shares") or one Class B voting share (the "Voting Shares", and, together with the Variable Voting Shares, the "Shares") of Air Canada, and one half of one share purchase warrant. Each whole share purchase warrant is defined as a "Warrant". Each Warrant will entitle the holder thereof to acquire one Variable Voting Share or one Voting Share (each, a "Warrant Share") at an exercise price of $2.20 per Warrant Share, at any time prior to 36 months following October 27, 2009. In the event that, prior to the time of expiry of the Warrants, the 20-day volume weighted average trading price of the Variable Voting Shares on the Toronto Stock Exchange ("TSX") is equal to or greater than $4.00 or the 20-day volume weighted average trading price of the Voting Shares on the TSX is equal to or greater than $4.00 (each, an "Acceleration Event"), Air Canada shall have the right, at its option, within 10 business days after the Acceleration Event, to accelerate the time of expiry of the Warrants.

The recorded values related to the Shares and Warrants were split based on their relative fair values. The value ascribed to Share capital was $230 and the value ascribed to Contributed surplus related to the Warrants was $19.

Accumulated Other Comprehensive Loss

Refer to Note 15 for the components of Accumulated other comprehensive loss.

12. EARNINGS PER SHARE

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

(in millions, except per share amounts)	2009	2008
Numerator:		
Numerator for basic earnings per share:		
Loss for the year	$ (24)	$ (1,025)
Adjusted numerator for diluted earnings per share	**$ (24)**	**$ (1,025)**
Denominator:		
Denominator for basic earnings per share:		
Weighted-average shares	132	100
Effect of potential dilutive securities:		
Contingently issuable shares	5	-
Warrant	-	-
Stock options	-	-
Performance share units	-	-
	5	-
Add back anti-dilutive impact	(5)	-
Adjusted denominator for diluted earnings per share	132	100
Basic loss per share	**$ (0.18)**	**$ (10.25)**
Diluted loss per share	**$ (0.18)**	**$ (10.25)**

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.

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. Contingently issuable shares relate to the dilutive impact of the shares issued under the Pension MOUs, as described in Note 8, from the date of the agreement in July to the date of their issuance on October 26, 2009.

Excluded from the 2009 calculation of diluted earnings per share were 3,724,659 (2008 - 1,701,447) outstanding options where the options' exercise prices were greater than the average market price of the common shares for the year. The 561,846 equity settled performance share units outstanding at December 31, 2009 (2008 - 559,885) were also excluded as management determined that the performance vesting criteria will not be met. 90,001,652 warrants were also excluded from the 2009 calculation of diluted earnings per share where the warrants' exercise prices were greater than the average market price of the common shares for the year.

13. SEGMENT INFORMATION

A reconciliation of the total amounts reported by geographic region for Passenger revenue and Cargo revenue on the Consolidated Statement of Operations is as follows:

Passenger revenues	2009	2008
Canada	$ 3,591	$ 4,108
US Transborder	1,641	1,876
Atlantic	1,721	1,883
Pacific	829	995
Other	717	851
	$ 8,499	**$ 9,713**

Cargo revenues	2009	2008
Canada	$ 63	$ 97
US Transborder	14	18
Atlantic	127	212
Pacific	112	142
Other	42	46
	$ 358	**$ 515**

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 origins and destinations principally in Europe. Pacific refers to flights that cross the Pacific Ocean with origins and destinations principally in Asia. Other passenger and cargo revenues refer to flights with origins and destinations principally in South America, South Pacific, and the Caribbean. Other operating revenues are principally derived from customers located in Canada.

14. COMMITMENTS

Boeing

As at December 31, 2009, the Corporation has outstanding purchase commitments with The Boeing Company ("Boeing") for the acquisition of 37 Boeing 787 aircraft. The Corporation also has purchase rights for 18 Boeing 777, purchase options for 13 Boeing 787 aircraft and purchase rights for 10 Boeing 787 aircraft. During 2009, the Corporation and Boeing agreed to amend certain commercial terms, including revisions to delivery dates. The Corporation's first Boeing 787 aircraft is now scheduled for delivery in the second half of 2013.

For the firm aircraft orders, the Corporation has financing commitments from Boeing and the engine manufacturer covering 31 of the 37 Boeing 787 aircraft. The financing terms for 28 out of the 31 covered aircraft is for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments. For the remaining three out of the 31 covered aircraft, the financing under the commitment covers up to 90% of the capital expenditure and the term to maturity is 15 years with principal payments made on a mortgage style basis resulting in equal instalment payments of principal and interest over the term to maturity.

Capital Commitments

The estimated aggregate cost of the future firm Boeing 787 aircraft deliveries and other capital purchase commitments as at December 31, 2009 approximates $4,812 (of which $3,117 is subject to committed financing, subject to the fulfillment of certain terms and conditions). US dollar amounts are converted using the December 31, 2009 noon day rate of CDN$1.0466. 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 US LIBOR rate at December 31, 2009. Other capital purchase commitments relate principally to building and leasehold improvement projects.

	2010	2011	2012	2013	2014	Thereafter	Total
Capital Commitments	$ 74	$ 47	$ 121	$ 731	$ 979	$ 2,860	$ 4,812

Operating Lease Commitments

During 2009, the Corporation took delivery of its last two planned Boeing 777 aircraft, one of which was leased under an operating lease.

As at December 31, 2009 the future minimum lease payments under existing operating leases of aircraft and other property amount to $2,630 using year end exchange rates.

	2010	2011	2012	2013	2014	Thereafter	Total
Aircraft	$ 370	$ 334	$ 317	$ 295	$ 232	$ 754	$ 2,302
Other property	49	41	38	27	25	148	328
Total	**$ 419**	**$ 375**	**$ 355**	**$ 322**	**$ 257**	**$ 902**	**$ 2,630**

The above minimum lease payments include residual value guarantees, except for those for which the Corporation has obtained residual value support.

The Corporation subleases certain aircraft to Jazz on a flow through basis, which are reported net on the statement of operations. These subleases relate to 29 Bombardier CRJ-200 aircraft and 15 Bombardier CRJ-705 aircraft. The operating lease commitments under these aircraft, which are recovered from Jazz, are not included in the aircraft operating lease commitments table above but are summarized as follows:

2010	2011	2012	2013	2014	Thereafter	Total
$ 81	$ 80	$ 80	$ 80	$ 80	$ 553	$ 954

The subleases with Jazz have the same terms and maturity as the Corporation's corresponding lease commitments to the lessors.

The future minimum non-cancellable commitment for the next 12 months under the capacity purchase agreements with Jazz is approximately $732 (2008 - $764) and with other regional carriers is $29 (2008 - $30). As described in Note 2D and based upon amended terms as described in Note 1C, the Jazz CPA expires December 31, 2020. The rates under the Jazz CPA are subject to change based upon, amongst other things, changes in Jazz's costs and the results of a benchmarking exercise with other regional carriers planned to be completed in 2010.

