AIR CANADA

2011
Management's Discussion and Analysis of Results of Operations and Financial Condition

February 9, 2012

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1. Highlights

Effective January 1, 2011, Air Canada began reporting its financial results in accordance with IFRS, including comparative figures for 2010. The financial and operating highlights for Air Canada for the periods indicated are as follows.

	Fourth Quarter			Full Year		
(Canadian dollars in millions, except where indicated)	**2011**	**2010**	**Change $**	**2011**	**2010**	**Change $**
Financial Performance Metrics						
Operating revenues	2,699	2,616	83	11,612	10,786	826
Operating income (loss) before the provision adjustment for cargo investigations, net [1]	(98)	15	(113)	179	232	(53)
Operating income (loss)	(98)	61	(159)	179	278	(99)
Non-operating income (loss)	38	28	10	(429)	(303)	(126)
Income (loss) before income taxes	(60)	89	(149)	(250)	(25)	(225)
Net income (loss) for the period	(60)	89	(149)	(249)	(24)	(225)
Operating margin before the provision adjustment for cargo investigations, net % [1]	(3.6)%	0.6%	(4.2) pp	1.5%	2.2%	(0.6) pp
Operating margin %	(3.6)%	2.3%	(5.9) pp	1.5%	2.6%	(1.0) pp
EBITDAR before the provision adjustment for cargo investigations, net [1] [2]	162	328	(166)	1,242	1,386	(144)
EBITDAR [2]	162	374	(212)	1,242	1,432	(190)
EBITDAR margin before the provision adjustment for cargo investigations, net % [1] [2]	6.0%	12.6%	(6.6) pp	10.7%	12.9%	(2.2) pp
EBITDAR margin % [2]	6.0%	14.3%	(8.3) pp	10.7%	13.3%	(2.6) pp
Cash, cash equivalents and short-term investments	2,099	2,192	(93)	2,099	2,192	(93)
Free cash flow [3]	(69)	122	(191)	366	746	(380)
Adjusted net debt [4]	4,576	4,874	(298)	4,576	4,874	(298)
Net income (loss) per share - Diluted	$ (0.22)	$ 0.27	$ (0.49)	$ (0.92)	$ (0.12)	$ (0.80)
Adjusted net loss per share - Diluted [5]	$ (0.64)	$ (0.17)	$ (0.47)	$ (0.72)	$ (0.58)	$ (0.14)
Operating Statistics			**Change %**			**Change %**
Revenue passenger miles (millions) (RPM)	12,065	11,756	2.6	54,223	51,875	4.5
Available seat miles (millions) (ASM)	15,290	14,918	2.5	66,460	63,496	4.7
Passenger load factor %	78.9%	78.8%	0.1 pp	81.6%	81.7%	(0.1) pp
Passenger revenue per RPM ("Yield") (cents)[6]	19.5	19.1	1.9	18.7	18.1	3.3
Passenger revenue per ASM ("RASM") (cents) [6]	15.4	15.1	2.0	15.3	14.8	3.2
Operating revenue per ASM (cents) [6]	17.7	17.3	2.2	17.5	17.0	2.9
Operating expense per ASM ("CASM") (cents)	18.3	17.4	4.9	17.2	16.6	3.5
CASM, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations (cents) [7]	12.6	12.8	(1.5)	11.7	12.0	(2.9)
Average number of full-time equivalent (FTE) employees (thousands) [8]	23.6	23.3	1.5	23.7	23.2	2.1
Aircraft in operating fleet at period end [9]	331	328	0.9	331	328	0.9
Average fleet utilization (hours per day) [10]	9.4	9.4	(0.3)	10.1	9.8	2.7
Revenue frequencies (thousands)	133	131	1.3	551	537	2.5
Average aircraft flight length (miles) [10]	857	850	0.8	892	868	2.7
Economic fuel price per litre (cents) [11]	88.6	67.5	31.3	85.2	66.4	28.3
Fuel litres (millions)	912	906	0.7	3,937	3,791	3.9

(1) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.

(2) EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent) is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for a reconciliation of EBITDAR before a provision adjustment for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).

(3) Free cash flow (cash flows from operating activities less additions to property, equipment and intangible assets) is a non-GAAP financial measure. Refer to section 9.5 of this MD&A for additional information.

(4) Adjusted net debt (total debt less cash, cash equivalents and short-term investments plus capitalized operating leases) is a non-GAAP financial measure. Refer to section 9.3 of this MD&A for additional information.

(5) Adjusted net income (loss) per share (diluted) is a non-GAAP financial measure. Refer to section 20 of this MD&A for additional information.

(6) A favourable revenue adjustment of $40 million related to Air Canada's transatlantic joint venture with United Airlines and Deutsche Lufthansa AG, which was finalized in December 2010 but with effect as of January 1, 2010, and to other interline agreements was recorded in the fourth quarter of 2010. For comparative purposes, these measures were adjusted to exclude the impact of the $40 million favourable adjustment recorded in the fourth quarter of 2010, which related to activities attributable to the first three quarters of 2010.

(7) Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, is a non-GAAP financial measure. Refer to section 20 of this MD&A for additional information.

(8) Reflects FTE employees at Air Canada. Excludes FTE employees at third party carriers (such as at Jazz Aviation LP ("Jazz")) operating under capacity purchase agreements with Air Canada.

(9) Includes Jazz aircraft covered under a capacity purchase agreement with Jazz (the "Jazz CPA"). Excludes aircraft operated by other third party carriers pursuant to capacity purchase agreements with Air Canada. Refer to section 8 of this MD&A for additional information.

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

(11) Excludes third party carriers, other than Jazz, operating under capacity purchase agreements. Includes fuel handling and is net of fuel hedging results. Economic fuel price per litre is a non-GAAP financial measure. Refer to sections 6 and 7 of this MD&A for additional information.

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. This 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 2011 and the full year 2011. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2011. All financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the Handbook of the Canadian Institute of Chartered Accountants – Part 1 ("CICA Handbook"), except for any financial information specifically denoted otherwise.

The CICA Handbook was revised to incorporate International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board, and requires publicly accountable enterprises to apply IFRS effective for years beginning on or after January 1, 2011. As a result of the adoption of IFRS, financial results for periods prior to the adoption of IFRS may no longer be comparable to financial results reported under IFRS. In addition, certain trends in operating results experienced under Canadian GAAP prior to the adoption of IFRS may no longer be extrapolated. In particular, the accounting standards for pension and other employee benefits, depreciation, amortization and impairment expense, and aircraft maintenance expense are significantly affected by the changeover to IFRS.

Starting in the first quarter of 2011, Air Canada revised the presentation of certain operating expenses on the statement of operations. These revisions include a new expense line category within operating expenses referred to as "sales and distribution costs" which includes sales commissions, credit card fees and other sales and distribution costs, including fees paid to global distribution system ("GDS") providers. The expense line category related to capacity purchase agreements has been expanded to include fees paid under all capacity purchase arrangements, including those paid to Jazz Aviation LP ("Jazz") pursuant to the capacity purchase agreement between Air Canada and Jazz (the "Jazz CPA") and those paid to other carriers operating flights on behalf of Air Canada under commercial agreements.

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 21 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of February 8, 2012.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of this MD&A.

Air Canada issued a news release dated February 9, 2012, reporting on its results for the fourth quarter of 2011 and for the full year 2011. This news release is available on Air Canada's website at **aircanada.com** and on SEDAR's website at **www.sedar.com**. For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult SEDAR at **www.sedar.com**.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

Air Canada's public communications may include 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 may be based on forecasts of future results and estimates of amounts not yet determinable. These statements may involve, but are not limited to, comments relating to strategies, expectations, planned operations or future actions. Forward-looking statements are identified 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, employee and labour relations, currency exchange and interest rates, competition, war, terrorist acts, epidemic diseases, environmental factors (including weather systems and other natural phenomena and factors arising from man-made sources), 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 18 "Risk Factors" of this MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of February 8, 2012 (or as of the date they are otherwise stated to be made), and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether 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 Canadian economy will continue to recover and assumes Canadian GDP growth of 1.5% to 2.0% in 2012. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C$1.01 per U.S. dollar in the first quarter of 2012 and C$1.00 per U.S. dollar for the full year 2012 and that the price of jet fuel will average 88 cents per litre for the first quarter of 2012 and 87 cents per litre for the full year 2012.

3. About Air Canada

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

In 2011, Air Canada, together with Jazz and other regional airlines operating flights on behalf of and under commercial agreements with Air Canada (which operate under the brand name "Air Canada Express"), operated, on average, 1,506 daily scheduled flights to 60 destinations in Canada, 57 destinations in the U.S. and 63 destinations in the Canada-Europe, Canada-Pacific, Canada-Caribbean/Central America and Canada-South America markets. Domestic, U.S. transborder and international departures accounted for approximately 67%, 25% and 8%, respectively, of the 1,506 average daily departures. In addition, Air Canada provides certain passenger charter services under the brand name "AC Jetz". In 2011, Air Canada carried almost 34 million passengers and provided passenger service to 180 direct destinations on five continents.

As at December 31, 2011, Air Canada operated a mainline fleet of 205 aircraft comprised of 89 Airbus narrowbody aircraft, 56 Boeing and Airbus widebody aircraft and 60 Embraer regional jets. In addition, under Air Canada's capacity purchase agreement with Jazz (the "Jazz CPA"), Jazz operated, for Air Canada, 126 aircraft comprised of 58 Bombardier regional jets and 68 Dash-8 aircraft.

Air Canada enhances its network through the Jazz CPA, pursuant to which Air Canada purchases the greater part of Jazz's fleet capacity based on predetermined rates and Air Canada determines the routes and schedule which Jazz operates on Air Canada's behalf. Under the Jazz CPA, Jazz operates with smaller jet and turboprop aircraft that have lower trip costs than conventional large jet aircraft, allowing Jazz to provide service to Air Canada's customers in lower density markets as well as in higher density markets throughout Canada and the United States.

Air Canada also offers scheduled passenger services on domestic and Canada-US transborder routes through capacity purchase agreements with other regional carriers, including Sky Regional Airlines, Inc. ("Sky Regional"), which operates, on behalf of Air Canada, between Toronto Island's Billy Bishop Airport and Montreal's International Trudeau Airport. In 2011, such other third party regional carriers under capacity purchase agreements with Air Canada operated 21 aircraft on behalf of Air Canada.

Air Canada is a founding member of the Star Alliance™ network. The Star Alliance network includes 28 member airlines. Through its membership in the Star Alliance network, Air Canada is able to offer its customers access to approximately 1,290 destinations in 189 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges.

Air Canada participates in a transatlantic joint venture with United Air Lines, Inc., Continental Airlines, Inc. (United Air Lines, Inc. and Continental Airlines, Inc. are collectively "United Airlines") and Deutsche Lufthansa AG through which the carriers provide customers with more choice and streamlined service on routings between North and Central America, and Africa, India, Europe and the Middle East. This transatlantic joint venture, including its revenue share structure, was implemented effective January 1, 2010.

Through its long-term relationship with Aeroplan Canada Inc. ("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.

Air Canada also generates revenue from 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 Vacations is one of Canada's leading tour operators offering a full range of leisure travel packages including cruises, tours, car rentals and excursions. Based in Montreal and Toronto, Air Canada Vacations operates its business in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, North, Central and South America, South Pacific and Asia) by developing, marketing and distributing vacation travel packages. Air Canada Vacations also offers cruise packages in North America, Europe and the Caribbean.

Air Canada Cargo provides direct cargo services to over 150 Canadian, U.S. transborder 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 flights on routes between Canada and major markets in Europe, Asia, South America and Australia.

4. Strategy

Air Canada has been pursuing a strategy of profitable growth and sustainability to create value for shareholders and to lower the overall risk profile of the company. The airline continues to focus its activities on improving its revenue performance while increasing its productivity and improving its cost structure with the objective of increasing operating earnings and cash flow. Key components of this strategy are to leverage Air Canada's strengths internationally, reduce costs and generate incremental revenues; profitably provide "best in class" customer services and products, with particular focus on the business traveller, and to transform Air Canada's corporate culture with an emphasis on leadership, accountability and entrepreneurship. Air Canada's goal is to enhance its position as one of the world's leading international carriers.

Leveraging the International Network

In 2010, in anticipation of growing demand for international passenger travel, Air Canada focused on progressively expanding its services in selected international markets while moderating growth in the domestic market. In 2010, capacity in the international markets (including U.S. transborder) increased 10.0%. In 2011, when compared to 2010, capacity growth of 6.6% in international markets (including U.S. transborder) reflected the full year impact of this initiative.

In 2012, Air Canada's focus is to continue leveraging its international network while maintaining a disciplined approach to growth. Air Canada believes it is well positioned to increase its international market by leveraging the following competitive advantages:

- Its widely-recognized brand and its strong position in the market for transatlantic and transpacific travel to and from Canada and the Canada-South America market;
- Its extensive global network, which is enhanced by Air Canada's membership in Star Alliance and by its participation in a transatlantic revenue sharing joint venture;
- Its young fleet, with an average age of 11.6 years at December 31, 2011 (average age of widebody aircraft of 12.3 years);
- Its Aeroplan program, which was voted "Program of the Year in the Americas" at the 2011 Frequent Travelers Awards;
- Its competitive products and services, including lie-flat beds in the Executive First cabin, concierge services and Maple Leaf lounges; and
- Its geographically well-positioned hubs (Toronto, Montreal and Vancouver), which provide natural advantages to serve customers travelling to or from the U.S. to Asia and Europe.

Through its world-class hub at Toronto Pearson International Airport ("Toronto Pearson") and strong international gateways at Montreal and Vancouver, Air Canada intends to grow global connecting traffic via Canada.

With its proximity to densely populated markets and superior facilities, Toronto Pearson provides a clear advantage, on which Air Canada intends to capitalize. Air Canada is working closely with the Greater Toronto Airport Authority ("GTAA") to continue to transform Toronto Pearson into a leading North American airport for international connections. With the consolidation of Air Canada's and most of its Star Alliance partners' operations in one terminal, Toronto Pearson's in-transit facilities now allow passengers to move seamlessly between Canada and U.S. Customs and Immigration.

Air Canada plans to continue to leverage its competitive advantages to capture sixth freedom traffic from the U.S. (meaning U.S. originating traffic carried through points in Canada to other international destinations), particularly from the Eastern U.S. where consumers are already in the habit of connecting to international flights. With its 54% share of passenger traffic at Toronto Pearson, Air Canada has the critical mass needed to attract a large share of traffic between the U.S. and Europe, Asia and Africa. Air Canada currently flies to 50 U.S. destinations from Toronto Pearson, including San Diego, Portland (Oregon), Cincinnati, Memphis, Portland (Maine), Syracuse (New York) and New Orleans, which were all added in 2010.

Air Canada believes that the significant increase in passenger flow that is now travelling from the United States and choosing to connect through the airline's hub airports in Canada to onward international flights is evidence that Air Canada's efforts are yielding results. While all hubs are experiencing connection growth, Toronto Pearson has experienced the highest increase in international connecting traffic with an increase of 110% since 2009.

Air Canada has been intensifying its focus on markets with high growth economies, such as Asia and South America, and has increased its capacity in those markets. Air Canada's decision to add capacity to the China market was also taken in light of Canada being granted Approved Destination Status from China in 2010, a designation that makes it easier for Chinese nationals to visit Canada. China and South America are both important strategic markets for Air Canada and the development of its franchise in those markets continues to be an important element of the airline's business strategy.