Maturity Analysis

Principal and interest repayment requirements as at December 31, 2009 on Long-term debt and capital lease obligations are as follows:

Principal	2010	2011	2012	2013	2014	Thereafter	Total
Long-term debt obligations	$ 368	$ 655	$ 418	$ 495	$ 383	$ 1,360	$ 3,679
Capital lease obligations	100	101	110	119	94	380	904
	$ 468	**$ 756**	**$ 528**	**$ 614**	**$ 477**	**$ 1,740**	**$ 4,583**

Interest	2010	2011	2012	2013	2014	Thereafter	Total
Long-term debt obligations	$ 213	$ 177	$ 144	$ 109	$ 75	$ 167	$ 885
Capital lease obligations	80	71	62	50	41	118	422
	$ 293	**$ 248**	**$ 206**	**$ 159**	**$ 116**	**$ 285**	**$ 1,307**

Principal repayments in the table above exclude transaction costs of $61 which are offset against Long-term debt and capital leases in the Consolidated Statement of Financial Position.

The following is a maturity analysis, based on contractual undiscounted cash flows, for selected financial liabilities. The analysis includes both the principal and interest component of the payment obligations on long-term debt and is based on interest rates and the applicable foreign exchange rate effective as at December 31, 2009.

	2010	2011	2012	2013	2014	Thereafter	Total
Long-term debt obligations	$ 581	$ 832	$ 562	$ 604	$ 458	$ 1,527	$ 4,564
Capital lease obligations	180	172	172	169	135	498	1,326
Accounts payable and accrued liabilities	1,215	-	-	-	-	-	1,215
Fuel derivatives	31	-	-	-	-	-	31
	$ 2,007	**$ 1,004**	**$ 734**	**$ 773**	**$ 593**	**$ 2,025**	**$ 7,136**

Minimum Committed Purchase of Aeroplan Miles

The CPSA between the Corporation and Aeroplan outlines a requirement for the Corporation to purchase a minimum number of Aeroplan Miles® from Aeroplan. The estimated minimum requirement for 2010 is $211. The annual commitment is based on 85% of the average total Aeroplan Miles® actually issued in respect of Air Canada flights or Air Canada airline affiliate products and services in the three preceding calendar years. During 2009, the Corporation purchased $249 from Aeroplan.

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15. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Summary of Financial Instruments

	Carrying Amounts					
	December 31, 2009					December 31, 2008
	Financial instruments classification					
	Held for trading	Held to maturity	Loans and receivables	Liabilities at amortized cost	Total	
Financial Assets						
Cash and cash equivalents	$ 1,115	$ -	$ -	$ -	$ 1,115	$ 499
Short-term investments	292	-	-	-	292	506
Restricted cash	78	-	-	-	78	45
Accounts receivable	-	-	701	-	701	702
Collateral deposits for fuel derivatives	43	-	-	-	43	328
Deposits and other assets						
Restricted cash	121	-	-	-	121	65
Asset backed commercial paper	29	-	-	-	29	29
Aircraft related and other deposits	-	256	-	-	256	323
Derivative instruments						
Foreign exchange derivatives	-	-	-	-	-	64
Interest rate swaps	11	-	-	-	11	21
	$ 1,689	$ 256	$ 701	$ -	$ 2,646	$ 2,582
Financial Liabilities						
Accounts payable	$ -	$ -	$ -	$ 1,215	$ 1,215	$ 1,262
Current portion of long-term debt and capital leases	-	-	-	468	468	663
Long-term debt and capital leases	-	-	-	4,054	4,054	4,691
Derivative instruments						
Fuel derivatives (1)	31	-	-	-	31	15
Foreign exchange derivatives	4	-	-	-	4	-
	$ 35	$ -	$ -	$ 5,737	$ 5,772	$ 6,631

(1) The fuel derivatives above relate to fuel derivatives not designated under fuel hedge accounting. There are no fuel derivatives designated under hedge accounting as at December 31, 2009. As at December 31, 2008, fuel derivatives under hedge accounting had a fair value of $405 in favour of the counterparties and are described further below.

There have been no changes in classification of financial instruments since December 31, 2008.

For cash flow purposes, the Corporation may settle, from time to time, certain short-term investments prior to their original maturity. For this reason, these financial instruments do not meet the criteria of held to maturity and are therefore designated as held for trading. They are recorded at fair value with changes in fair value recorded in Interest income.

Collateral Held in Leasing Arrangements

The Corporation holds security deposits with a carrying value of $10 (2008 - $18), which approximates fair value, as security for certain aircraft leased and sub-leased to third parties. These deposits do not pay interest to the lessee or sub-lessee. Of these deposits, $7 (2008 - $11) have been assigned as collateral to secure the Corporation's obligations to the lessors and financiers of the aircraft, with the remaining cash held by Air Canada being unrestricted during the term of the lease. Any collateral held by the Corporation is returned to the lessee or sub-lessee, as the case may be, at the end of the lease or sub-lease term provided there have been no events of default under the leases or sub-leases.

Summary of Gain on Financial Instruments Recorded at Fair Value

	2009	2008
Ineffective portion of fuel hedges	$ -	$ 83
Fuel derivatives not under hedge accounting	102	(9)
Cross currency interest rate swaps	-	4
Other	(7)	14
Gain on financial instruments recorded at fair value (1)	**$ 95**	**$ 92**

(1) See Fuel Price Risk for a discussion of losses on fuel derivatives recorded in Other comprehensive income ("OCI").

Risk Management

Under its risk management policy, the Corporation manages its interest rate risk, foreign exchange risk, and market risk through the use of various interest rate, foreign exchange, and fuel derivative financial instruments. The Corporation uses derivative financial instruments only for risk management purposes, not for generating trading profit.

As noted below, the Corporation engages in derivative hedging to mitigate various risks. The derivative fair values represent the amount of the consideration that could be exchanged in an arm's length transaction between willing parties who are under no compulsion to act. Fair value of these derivatives is determined using active markets, where available. When no such market is available, valuation techniques are applied such as discounted cash flow analysis. Where practical, the valuation technique incorporates all factors that would be considered in setting a price, including the Corporation's own credit risk and the credit risk of the counterparty.

<u>Interest Rate Risk</u>

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

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

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in the Corporation's capital structure and is based upon a long term objective of 60% fixed and 40% floating. The ratio at December 31, 2009 is 59% fixed and 41% floating, including the effects of interest rate swap positions (58% and 42%, respectively as at December 31, 2008).

The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded during 2009:

- During 2009, the Corporation entered into an interest rate swap agreement, with a term to November 2011, relating to the Credit Facility as described in Note 6, with an original notional value of $600 systematically declining as payments are made to $450 by the end of its two-year term. This swap converts the Credit Facility's bankers' acceptance rate setting from "in advance" to "in arrears minus 0.2%". The fair value of this contract as at December 31, 2009 was $1 in favour of the counterparty. This derivative instrument has not been designated as a hedge for accounting purposes and is recorded at fair value. During 2009, a loss of $1 was recorded in Gain on financial instruments recorded at fair value related to this derivative.

- As at December 31, 2009, the Corporation had two interest rate swap agreements in place with terms to July 2022 and January 2024 relating to two B767 aircraft financing agreements with an aggregate notional value of $92 (US$88) (2008 - $118 (US$96)). These swaps convert the lease payments on the two aircraft leases from fixed to floating rates. The fair value of these contracts as at December 31, 2009 was $12 in favour of the Corporation (2008 - $21 in favour of the Corporation). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2009, a loss of $9 was recorded in Gain on financial instruments recorded at fair value related to these derivatives (2008 - $14 gain).

Interest income includes $10 (2008 - $47) related to Cash and cash equivalents, Short-term investments, and Collateral deposits for fuel derivatives, which are classified as held for trading. Interest expense reflected on the Consolidated Statement of Operations relates to financial liabilities recorded at amortized cost.

Foreign Exchange Risk

Foreign exchange risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

The Corporation's risk management objective is to reduce cash flow risk related to foreign denominated cash flows.

The Corporation's cash inflows are primarily in Canadian dollars, while a large portion of its outflows are in US dollars. This unbalanced mix results in a US dollar shortfall from operations annually. In order to mitigate this imbalance, the Corporation has adopted the practice of converting excess revenues from offshore currencies into US dollars. In 2009, this conversion generated coverage of approximately 29% of the imbalance. The remaining 71% was covered through the use of a variety of foreign exchange derivatives, including spot transactions and USD investments, which had maturity dates corresponding to the forecasted shortfall dates. The level of foreign exchange derivatives expiring at any one point in time is dependent upon a number of factors, which include the amount of foreign revenue conversion available, US dollar net cash flows, as well as the amount attributed to aircraft and debt payments.

The following are the current derivatives employed in foreign exchange risk management activities and the adjustments recorded during 2009:

- As at December 31, 2009, the Corporation had outstanding foreign currency option agreements converting US dollars into Canadian dollars on $99 (US$95) which mature in 2010 (2008 - $632 (US$516) and $5 (EUR 3)). The fair value of these foreign currency contracts as at December 31, 2009 was $4 in favour of the counterparties (2008 - $64 in favour of the Corporation). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2009, a loss of $7 was recorded in Foreign exchange gain (loss) related to these derivatives (2008 - $327 gain).

Liquidity Risk

Along with many airline carriers globally, Air Canada faced a number of significant challenges in 2008 and 2009 as a result of volatile fuel prices and the weakening demand for air travel. The recession put significant pressures on passenger and cargo revenues for many airlines, including Air Canada. At the same time, lower fuel prices in 2009 and capacity adjustments made in 2008 and 2009 provided some relief.

Management believes however that the significant events as described in Note 1C improve the Corporation's current liquidity position. Risks remain such as those related to the current economic environment, including risks related to market volatility in the price of fuel, foreign exchange and interest rates and increased competitive pressures, as well as risks relating to restrictive terms under the Corporation's financing, credit card processing and other arrangements and other risks identified. These notes to the financial statements contain information regarding the key liquidity risks being monitored by the Corporation (refer to information below regarding Market risks, Note 8 for information regarding pension funding obligations, Note 17 for information regarding contingencies including the Cargo investigations, Note 6 regarding covenants in financing arrangements and below for information regarding covenants in the Corporation's credit card agreements).

The H1N1 influenza virus may also adversely impact demand for air travel. The Corporation is continuing to monitor the H1N1 influenza virus risk. While the Corporation has developed contingency plans related to the H1N1 influenza virus risk, it is unable to predict the likelihood of this risk materializing or the impact on the Corporation to the extent this risk does materialize. The Corporation is also monitoring the impact on the demand for air travel of the new security measures imposed December 2009 by Canadian and U.S. government authorities on flights from Canada to the U.S.

Liquidity risk is the risk that the Corporation will encounter difficulty in meeting obligations associated with its financial liabilities and other contractual obligations. The Corporation monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as well as those assets being used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. The Corporation's principal objective in managing liquidity risk is to maintain a minimum unrestricted cash balance in excess of a target liquidity level of 15% of annual operating revenues.

At December 31, 2009, Air Canada had Cash and cash equivalents and Short-term investments of $1,407, which represents 14% of 2009 operating revenues. Management continues to closely monitor the cash flows as part of its efforts to ensure the Corporation has adequate cash resources to meet its obligations and commitments when they become due.

A maturity analysis of the Corporation's financial liabilities, other fixed operating commitments and capital commitments is set out in Note 14.

Market Risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: foreign exchange risk; interest rate risk; and other price risk, which includes commodity price risk.

The Corporation uses derivative instruments to reduce market exposures from changes in foreign currency rates, interest rates, and fuel prices. The Corporation uses derivative instruments only for risk management purposes and not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows related to the risk being hedged.

Refer to the Asset Backed Commercial Paper section below for information regarding these instruments held by the Corporation and the associated market risks.

Sensitivity Analysis

The following table is a sensitivity analysis for each type of market risk relevant to the significant financial instruments recorded by the Corporation as at December 31, 2009. The sensitivity analysis is based on a reasonably possible movement in the relevant risk factor. These assumptions may not be representative of actual movements in these risks and should not be relied upon. Given the recent volatility in the financial and commodity markets, the actual percentage changes may differ significantly from the percentage changes outlined below. Each risk is contemplated independent of other risks.

	Interest rate risk (1)	Foreign exchange rate risk (2)		Other price risk (3)	
	Income	Income		Income	
	1% increase	5% increase	5% decrease	10% increase	10% decrease
Cash and cash equivalents	$ 11	$ (7)	$ 7	$ -	$ -
Short-term investments	$ 3	$ (1)	$ 1	$ -	$ -
Aircraft related deposits	$ -	$ (8)	$ 8	$ -	$ -
Long-term debt and capital leases	$ (15)	$ 195	$ (195)	$ -	$ -
Fuel derivatives	$ -	$ -	$ -	$ 25	$ (22)
Foreign exchange derivatives	$ -	$ (6)	$ 5	$ -	$ -
Interest rate swaps	$ 1	$ -	$ -	$ -	$ -

(1) Due to currently low market rates of interest, a 1% decrease in interest rates was not considered a reasonable scenario within the forecast period, being one year.

(2) Increase (decrease) in foreign exchange relates to a strengthening (weakening) of the Canadian dollar.

(3) Other price risk relates to the Corporation's fuel derivatives. The sensitivity analysis is based upon a 10% decrease or increase in the price of the underlying commodity.

Covenants in Credit Card Agreements

The Corporation has various agreements with companies that process customer credit card transactions. Approximately 85% of the Corporation's sales are processed using credit cards, with remaining sales processed through cash based transactions. The Corporation receives payment for a credit card sale generally in advance of when the passenger transportation is provided.

As at December 31, 2008, under the terms with one of its principal credit card processors, the processor was able to withhold payment of funds to Air Canada upon the occurrence of certain events ("triggering events"), which included unrestricted cash (as defined per the agreement and generally based on the aggregate sums of Cash and cash equivalents and Short-term investments) being less than $900 as at the end of any month and operating losses in excess of certain amounts. During 2009, the Corporation entered into amendments with this processor to amend certain credit card processing agreements under which the triggering events related to operating losses were removed, the levels of unrestricted cash required to be maintained by Air Canada were reduced to $800 and Air Canada provides the processor with deposits, to be accumulated over time, and security. The agreements provide that should Air Canada maintain unrestricted cash of more than $1,200 for two consecutive months, the unrestricted cash requirement increases to $1,100 at which time the processor will return to Air Canada all deposits and security previously provided by Air Canada. This occurred during the third quarter of 2009, and as a result, no deposit was provided under these processing agreements as at December 31, 2009. As long as unrestricted cash remains at or above $1,100 at each month-end, Air Canada will have no obligation to provide deposits or security to the processor. In addition, should the Corporation's unrestricted cash be less than $1,100 at any month-end, its obligation to provide deposits to the processor would be capped at an amount not to exceed $75, provided unrestricted cash is not less than $800. The current agreement expires in May 2010.