The further development of commercial alliances with major international carriers also continues to be an important aspect of Air Canada's business strategy. Through its membership in Star Alliance, which allows the airline to offer its customers a choice of 1,290 airports in 189 countries, Air Canada is expanding its global reach. Air Canada is also strengthening its market presence in North and Central America, Europe, the Middle East, Africa and India through its participation in a transatlantic revenue sharing joint venture with United Airlines and Deutsche Lufthansa AG, referred to as A++. By coordinating pricing, scheduling and sales, Air Canada is better able to serve customers by offering more travel options, while reducing travel times.

Leveraging New Opportunities for Revenue Growth and Cost Transformation

A competitive cost structure is a key element for long-term profitability and sustainability. A key element of Air Canada's business strategy is to pursue sustainable reductions in its cost structure without compromising customer experience and to leverage opportunities for revenue growth.

Pursuing its goal to develop a competitive cost structure, in mid-2009, Air Canada launched a company-wide cost transformation program, referred to as the CTP, with a goal of generating annualized revenue gains and cost savings of $530 million by the end of 2011. Through the renegotiation of various contracts, operating process improvements and productivity gains, Air Canada achieved its overall CTP target of $530 million, on a run-rate basis, by the end of the third quarter of 2011.

The airline continues to seek cost reduction and revenue generating initiatives beyond those achieved through the CTP through its Business Transformation team and other avenues. These initiatives include the use of technology and the streamlining of processes to reduce costs and increase customer satisfaction, and the leveraging of cross branch synergies to find new revenue sources and eliminate waste.

A key structural change in aviation over the past decade has been the proliferation of low-cost carriers. The low-cost model has overwhelmingly been the preferred mode of airline start-ups over the last decade, and their spread around the world, into both the short-haul and long-haul markets has caused a fundamental shift in the competitive dynamic of the industry.

Air Canada views its participation in the low-cost segment of the leisure market as important to the airline. Air Canada is currently evaluating various models that would allow its participation in this market segment. The airline's commercial strategy would focus on: 1) maintaining the appeal of Air Canada's mainline operations for passengers who require a large choice of frequencies and other full service amenities 2) stimulating demand with lower fares and 3) preventing the erosion of passengers on leisure routes through a low-cost carrier venture.

Air Canada also expects to achieve further cost savings starting in 2014 when it is scheduled to begin introducing Boeing 787 aircraft into its fleet. The Boeing 787 aircraft would allow the airline to reduce operating expenses through fuel and maintenance savings, in addition to gaining greater workforce efficiency. These new aircraft will also provide the airline with the ability to serve new markets that it cannot currently serve in an efficient manner. Air Canada is evaluating which and how many of its existing Boeing 767-300 aircraft, which would be more expensive to operate, will be removed from service on lease expiry as the Boeing 787 aircraft are delivered.

Engaging with Customers with a Focus on Premium Passengers and Premium Products

Increasing customer satisfaction levels and growing the airline's premium customer base remain key elements of Air Canada's business strategy. Air Canada's goal is to continuously meet and exceed customer expectations by delivering consistently friendly, professional and "best in class" service.

In 2011, Air Canada was successful in promoting its premium cabin, as evidenced by an 8.3% increase in premium cabin revenues when compared to 2010.

Air Canada was also recognized with the following awards, reflecting both the skill and professionalism of its employees and the quality of its product offerings:

- "Best In-Flight Services in North America" and "Best North American Airline for International Travel" in Business Traveler's "Best in Business Travel" award program, for a fourth consecutive year.

- "Best Airline in North America" in the annual The Global Traveler Reader Survey Awards, based on the responses of more than 25,000 readers of Global Traveler Magazine, for a third consecutive year.

- "Best Flight Experience to Canada from Anywhere in the World" by readers of Executive Travel Magazine in their annual "Leading Edge Awards" readership survey of frequent international travelers, for a fourth consecutive year.

- "Best International Airline in North America" in a worldwide survey of more than 17 million air travelers conducted by independent research firm, Skytrax, for their 2011 World Airline Awards, for a second consecutive year.

The 2011 Ipsos Reid Business Travel Study also reflected encouraging results with 73% of Canadian business travellers choosing Air Canada as the preferred airline. This was the third consecutive year of improved results, which also registered increases in customer satisfaction and in Air Canada's ranking as the airline used most often.

In 2012, the airline will continue to focus on better managing its premium class cabin to maximize revenues, and seeking new opportunities to increase premium revenues. Air Canada will also look to broaden its access to corporate customers by focusing on small to medium size enterprises. Air Canada believes it maintains a revenue premium that more than offsets the higher costs associated with service to premium passengers.

Enhancing the Corporate Culture and Developing a Strong Employee Brand

Another cornerstone of Air Canada's business strategy and objectives is to transform its corporate culture to one that embraces leadership, accountability and entrepreneurship. Air Canada believes that a healthy, dynamic corporate culture can provide many benefits, including a competitive edge through innovation and customer service, a shared purpose, team cohesiveness, and high employee morale and performance, all of which can have an important impact on a company's long-term performance.

Air Canada experienced difficult labour negotiations in 2011, which diverted focus from this strategic component. Nevertheless, the manner in which employees overcame challenges arising from the labour context was remarkable and a true demonstration that culture change is taking shape at Air Canada. There were countless instances where employees took ownership to resolve customer concerns and where empowered employees acted as true leaders, promoting the Air Canada brand and delivering great customer service despite adversity. Air Canada continues to be awarded many industry honours, proof that employees continue to participate in the airline's transformation and recognize that maintaining high levels of customer satisfaction is fundamental to the airline's success. The emphasis on cost containment is also reinforcing the value placed on a more entrepreneurial culture at Air Canada, one in which all employees are encouraged to act as owners and ambassadors of the airline.

5. Overview

Air Canada's results of operations for 2011 compared to 2010 are as follows:

- Operating income of $179 million decreased $53 million from 2010 while EBITDAR of $1,242 million declined $144 million, both before a favourable adjustment of $46 million to a provision for cargo investigations in 2010. On a capacity increase of 4.7%, Air Canada experienced strong revenue growth in the year, driven by increased fares and fuel surcharges, however the revenue growth was more than offset by an increase in total operating expenses, the result of significantly higher jet fuel prices year-over-year.

- Operating revenues increased $826 million or 8% from 2010, on passenger revenue growth of 8.3%. The growth in system passenger revenues in 2011 was due to a 4.5% increase in system passenger traffic and a 3.3% improvement in system yield. In 2011, the impact of a stronger Canadian dollar on foreign currency denominated passenger revenues reduced system passenger revenues by $64 million while the impact of the Japan earthquake and its aftermath is believed to have reduced passenger revenues by $28 million. Overall capacity was 4.7% higher than in 2010, reflecting ASM growth in all markets. This system capacity growth was slightly above the 4.0% to 4.5% full year 2011 ASM capacity increase projected in Air Canada's news release dated November 4, 2011 due to fewer weather-related flight cancellations than previously forecasted. System RASM increased 3.2% year-over-year on the yield growth.

- Operating expenses increased $879 million or 8% from 2010, of which $723 million was due to higher fuel expense year-over-year. Excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, CASM decreased 2.9% from 2010. CASM, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, was favourably impacted by the following: a stronger Canadian dollar on foreign currency denominated expenses which reduced operating expenses by $60 million; the 4.7% capacity growth; an increase in both aircraft utilization and stage length of 2.7%; a decrease in depreciation, amortization and impairment expense; a decrease in wages and salaries; and the benefits of the airline's cost transformation program. Partially offsetting these decreases was an increase in employee benefits expense.

- A key element of Air Canada's business strategy is to consistently improve unit revenue and cost productivity. To this end, in early 2009, Air Canada launched a major company-wide cost transformation program (the "CTP") with the objective of achieving annualized revenue improvements and cost savings of $530 million by the end of 2011. As at September 30, 2011, Air Canada had surpassed this CTP target. Air Canada views continuous cost transformation and improvement as one of its most important priorities, and a critical objective going forward to support ongoing unit cost improvements.

- A net loss of $249 million or $0.92 per diluted share was a deterioration of $225 million from the net loss of $24 million or $0.12 per diluted share recorded in 2010. The net loss in 2011 included foreign exchange losses of $54 million while the net loss in 2010 included foreign exchange gains of $184 million, an interest expense charge of $54 million related to the repayment of the term credit facility, an impairment charge on aircraft of $49 million, and the net favourable adjustment to the provision for cargo investigations of $46 million.

- Free cash of $366 million decreased $380 million from 2010, largely due to a decline in net cash from operations of $210 million, higher pension payments of $129 million, and a reduction in cash provided by working capital of $79 million.

- At December 31, 2011, adjusted net debt of $4,576 million decreased $298 million from December 31, 2010. Debt repayments of $608 million in 2011 were funded from positive free cash flow of $366 million and the proceeds from new debt borrowings of $232 million. The favourable impact of foreign exchange on aircraft rent also lowered capitalized operating lease obligations by $126 million in 2011. Cash, cash equivalents and short-term investments totaled $2,099 million as at December 31, 2011, representing 18% of twelve-month trailing operating revenues.

6. Results of Operations – Full Year of 2011 versus Full Year 2010

The following table and discussion compares the results of Air Canada for the full year of 2011 versus the full year of 2010.

(Canadian dollars in millions, except per share figures)	Full Year 2011	Full Year 2010	Change $	Change %
Operating revenues				
Passenger	$ 10,208	$ 9,427	$ 781	8
Cargo	481	466	15	3
Other	923	893	30	3
	11,612	**10,786**	**826**	**8**
Operating expenses				
Aircraft fuel	3,375	2,652	723	27
Wages, salaries, and benefits	1,991	1,913	78	4
Airport and navigation fees	1,007	961	46	5
Capacity purchase agreements	1,003	971	32	3
Depreciation, amortization and impairment	728	801	(73)	(9)
Aircraft maintenance	681	654	27	4
Sales and distribution costs	612	581	31	5
Food, beverages and supplies	278	279	(1)	-
Communications and information technology	193	195	(2)	(1)
Aircraft rent	335	353	(18)	(5)
Other	1,230	1,194	36	3
	11,433	**10,554**	**879**	**8**
Operating income before exceptional item	**179**	**232**	**(53)**	
Provision adjustment for cargo investigations, net [1]	**-**	**46**	**(46)**	
Operating income	**179**	**278**	**(99)**	
Non-operating income (expense)				
Foreign exchange gain (loss)	(54)	184	(238)	
Interest income	36	19	17	
Interest expense	(320)	(397)	77	
Net financing expense relating to employee benefit liabilities	(16)	(75)	59	
Loss on financial instruments recorded at fair value	(63)	(3)	(60)	
Other	(12)	(31)	19	
	(429)	(303)	(126)	
Loss before income taxes	**(250)**	**(25)**	**(225)**	
Recovery of income taxes	1	1	-	
Loss for the period	**$ (249)**	**$ (24)**	**$ (225)**	
EBITDAR before the provision adjustment for cargo investigations, net [1] [2]	**$ 1,242**	**$ 1,386**	**$ (144)**	
EBITDAR [2]	**$ 1,242**	**$ 1,432**	**$ (190)**	
Loss per share – Diluted	**$ (0.92)**	**$ (0.12)**	**$ (0.80)**	

(1) *In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.*

(2) *See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before the provision adjustment for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).*

System passenger revenues increased 8.3% from 2010

Compared to 2010, system passenger revenues increased $781 million or 8.3% to $10,208 million in 2011 due to traffic and yield growth.

The table below provides passenger revenue by geographic region for the full year of 2011 and the full year of 2010.

Passenger Revenue	Full Year 2011 $ Million	Full Year 2010 $ Million	$ Change	% Change
Canada	4,015	3,790	225	5.9
U.S. transborder	2,064	1,797	267	14.8
Atlantic	2,033	1,962	71	3.6
Pacific	1,177	1,087	90	8.3
Other	919	791	128	16.1
System	**10,208**	**9,427**	**781**	**8.3**

The table below provides year-over-year percentage changes in passenger revenues and other operating statistics for the full year of 2011 versus 2010.

Full Year 2011 Versus Full Year 2010	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	5.9	0.3	0.9	0.4	4.7	5.3
U.S. transborder	14.8	6.7	9.8	2.2	4.3	7.3
Atlantic	3.6	5.9	3.8	(1.7)	(0.5)	(2.5)
Pacific	8.3	7.2	5.6	(1.3)	2.3	0.8
Other	16.1	7.1	7.3	0.2	8.1	8.4
System	**8.3**	**4.7**	**4.5**	**(0.1)**	**3.3**	**3.2**

Air Canada increased its overall capacity by 4.7% in 2011. Consistent with a key Air Canada strategy of expanding international operations, international capacity (including the U.S. transborder market) increased 6.6% from 2010. Components of the year-over-year change in full year system passenger revenues included:

- The system traffic increase which reflected growth in all markets. The traffic increase was slightly below the capacity growth, resulting in a minimally lower passenger load factor.
- The system yield increase which reflected growth in all markets, with the exception of the Atlantic. The yield increase was mainly due to increased fares and fuel surcharges to partly offset higher fuel prices. Gains in premium cabin traffic also contributed to the yield improvement.
- The system yield improvement which was achieved in spite of a $64 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated passenger revenues.

The system RASM increase was due to the yield improvement.

Refer to section 7 of this MD&A for year-over-year percentage changes in passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the fourth quarter 2011 and each of the previous four quarters.

Domestic passenger revenues increased 5.9% from 2010

Domestic passenger revenues of $4,015 million in 2011 increased $225 million or 5.9% from 2010 due to yield and traffic growth. The capacity growth in 2011 was mainly due to Air Canada's new service from Toronto Island's Billy Bishop Airport to Montreal Trudeau Airport.

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

- The traffic increase which reflected growth on all major domestic services. The traffic increase was slightly above the capacity growth, resulting in a slightly higher passenger load factor.

- The yield increase which reflected growth on all major domestic services. The yield improvement was mainly due to fuel-related fare increases to partly offset higher fuel prices. The yield improvement was achieved in spite of a $12 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated domestic passenger revenues.

The RASM growth was mainly due to the yield improvement.

U.S. transborder passenger revenues increased 14.8% from 2010

U.S. transborder passenger revenues of $2,064 million in 2011 increased $267 million or 14.8% from 2010 due to traffic and yield growth. The capacity growth in 2011 mainly reflected an increase in frequencies on routes to California, Florida and Las Vegas, as well as the addition of the airline's new service to New Orleans. Components of the year-over-year change in U.S. transborder passenger revenues included:

- The traffic increase which reflected growth on all major U.S. transborder services and was in part due to sixth freedom traffic flows from the U.S. (meaning U.S. originating traffic carried through points in Canada to other international destinations) in support of Air Canada's international expansion initiatives.

- The yield improvement which was due to fuel-related fare increases to offset higher fuel prices. A gain in premium cabin traffic was also a contributing factor. Yield improvements were recorded on all major U.S. transborder services with the exception of routes to Hawaii where a more competitive pricing environment had a negative impact on yields. The yield improvement was achieved in spite of a $31 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated U.S. transborder passenger revenues.