Credit Risk

Credit risk is the risk of loss due to a counterparty's inability to meet its obligations. As at December 31, 2009, the Corporation's credit risk exposure consists mainly of the carrying amounts of Cash and cash equivalents, Short-term investments and Accounts receivable as well as Collateral deposits for fuel derivatives extended to counterparties. Cash and cash equivalents and Short-term investments are in place with major financial institutions, the Canadian government, and major corporations. Accounts receivable are generally the result of sales of tickets to individuals, often through the use of major credit cards, through geographically dispersed travel agents, corporate outlets, or other airlines. Credit rating guidelines are used in determining counterparties for fuel hedging. In order to manage its exposure to credit risk and assess credit quality, the Corporation reviews counterparty credit ratings on a regular basis and sets credit limits when deemed necessary.

The Corporation has $43 in collateral deposits extended to fuel hedge counterparties. Credit risk related to these deposits is offset against the related liability to the counterparty under the fuel derivative.

Refer to the Asset Backed Commercial Paper section below for further credit risk information.

Fuel Price Risk

In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, the Corporation enters into derivative contracts with financial intermediaries. The Corporation uses derivative contracts on jet fuel and other crude oil-based commodities, heating oil and crude oil. Heating oil and crude oil commodities are used due to the relative limited liquidity of jet fuel derivative instruments on a medium to long-term horizon since jet fuel is not traded on an organized futures exchange. The Corporation's policy permits hedging of up to 75% of the projected jet fuel purchases for the next 12 months, 50% for the next 13 to 24 months and 25% for the next 25 to 36 months. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. There are regular reviews to adjust the strategy in light of market conditions. The Corporation does not purchase or hold any derivative financial instrument for speculative purposes.

During 2009, the Corporation purchased crude-oil call options. The premium related to these contracts was $6.

As of December 31, 2009, approximately 18% of the Corporation's anticipated purchases of jet fuel for 2010 are hedged at an average West Texas Intermediate ("WTI") capped price of USD$95 per barrel and approximately 10% is subject to an average floor price of US$96 per barrel. The Corporation's contracts to hedge anticipated jet fuel purchases over the 2010 period are comprised of crude-oil based contracts.

The following table outlines the notional volumes per barrel along with the WTI weighted average floor and capped price for each year currently hedged by type of derivative instruments as at December 31, 2009.

Derivative Instruments	Term	Volume (BBLs)	WTI Weighted Average Floor Price (US$/bbl)	WTI Weighted Average Capped Price (US$/bbl)
Call options (a)	2010	1,835,000	$ n/a	$ 92
Swaps (a)	2010	1,070,000	$ 99	$ 99
Collars (a)	2010	1,180,000	$ 93	$ 95

(a) The Corporation is expected to generate fuel hedging gains if oil prices increase above the average capped price and is exposed to fuel hedging losses if prices decrease below the average floor price.

During 2009, fuel derivative contracts cash settled with a fair value of $88 in favour of the counterparties ($129 in favour of the Corporation in 2008).

During 2009, the Corporation modified its fuel hedge portfolio with the termination of swap and put option contracts for $192, in favour of the counterparties. The collateral held by the counterparties covered the majority of the settlement amount, therefore minimal additional cash outflows resulted. Certain of these contracts were previously designated under hedge accounting. The value of the AOCL balance recognized in connection with these derivatives while designated under hedge accounting will be taken into fuel expense in the period where the derivative was scheduled to mature.

As at December 31, 2009, the net amount of existing losses reported in AOCL that are expected to be reclassified to net income (loss) during the following 12 months is $183 before tax. Due to the discontinuation of hedge accounting effective the third quarter of 2009 (refer to Note 2L), the AOCL balance related to fuel hedging contracts will be completely depleted as of December 31, 2010.

The types of derivative instruments used by the Corporation within its hedging program, such as swaps and put options within collar structures, expose the Corporation to the potential of providing collateral deposits to its counterparties. When fuel prices decrease causing the Corporation's derivative position to be in a liability position below the set credit thresholds with counterparties, the Corporation is responsible for extending collateral to the counterparties. As at December 31, 2009, the Corporation had extended $43 of collateral to counterparties (2008 – $328).

The following information summarizes the financial statement impact of fuel derivatives:

For the year ended December 31 (Canadian dollars in millions except per share figures)			2009		2008
Consolidated Statement of Operations					
Operating expenses					
Aircraft fuel	Realized effective gain (loss) on derivatives designated under hedge accounting	$	(419)	$	79
Non-operating income (expense)					
Gain (loss) on financial instruments recorded at fair value	Ineffective gain (loss) on derivatives designated under hedge accounting	$	-	$	83
	Fair market value gain (loss) on economic hedges	$	102	$	(9)
Consolidated Statement of Comprehensive Income (Loss)					
	Effective gain (loss) on derivatives designated under hedge accounting	$	(1)	$	(605)
	Tax expense on effective gain	$	-	$	-
	Reclassification of net realized (gain) loss on fuel derivatives designated under hedge accounting to Aircraft fuel expense	$	419	$	(79)
	Tax on reclassification	$	4	$	22

As at December 31 (Canadian dollars in millions)			2009		2008
Consolidated Statement of Financial Position					
Current assets	Collateral deposits for fuel derivatives	$	43	$	328
Current liabilities*	Fair market value of fuel derivatives designated under hedge accounting		n/a	$	(405)
	Fair market value of fuel derivatives economic hedges	$	(31)	$	(15)
Shareholders' equity (AOCL)	Net loss from fuel derivatives designated under hedge accounting (net of tax of 2009 - $1 and 2008 - $5)	$	(184)	$	(606)

* The balance is reflected within Current liabilities on the Consolidated Statement of Financial Position due to the counterparty's ability to terminate the derivatives at fair value at any time prior to maturity.

Financial Instrument Fair Values in the Consolidated Statement of Financial Position

The carrying amounts reported in the Consolidated Statement of Financial Position for short term financial assets and liabilities, which includes Accounts receivable and Accounts payable, approximate fair values due to the immediate or short-term maturities of these financial instruments. Cash equivalents, Short-term investments, and Collateral deposits for fuel derivatives are classified as held for trading and therefore are recorded at fair value.

The carrying amounts of interest rate swaps, foreign exchange, and fuel derivatives are equal to fair value, which is based on the amount at which they could be settled based on estimated current market rates.

Management estimated the fair value of its long-term debt based on valuation techniques taking into account market rates of interest, the current tightness in credit markets and current estimated credit margins applicable to the Corporation based on recent transactions. The current low market rates of interest partially offset any increase in credit margins observed in recent transactions. The estimated fair value of debt is approximately $4,200 as compared to its carrying value of $4,522, reflecting primarily the declines in fair values of aircraft financings completed in prior years.

Following is a classification of fair value measurements recognized in the Consolidated Statement of Financial Position using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

	December 31 2009	Fair value measurements at reporting date using: Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Financial Assets				
Held-for-trading securities				
Cash equivalents	$ 323	$ -	$ 323	$ -
Short-term investments	292	-	292	-
Restricted cash in short-term investments	70	-	70	-
Deposits and other assets				
Asset backed commercial paper	29	-	-	29
Derivative instruments				
Interest rate swaps	11	-	11	-
Total	**$ 725**	**$ -**	**$ 696**	**$ 29**

	December 31 2009	Fair value measurements at reporting date using: Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Financial Liabilities				
Derivative instruments				
Fuel derivatives	$ 31	$ -	$ 31	$ -
Foreign exchange derivatives	4	-	4	-
Total	**$ 35**	**$ -**	**$ 35**	**$ -**

Financial assets held by financial institutions in the form of cash, restricted cash and collateral deposits for fuel derivatives have been excluded from the fair value measurement classification table above as they are not valued using a valuation technique.

Asset Backed Commercial Paper ("ABCP")

The Corporation has $37 ($29 net of a fair value adjustment) in non-bank sponsored ABCP which has been recorded in Deposits and other assets. The carrying value as at December 31, 2009 is based on a number of assumptions as to the fair value of the investments including factors such as estimated cash flow scenarios and risk adjusted discount rates. The assumptions used in estimating the fair value of the investments are subject to change, which may result in further adjustments to non-operating results in the future. No adjustments to the carrying value were recorded during 2009.

16. CAPITAL DISCLOSURES

The Corporation views capital as the sum of Long-term debt and capital leases, Non-controlling interest, capitalized operating leases, and Shareholders' equity. As at December 31, 2008, the Corporation had pre-delivery financing arranged, which was related to future deliveries, and, as the aircraft had not yet been delivered, this debt was excluded from the capital base. The Company includes capitalized operating leases, which is a measure commonly used in the industry ascribing a value to obligations under operating leases. The value is based on annualized aircraft rent expense multiplied by 7.5, which is a factor commonly used in the airline industry. The measure used may not necessarily reflect the fair value or net present value related to the future minimum lease payments as the measure is not based on the remaining contractual payments and the factor may not recognize discount rates implicit in the actual leases or current rates for similar obligations with similar terms and risks. This definition of capital is used by management and may not be comparable to measures presented by other public companies.

The Corporation also monitors its ratio of adjusted net debt to net debt plus shareholders' equity. Adjusted net debt is calculated as the sum of Long-term debt and capital lease obligations, Non-controlling interest, capitalized operating leases, and Shareholders' equity less Cash and cash equivalents and Short-term investments.

The Corporation's main objectives when managing capital are:

- to structure repayment obligations in line with the expected life of the Corporation's principal revenue generating assets;
- to ensure the Corporation has access to capital to fund contractual obligations as they become due and to ensure adequate cash levels to withstand deteriorating economic conditions;
- to maintain an appropriate balance between debt supplied capital versus investor supplied capital as measured by the adjusted net debt to net debt plus equity ratio; and
- to monitor the Corporation's credit ratings to facilitate access to capital markets at competitive interest rates.

In order to maintain or adjust the capital structure, the Corporation may adjust the type of capital utilized, including purchase versus lease decisions, defer or cancel aircraft expenditures by not exercising available options or selling current aircraft options, and issuing debt or equity securities, all subject to market conditions and the terms of the underlying agreements.

The total capital as at December 31 is calculated as follows:

	2009	2008
Long-term debt and capital leases	$ 4,054	$ 4,691
Current portion of long-term debt and capital leases	468	663
	4.522	5,354
Non-controlling interest	201	190
Capitalized operating leases	2.513	2,093
Less pre-delivery financing included in long-term debt	-	(81)
Adjusted debt and non-controlling interest	7,236	7,556
Shareholders' equity	1,446	762
Total Capital	**$ 8,682**	**$ 8,318**
Adjusted debt and non-controlling interest	**$ 7,236**	**$ 7,556**
Less Cash and cash equivalents and Short-term investments	(1,407)	(1,005)
Adjusted net debt and non-controlling interest	**$ 5,829**	**$ 6,551**
Adjusted net debt to adjusted net debt plus shareholders' equity ratio	**80.1%**	**89.6%**

The adjusted net debt and non-controlling interest amount has decreased by $722 in 2009 largely attributable to the impact of the appreciation of the Canadian dollar and the resulting impact on US dollar debt. The increase in the cash balance during the year was also a significant contributor driven by the completion of a share and warrant public offering and other transactions described in Note 1C.

17. CONTINGENCIES, GUARANTEES AND INDEMNITIES

Contingencies

Investigations 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 Air Canada. Competition authorities have sought or requested information from Air Canada as part of their investigations. Air Canada is cooperating with these investigations, which are likely to lead, or have led, to proceedings against Air Canada and a number of airlines and other cargo operators in certain jurisdictions including in the European Union where all formal procedural steps preceding a decision have been completed. Air Canada 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.

During 2008, Air Canada recorded a provision of $125 as a preliminary estimate. This is only an estimate based upon the current status of the investigations and proceedings and Air Canada's assessment as to the potential outcome for certain of them. This provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Management has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings and investigations. Additional material provisions may be required and such provisions could have a material adverse effect on Air Canada's financial position.

Porter Airlines Inc.

In February 2006, Jazz commenced proceedings before the Ontario Superior Court of Justice against Porter Airlines Inc. ("Porter") and other defendants (collectively the "Porter Defendants") after Jazz became aware that it would be excluded from operating flights from Toronto City Centre (Island) Airport (the "TCCA"). On October 26, 2007, the Porter Defendants counter-claimed against Jazz and Air Canada alleging various violations of competition law, including that Jazz and Air Canada's commercial relationship contravenes Canadian competition laws, and claiming $850 in damages. Concurrently with the Ontario Superior Court of Justice proceedings, Jazz commenced judicial review proceedings against the Toronto Port Authority ("TPA") before the Federal Court of Canada relating to Jazz's access to the TCCA. The Porter Defendants were granted intervener and party status in these proceedings. In January of 2008, Porter filed a defence and counterclaim against Jazz and Air Canada making allegations and seeking conclusions similar to those in the Ontario Superior Court counterclaim. On October 16, 2009, Jazz discontinued its suit in the Ontario Superior Court against Porter. However, Jazz is continuing its proceedings in the Federal Court of Canada against the TPA, to which Porter intervened. The counterclaim filed by Porter in the Ontario Court against Jazz and Air Canada has been stayed pending the outcome of the mirror counterclaim in the Federal Court. Management views Porter's counterclaims in both jurisdictions as being without merit.

Pay Equity

The Canadian Union of Public Employees ("CUPE"), which represents Air Canada's flight attendants, has filed a complaint 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 complaint dates from 1991 but has 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 complaint. On March 16, 2007, the Canadian Human Rights Commission referred the complaint against Air Canada for investigation. Air Canada considers that any investigation will show that it is complying with the equal pay provisions of the Canadian Human Rights Act, however, Management has determined that it is not possible at this time to predict with any degree of certainty the final outcome of the Commission's investigation.

Mandatory Retirement

Air Canada is engaged in a number of proceedings involving challenges to the mandatory retirement provisions of certain of its collective agreements, including the Air Canada-Air Canada Pilots Association collective agreement which incorporate provisions of the pension plan terms and conditions applicable to pilots requiring them to retire at age 60. Air Canada is defending these challenges. At this time, it is not possible to determine with any degree of certainty the extent of any financial liability that may arise from Air Canada being unsuccessful in its defense of these proceedings, though any such financial liability, if imposed, would not be expected to be material.

Other Contingencies

Various other lawsuits and claims, including claims filed by various labour groups of Air Canada 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.

With respect to 45 aircraft leases, the difference between the amended rents as a result of the implementation of the Plan of Reorganization, Compromise and Arrangement (the “Plan”) under the Companies’ Creditors Arrangement Act (“CCAA”) on September 30, 2004 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, which does not include any cross defaults to other agreements, 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

Guarantees in Fuel Facilities Arrangements

The Corporation participates in fuel facility arrangements operated through 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 $162 as at December 31, 2009 (2008 - $127), 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.