The RASM improvement was due to the higher yield and passenger load factor.

Atlantic passenger revenues increased 3.6% from 2010

Atlantic passenger revenues of $2,033 million in 2011 increased $71 million or 3.6% from 2010 due to traffic growth. The capacity increase in 2011 was mainly due to additional frequencies on summer seasonal routes, including Montreal and Toronto to Athens, Toronto to Barcelona and Madrid, and Toronto to Dublin. In addition, Air Canada operated an additional Montreal to London Heathrow flight, as well as additional frequencies from Toronto to Copenhagen. Air Canada also operated larger aircraft on flights from Toronto to Munich and Zurich and on its Toronto – Montreal to Brussels service. Components of the year-over-year change in Atlantic passenger revenues included:

- The traffic increase which reflected growth on all major Atlantic services, with the exception of routes to the United Kingdom. The U.K. market continued to be challenged by the weak economic environment and additional competitive pricing actions, impacting both local traffic and connecting markets over Air Canada's London gateway. The traffic increase was below the capacity growth, resulting in a lower passenger load factor.

- The yield decline which was mainly due to the impact of increased competition and competitive pricing activities and the continuing weak economic conditions in Europe. Despite this, premium cabin traffic experienced gains when compared to 2010. The yield decline was also due to a $13 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated Atlantic passenger revenues.

The RASM decrease was due to the lower passenger load factor and the decline in yield.

Pacific passenger revenues increased 8.3% from 2010

Pacific passenger revenues of $1,177 million in 2011 increased $90 million or 8.3% from 2010 due to traffic and yield growth. The capacity growth in 2011 mainly reflected a capacity increase on routes to China partly offset by a capacity decrease on routes to Japan. Air Canada estimates that the impact of the Japan earthquake and is aftermath reduced passenger revenues by $28 million in 2011. Components of the year-over-year change in Pacific passenger revenues included:

- The traffic increase which reflected growth on routes to China and Korea and, to a lesser extent, Hong Kong. The traffic increase was below the capacity growth, resulting in a lower passenger load factor.

- The yield improvement which was in part due to yield improvements in the economy cabin on routes to Japan and Korea, as well as to fuel surcharges to offset higher fuel prices. A gain in premium cabin traffic was also a factor in the yield improvement. The yield improvement was achieved in spite of a $5 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated Pacific passenger revenues.

The RASM improvement was due to the yield growth in the economy cabin, combined with overall traffic gains in the premium cabin.

Other passenger revenues increased 16.1% from 2010

Other passenger revenues (comprised of Australia, Caribbean, Mexico and Central and South America) of $919 million in 2011 increased $128 million or 16.1% from 2010, mainly due to yield and traffic growth. In 2011, the capacity growth was largely due to capacity increases on routes to Mexico, Chile and Argentina and, to a lesser extent, on routes to the Caribbean. Components of the year-over-year increase in Other passenger revenues included:

- The overall traffic increase which reflected growth on all major services. The overall traffic increase slightly exceeded the capacity growth, resulting in a minimally higher passenger load factor.

- The overall yield improvement which reflected growth on all major services. The overall yield improvement was due to increased fares and fuel surcharges to partly offset higher fuel prices. Routes to Australia and South America recorded significant yield improvements year-over-year, on stronger passenger demand and increased network flows. A gain in premium cabin traffic was also a factor in the yield improvement. The year-over-year yield improvement was achieved in spite of a $2 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated Other passenger revenues.

The overall RASM improvement was mainly due to the yield growth.

Cargo revenues increased 3.3% from 2010

In the full year of 2011, cargo revenues amounted to $481 million, a $15 million or 3.3% increase from 2010 due to a yield improvement.

The table below provides cargo revenue by geographic region for the full year of 2011 and the full year of 2010.

Cargo Revenue	**Full Year 2011 $ Million**	**Full Year 2010 $ Million**	**$ Change**	**% Change**
Canada	66	69	(3)	(4.4)
U.S. transborder	17	17	-	0.3
Atlantic	194	164	30	18.2
Pacific	146	164	(18)	(11.1)
Other	58	52	6	12.3
System	**481**	**466**	**15**	**3.3**

The table below provides year-over-year percentage changes in cargo revenues and operating statistics for the full year of 2011 versus the full year of 2010.

Full Year 2011 Versus Full Year 2010	Cargo Revenue % Change	Capacity (ETMs) % Change	Rev / ETM % Change	Traffic (RTMs) % Change	Yield / RTM % Change
Canada	(4.4)	(7.1)	2.9	(10.2)	5.3
U.S. transborder	0.3	13.6	(11.7)	(0.2)	0.5
Atlantic	18.2	5.7	11.8	2.1	15.8
Pacific	(11.1)	7.2	(17.1)	(6.4)	(5.0)
Other	12.3	3.1	9.0	3.9	8.0
System	**3.3**	**4.6**	**(1.3)**	**(1.7)**	**5.0**

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

- The growth in cargo yield which was due to increased fuel surcharges year-over-year. Partially offsetting this increase was the unfavourable impact of a stronger Canadian dollar on foreign currency denominated revenues (mainly U.S. dollars), which reduced cargo revenues by $3 million in 2011.

- The overall decline in cargo traffic which was largely due to a continuing weak economic environment in Asia, in part due to the Japan earthquake and its aftermath.

Refer to section 7 of this MD&A for year-over-year percentage changes in cargo revenues, capacity, revenue per ETM, traffic and yield by quarter for the fourth quarter 2011 and each of the previous four quarters.

Other revenues increased 3% from 2010

Other revenues consist primarily of revenues from the sale of the ground portion of vacation packages, ground handling services, and other airline-related services, as well as revenues related to the lease or sublease of aircraft to third parties.

Other revenues of $923 million in 2011 increased $30 million or 3% from 2010. The growth in other revenues was due to a $33 million increase in third party ground package revenues at Air Canada Vacations, which was mainly due to higher passenger volumes, and by an increase in cancellation and change fees year-over-year. Partly offsetting these increases were a decrease in aircraft sublease revenues due to fewer aircraft being subleased to third parties compared to 2010, and the unfavourable impact of a stronger Canadian dollar on U.S. currency denominated aircraft lease and sublease revenues.

CASM increased 3.5% from 2010. Excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, CASM decreased 2.9% from 2010

The following table compares Air Canada's CASM for the full year of 2011 to Air Canada's CASM for the corresponding period in 2010.

	Full Year		Change	
(cents per ASM)	**2011**	**2010**	**cents**	**%**
Wages and salaries	2.31	2.39	(0.08)	(3.3)
Benefits	0.69	0.62	0.07	11.3
Aircraft fuel	5.08	4.18	0.90	21.5
Airport and navigation fees	1.52	1.51	0.01	0.7
Capacity purchase agreements	1.51	1.53	(0.02)	(1.3)
Ownership (DAR) (1)	1.60	1.82	(0.22)	(12.1)
Aircraft maintenance	1.03	1.03	-	-
Sales and distribution costs	0.92	0.92	-	-
Food, beverages and supplies	0.42	0.44	(0.02)	(4.5)
Communications and information technology	0.29	0.31	(0.02)	(6.5)
Other	1.83	1.87	(0.04)	(2.1)
Total operating expense	**17.20**	**16.62**	**0.58**	**3.5**
Remove:				
Cost of fuel expense and cost of ground packages at Air Canada Vacations	(5.54)	(4.61)	(0.93)	20.2
Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations (2)	**11.66**	**12.01**	**(0.35)**	**(2.9)**

(1) DAR refers to the combination of depreciation, amortization and impairment, and aircraft rent expenses.

(2) Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

The main factors contributing to the year-over-year change in CASM, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, in the full year included:

- The favourable impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), which reduced operating expenses by $60 million;
- The 4.7% capacity growth, which resulted in the airline's fixed costs being allocated over a greater number of ASMs;
- An increase in both aircraft utilization and average stage length of 2.7%;
- A decrease in depreciation, amortization and impairment expense;
- A decrease in wages and salaries largely reflecting reduced expenses related to incentive compensation programs partly offset by higher average salaries; and
- The impact of CTP initiatives which reduced various operating expense categories, including: wages and salaries, capacity purchase costs, food, beverage and supplies, communications and information technology and other operating expenses.

These above-noted decreases were partly offset by an increase in employee benefits expense.

Excluding fuel expense, CASM decreased 2.6% from 2010. The 2.6% decrease in CASM, excluding fuel expense, was in line with the 2.0% to 3.0% decrease projected in Air Canada's news release dated November 4, 2011.

Operating expenses increased 8% from 2010

Air Canada recorded operating expenses of $11,433 million, an increase of $879 million or 8% from the operating expenses of $10,554 million recorded in 2010. The more significant variances are discussed below.

Fuel expense increased 27% from 2010

Fuel expense amounted to $3,375 million in 2011, an increase of $723 million or 27% from 2010. Factors contributing to the year-over-year change in fuel expense included:

- A higher base fuel price, which accounted for an increase of $973 million.
- A higher volume of fuel consumed, which was driven by the additional capacity year-over-year, and which accounted for an increase of $93 million.

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

- Fuel hedging losses reclassified from AOCL of $183 million in 2010 versus no fuel hedging losses recorded in fuel expense in 2011, resulting in a favourable variance of $183 million year-over-year.
- The favourable impact of a stronger Canadian dollar versus the U.S. dollar which accounted for a decrease of $160 million.

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

		Full Year		Change	
(Canadian dollars in millions, except where indicated)		**2011**	**2010**	**$**	**%**
Aircraft fuel expense - GAAP (1)		$ 3,349	$ 2,638	$ 711	27
Remove:	*Fuel hedging losses reclassified from AOCL into fuel expense*	-	(183)	183	100
Add:	*Net cash payments on fuel derivatives (2)*	4	60	(56)	(93)
Economic cost of fuel - Non-GAAP (3)		**$ 3,353**	**$ 2,515**	**$ 838**	**33**
Fuel consumption (thousands of litres)		3,937,102	3,790,911	146,191	4
Fuel costs per litre (cents) – GAAP		85.1	69.6	15.5	22
Fuel costs per litre (cents) - excluding fuel hedging losses		85.1	64.8	20.3	31
Economic fuel costs per litre (cents) - Non-GAAP		85.2	66.4	18.8	28

(1) Excludes fuel expense related to third party carriers, other than Jazz, operating under capacity purchase agreements.

(2) Includes net cash settlements on maturing fuel derivatives and premium costs associated with those derivatives. Excludes early terminated hedging contracts of $5 million in the second quarter of 2010 covering 2010 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 its cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period and premium costs associated with those derivatives. It excludes non-cash accounting gains and losses from fuel derivative instruments.

Wages, salaries and benefits expense amounted to $1,991 million in 2011, an increase of $78 million or 4% from 2010

Wages and salaries expense amounted to $1,533 million in 2011, an increase of $12 million or 1% from 2010, mainly due to higher average salaries and an increase in the average number of FTE employees year-over-year. On capacity growth of 4.7%, the average number of FTE employees increased 2.1% year-over-year, resulting in a productivity improvement of 2.5%, as measured by ASMs per FTE employee. Partly offsetting these increases was a decrease in expenses related to incentive compensation programs, including those linked to Air Canada's operational performance.

Employee benefits expense amounted to $458 million in 2011, an increase of $66 million or 17% from 2010. The increase in employee benefits expense was mainly due to higher pension and post-employment expenses resulting from changes in actuarial assumptions year-over-year. The $66 million increase in employee benefits expense was slightly above the increase of $60 million projected in Air Canada's news release dated November 4, 2011.

Airport and navigation fees increased 5% from 2010

Airport and navigation fees amounted to $1,007 million in 2011, an increase of $46 million or 5% from 2010. This increase was mainly due to a 2.5% increase in aircraft departures, the impact of changes in schedule and aircraft types operated to certain destinations and to an increase in terminal user fees, effective April 1, 2011, at London Heathrow Airport. Costs associated with Air Canada's new services operated by Sky Regional between Billy Bishop Toronto City Airport and Montreal Trudeau Airport were also contributing factors to this increase.

Capacity purchase costs increased 3% from 2010

Capacity purchase costs amounted to $1,003 million in 2011 compared to $971 million in 2010, an increase of $32 million or 3%. This increase was mainly due to higher Jazz CPA rates, increased flying by Jazz, and costs associated with Air Canada's new services operated by Sky Regional between Billy Bishop Toronto City Airport and Montreal Trudeau Airport. Partly offsetting these increases was the favourable impact of foreign exchange on U.S. currency denominated Jazz CPA charges paid by Air Canada, which accounted for a decrease of $13 million in capacity purchase costs in 2011. In addition, in 2010, Air Canada recorded a charge of $7 million related to Jazz covered aircraft returns while no such charge was recorded in 2011.

Ownership costs decreased 8% from 2010

Ownership costs, which are comprised of depreciation, amortization and impairment, and aircraft rent expenses, of $1,063 million in 2011 decreased $91 million or 8% from the same period in 2010. This decrease was largely due to Air Canada having recorded an impairment charge of $49 million relating to Airbus A340-300 and Boeing 767-200 aircraft in 2010 while no such charge was recorded in 2011. Other contributing factors included the favourable impact of a stronger Canadian dollar versus the U.S. dollar, which reduced aircraft rent expense by $18 million, the impact of lower rates associated with leased Airbus A320 aircraft, as well as decreases in software amortization costs and depreciation expense on rotable aircraft parts. Costs associated with the airline's new services between Billy Bishop Toronto City Airport and Montreal Trudeau Airport partly offset these decreases. The $73 million decrease in depreciation, amortization and impairment expense was essentially in line with the decrease of $75 million projected in Air Canada's news release dated November 4, 2011.

Aircraft maintenance expense increased 4% from 2010

In 2011, aircraft maintenance expense of $681 million increased $27 million or 4% from 2010, of which $20 million was due to changes in cost and discount rate assumptions for provisions related to end of lease maintenance return conditions. A higher volume of engine maintenance events and an increase in maintenance cost obligations related to aircraft lease terminations were also contributing factors to the increase in aircraft maintenance expense versus 2010. Partly offsetting these increases were a decrease in components maintenance activity and the favourable impact of a stronger Canadian dollar on U.S. currency denominated maintenance expenses. The 4% increase in aircraft maintenance expense was in line with the increase of 4.0% to 5.0% projected in Air Canada's news release dated November 4, 2011.

Sales and distribution costs increased 5% from 2010

In 2011, sales and distribution costs of $612 million increased $31 million or 5% from 2010. Factors contributing to the year-over-year change in sales and distribution costs in the full year included:

- The passenger revenue growth of 8.3%;
- An increase in credit card fees which was due to higher passenger sales and an increase in the percentage of sales made on credit cards;
- An increase in sales and distribution costs at Air Canada Vacations which was due to a change in commission structure and higher passenger sales.

Food, beverages and supplies expense decreased $1 million from 2010

In 2011, food, beverages and supplies expense of $278 million decreased $1 million from 2010. The impact of growth in passenger traffic, including in the premium class cabin, was offset by the favourable impact of cost reduction initiatives, most of which are related to contract and process improvements.

Other operating expenses increased 3% from 2010

Other operating expenses amounted to $1,230 million in 2011, an increase of $36 million or 3% from 2010.