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 various tax consequences including in relation to the leased or financed aircraft, the use, possession, operation maintenance, leasing, subleasing, repair, insurance, delivery, import, export of such aircraft, the lease or finance arrangements entered in connection therewith, changes of law and certain income, commodity and withholding 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 and pursuant to contractual agreements between the Corporation and each of its officers and directors, 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

At December 31, 2009, ACE holds a 27% ownership interest in Air Canada. Air Canada has various related party transactions with ACE and Aveos (formerly called ACTS Aero Technical Support & Services Inc. ("ACTS Aero")), which conducts the business previously operated by ACTS LP ("ACTS") prior to the sale of ACTS by ACE on October 16, 2007.

During 2008, ACTS LP settled certain contracts with Air Canada for $11, in relation to the October 2007 sale of assets of ACTS LP. These contracts were accounted for as equity transactions, resulting in an increase to Contributed surplus of $11.

Related party trade balances, as outlined below, mainly arise from the provision of services, including the allocation of employee related costs, as further described in Note 8. Trade balances between the related parties have trade terms which generally require payment 30 days after receipt of invoice.

The related party balances resulting from the application of the related party agreements were as follows:

	2009	2008
Accounts receivable		
ACE	$ -	$ 2
Aveos	135	120
	$ 135	**$ 122**
Prepaid maintenance		
Aveos	$ 9	$ 5
	$ 9	**$ 5**
Accounts payable and accrued liabilities		
ACE	$ 3	$ -
Aveos	92	99
	$ 95	**$ 99**
Long-term debt including current portion and value of warrants		
ACE	$ 150	$ -
	$ 150	**$ -**

Revenues and expenses with related parties are summarized as follows:

	2009	2008
Revenues		
Property rental revenues from ACE and Aveos	$ 31	$ 29
Revenues from information technology services to Aveos	6	15
Revenues from corporate services and other to ACE and Aveos	9	15
	$ 46	**$ 59**
Expenses		
Maintenance expense for services from Aveos	$ 514	$ 478
Recovery of wages, salary and benefit expense for employees assigned to ACE and Aveos	(228)	(277)
Interest expense for ACE's participation in the Credit Facility	8	-
Other expenses	-	1
	$ 294	**$ 202**

Summary of significant related party agreements

The Relationship between the Corporation and Aveos

Refer to the "Aveos Restructuring Plan" section below for a description of a restructuring plan announced by Aveos on January 26, 2010. Closing of Aveos restructuring transactions is expected to occur during the first quarter of 2010 and is dependant on completion of formal documentation and certain conditions. This restructuring would modify the terms of certain commercial agreements between Air Canada and Aveos, including terms of the Pension and Benefits Agreement and the Agreement with Aveos on Revised payment terms described below.

<u>Pension and Benefits Agreement</u>

The Corporation, ACTS and Aveos entered into a Pension and Benefits Agreement effective as of October 16, 2007, as amended ("Pension and Benefits Agreement"), relating to pension and benefits arrangements pertaining to (i) the non-unionized employees of Air Canada who were previously assigned to the ACTS operation and who became employees of Aveos on October 16, 2007 and (ii) those unionized employees of Air Canada who were assigned to ACTS Aero operation pursuant to general services agreements between Air Canada and ACTS for the assignment of unionized employees from Air Canada to ACTS (these agreements were assigned to ACTS Aero (i.e. Aveos) in 2007). Aveos is required to establish new defined benefit and defined contribution pension plans as well as other employee and retiree benefit arrangements (including health, life and disability) (the "ACTS Benefit Arrangements").

Upon receipt of regulatory approval where required and based upon valuations of the relevant pension and benefit arrangements of Air Canada (the "Air Canada Benefit Arrangements") as at October 16, 2007, the assets and obligations under the Air Canada Benefit Arrangements pertaining to the transferring non-unionized employees will be transferred to Aveos or the ACTS Benefit Arrangements, as applicable. Amounts with a present value equal to the solvency deficiency in the defined benefit pension plans as at October 16, 2007 related to transferring non-unionized employees will be paid by Air Canada through quarterly payments to Aveos until 2014. Amounts with a present value equal to the accounting liability as at October 16, 2007 in respect of retiree and disability benefits related to transferring non-unionized employees are to be paid by Air Canada through quarterly payments to Aveos until 2012. The present value of these quarterly payments is also referred to as the compensation amount. Until such future time as the assets and obligations under the Air Canada Benefit Arrangements pertaining to non-unionized employees may be transferred to Aveos, the current service pension cost and the current service and interest costs for other employee benefits are expensed by Air Canada with a full offset recorded as an amount charged to affiliates (Aveos).

In addition, the Pension and Benefits Agreement contemplates similar asset and liability transfer and compensation arrangements in respect of unionized employees, which arrangements would take effect at such future time as those unionized employees may commence employment with Aveos pursuant to the Transition Memorandum of Agreement ("the Transition MOA"), as described further below. However, the solvency deficiencies in respect of transferring unionized employees for which the future quarterly compensation payments would be made are determined as at October 16, 2007, subject to certain adjustments, and the discount rate used to compute the accounting liability for the unionized employees' retiree and disability benefits is fixed as at October 16, 2007. The compensation payments in respect of these solvency deficiencies and accounting liabilities will be made quarterly during the five years beginning after the unionized employees are transferred to Aveos, but only if such a transfer occurs. Until such future time as the assets and obligations under the Air Canada Benefit Arrangement pertaining to unionized employees may be transferred to Aveos, the current service pension cost and the current service and interest costs for other employee benefits in respect of Air Canada employees providing services to Aveos are charged by Air Canada to Aveos.

The Pension and Benefits Agreement also required that Air Canada provide letters of credit to Aveos on October 16, 2007, to secure the above-described payment obligations in respect of the solvency deficiencies of the defined benefit pension plans and accounting liabilities for other retiree and disability benefit arrangements. The letters of credit initially totaled $101, subject to adjustment once the exact amounts of the relevant solvency deficiencies and accounting liabilities as at October 16, 2007 were determined by actuarial valuations. The face amount of the letter of credit in respect of the unionized solvency deficiency is also adjusted annually to recognize past service costs paid by Air Canada to the plan in respect of unionized employees assigned to Aveos. The face amount of the letters of credit decreases as the related quarterly funding payments described above are made. During 2008, as described below under "Agreement with Aveos on Revised Payment Terms", the Corporation and Aveos also agreed to temporarily cancel certain letters of credit in the amount of $40.

Aveos may call the letters of credit in whole or in part, in the event of a default as defined in the Pension and Benefits Agreement. Collateral equal to the amount of the letters of credit was paid in cash with the asset recorded in Deposits and other assets. Refer to Note 5 for the current amount of the letters of credit related to the Pension and Benefits Agreement. Refer to the Aveos Restructuring Plan section below for a description of amendments which would be made to this agreement pursuant to the restructuring.