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

	Full Year		Change	
(Canadian dollars in millions)	2011	2010	$	%
Air Canada Vacations' land costs	$ 307	$ 272	$ 35	13
Terminal handling	193	185	8	4
Building rent and maintenance	127	126	1	1
Crew cycle	115	117	(2)	(2)
Miscellaneous fees and services	108	110	(2)	(1)
Remaining other expenses	380	384	(4)	(1)
	$ 1,230	**$ 1,194**	**$ 36**	**3**

Factors contributing to the year-over-year change in Other expenses in the full year included:

- The 4.7% growth in capacity;
- An increase of $35 million or 13% in expenses related to ground packages at Air Canada Vacations which was due to increased passenger volumes;
- An increase of $8 million or 4% in terminal handling expenses which was largely due to a 2.5% increase in system frequencies and to costs associated with Air Canada's new service between Billy Bishop Toronto City Airport and Montreal Trudeau Airport; and
- The favourable impact of CTP initiatives which reduced various other operating expenses

Non-operating expense amounted to $429 million in 2011 compared to non-operating expense of $303 million in 2010.

The following table provides a breakdown of non-operating expenses for the periods indicated:

	Full Year		Change
(Canadian dollars in millions)	2011	2010	$
Foreign exchange gain (loss)	$ (54)	$ 184	$ (238)
Interest income	36	19	17
Interest expense	(320)	(397)	77
Net financing expense relating to employee benefit liabilities	(16)	(75)	59
Loss on financial instruments recorded at fair value	(63)	(3)	(60)
Other	(12)	(31)	19
	$ (429)	**$ (303)**	**$ (126)**

Factors contributing to the year-over-year increase in non-operating expense in the full year included:

- Losses on foreign exchange (mainly related to U.S. currency denominated long-term debt) which amounted to $54 million in 2011 compared to gains of $184 million in 2010. The losses in 2011 were mainly attributable to a weaker Canadian dollar at December 31, 2011 compared to December 31, 2010. The December 31, 2011 closing exchange rate was US$1 = C$1.017 while the December 31, 2010 closing exchange rate was US$1 = C$0.9946.

- An increase in interest income of $17 million which was mainly due to higher returns on investments.

- A decrease in interest expense of $77 million which was mainly due to Air Canada having recorded a charge of $54 million related to the repayment of its secured term credit facility in 2010 while no such charge was recorded in 2011, as well as higher debt repayments year-over-year. The impact of net debt repayments made in 2011, the impact of lower interest rates, and the favourable impact of a stronger Canadian dollar on U.S. currency denominated interest expense when compared to 2010 were also contributing factors in the decrease in interest expense year-over-year.

- A decrease in net financing expense relating to employee benefit liabilities of $59 million which was due to a decline in the discount rate used to measure the expense.

- Losses related to fair value adjustments on derivative instruments which amounted to $63 million in 2011 versus losses of $3 million in 2010. Refer to section 12 of this MD&A for additional information.

7. Results of Operations – Fourth Quarter 2011 versus Fourth Quarter 2010

The following table and discussion compares the results of Air Canada for the fourth quarter of 2011 versus the fourth quarter of 2010.

	Fourth Quarter		Change	
(Canadian dollars in millions, except per share figures)	**2011**	**2010**	**$**	**%**
Operating revenues				
Passenger	$ 2,374	$ 2,296	$ 78	3
Cargo	125	124	1	1
Other	200	196	4	2
	2,699	**2,616**	**83**	**3**
Operating expenses				
Aircraft fuel	808	640	168	26
Wages, salaries, and benefits	501	487	14	3
Airport and navigation fees	237	229	8	3
Capacity purchase agreements	251	241	10	4
Depreciation, amortization and impairment	174	227	(53)	(23)
Aircraft maintenance	212	164	48	29
Sales and distribution costs	140	146	(6)	(4)
Food, beverages and supplies	53	54	(1)	(2)
Communications and information technology	48	50	(2)	(4)
Aircraft rent	86	86	-	-
Other	287	277	10	4
	2,797	**2,601**	**196**	**8**
Operating income (loss) before exceptional item	**(98)**	**15**	**(113)**	
Provision adjustment for cargo investigations, net (1)	**-**	**46**	**(46)**	
Operating income (loss)	**(98)**	**61**	**(159)**	
Non-operating income (expense)				
Foreign exchange gain	114	136	(22)	
Interest income	10	9	1	
Interest expense	(76)	(86)	10	
Net financing expense relating to employee benefit liabilities	(4)	(18)	14	
Gain (loss) on financial instruments recorded at fair value	(5)	8	(13)	
Other	(1)	(21)	20	
	38	28	10	
Income (loss) before income taxes	**(60)**	**89**	**(149)**	
Recovery of (provision for) income taxes	-	-	-	
Net income (loss) for the period	**$ (60)**	**$ 89**	**$ (149)**	
EBITDAR before the provision adjustment for cargo investigations, net (1) (2)	**$ 162**	**$ 328**	**$ (166)**	
EBITDAR (2)	**$ 162**	**$ 374**	**$ (212)**	
Net income (loss) per share – Diluted	**$ (0.22)**	**$ 0.27**	**$ (0.49)**	

(1) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.

(2) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before the provision adjustment for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).

System passenger revenues increased 3.4% from the fourth quarter of 2010

System passenger revenues of $2,374 million in the fourth quarter of 2011 increased $78 million or 3.4% from 2010 fourth quarter passenger revenues of $2,296 million. Fourth quarter 2010 passenger revenues included a favourable annual adjustment of $40 million related to the airline's transatlantic joint venture with United Airlines and Deutsche Lufthansa AG, which was finalized in December 2010 but with effect as of January 1, 2010, and to other interline agreements. For comparative purposes, the tables and the discussion below excludes the impact of the $40 million favourable adjustment recorded in the fourth quarter of 2010, which related to activities attributable to the first three quarters of 2010.

System passenger revenues of $2,374 million in the fourth quarter of 2011 increased $118 million or 5.2% from the adjusted fourth quarter passenger revenues of $2,256 million in 2010, due to traffic and yield growth. Premium cabin revenues increased $23 million or 4.5% from the fourth quarter of 2010 due to a traffic increase of 8.2% as yield declined 2.2%.

The table below provides passenger revenue by geographic region for the fourth quarter of 2011 and the fourth quarter of 2010.

Passenger Revenue	Fourth Quarter 2011 $ Million	Fourth Quarter 2010 $ Million	$ Change	% Change
Canada	981	950	31	3.2
U.S. transborder	500	448	52	11.6
Atlantic	400	404	(4)	(1.0)
Pacific	279	261	18	6.9
Other	214	193	21	11.1
System	**2,374**	**2,256**	**118**	**5.2**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the fourth quarter of 2011 versus the fourth quarter of 2010.

Fourth Quarter 2011 Versus Fourth Quarter 2010	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	3.2	2.1	2.1	-	0.4	0.4
U.S. transborder	11.6	3.2	5.3	1.4	5.4	7.4
Atlantic	(1.0)	2.2	1.2	(0.8)	(3.1)	(4.0)
Pacific	6.9	1.4	1.6	0.1	4.7	4.9
Other	11.1	4.6	4.9	0.2	5.7	5.9
System	**5.2**	**2.5**	**2.6**	**0.1**	**1.9**	**2.0**

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
System	Q4'10	Q1'11	Q2'11	Q3'11	Q4'11
Passenger Revenues	11.2	10.3	11.7	7.9	5.2
Capacity (ASMs)	7.8	7.7	6.4	2.6	2.5
Traffic (RPMs)	8.0	5.7	6.1	3.8	2.6
Passenger Load Factor (pp Change)	0.2	(1.5)	(0.2)	1.1	0.1
Yield	2.8	4.2	5.2	3.8	1.9
RASM	3.0	2.2	4.9	5.1	2.0

In the fourth quarter of 2011, Air Canada's overall capacity was 2.5% higher than the fourth quarter of 2010, with capacity growth reflected in all markets. The system capacity growth was in line with the 1.5% to 2.5% fourth quarter 2011 ASM capacity increase projected in Air Canada's news release dated November 4, 2011.

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

- The system traffic increase which reflected growth in all markets. The traffic increase was slightly above the capacity growth, resulting in a minimally higher passenger load factor.

- The system yield growth which reflected growth in all markets, with the exception of the Atlantic. The overall yield improvement was due to increased fares and fuel surcharges to partly offset higher fuel costs.

The adjusted system RASM improvement was mainly due to the higher yield.

Domestic passenger revenues increased 3.2% from the fourth quarter of 2010

Domestic passenger revenues of $981 million in the fourth quarter of 2011 increased $31 million or 3.2% from the fourth quarter of 2010 due to traffic growth and, to a lesser extent, a yield improvement.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
Canada	**Q4'10**	**Q1'11**	**Q2'11**	**Q3'11**	**Q4'11**
Passenger Revenues	7.5	8.4	7.9	4.7	3.2
Capacity (ASMs)	0.2	(0.9)	(0.2)	0.3	2.1
Traffic (RPMs)	2.0	(0.5)	(0.6)	2.1	2.1
Passenger Load Factor (pp Change)	1.4	0.4	(0.3)	1.5	-
Yield	5.3	8.7	8.4	2.4	0.4
RASM	7.1	9.2	8.0	4.3	0.4

On May 1, 2011, Sky Regional, on behalf of Air Canada, began operating 15 daily flights from Toronto Island's Billy Bishop Airport to Montreal's Pierre Elliott Trudeau International Airport ("Montreal Trudeau Airport"). The domestic capacity growth in the fourth quarter of 2011 was mainly due to this new service and to an increase in frequencies on Air Canada's Toronto-Vancouver service. Components of the year-over-year change in fourth quarter domestic passenger revenues included:

- The traffic increase which reflected growth on all major domestic services. The traffic gains were in line with the capacity growth, resulting in a passenger load factor unchanged from the fourth quarter of 2010.

- The yield improvement which was due to fuel-related fare increases to partly offset higher fuel prices.

The RASM improvement reflected the higher yield as passenger load factor was unchanged from the fourth quarter of 2010.

U.S. transborder passenger revenues increased 11.6% from the fourth quarter of 2010

U.S. transborder passenger revenues of $500 million in the fourth quarter of 2011 increased $52 million or 11.6% from the fourth quarter of 2010 due to yield and traffic growth.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
U.S. transborder	**Q4'10**	**Q1'11**	**Q2'11**	**Q3'11**	**Q4'11**
Passenger Revenues	10.7	14.5	20.2	13.2	11.6
Capacity (ASMs)	11.7	10.8	7.8	4.7	3.2
Traffic (RPMs)	12.0	11.5	12.9	9.3	5.3
Passenger Load Factor (pp Change)	0.2	0.4	3.5	3.4	1.4
Yield	(1.3)	2.5	6.4	3.4	5.4
RASM	(1.0)	3.1	11.4	8.0	7.4

In the fourth quarter of 2011, the growth in capacity was largely due to an increase in frequencies on routes to California, Florida, Las Vegas and Hawaii.

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

- The traffic increase which reflected growth on all major U.S. transborder services and was in part due to sixth freedom traffic flows from the U.S. (meaning U.S. originating traffic carried through points in Canada to other international destinations) in support of Air Canada's international expansion initiatives. The traffic gains exceeded the capacity growth, resulting in a higher passenger load factor.

- The yield improvement which reflected growth on all major U.S. transborder services. The yield improvement was due to fuel-related fare increases to offset higher fuel prices.

The RASM improvement was due to the higher yield and passenger load factor.

Atlantic passenger revenues decreased 1.0% from the fourth quarter of 2010

For comparative purposes, the table and the discussion below regarding the Atlantic market excludes the impact of the $40 million favourable adjustment recorded in the fourth quarter of 2010, which related to activities attributable to the first three quarters of 2010.

On an adjusted basis, Atlantic passenger revenues of $400 million in the fourth quarter of 2011 decreased $4 million or 1.0% from the fourth quarter of 2010 due to a yield decline.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
Atlantic	**Q4'10**	**Q1'11**	**Q2'11**	**Q3'11**	**Q4'11**
Passenger Revenues	7.5	0.8	11.6	8.2	(1.0)
Capacity (ASMs)	5.5	6.2	12.3	3.6	2.2
Traffic (RPMs)	2.5	(0.8)	8.4	4.1	1.2
Passenger Load Factor (pp Change)	(2.2)	(5.0)	(3.0)	0.5	(0.8)
Yield	4.7	1.3	2.7	3.8	(3.1)
RASM	1.7	(5.4)	(0.8)	4.3	(4.0)

In the fourth quarter of 2011, the growth in capacity year-over-year was mainly due to extended operations on summer seasonal routes, including Greece, Spain, Italy and St. John's, Newfoundland to London. Additional frequencies to Brussels and, the use of larger aircraft on routes to Germany also contributed to the capacity growth.

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

- The traffic increase which reflected growth on all major Atlantic services, with the exception of routes to the United Kingdom. Traffic on routes to the U.K. continued to be challenged by the weak economic environment in the U.K. and additional competitive pricing actions, impacting both local traffic and connecting markets over Air Canada's London gateway. The traffic gains did not meet the capacity growth, resulting in a lower passenger load factor.

- The adjusted yield decline which was due in part to the impact of increased competitive activities and continued weak economic conditions in Europe, especially in some of our core markets; UK, France, and Germany. Approximately 30 percent of our Atlantic revenues are generated from point of sale Europe.

The adjusted RASM decline was due to the lower yield and passenger load factor.

Pacific passenger revenues increased 6.9% from the fourth quarter of 2010

Pacific passenger revenues of $279 million in the fourth quarter of 2011 increased $18 million or 6.9% from the fourth quarter of 2010, mainly due to yield and traffic growth.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
Pacific	**Q4'10**	**Q1'11**	**Q2'11**	**Q3'11**	**Q4'11**
Passenger Revenues	31.7	17.0	6.4	5.8	6.9
Capacity (ASMs)	23.0	21.5	7.2	2.0	1.4
Traffic (RPMs)	22.9	16.0	5.9	1.5	1.6
Passenger Load Factor (pp Change)	(0.1)	(4.0)	(1.1)	(0.5)	0.1
Yield	7.2	0.7	0.4	4.2	4.7
RASM	7.0	(3.9)	(0.8)	3.6	4.9

In the fourth quarter of 2011, the increase in Pacific capacity mainly reflected a capacity increase on routes to Korea.

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

- The traffic increase which reflected growth on routes to China and Korea. The traffic growth was slightly higher than the capacity growth, resulting in a higher passenger load factor.

- The yield increase which reflected growth on all major Pacific services. The yield growth was due to fare improvements, gains in premium cabin traffic, and to increased fuel surcharges to partly offset higher fuel prices.

The RASM improvement was mainly due to stronger yields on routes to China.

Other passenger revenues increased 11.1% from the fourth quarter of 2010

Other passenger revenues (comprised of routes to Australia, the Caribbean, Mexico, Central and South America) of $214 million in the fourth quarter of 2011 increased $21 million or 11.1% from the fourth quarter of 2010 due to yield and traffic growth.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
Other	**Q4'10**	**Q1'11**	**Q2'11**	**Q3'11**	**Q4'11**
Passenger Revenues	15.4	16.4	20.7	16.9	11.1
Capacity (ASMs)	7.2	9.1	8.6	5.3	4.6
Traffic (RPMs)	9.4	7.7	10.9	5.8	4.9
Passenger Load Factor (pp Change)	1.6	(1.1)	1.7	0.4	0.2
Yield	5.4	8.1	9.0	10.4	5.7
RASM	7.5	6.7	11.4	11.0	5.9

In the fourth quarter of 2011, the capacity growth was largely due to capacity increases on routes to South America. Components of the year-over-year change in fourth quarter Other passenger revenues included:

- The overall traffic increase which reflected growth on all major services. The overall traffic increase slightly exceeded the capacity growth, resulting in a higher passenger load factor.

- The overall yield improvement which was due to increased fares and fuel surcharges to partly offset higher fuel prices. A gain in premium cabin traffic was also a factor in the yield improvement. Routes to Australia and South America recorded significant yield improvements year-over-year, on stronger passenger demand and increased network flows.

The overall RASM improvement was mainly due to the yield growth.

Cargo revenues increased 1.2% from the fourth quarter of 2010

Cargo revenues of $125 million in the fourth quarter of 2011 increased $1 million or 1.2% from the fourth quarter of 2010 due to yield growth.

The table below provides cargo revenue by geographic region for the fourth quarter of 2011 and the fourth quarter of 2010.

Cargo Revenue	**Fourth Quarter 2011 $ Million**	**Fourth Quarter 2010 $ Million**	**$ Change**	**% Change**
Canada	16	17	(1)	(2.4)
U.S. transborder	5	5	-	(2.5)
Atlantic	47	45	2	5.1
Pacific	40	42	(2)	(6.0)
Other	17	15	2	13.6
System	**125**	**124**	**1**	**1.2**

The table below provides year-over-year percentage changes in system cargo revenues and operating statistics for the fourth quarter 2011 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
System	**Q4'10**	**Q1'11**	**Q2'11**	**Q3'11**	**Q4'11**
Cargo Revenues	13.0	12.0	3.8	(1.7)	1.2
Capacity (ETMs)	7.7	7.4	7.0	1.9	2.5
Revenue per ETM	3.9	3.3	(3.1)	(3.5)	(1.3)
Traffic (RTMs)	10.0	5.8	(2.4)	(7.7)	(0.4)
Yield per RTM	1.6	4.9	6.3	6.5	1.6

The table below provides year-over-year percentage changes in cargo revenues and operating statistics for the fourth quarter of 2011 versus the fourth quarter of 2010.

Fourth Quarter 2011 Versus Fourth Quarter 2010	**Cargo Revenue % Change**	**Capacity (ETMs) % Change**	**Rev / ETM % Change**	**Traffic (RTMs) % Change**	**Yield / RTM % Change**
Canada	(2.4)	3.5	(5.7)	1.6	(4.0)
U.S. transborder	(2.5)	6.0	(8.0)	(7.4)	5.4
Atlantic	5.1	2.0	3.1	(6.6)	12.6
Pacific	(6.0)	1.8	(7.7)	2.7	(8.5)
Other	13.6	3.2	10.1	11.1	2.3
System	**1.2**	**2.5**	**(1.3)**	**(0.4)**	**1.6**

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

- The yield improvement which was mainly due to higher fuel surcharges year-over-year.
- The traffic decline which was mainly due to the adverse impact of increased industry capacity on Atlantic services. Following three quarters of year-over-year declines resulting from the earthquake in Japan and its aftermath, the Pacific reflected a recovery in cargo traffic, where pricing actions were taken to stimulate demand.

Other revenues increased 2% from the fourth quarter of 2010

Other revenues of $200 million in the fourth quarter of 2011 increased $4 million or 2% from the fourth quarter of 2010. The growth in other revenues was due to a $6 million increase in third party ground package revenues at Air Canada Vacations. This increase in third party revenues at Air Canada Vacations was due to a higher selling price of ground packages and, to a lesser extent, an increase in passenger volumes.

CASM increased 4.9% from the fourth quarter of 2010. Excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, CASM decreased 1.5% from the fourth quarter of 2010

The following table compares Air Canada's CASM for the fourth quarter of 2011 to Air Canada's CASM for the corresponding period in 2010.

	Fourth Quarter		Change	
(cents per ASM)	**2011**	**2010**	**cents**	**%**
Wages and salaries	2.57	2.69	(0.12)	(4.5)
Benefits	0.71	0.58	0.13	22.4
Aircraft fuel	5.29	4.29	1.00	23.3
Airport and navigation fees	1.55	1.54	0.01	0.6
Capacity purchase agreements	1.65	1.62	0.03	1.9
Ownership (DAR) (1)	1.70	2.10	(0.40)	(19.0)
Aircraft maintenance	1.39	1.10	0.29	26.4
Sales and distribution costs	0.92	0.98	(0.06)	(6.1)
Food, beverages and supplies	0.35	0.37	(0.02)	(5.4)
Communications and information technology	0.31	0.34	(0.03)	(8.8)
Other	1.85	1.83	0.02	1.1
Total operating expense	**18.29**	**17.44**	**0.85**	**4.9**
Remove:				
Cost of fuel expense and cost of ground packages at Air Canada Vacations	(5.66)	(4.62)	(1.04)	22.5
Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations (2)	**12.63**	**12.82**	**(0.19)**	**(1.5)**

(1) DAR refers to the combination of depreciation, amortization and impairment, and aircraft rent expenses.

(2) Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

The main factors contributing to the year-over-year change in fourth quarter CASM, excluding fuel and the cost of ground packages at Air Canada Vacations, included:

- A decrease in depreciation, amortization and impairment expense;
- A decrease in wages and salaries largely reflecting reduced expenses related to incentive compensation programs partly offset by higher average salaries ;
- The 2.5% capacity growth, which resulted in Air Canada's fixed costs being allocated over a greater number of ASMs; and
- An increase in average stage length of 0.8%.

These above-noted decreases were partly offset by an increase in aircraft maintenance expense and an increase in employee benefits expense.

Excluding fuel expense, CASM decreased 1.1% from the fourth quarter of 2010. The 1.1% decrease in CASM, excluding fuel expense, was better than the 0.5% to 1.0% increase projected in Air Canada's news release dated November 4, 2011. The better than expected performance was mainly due to lower than forecasted food, beverages and supplies expense and depreciation, amortization and impairment expense.

Operating expenses increased 8% from the fourth quarter of 2010

Air Canada recorded operating expenses of $2,797 million, an increase of $196 million or 8% from the operating expenses of $2,601 million recorded in the fourth quarter of 2010. The more significant variances are discussed below.

Fuel expense increased 26% from the fourth quarter of 2010

Fuel expense of $808 million in the fourth quarter of 2011, increased $168 million or 26% from the fourth quarter of 2010, mainly due to higher base fuel prices which accounted for an increase of $200 million year-over year. Fuel hedging losses of $31 million were reclassified from Accumulated Other Comprehensive Loss ("AOCL") to fuel expense in the fourth quarter of 2010 while no fuel hedging losses were recorded in fuel expense in the fourth quarter of 2011, resulting in a favourable variance of $31 million year-over-year.

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

(Canadian dollars in millions, except where indicated)		Fourth Quarter 2011	Fourth Quarter 2010	Change $	Change %
Aircraft fuel expense – GAAP (1)		$ 801	$ 636	$ 165	26
Remove:	*Fuel hedging losses reclassified from AOCL into fuel expense*	-	(31)	31	100
Add:	*Net cash payments on fuel derivatives (2)*	8	7	1	14
Economic cost of fuel – Non-GAAP (3)		**$ 809**	**$ 612**	**$ 197**	**32**
Fuel consumption (thousands of litres)		912,423	905,519	6,904	1
Fuel price per litre (cents) – GAAP		87.7	70.2	17.5	25
Fuel price per litre (cents) – excluding fuel hedging losses		87.7	66.8	20.9	31
Economic fuel price per litre (cents) – Non-GAAP		88.6	67.5	21.1	31

(1) Excludes fuel expense related to third party carriers, other than Jazz, operating under capacity purchase agreements.

(2) Includes net cash settlements on maturing fuel derivatives and premium costs associated with those derivatives.

(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 its cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period and premium costs associated with those derivatives. It excludes non-cash accounting gains and losses from fuel derivative instruments.

Wages, salaries and benefits expense amounted to $501 million in the fourth quarter of 2011, an increase of $14 million or 3% from the fourth quarter of 2010

Wages and salaries expense amounted to $392 million in the fourth quarter of 2011, a decline of $9 million or 2% from the fourth quarter of 2010. A decrease in expenses related to incentive compensation programs was partly offset by the impact of higher average salaries year-over-year and an increase in the average number of full-time equivalent ("FTE") employees from the fourth quarter of 2010. On capacity growth of 2.5%, the average number of FTE employees, increased 1.5% year-over-year, resulting in a productivity improvement of 1.0%, as measured by ASMs per FTE employee.

Employee benefits expense amounted to $109 million in the fourth quarter of 2011, an increase of $23 million or 27% from the fourth quarter of 2010, in large part due to an increase in pension and post-employment benefits expenses resulting from changes in actuarial assumptions year-over-year. An increase of $5 million related to an updated valuation of workers' compensation liabilities was also a factor in the increase in employee benefits expense.

Airport and navigation fees increased 3% from the fourth quarter of 2010

Airport and navigation fees amounted to $237 million in the fourth quarter of 2011, an increase of $8 million or 3% from the fourth quarter of 2010. This increase was mainly due to a growth of 1.3% in aircraft departures, the impact of changes in schedule and aircraft types operated to certain destinations, as well as an increase in terminal user fees, effective April 1, 2011, at London Heathrow Airport. Costs associated with Air Canada's new services operated by Sky Regional between Billy Bishop Toronto City Airport and Montreal Trudeau Airport also contributed to the increase.

Capacity purchase costs increased 4% from the fourth quarter of 2010

Capacity purchase costs amounted to $251 million in the fourth quarter of 2011 compared to $241 million in the fourth quarter of 2010, an increase of $10 million or 4%. This increase was mainly due to higher Jazz CPA rates and costs associated with Air Canada's new services operated by Sky Regional between Billy Bishop Toronto City Airport and Montreal Trudeau Airport.

Ownership costs decreased 17% from the fourth quarter of 2010

Ownership costs, which are comprised of depreciation, amortization and impairment, and aircraft rent expenses, of $260 million in the fourth quarter of 2011 declined $53 million or 17% from the fourth quarter of 2010. This decrease was due to Air Canada having recorded an impairment charge of $49 million relating to Airbus A340-300 and Boeing 767-200 aircraft in the fourth quarter of 2010 while no such charge was recorded in the fourth quarter of 2011.

Aircraft maintenance expense increased 29% from the fourth quarter of 2010

In the fourth quarter of 2011, aircraft maintenance expense of $212 million increased $48 million or 29% from the fourth quarter of 2010. In the fourth quarter of 2011, Air Canada recorded an unfavourable adjustment of $20 million to its end of lease maintenance return provision, resulting from changes in cost and discount rate assumptions. A higher volume of engine maintenance events, which was largely related to Air Canada's narrowbody fleet, and an increase in maintenance cost obligations related to aircraft lease terminations were also contributing factors to the increase.

Sales and distribution costs decreased 4% from the fourth quarter of 2010

In the fourth quarter of 2011, sales and distribution costs of $140 million decreased $6 million or 4% from the fourth quarter of 2010 on passenger revenue growth of 5.2%. Sales and distribution costs are comprised of commissions and incentives paid to passenger and cargo distributors, credit card and GDS transaction fees, as well as sales and distribution costs related to Air Canada Vacations. Factors contributing to the year-over-year change in fourth quarter sales and distribution costs included:

- A decrease in GDS transaction fees, which was in part due to higher volume credits accrued in the fourth quarter of 2011 compared to the fourth quarter of 2010, as well as the impact of contract improvements.

- A decrease in interline commissions which was due to contract improvements.

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

- The passenger revenue growth of 5.2%.

- An increase in credit card fees which was due to higher passenger sales and an increase in the percentage of sales made on credit cards.

Food, beverages and supplies expense decreased 2% from the fourth quarter of 2010

In the fourth quarter of 2011, food, beverages and supplies expense of $53 million decreased $1 million or 2% from the fourth quarter of 2010. The impact of a 2.6% growth in passenger traffic was more than offset by the favourable impact of CTP initiatives, most of which are related to contract and process improvements.

Other operating expenses increased 4% from the fourth quarter of 2010

Other operating expenses amounted to $287 million in the fourth quarter of 2011, an increase of $10 million or 4% from the fourth quarter of 2010.

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

	Fourth Quarter		Change	
(Canadian dollars in millions)	**2011**	**2010**	**$**	**%**
Air Canada Vacations' land costs	$ 57	$ 49	$ 8	16
Terminal handling	43	44	(1)	(2)
Building rent and maintenance	29	31	(2)	(7)
Crew cycle	30	28	2	6
Miscellaneous fees and services	32	33	(1)	(2)
Remaining other expenses	96	92	4	4
	$ 287	**$ 277**	**$ 10**	**4**

Factors contributing to the year-over-year change in fourth quarter Other expenses included:

- The 2.5% growth in capacity; and
- An increase of $8 million or 16% in expenses related to ground packages at Air Canada Vacations which was due to a higher cost of ground packages and, to a lesser extent, an increase in passenger volumes.

Non-operating income amounted to $38 million in the fourth quarter of 2011 compared to non-operating income of $28 million in the fourth quarter of 2010.

The following table provides a breakdown of non-operating income for the periods indicated:

	Fourth Quarter		Change
(Canadian dollars in millions)	**2011**	**2010**	**$**
Foreign exchange gain	$ 114	$ 136	$ (22)
Interest income	10	9	1
Interest expense	(76)	(86)	10
Net financing expense relating to employee benefit liabilities	(4)	(18)	14
Gain (loss) on financial instruments recorded at fair value	(5)	8	(13)
Other	(1)	(21)	20
	$ 38	**$ 28**	**$ 10**

Factors contributing to the year-over-year change in fourth quarter non-operating income included:

- Gains on foreign exchange (mainly related to U.S. currency denominated long-term debt) which amounted to $114 million in the fourth quarter of 2011 compared to gains of $136 million in the fourth quarter of 2010. The gains in the fourth quarter of 2011 were mainly attributable to a stronger Canadian dollar at December 31, 2011 when compared to September 30, 2011. The December 31, 2011 closing exchange rate was US$1 = C$1.017 while the September 30, 2011 closing exchange rate was US$1 = C$1.0482.
- A decrease in interest expense of $10 million in the fourth quarter of 2011 which was largely due to the impact of net debt repayments made in 2011 and the impact of lower interest rates when compared to the fourth quarter of 2010.
- A decrease in net financing expense relating to employee benefit liabilities of $14 million which was due to a decline in the discount rate used to measure the expense.

- Losses related to fair value adjustments on derivative instruments which amounted to $5 million in the fourth quarter of 2011 versus gains of $8 million in the fourth quarter of 2010. Refer to section 12 of this MD&A for additional information.

8. Fleet

The following table provides Air Canada's operating fleet as at December 31, 2011 (excluding aircraft which are leased or subleased to third parties and excluding aircraft operated by Jazz under the Jazz CPA and by other regional airlines operating flights on behalf of Air Canada under commercial agreements with Air Canada).