During 2008, Air Canada, Aveos, and the union representing the employees assigned to Aveos continued discussions regarding the options under which certain unionized employees would commence employment directly with Aveos and the creation of a separate bargaining unit for those employees at Aveos. On January 8, 2009, these same parties entered into the Transition MOA in order to resolve certain remaining issues and in order to (i) facilitate the orderly transition of certain Air Canada employees to Aveos and (ii) to establish terms and conditions of employment that will apply to those Air Canada employees who elect to become employees of Aveos. In relation to the Transition MOA, the Corporation and Aveos also entered into certain ancillary agreements (the "Ancillary Transition Agreements") to address commercial issues relating to the transition of employees contemplated by the Transition MOA. On March 5, 2009, the Corporation received the decision of the arbitrator seized with resolving five issues which remained outstanding following the execution of the Transition MOA. The Corporation and the IAMAW subsequently amended the Transition MOA, by establishing timelines for the steps for the transition and by providing for a date on which the employees who will transition to Aveos will become employees of Aveos, namely, April 1, 2011.

<u>Non-Compete and Repair Schemes Transfer Agreement</u>

Aveos and Air Canada are parties to a Non-Compete and Repair Schemes Transfer Agreement, effective as of October 16, 2007. Generally described, repair schemes are processes and methods which may be used in the maintenance and repair of aircraft and related equipment. The Non-Compete and Repair Schemes Transfer Agreement confirmed an arrangement and provides for the sale from Air Canada to ACTS Aero (as successor to ACTS LP) of an undivided joint ownership interest in repair schemes owned by Air Canada or approved under Air Canada's airworthiness engineering organization as well as the sale from Aveos to Air Canada of an undivided joint ownership interest in the repair schemes owned or developed by Aveos and applicable to airframe heavy maintenance services provided by ACTS to Air Canada under the parties' airframe heavy maintenance services agreement. However, in September 2004 as part of the implementation of the Corporation's plan of arrangement under the Companies' Creditors Arrangement Act, the Corporation had already granted ACTS full and exclusive right to these schemes on a royalty free basis.

The Non-Compete and Repair Schemes Transfer Agreement also restricts Air Canada's ability to own any equity interest in an entity (other than entities in which Air Canada previously held interests), or to carry on a business activity, related to the following commercial maintenance, repair and overhaul services in the airline industry, namely, airframe heavy maintenance and paint services, engine and auxiliary power unit ("APU") overhaul maintenance services, and component maintenance services. The applicable non-compete periods are as follows:

- With respect to airframe heavy maintenance services and paint services, the non-compete period ends one year after the current heavy maintenance services agreement is terminated or expires (the current term of the heavy maintenance services agreement expires October 1, 2011);
- With respect to engine and APU overhaul maintenance services, the non-compete period ends on October 1, 2015; and
- With respect to component maintenance services, the non-compete period ends on October 1, 2016;

The Non-Compete and Repair Schemes Transfer Agreement does not restrict Air Canada from holding interests in any entities in which it held interests at the time of concluding the agreement nor does it limit Air Canada's line maintenance activities which it continues to operate.

Agreement with Aveos on Revised Payment Terms

Air Canada and Aveos entered into an agreement dated October 28, 2008 pursuant to which Air Canada has agreed to temporarily extend payment terms to Aveos under certain related party agreements. In exchange for the extended payment terms, certain letters of credit related to the Pension and Benefits Agreement, as described above, were cancelled. The cancellation of the letters of credit provided cash to Air Canada of approximately $40 and was offset by the impact of extended payment terms to Aveos of $22, for a net cash flow benefit of $18 to the Corporation. The extended payment terms to Aveos were originally scheduled to begin reducing in May 2009 with a corresponding return of the letters of credit to Aveos.

As a result of amendments, the payment terms were extended. The extended payment terms will be reduced starting in February 2010 with the expiration of the extended payment terms to be completed over the following six months. By July 2010, following expiration of the extended payment terms, the letters of credit would be reinstated to the levels then required under the Pension and Benefits Agreement between the two parties. Refer to the Aveos Restructuring Plan section below for a description of amendments which would be made to this Agreement pursuant to the restructuring.

Maintenance Agreements

Aveos and Air Canada are parties to a general terms and related services agreements effective October 1, 2006, pursuant to which Aveos provides technical services to the Corporation including engine and auxiliary power unit maintenance services, aircraft heavy maintenance services (excluding line and cabin maintenance services which are provided by the Corporation),and component maintenance. Aveos serves as the Corporation'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. The services agreement relating to aircraft heavy maintenance services, which expires in October 2011, will be extended to June 2013 conditional upon the issuance of an order of the Canada Industrial Relations Board establishing that Aveos is a distinct employer, bound by separate collective agreements and providing for the transition of employees from Air Canada to Aveos which are fully within the scope of the Transition MOA and the Ancillary Transition Agreements mentioned above. The services agreement relating to engine maintenance expires in October 2013, except in respect of certain engine types, for which the parties have agreed to extend the term to December 31, 2018. Each of the other maintenance agreements referred to above expire in October 2013.

Master Services Agreement (MSA)

Aveos and Air Canada are parties to an amended and restated master services agreement (the "Aveos MSA"), effective January 1, 2007, pursuant to which the Corporation provides Aveos with services including infrastructure support and services which are mostly administrative in nature, including information technology, human resources, finance and accounting services in return for fees paid by Aveos to the Corporation. Aveos may elect to terminate any services under the Aveos MSA or the entire Aveos MSA upon six months' prior written notice, with the exception of services relating to information technology which Aveos cannot terminate prior to the expiry of the Aveos MSA. Air Canada may elect to terminate any services under the Aveos MSA or the entire Aveos MSA upon 18 months' prior written notice. These amounts are recorded in the above table summarizing related party revenues and expenses under Revenues from corporate services and other.

General Services Agreements

Aveos and Air Canada are parties to an amended and restated general services agreement (the "Aveos GSA"), effective as of June 22, 2007, pursuant to which the Corporation provides Aveos with the services of a group of unionized employees for which the Corporation is reimbursed by Aveos for all costs, including salary and benefits, on a fully allocated basis. The Aveos GSA may be terminated by either party at any time upon 30 days' prior written notice.

Real Estate Agreements

Aveos and Air Canada are parties to a master lease agreement, effective as of October 1, 2006, pursuant to which Aveos leases space from the Corporation at the Vancouver, Winnipeg, Toronto and Montreal airports.

Aveos Restructuring Plan

On January 26, 2010, Aveos reached an agreement with its lenders and equity holders on the terms of a consensual restructuring plan to recapitalize the company. As part of this recapitalization, Air Canada and Aveos entered into a preliminary agreement to settle certain issues and modify the terms of certain contractual arrangements in exchange for Air Canada receiving a minority equity interest in Aveos. The modified terms relating to the maintenance agreements are not expected to have a material impact on maintenance expense over their terms.

Closing of Aveos' recapitalization, including the related transactions between Air Canada and Aveos, is subject to completion of formal documentation and other conditions and is expected to occur during the first quarter of 2010. As part of these agreements, the Corporation would also agree to extend repayment terms on $22 of receivables (described above under Agreement with Aveos on Revised Payment Terms), due in 2010, over six years with annual repayments on a non-interest bearing basis, with such payments subject to satisfaction of certain conditions.

The terms of the Pension and Benefits Agreement (described above) would also be modified to defer the determination of pension assets and related solvency deficiencies of transferring unionized employees performing airframe maintenance services to April 2011. This would have the result of Air Canada assuming changes in the solvency deficiency for those affected employees from the date of the Pension and Benefits Agreement to the date of their transfer to Aveos, scheduled for April 2011. As part of the amendment, all letters of credit issued under the Pension and Benefits Agreement would be cancelled and a new letter of credit in a maximum amount of $20 would be issued by Air Canada in favour of Aveos to secure the payment of all compensation payments owing by Air Canada to Aveos in respect of pension, disability, and retiree liabilities for which Air Canada is liable under the PBA. This modification would result in a reduction to the outstanding deposit under Air Canada's letter of credit facility of approximately $20 in the first quarter of 2010.

The accounting for the above agreements will be determined upon closing.

The Relationship between the Corporation and ACE

Term Credit Facility

ACE is a participant lender in the Credit Facility as described in Note 6. ACE's participation in the Credit Facility represents $150 of the outstanding loan of $600 as at December 31, 2009. The participant lenders participate on a pro-rata basis with respect to any warrants and principal and interest payments. ACE's pro-rata share of interest expense reported during the year amounts to $8 and its pro-rata share of the warrants as reported in Contributed surplus is approximately $2.

Master Services Agreement

Air Canada provides certain accounting and administrative services to ACE in return for a fee. ACE terminated the majority of these service agreements in 2009.

OFFICERS

David I. Richardson	Chairman of the Board
Calin Rovinescu	President and Chief Executive Officer
Duncan Dee	Executive Vice President and Chief Operating Officer
Michael Rousseau	Executive Vice President and Chief Financial Officer
Benjamin M. Smith	Executive Vice President and Chief Commercial Officer
Lise Fournel	Senior Vice President, E-Commerce and Chief Information Officer
Kevin C. Howlett	Senior Vice President, Employee Relations
David Legge	Senior Vice President, Operations
Susan Welscheid	Senior Vice President, Customer Service
Alan D. Butterfield	Vice President, Air Canada Maintenance and Engineering
Nick Careen	Vice President, Airports
Yves Dufresne	Vice President, Alliances, International Operations and Regulatory Affairs
Marcel Forget	Vice President, Network Planning
Lucie Guillemette	Vice President, Revenue Management
Carolyn M. Hadrovic	Corporate Secretary
Chris Isford	Vice President and Controller
Priscille LeBlanc	Vice President, Corporate Communications
Scott Morey	Vice President, Labour Relations
Claude Morin	Vice President, Global Sales
David J. Shapiro	Vice President and General Counsel

DIRECTORS

David I. Richardson	Corporate Director and Chairman of the Board, Air Canada, Grafton, Ontario
Bernard Attali	Senior Advisor, TPG Capital, Paris, France
Michael M. Green	Chief Executive Officer and Managing Director, Tenex Capital Management, Radnor, Pennsylvania
Jean Marc Huot	Partner, Stikeman Elliott LLP, Montreal, Quebec
Pierre Marc Johnson	Counsel, Heenan Blaikie LLP, Montreal, Quebec
Joseph B. Leonard	Corporate Director, Minneapolis, Minnesota
Arthur T. Porter	Director General and Chief Executive Officer, McGill University Health Centre, Montreal, Quebec
Roy J. Romanow	Senior Fellow, Public Policy, University of Saskatchewan, Saskatoon, Saskatchewan
Calin Rovinescu	President and Chief Executive Officer, Air Canada, Montreal, Quebec
Vagn Sørensen	Senior Industrial Advisor, EQT Partners, Holte, Denmark

Investor and Shareholder Information

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

2009	High	Low	Volume Traded
1st Quarter	$ 2.70	$ 0.76	4,544,625
2nd Quarter	$ 1.90	$ 0.68	5,644,631
3rd Quarter	$ 2.10	$ 1.23	2,454,576
4th Quarter	$ 1.88	$ 1.01	13,015,378
			25,659,210

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

2009	High	Low	Volume Traded
1st Quarter	$ 2.65	$ 0.77	9,325,349
2nd Quarter	$ 1.89	$ 0.73	9,667,221
3rd Quarter	$ 2.10	$ 1.29	4,831,590
4th Quarter	$ 1.86	$ 1.03	64,067,473
			87,891,633

Price Range and Trading Volume of Air Canada Warrants (AC.WT)

2009	High	Low	Volume Traded
4th Quarter*	$ 0.38	$ 0.17	6,130,296

* Air Canada Warrants commenced trading October 27, 2009

Restrictions on Voting Securities

Currently, the *Air Canada Public Participation Act* (ACCPA) limits ownership of Air Canada's voting interests by 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. Accordingly, Air Canada's articles contain restrictions to ensure that it remains "Canadian" as defined under the CTA. The restrictions provide that non-Canadians can only hold variable voting shares of Air Canada, that such variable voting shares will not carry more than 25% (or any higher percentage that the Governor in Council may by regulation specify) 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 of shareholders will not exceed 25% (or any such higher percentage) of the votes that may be cast at such meeting.

The Government of Canada's Bill C-10, the *Budget Implementation Act 2009*, contains provisions whereby the restrictions on voting securities in the ACPPA would be repealed and the CTA would be amended to provide the Governor in Council with flexibility to increase the foreign ownership limit from the existing 25% level to a maximum of 49%. These provisions will come into force on a date to be fixed by order of the Governor in Council made on the recommendation of the Minister of Finance, in the case of the ACPPA, and on the recommendation of the Minister of Transport, in the case of the CTA.

For Further Information

Shareholder Relations
Telephone: 514-422-6644
Facsimile: 514-422-0296
Email: shareholders.actionnaires@aircanada.ca

Investor Relations
Telephone: 514-422-7849
Facsimile: 514-422-7877

Head Office
Air Canada Centre
7373 Côte-Vertu Blvd. West
Saint-Laurent, Quebec H4S 1Z3

Internet
www.aircanada.com

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

Transfer Agents and Registrar
CIBC Mellon Trust Company
Telephone: 1-800-387-0825
Halifax, Montreal, Toronto,
Calgary and Vancouver.

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:
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Montreal, Quebec H3A 2A6

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

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ENGLISH OR FRENCH, IT'S THE CLIENT'S CHOICE.

Official Languages at Air Canada

For Air Canada, offering service in the language chosen by its customers is essential. Verbal exchanges with clients, public-address announcements at the airport and on board as well as briefing of passengers with special needs all constitute the very heart of customer service and call upon our employees linguistic skills at all times. Our consideration to bilingualism not only makes good sense customer-wise, but also supports our legal obligations to serve the public in the two official languages of Canada.

Air Canada puts great efforts to better serve clients in the language of their choice. It is through reach-out activities with the minority language communities as well as ongoing employee awareness and training that we can face the daily challenges, whether it is the growing difficulty to recruit bilingual candidates outside the province of Quebec and the national capital region, or for our employees to maintain their language skills with very little opportunities to practice the acquired language in some regions of the country.

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 2009, represented 87% of its total operating revenues.

During 2009, Air Canada, together with Jazz, operated, on average, approximately 1,331 scheduled flights daily and carried almost 31 million passengers. In 2009, Air Canada and Jazz provided direct passenger air transportation to 156 destinations and, through commercial agreements with other unaffiliated regional airlines referred to as tier III carriers, to an additional 11 destinations, for a total of 167 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 Network, the world's largest airline alliance group. The Star Alliance Network includes 26 member airlines. Through its strategic and commercial arrangements with Star Alliance members, Air Canada is able to offer its customers access to approximately 1,077 destinations in 175 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges.

The Corporation also generates revenue from its cargo services division (doing business as 'Air Canada Cargo') and from tour operator services provided by its wholly-owned subsidiary, Air Canada Vacations.

aircanada.com

AIR CANADA

A STAR ALLIANCE MEMBER