	Total Seats	Number of Operating Aircraft(1)	Average Age	Owned(1)	Finance Lease(2)	Owned – Special Purpose Entities(2)	Operating Lease
Widebody Aircraft							
Boeing 777-300	349	12	3.8	3	1	-	8
Boeing 777-200	270	6	4.1	4	-	-	2
Boeing 767-300	191-213	30	17.7	5	8	2	15
Airbus A330-300	265	8	11.2	-	-	8	-
Narrowbody Aircraft							
Airbus A321	174	10	9.8	-	-	5	5
Airbus A320	146	41	18.7	-	-	-	41
Airbus A319	120	38	13.8	8	10	14	6
EMBRAER 190	93	45	4.8	45	-	-	-
EMBRAER 175	73	15	6.3	15	-	-	-
Total		**205**	**11.6**	**80**	**19**	**29**	**77**

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

(2) Owned aircraft, aircraft under finance leases, and other aircraft under lease from special purpose entities that are consolidated by Air Canada and are carried on Air Canada's statement of financial position. Owned aircraft include aircraft financed under conditional sales agreements.

The following table provides the number of aircraft in Air Canada's operating fleet as at December 31, 2011 and 2010, as well as planned changes to its operating fleet (excluding aircraft which are leased or subleased to third parties and excluding aircraft operated by Jazz under the Jazz CPA and by other regional airlines operating flights on behalf of Air Canada under commercial agreements with Air Canada).

	Actual (As at December 31, 2011)			Planned (As at December 31, 2011)			
	December 31, 2010	**2011 Fleet Changes**	**December 31, 2011**	**2012 Fleet Changes**	**December 31, 2012**	**2013 Fleet Changes**	**December 31, 2013**
Boeing 777-300	**12**	-	**12**	-	**12**	-	**12**
Boeing 777-200	**6**	-	**6**	-	**6**	-	**6**
Boeing 767-300	**30**	-	**30**	-	**30**	-	**30**
Airbus A330-300	**8**	-	**8**	-	**8**	-	**8**
Airbus A321	**10**	-	**10**	-	**10**	-	**10**
Airbus A320	**41**	-	**41**	-	**41**	-	**41**
Airbus A319	**38**	-	**38**	-	**38**	-	**38**
EMBRAER 190	**45**	-	**45**	-	**45**	-	**45**
EMBRAER 175	**15**	-	**15**	-	**15**	-	**15**
Total	**205**	-	**205**	-	**205**	-	**205**
Average age (years)	**10.7**		**11.6**		**12.6**		**13.6**

The following table provides, as at December 31, 2011, the number of aircraft operated by Jazz under the Jazz CPA and by other airlines operating flights under the Air Canada Express banner on behalf of Air Canada pursuant to commercial agreements with Air Canada.

	As at December 31, 2011			
	Jazz	**Sky Regional**	**Other**	**Total**
CRJ-100	17	-	-	17
CRJ-200	25	-	-	25
CRJ-705	16	-	-	16
Dash 8-100	34	-	-	34
Dash 8-300	26	-	-	26
Dash 8-400	8	5	-	13
Beech 1900	-	-	16	16
Total	**126**	**5**	**16**	**147**

At December 31, 2011, the 126 total aircraft operated by Jazz under the Jazz CPA included one Dash 8-400 aircraft which operated earlier than planned. In January 2012, the number of aircraft operated by Jazz under the CPA reverted to a total 125 aircraft. During 2012, seven Dash 8-400 aircraft, owned by Jazz, will be introduced into the Jazz CPA fleet and eight Bombardier CRJ-100 aircraft, owned by Air Canada, will be removed from the Jazz CPA fleet. The Jazz covered fleet is expected to remain at 125 aircraft throughout 2012.

On May 1, 2011, Sky Regional, on behalf of Air Canada and pursuant to a capacity purchase agreement between the parties, commenced service between Toronto Island's Billy Bishop Airport and Montreal's Trudeau Airport.

Air Canada leases or subleases 83 aircraft to third parties, which have final maturities ranging from 2012 to 2024. Air Canada aircraft, which are leased or subleased to third parties, are not shown in Air Canada's operating fleet table. These leased or subleased aircraft include six Airbus A340-300s, two Airbus A340-500s, 18 Bombardier CRJ-100 aircraft, 25 Bombardier CRJ-200 aircraft and 15 Bombardier CRJ-705 aircraft. All of the CRJ aircraft are leased or subleased to Jazz. In addition, seven Dash 8-100 aircraft are leased to Jazz, five Dash 8-400 aircraft are subleased to Sky Regional and five Beech aircraft are subleased to other Tier III carriers. In 2011, Air Canada exercised purchase rights for two Boeing 777 aircraft with scheduled deliveries in mid-2013. Air Canada is currently reviewing operating alternatives which may include subleasing, and as a result, these two aircraft have not been included in the fleet tables above.

9. Financial and Capital Management

9.1 Liquidity

Air Canada manages its liquidity needs through a variety of strategies, which include seeking to achieve positive cash from operations, sourcing committed financing for new and existing aircraft and through other financing activities.

At December 31, 2011, cash, cash equivalents and short-term investments amounted to $2,099 million, or 18% of 2011 operating revenues (2010 – $2,192 million, or 20% of 2010 operating revenues), exceeding Air Canada's minimum target liquidity level of 15% of 12-month trailing operating revenues.

Liquidity needs are primarily related to meeting obligations associated with financial liabilities, capital commitments, ongoing operations, contractual and other obligations (including pension funding obligations), covenants in credit card and other agreements. Refer to sections 9.6, 9.7 and 9.8 for schedules of Air Canada's capital commitments, contractual and pension funding obligations. Air Canada 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. Air Canada'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.

9.2 Financial Position

The following table provides a condensed statement of financial position of Air Canada as at December 31, 2011 and as at December 31, 2010.

(Canadian dollars in millions)	December 31, 2011	December 31, 2010	Change $
Assets			
Cash, cash equivalents and short-term investments	$ 2,099	$ 2,192	$ (93)
Other current assets	1,228	1,155	73
Current assets	3,327	3,347	(20)
Property and equipment	5,088	5,629	(541)
Intangible assets	312	317	(5)
Goodwill	311	311	-
Deposits and other assets	595	549	46
Total assets	**$ 9,633**	**$ 10,153**	**$ (520)**
Liabilities			
Current liabilities	$ 3,153	$ 3,124	$ 29
Long-term debt and finance leases	3,906	4,028	(122)
Pension and other benefit liabilities	5,563	3,328	2,235
Maintenance provisions	548	493	55
Other long-term liabilities	469	468	1
Total liabilities	**13,639**	**11,441**	**2,198**
Total equity	**(4,006)**	**(1,288)**	**(2,718)**
Total liabilities and equity	**$ 9,633**	**$ 10,153**	**$ (520)**

Movements in current assets and current liabilities are described in section 9.4 of this MD&A. Long-term debt and finance leases are discussed in section 9.3 of this MD&A.

Property and equipment amounted to $5,088 million at December 31, 2011, a reduction of $541 million from December 31, 2010. The reduction was mainly due to the impact of depreciation expense of $688 million in 2011. Additions to property and equipment amounted to $160 million in 2011, including progress payments on future aircraft deliveries and facilities of $77 million, flight equipment including capitalized maintenance events of $64 million, and ground and other equipment of $14 million.

Pension and other benefit liabilities increased $2,235 million in 2011, mainly due to a decrease in interest rates used to determine the pension obligations. Total pension funding payments in 2011 amounted to $385 million. Refer to section 9.8 for additional information on Air Canada's pension funding obligations.

9.3 Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at December 31, 2011 and as at December 31, 2010.

(Canadian dollars in millions)	December 31, 2011	December 31, 2010	Change $
Total long-term debt and finance leases	$ 3,906	$ 4,028	$ (122)
Current portion of long-term debt and finance leases	424	567	(143)
Total long-term debt and finance leases, including current portion	4,330	4,595	(265)
Less cash, cash equivalents and short-term investments	(2,099)	(2,192)	93
Net debt	**$ 2,231**	**$ 2,403**	**$ (172)**
Capitalized operating leases (1)	2,345	2,471	(126)
Adjusted net debt	**$ 4,576**	**$ 4,874**	**$ (298)**

(1) Adjusted net debt is a non-GAAP financial measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7.0. This definition of capitalized operating leases is used by Air Canada and may not be comparable to similar measures presented by other public companies. Aircraft rent was $335 million in 2011 and $353 million in 2010.

Total debt and finance leases, including current portion, amounted to $4,330 million at December 31, 2011, a decrease of $265 million from December 31, 2010. The reduction in long-term debt and finance leases from December 31, 2010 was mainly due to debt repayments of $608 million, including balloon maturities related so special purpose aircraft leasing entities totaling $221 million, as further described below. This decrease was partly offset by the unfavourable impact of a weaker Canadian dollar at December 31, 2011 compared to December 31, 2010 on Air Canada's foreign currency denominated debt (mainly U.S. dollars), which accounted for an increase of $92 million, and by proceeds from borrowings of $232 million.

In the fourth quarter of 2011, long-term debt and finance lease obligations decreased $149 million. The decrease in long-term debt and finance lease obligations was due to foreign exchange gains of $120 million and scheduled debt repayments of $124 million partly offset by new borrowings of $107 million.

In 2011, Air Canada received net financing proceeds of $125 million (U.S. $128 million), after financing fees of $2 million, through draws on a secured term loan facility (the "Facility"). The draws on the Facility were utilized to refinance amounts related to eight Airbus A319 aircraft and four Boeing 767-300ER aircraft with refinanced terms of seven and four years, respectively. The Facility will also be available in 2012 to refinance up to US$42 million of the amount related to four Airbus A319 aircraft.

In 2011, Air Canada entered into a revolving loan facility consisting of a Canadian dollar denominated revolving facility in the amount of $50 million and a U.S. dollar denominated revolving facility in the amount of $100 million. The agreement expires on January 31, 2015. An amount of $22 million was drawn under the facility in the fourth quarter of 2011.

In the fourth quarter of 2011, proceeds of $85 million were raised through the issuance of a bond by a Fuel Facility Corporation that is part of the consolidated accounts of Air Canada. The financing will be used to fund capital expenditures by the Fuel Facility Corporation over the next several years.

9.4 Working Capital

The following table provides information on Air Canada's working capital balances at December 31, 2011 and at December 31, 2010.

(Canadian dollars in millions)	December 31, 2011	December 31, 2010	Change $
Cash and short-term investments	$ 2,099	$ 2,192	$ (93)
Accounts receivable	712	641	71
Other current assets	516	514	2
Accounts payable and accrued liabilities	(1,175)	(1,182)	7
Advance ticket sales	(1,554)	(1,375)	(179)
Current portion of long-term debt and finance leases	(424)	(567)	143
Net working capital	**$ 174**	**$ 223**	**$ (49)**

The net positive working capital of $174 million at December 31, 2011 represented a decrease of $49 million from December 31, 2010. Positive net cash from operating activities of $588 million was partially offset by cash flows required to retire certain balloon maturities on debt, as described in section 9.3 of this MD&A, the impact of capital expenditures of $220 million, and the excess of employee benefit funding over expense of $153 million in 2011.

9.5 Consolidated Cash Flow Movements

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

(Canadian dollars in millions)	Fourth Quarter 2011	Fourth Quarter 2010	Fourth Quarter Change $	Full Year 2011	Full Year 2010	Full Year Change $
Net cash from operating activities, before the under noted items	$ 3	$ 143	$ (140)	$ 588	$ 798	$ (210)
Net cash used for fuel hedge settlements, premiums and collateral deposits	(11)	(16)	5	(3)	(37)	34
Excess of employee benefit funding over expense	(57)	(9)	(48)	(153)	(24)	(129)
Change in maintenance provisions	52	15	37	94	57	37
Changes in non-cash working capital balances	-	25	(25)	60	139	(79)
Cash flows from (used for) operating activities	(13)	158	(171)	586	933	(347)
Additions to property, equipment and intangible assets	(56)	(36)	(20)	(220)	(187)	(33)
Free cash flow (1)	**(69)**	**122**	**(191)**	**366**	**746**	**(380)**
Proceeds from sale of assets	2	1	1	6	29	(23)
Proceeds from sale and leaseback transactions	-	-	-	-	20	(20)
Reduction to Aveos letter of credit	-	-	-	-	23	(23)
Short-term investments	(46)	(440)	394	(149)	(810)	661
Other	4	(6)	10	(37)	(40)	3
Cash flows used for investing activities (excluding additions to property, equipment and intangible assets)	**(40)**	**(445)**	**405**	**(180)**	**(778)**	**598**
Proceeds from borrowings	107	-	107	232	1,175	(943)
Shares issued	-	2	(2)	-	2	(2)
Reduction of long-term debt and finance lease obligations	(124)	(100)	(24)	(608)	(1,159)	551
Distributions related to aircraft special purpose leasing entities	-	-	-	(52)	(11)	(41)
Cash flows from (used for) financing activities	**(17)**	**(98)**	**81**	**(428)**	**7**	**(435)**
Net increase (decrease) in cash and cash equivalents	(126)	(421)	295	(242)	(25)	(217)
Net increase (decrease) in short-term investments	46	440	(394)	149	810	(661)
Net increase (decrease) in cash, cash equivalents and short-term investments	**$ (80)**	**$ 19**	**$ (99)**	**$ (93)**	**$ 785**	**$ (878)**

(1) Free cash flow is a non-GAAP financial measure used by Air Canada 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, including repaying debt, meeting ongoing financial obligations and reinvesting in Air Canada.

Negative free cash flow amounted to $69 million in the fourth quarter of 2011 compared to positive free cash flow of $122 million in the fourth quarter of 2010, a year-over-year decrease of $191 million. This decrease in free cash flow from the fourth quarter of 2010 was largely due to a decline in net cash from operations, consistent with the decline in fourth quarter EBITDAR, the impact of higher pension payments, and an increase in capital expenditures of $20 million.

When compared to 2010, free cash flow of $366 million declined $380 million. This decrease in free cash flow from December 31, 2010 was largely due to a decline in net cash from operations, a reduction in cash provided by working capital and an increase in past service pension funding obligations. Starting in 2011, Air Canada resumed making past service contributions to its domestic registered plans pursuant to the terms of the Air Canada 2009 Pension Regulations, whereas no such contributions were required or made in 2010. Refer to section 9.8 of this MD&A for additional information.

9.6 Capital Expenditures and Related Financing Arrangements

Boeing

As at December 31, 2011, Air Canada had outstanding purchase commitments with The Boeing Company ("Boeing") for the acquisition of 37 Boeing 787 aircraft and two Boeing 777 aircraft following the exercise of its purchase rights as described below. Air Canada also has purchase rights for 16 Boeing 777 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing), purchase options for 13 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing and delivery position), and purchase rights for 10 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on Boeing's current pricing). In 2011, Air Canada exercised purchase rights for two Boeing 777 aircraft with scheduled deliveries in mid-2013. Air Canada is currently reviewing operating alternatives for these two aircraft and, as a result, these two aircraft have not been included in the fleet table in section 8 of this MD&A, however, they have been included in the table below.

The first seven deliveries of its Boeing 787 aircraft are currently scheduled for delivery in 2014 and the remaining 30 between 2015 and 2019.

Air Canada has financing commitments from Boeing and the engine manufacturer covering 31 of the 37 Boeing 787 firm aircraft orders. The financing terms for 28 out of the 31 covered aircraft are 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.

Capital Commitments

The estimated aggregate cost of the future firm Boeing 787 aircraft deliveries and other capital purchase commitments as at December 31, 2011 approximates $4,976 million (of which $3,110 million is subject to committed financing, subject to the fulfillment of certain terms and conditions). Other capital purchase commitments relate principally to building and leasehold improvement projects.

The table below provides Air Canada's current projected, planned and committed capital expenditures for 2012, for the next four years and after 2016.

(Canadian dollars in millions)	2012	2013	2014	2015	2016	Thereafter	Total
Projected committed expenditures	$ 155	$ 318	$ 755	$ 575	$ 1,017	$ 2,156	$ 4,976
Projected planned but uncommitted expenditures	122	120	120	120	120	not available	not available
Total projected expenditures[(1) (2)]	277	438	875	695	1,137	not available	not available
Projected financing on committed expenditures	-	-	(604)	(460)	(813)	(1,233)	(3,110)
Total projected expenditures, net of financing	**$ 277**	**$ 438**	**$ 271**	**$ 235**	**$ 324**	**not available**	**not available**

(1) U.S. dollar amounts are converted using the December 31, 2011 closing exchange rate of US$1 = C$1.017. Final aircraft delivery prices include estimated escalation and, where applicable, interest on deferred delivery payments.

(2) The table above excludes certain maintenance events that are capitalized under IFRS amounting to $60 million in 2012. Future capitalized maintenance amounts for 2013 and beyond are not yet determinable.

9.7 Contractual Obligations

The table below provides updated information on Air Canada's long-term debt and finance lease obligations, including interest and principal repayment obligations as at December 31, 2011. The table also includes the impact of the loan facility as described in section 9.3 of this MD&A, assuming the full commitment will be drawn upon, including the balance available in 2012 of US$42 million related to the refinancing of the last four Airbus A319 aircraft under this facility.

(Canadian dollars in millions)	2012	2013	2014	2015	2016	Thereafter	Total
Principal							
Long-term debt obligations	$ 367	$ 535	$ 261	$ 1,261	$ 455	$ 1,090	$ 3,969
Finance lease obligations	57	61	57	52	25	174	426
	424	596	318	1,313	480	1,264	4,395
Interest							
Long-term debt obligations	231	226	193	142	51	108	951
Finance lease obligations	41	34	28	22	18	65	208
	272	260	221	164	69	173	1,159
Total long-term debt, finance leases and interest repayment obligations(1-5)	**$ 696**	**$ 856**	**$ 539**	**$ 1,477**	**$ 549**	**$ 1,437**	**$ 5,554**
Net impact of loan facility	(34)	9	9	9	9	5	7
Total long-term debt and finance lease obligations, including net impact of loan facility	**$ 662**	**$ 865**	**$ 548**	**$ 1,486**	**$ 558**	**$ 1,442**	**$ 5,561**
Operating lease obligations	**$ 395**	**$ 362**	**$ 296**	**$ 247**	**$ 205**	**$ 612**	**$ 2,117**
Committed capital expenditures	**$ 155**	**$ 318**	**$ 755**	**$ 575**	**$ 1,017**	**$ 2,156**	**$ 4,976**
Total obligations, including net impact of loan facility	**$ 1,212**	**$ 1,545**	**$ 1,599**	**$ 2,308**	**$ 1,780**	**$ 4,210**	**$ 12,654**

(1) The interest repayment obligations relate to long-term debt, debt consolidated under special purpose entities and finance 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 that are non-cash in nature.

(5) The table above excludes the future minimum non-cancelable commitment under the Jazz CPA of $760 million in 2012, the future minimum non-cancelable commitment under capacity purchase agreements with other regional carriers of $57 million in 2012 and the minimum annual commitment to purchase Aeroplan® Miles from Aeroplan of $222 million for 2012. Future commitments for 2013 and beyond are not yet determinable.

Covenants in Credit Card Agreements

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

Air Canada's principal credit card processing agreements for card processing services requirements in North America have an expiry date of May 2012. Air Canada is in the process of negotiating longer-term arrangements. Air Canada's obligation to provide a deposit to the credit card processor under these agreements, as well as the amount of such deposit, are determined pursuant to a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for Air Canada and the unrestricted cash of Air Canada. Air Canada also has agreements with this processor for the provision of certain credit card processing services requirements for markets other than North America and for its cargo operations worldwide and such agreements contain deposit obligations similar to the obligations set forth above.

9.8 Pension Funding Obligations

Air Canada maintains several pension plans, including defined benefit and defined contribution pension plans and plans providing other retirement and post-employment benefits to its employees. Based on actuarial valuations completed in the third quarter of 2011, the aggregate solvency deficit in its domestic registered pension plans as at January 1, 2011 was $2,167 million. The valuations as of January 1, 2012 will be completed in the first half of 2012 but, as described in the paragraph below, valuations will not increase pension past service cost funding obligations required prior to 2014. Solvency deficit obligations for 2014 would be determined based actuarial valuations completed in mid-2014.

In July 2009, the Government of Canada adopted the Air Canada 2009 Pension Regulations. The Air Canada 2009 Pension Regulations relieved Air Canada from making any past service contributions (i.e. special payments to amortize the plan solvency 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 is the lesser of (i) $150 million, $175 million, and $225 million in 2011, 2012, and 2013, respectively, on an accrued basis, and (ii) the maximum past service contribution permitted under the Canadian Income Tax Act. Current service contributions 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, total employer pension funding contributions in 2011 amounted to $385 million.

(Canadian dollars in millions)	2011	2010
Past service cost for registered pension plans	$ 138	$ -
Current service cost for registered pension plans	171	169
Other pension arrangements(1)	76	74
Total contributions	**$ 385**	**$ 243**

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

Funding obligations are generally dependent on a number of factors, including the assumptions used in the most recently filed actuarial valuation reports for current service (including the applicable discount rate used or assumed in the actuarial valuation), the plan demographics at the valuation date, the existing plan provisions, existing pension legislation and changes in economic conditions (mainly the return on fund assets and changes in interest rates). Actual contributions that 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 due to changes in plan experience, financial markets, future expectations, changes in legislation and other factors. Until 2013, Air Canada's past service pension funding obligations are also limited by the Air Canada 2009 Pension Plan Funding Regulations.

Air Canada's projected pension funding obligations, on a cash basis, for 2012 and for the next year, are provided in the table below. 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 those identified above.

(Canadian dollars in millions)	**2012**	**2013**
Past service domestic registered plans	$ 173	$ 221
Current service domestic registered plans	168	173
Other pension arrangements(1)	85	82
Projected pension funding obligations	**$ 426**	**$ 476**

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

Amendments to the Defined Benefit Pension Plans

In 2011, Air Canada reached an agreement with the Canadian Auto Workers union ("CAW") Local 2002, which represents approximately 4,000 call centre and airport check-in and gate agents employed by Air Canada and the Canadian Union of Public Employees ("CUPE"), the union representing the airline's 6,800 flight attendants. The agreements include amendments to the defined benefit pension plans of CAW and CUPE members, which are subject to regulatory approval and will be accounted for at the time this approval has been received. In addition, a hybrid pension regime consisting of defined contribution and defined benefit components applies to new employees represented by the CAW and CUPE, hired after the date of ratification of the new agreements. The expense and obligations relating to the hybrid pension plan as at December 31, 2011 are negligible.

Pension and Benefits Agreement with Aveos

Air Canada and Aveos are parties to a Pension and Benefits Agreement covering the transfer of certain pension and benefit assets and obligations to Aveos. On July 14, 2011 (the "Certification Date"), certain unionized employees of Air Canada elected to become employees of Aveos. Under the terms of the Pension and Benefits Agreement and subject to regulatory approval where required, the assets and obligations under the pension, other post-retirement and post-employment benefits plans pertaining to the transferred unionized employees will be transferred to Aveos.

The terms of the Pension and Benefits Agreement relating to transferred unionized employees provide for the determination of solvency liabilities and pension assets as at July 14, 2011, in respect of unionized employees transferred to Aveos employed in the airframe function and, as at October 16, 2007 in respect of unionized employees transferred to Aveos employed in all other functions.

Air Canada will compensate Aveos for the present value of the accounting liability in respect of other post-retirement and post-employment liabilities as at July 14, 2011. These compensation amounts will be paid by Air Canada through quarterly payments to Aveos over a period not exceeding five years after the transfer. Airframe employees represent approximately half of the approximate 2,200 transferred employees.

Until the Certification Date, the current service pension cost and the current service and interest costs for other employee benefits, in respect of employees assigned to Aveos, were expensed by Air Canada with a full recovery recorded as an amount charged to Aveos. From the Certification Date, transferred employees accrue employee benefits in the Aveos defined benefit plans. Air Canada's financial statements do not reflect the determination of the solvency liabilities to be transferred to Aveos, the determination of amount of assets to be transferred to Aveos and the resulting compensation amount to be paid by Air Canada to Aveos, as these amounts are not yet determined. Based on the January 1, 2011 actuarial valuation, these compensation amounts are not expected to be material.

9.9 Share Information

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

	Number of Shares at	
	January 31, 2012	**January 31, 2011**
Issued and outstanding shares		
Class A variable voting shares	42,271,105	48,424,211
Class B voting shares	235,134,838	230,548,173
Total issued and outstanding shares	**277,405,943**	**278,972,384**
Class A variable voting and Class B voting shares potentially issuable		
Warrants	89,430,300	89,430,300
Shares held in trust	1,502,542	-
Stock options	6,581,242	3,460,027
Performance share units	-	2,500
Total shares potentially issuable	**97,514,084**	**92,892,827**
Total outstanding and potentially issuable shares	**374,920,027**	**371,865,211**

Issuer Bid

In December 2011, Air Canada announced that it received approval from the Toronto Stock Exchange ("TSX") to implement a normal course issuer bid to purchase, for cancellation, up to 24,737,753 Class A Variable Voting Shares and/or Class B Voting Shares (the "Shares"), representing, at that time, 10% of the total public float of the Shares.

The repurchase program, which commenced on December 12, 2011 and will end no later than December 11, 2012, will be conducted through the facilities of the TSX, or alternative trading systems, if eligible, and will conform to their regulations.

In 2011, Air Canada purchased and cancelled 239,524 shares under its normal issuer bid for cash at an average cost of $1.08 per share.

Shareholder Rights Plan

In 2011, the shareholders of Air Canada ratified a shareholder rights plan agreement (the "Plan") designed to foster fair treatment of all shareholders in connection with any take-over bid for Air Canada.

The Plan is scheduled to expire at the close of business on the date immediately following the date of Air Canada's annual meeting of shareholders to be held in 2014, unless terminated earlier in accordance with the terms of the Plan.

10. Quarterly Financial Data

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

(Canadian dollars in millions, except where indicated)	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
Operating revenues	**$ 2,519**	**$ 2,625**	**$ 3,026**	**$ 2,616**	**$ 2,753**	**$ 2,918**	**$ 3,242**	**$ 2,699**
Aircraft fuel	619	660	733	640	742	882	943	**808**
Ownership (DAR)(1)	286	281	274	313	273	265	265	**260**
Other operating expenses	1,750	1,637	1,713	1,648	1,804	1,698	1,764	**1,729**
Operating expenses	**2,655**	**2,578**	**2,720**	**2,601**	**2,819**	**2,845**	**2,972**	**2,797**
Operating income (loss) before exceptional item	**(136)**	**47**	**306**	**15**	**(66)**	**73**	**270**	**(98)**
Provision adjustment for cargo investigations, net(2)	-	-	-	46	-	-	-	**-**
Operating income (loss)	**(136)**	**47**	**306**	**61**	**(66)**	**73**	**270**	**(98)**
Total non-operating income (expense)	**23**	**(365)**	**11**	**28**	**47**	**(120)**	**(394)**	**38**
Recovery of (provision for) income taxes	1	-	-	-	-	1	-	**-**
Net income (loss)	**$ (112)**	**$ (318)**	**$ 317**	**$ 89**	**$ (19)**	**$ (46)**	**$ (124)**	**$ (60)**

(1) DAR refers to the combination of depreciation, amortization and impairment, and aircraft rent expense.

(2) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.

(Canadian dollars in millions, except where indicated)	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Q1 2011	Q2 2011	Q3 2011	Q4 2011
Revenue passenger miles (millions)	11,692	12,896	15,531	11,756	12,355	13,677	16,126	12,065
Available seat miles (millions)	14,727	15,523	18,328	14,918	15,859	16,512	18,799	15,290
Passenger load factor (%)	79.4	83.1	84.7	78.8	77.9	82.8	85.8	78.9
RASM (cents)(1)	14.2	14.8	14.8	15.1	14.5	15.6	15.5	15.4
CASM (cents)	18.0	16.6	14.8	17.4	17.8	17.2	15.8	18.3
CASM, excluding fuel expense (cents)	13.8	12.3	10.8	13.2	13.1	11.9	10.8	13.0
CASM, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations (cents) (2)	12.9	12.0	10.6	12.8	12.2	11.5	10.6	12.6
Economic fuel price per litre (cents)(3)	66.2	66.8	64.6	67.5	78.2	87.9	85.8	88.6
EBITDAR before the provision adjustment for cargo investigations, net (4)(5)	**$ 150**	**$ 328**	**$ 580**	**$ 328**	**$ 207**	**$ 338**	**$ 535**	**$ 162**
EBITDAR(4)(5)	**$ 150**	**$ 328**	**$ 580**	**$ 374**	**$ 207**	**$ 338**	**$ 535**	**$ 162**
Net income (loss) per share								
- Basic	**$ (0.41)**	**$ (1.14)**	**$ 1.13**	**$ 0.31**	**$ (0.07)**	**$ (0.17)**	**$ (0.45)**	**$ (0.22)**
- Diluted	**$ (0.41)**	**$ (1.14)**	**$ 1.10**	**$ 0.27**	**$ (0.07)**	**$ (0.17)**	**$ (0.45)**	**$ (0.22)**

(1) System RASM excludes the impact of a $40 million favourable adjustment recorded in the fourth quarter of 2010.

(2) Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, is a non-GAAP financial measure. Refer to section 20 of this MD&A for additional information.

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

(4) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.

(5) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before a provision adjustment for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).

11. Selected Annual Information

The following table provides selected annual information for Air Canada for the years 2009 through to 2011. The information for 2009 is reported on a Canadian GAAP basis (prior to the adoption of IFRS), while the information for 2010 and 2011 is reported on an IFRS basis. Accordingly, the financial information for 2009 is not directly comparable to subsequent periods.

(Canadian dollars in millions, except where indicated)	2011	2010	2009
	IFRS	IFRS	GAAP
Operating revenues	$ 11,612	$ 10,786	$ 9,739
Operating expenses	11,433	10,554	10,055
Operating income (loss) before exceptional item	**179**	**232**	**(316)**
Provision for cargo investigations, net (1)	-	46	-
Operating income (loss)	**179**	**278**	**(316)**
Total non-operating income (expense), non-controlling interest, and income taxes	(429)	(303)	292
Net loss	**$ (249)**	**$ (24)**	**$ (24)**
EBITDAR before a provision adjustment for cargo investigations, net (1) (2)	**$ 1,242**	**$ 1,386**	**$ 679**
EBITDAR (2)	**$ 1,242**	**$ 1,432**	**$ 679**
Net loss per share – Basic	**$ (0.92)**	**$ (0.12)**	**$ (0.18)**
Net loss per share – Diluted	**$ (0.92)**	**$ (0.12)**	**$ (0.18)**
Cash, cash equivalents and short-term investments	**$ 2,099**	**$ 2,192**	**$ 1,407**
Total assets	**$ 9,633**	**$ 10,153**	**$ 10,406**
Total long-term liabilities (3)	**$ 10,910**	**$ 8,884**	**$ 6,140**
Total liabilities	**$ 13,639**	**$ 11,441**	**$ 8,759**

(1) *In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.*

(2) *See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR before a provision adjustment for cargo investigations to operating income (loss) and EBITDAR to operating income (loss).*

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

12. Financial Instruments and Risk Management

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

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

	Fourth Quarter		Full Year	
(Canadian dollars in millions)	**2011**	**2010**	**2011**	**2010**
Fuel derivatives	$ 1	$ 11	$ (26)	$ (11)
Interest rate swaps	(1)	(3)	(22)	7
Share forward contracts	(3)	1	(10)	4
Other	(2)	(1)	(5)	(3)
Gain (loss) on financial instruments recorded at fair value	**$ (5)**	**$ 8**	**$ (63)**	**$ (3)**

Risk Management

Under its risk management policy, Air Canada manages its interest rate risk, foreign exchange risk, share based compensation risk and market risk through the use of various interest rates, foreign exchange, fuel and other derivative financial instruments. Air Canada uses derivative financial instruments only for risk management purposes, 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.

As noted below, Air Canada engages in derivative hedging in an effort 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 Air Canada's own credit risk and the credit risk of the counterparty.

Interest Rate Risk Management

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

Air Canada enters into both fixed and floating rate debt and leases certain assets where the rental amount fluctuates based on changes in short term interest rates. Air Canada manages interest rate risk on a portfolio basis and seeks financing terms in individual arrangements that are most advantageous taking into account all relevant factors, including credit margin, term and basis. The risk management objective is to minimize the potential for changes in interest rates to cause adverse changes in cash flows to Air Canada. The 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 Air Canada's capital structure and is based upon a long term objective of 60% fixed and 40% floating but allows the flexibility to 75% fixed in the short term to adjust to prevailing market conditions. The ratio at December 31, 2011, was 69% fixed and 31% floating, including the effects of interest rate swap positions (69% and 31%, respectively, as at December 31, 2010).

The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded during 2011:

- Certain payments based upon aircraft rental amounts for the delivery of 15 Dash 8-400 aircraft to Jazz to be operated under the Jazz CPA are based on medium-term US interest rates at the time of delivery. To hedge against the exposure to increases in interest rates until the expected delivery date, Air Canada entered into forward start interest rate swaps with an aggregate notional value of US$234 million. The swaps have contractual terms of maturity that coincide with the term of the rental agreements. However, the derivatives will be settled on each expected delivery date of the aircraft with maturities ranging to July 2012. The aggregate notional value outstanding at December 31, 2011 was US$109 million for future delivery of seven Dash 8-400 aircraft. These derivatives have not been designated as hedges for accounting purposes. The fair value of these contracts as at December 31, 2011 was $13 million in favour of the counterparties, with a loss of $28 million recorded in gain on financial instruments at fair value on Air Canada's consolidated statement of operations.

- As at December 31, 2011, Air Canada 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 $74 million (US$73 million) (2010 - $80 million (US$80 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, 2011 was $15 million in favour of Air Canada (2010 - $13 million in favour of Air Canada). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2011, a gain of $6 million was recorded in gain on financial instruments recorded at fair value on Air Canada's consolidated statement of operations (2010 - $6 million gain).

Interest income includes $32 million (2010 - $15 million) related to cash and cash equivalents and short-term investments, 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.

Air Canada's risk management objective is to reduce cash flow risk related to foreign denominated cash flows.

Air Canada'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 an annual U.S. dollar shortfall from operations. In order to mitigate this imbalance, Air Canada has adopted the practice of converting excess revenues from offshore currencies into U.S. dollars. In 2011, this conversion generated coverage of approximately 20% of the imbalance. The remaining 80% 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 2011:

- As at December 31, 2011, Air Canada had outstanding foreign currency options and swap agreements to purchase U.S. dollars against Canadian dollars on $1,008 million (US$991 million) which mature in 2012 (2010 - $223 million (US$224 million) which matured in 2011). Air Canada did not have any agreements outstanding at December 31, 2011 to buy Euro dollars against Canadian dollars (2011 – Euro dollars against Canadian dollars on $15 million (EUR 11 million)). The fair value of these foreign currency contracts as at December 31, 2011 was $5 million in favour of Air Canada (2010 - $3 million in favour of the counterparties). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In 2011, a gain of $26 million was recorded in foreign exchange gain (loss) on Air Canada's consolidated statement of operations (2010 - $2 million gain).

Fuel Price Risk Management

Fuel price risk is the risk that future cash flows relating to jet fuel purchases will fluctuate because of changes in jet fuel prices. In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, Air Canada enters into derivative contracts with financial intermediaries. Air Canada uses derivative contracts on jet fuel and other crude oil-based commodities, heating oil and crude oil. Heating oil and crude oil derivatives 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. Air Canada'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. Air Canada performs regular reviews and, if necessary, adjusts the strategy in light of market conditions. Air Canada does not purchase or hold any derivative financial instrument for speculative purposes.

In 2011:

- Air Canada recorded a loss of $26 million in gain (loss) on financial instruments recorded at fair value on Air Canada's consolidated statement of operations (2010 - $11 million loss).
- Air Canada purchased crude-oil call options and collars covering a portion of 2011 and 2012 fuel exposure. The cash premium related to these contracts was $35 million.
- Fuel derivative contracts cash settled with a net fair value of $31 million in favour of Air Canada ($27 million in favour of the counterparties in 2010).

As of December 31, 2011, approximately 23% of Air Canada's anticipated purchases of jet fuel for 2012 are hedged at an average West Texas Intermediate ("WTI") equivalent weighted average capped price of US$114 per barrel. Air Canada's contracts to hedge anticipated jet fuel purchases over 2012 are crude-oil based contracts, comprised of call options and call spreads. The fair value of the fuel derivatives portfolio at December 31, 2011 was $11 million in favour of Air Canada ($33 million in favour of Air Canada in 2010) and is recorded in prepaid and other current assets on Air Canada's consolidated statement of financial position.

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, 2011.

Derivative Instruments	Term	Volume (bbls)	WTI Equivalent Weighted Average Floor Price (US$/bbl)	WTI Equivalent Weighted Average Capped Price (US$/bbl)
Call options	2012	5,279,106	n/a	$115
Call spreads	2012	360,000	n/a	$107

Air Canada is expected to generate fuel hedging gains if oil prices increase above the average capped price.

Air Canada discontinued applying hedge accounting in the third quarter of 2009. Amounts that were deferred to Accumulated Other Comprehensive Loss ("AOCL") for derivatives previously designated under hedge accounting were taken into fuel expense in the period when the previously forecasted hedge transaction occurred. In 2010, $183 million was reclassified from AOCL to aircraft fuel expense, leaving no amounts remaining in AOCL.

The following information summarizes the impact of fuel derivatives on Air Canada's consolidated statement of operations and consolidated statement of comprehensive income.

		Fourth Quarter		Full Year	
(Canadian dollars in millions)		**2011**	**2010**	**2011**	**2010**
Consolidated Statement of Operations					
Operating expenses					
Aircraft fuel	Realized effective loss on fuel derivatives previously designated under hedge accounting	n/a	$ (31)	n/a	$ (183)
Non-operating income (expense)					
Gain (loss) on financial instruments recorded at fair value					
	Fair market value gain (loss) – economic hedges	$ 1	$ 11	$ (26)	$ (11)
Consolidated Other Comprehensive Income					
	Reclassification of net realized loss on fuel derivatives previously designated under hedge accounting to aircraft fuel expense	n/a	$ 31	n/a	$ 183
	Tax on reclassification	n/a	$ 1	n/a	$ 1

13. Critical Accounting Estimates

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

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

Passenger Revenues

Air Canada performs regular evaluations on the advance ticket sales liability, which may result in adjustments being recognized as passenger 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 amounts that are different from those estimates.

Employee Future Benefits

The cost and related liabilities of Air Canada's pensions, other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations involve assumptions, including discount rates, expected rates of return on assets, future salary increases, mortality rates and future benefit increases. Also, due to the long-term nature of these programs, such estimates are subject to significant uncertainty.

Air Canada maintains several defined benefit plans providing pension, other retirement and post-employment benefits to its employees. Management makes a number of assumptions in the calculation of both the accrued benefit obligation as well as the pension costs.

	December 31, 2011	December 31, 2010
Weighted average assumptions used to determine the accrued benefit liability		
Discount rate	5.20%	5.50%
Rate of compensation increase	2.50%	2.50%
Weighted average assumptions used to determine the accrued benefit cost		
Discount rate	5.50%	6.40%
Expected long-term rate	6.90%	7.00%
Rate of compensation increase	2.50%	2.50%

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 or decrease in the discount rate of 0.25% results in a decrease or increase of $473 million to the pension obligation, respectively. A sensitivity analysis on pension expense assuming a change in the discount rate on plan obligations is provided below.

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 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

Domestic Registered Plans

The composition of the domestic registered plan assets and the target allocation as follows:

	2011	2010	Target allocation (1)
Non-matched assets (mainly equities)	53.0%	54.0%	54.4%
Matched assets (mainly Canadian bonds)	47.0%	46.0%	45.6%
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 Trust Fund target allocation. The Bond Trust 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.

For the domestic registered plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Funds as amended during 2011. 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 25% to 39% 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, 2011, a 15% derivative exposure to matched assets is in place to hedge interest rate risk related to pension liabilities.

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

The trusts for the supplemental plans are invested 50% in indexed equity investments, in accordance with their investment policies, with the remaining 50% held by the Canada Revenue Agency as a refundable tax, in accordance with tax legislation.

Air Canada'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 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. While the review considers recent fund performance and historical returns, the assumption is primarily a long-term, prospective rate.

Sensitivity Analysis

Sensitivity analysis on 2011 employee benefits expense and on net financing expense relating to employee benefit liabilities, based on different actuarial assumptions with respect to discount rate and expected return on plan assets, is as follows:

	0.25 Percentage Point	
(Canadian dollars in millions)	**Decrease**	**Increase**
Discount rate on obligation assumption		
Employee benefits expense	$ 15	$ (15)
Net financing expense relating to employee benefit liabilities	(10)	8
	5	**(7)**
Long-term rate of return on plan assets assumption		
Net financing expense relating to employee benefit liabilities	28	(28)
	$ 28	**$ (28)**

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 7.50% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2011 (2010 - 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 current service and interest costs by $5 million and the obligation by $57 million. A one percentage point decrease in assumed health care trend rates would have decreased the current service and interest costs by $4 million and the obligation by $55 million.

Impairment Considerations of Long-Lived Assets

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

Depreciation and Amortization Period for Long-Lived Assets

Air Canada makes estimates about the expected useful lives of long-lived assets and the expected residual values of the assets based on the estimated current fair value of the assets, Air Canada's fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by a variety of factors, including changes to maintenance programs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. Estimates and assumptions are evaluated at least annually. Generally, these adjustments are accounted for on a prospective basis, through depreciation and amortization expense. For the purposes of sensitivity analysis on these estimates, a 50% reduction to residual values on aircraft with remaining useful lives greater than five years results in an increase of $17 million to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.

Maintenance Provisions

The recording of maintenance provisions related to return conditions on aircraft leases requires management to make estimates of the future costs associated with the maintenance events required under the lease return condition and estimates of the expected future maintenance condition of the aircraft at the time of lease expiry. These estimates take into account current costs of these maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in maintenance expense in the period. The effect of any changes in estimates, including changes in discount rates, inflation assumptions, cost estimates or lease expiries, is also recognized in maintenance expense in the period. For the purposes of sensitivity of these estimates, a 2% increase in the aggregate cost for return conditions, holding all other factors constant, results in a cumulative balance sheet adjustment increasing the provision by $12 million at December 31, 2011 and an increase to maintenance expense in 2012 of approximately $1 million. If the discount rates were to increase by 1%, holding all other factors constant, there would be a cumulative balance sheet adjustment to decrease the provision by $13 million at December 31, 2011. Due to low market rates of interest, a 1% decrease in discount rates was not considered a reasonable scenario.

14. Accounting Policies

14.1 Future Accounting Standards

The following is an overview of accounting standard changes that Air Canada will be required to adopt in future years. Except as otherwise noted below for IFRS 9, IAS 32 and amendments to IFRS 7, the standards are effective for Air Canada's annual periods beginning on or after January 1, 2013, with earlier application permitted. Air Canada does not expect to adopt any of these standards before their effective dates. Air Canada continues to evaluate the impact of these standards on its consolidated statement of operations and financial position.

IFRS 9 – Financial Instruments

IFRS 9 introduces new requirements for the classification and measurement of financial assets. IFRS 9 requires all recognized financial assets that are within the scope of IAS 39 Financial Instruments: Recognition and Measurement to be subsequently measured at amortized cost or fair value. Specifically, financial assets that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortized cost at the end of subsequent accounting periods. All other financial assets including equity investments are measured at their fair values at the end of subsequent accounting periods.

Requirements for financial liabilities were added in October 2010 and they largely carried forward existing requirements in IAS 39, Financial Instruments – Recognition and Measurement, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss would generally be recorded in other comprehensive income.

IFRS 9 is effective for annual periods beginning on or after January 1, 2015.

IFRS 10 – Consolidation

IFRS 10 requires an entity to consolidate an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Under existing IFRS, consolidation is required when an entity has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. IFRS 10 replaces SIC-12 Consolidation – Special Purpose Entities and parts of IAS 27 Consolidated and Separate Financial Statements.

IFRS 11 - Joint Arrangements

IFRS 11 requires a venturer to classify its interest in a joint arrangement as a joint venture or joint operation. Joint ventures will be accounted for using the equity method of accounting whereas for a joint operation the venturer will recognize its share of the assets, liabilities, revenue and expenses of the joint operation. Under existing IFRS, entities have the choice to proportionately consolidate or equity account for interests in joint ventures. IFRS 11 supersedes IAS 31, Interests in Joint Ventures, and SIC-13, Jointly Controlled Entities – Non-monetary Contributions by Venturers.

IFRS 12 – Disclosure of Interests in Other Entities

IFRS 12 establishes disclosure requirements for interests in other entities, such as joint arrangements, associates, special purpose vehicles and off balance sheet vehicles. The standard carries forward existing disclosures and also introduces significant additional disclosure requirements that address the nature of, and risks associated with, an entity's interests in other entities.

IFRS 13 - Fair Value Measurement

Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements. IFRS 13 is a more comprehensive standard for fair value measurement and disclosure requirements for use across all IFRS standards. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. It also establishes disclosures about fair value measurement.

Amendments to IAS 19 - Employee Benefits

The amendments to IAS 19 make significant changes to the recognition and measurement of defined benefit pension expense and termination benefits, and to enhance the disclosures for all employee benefits. Actuarial gains and losses are renamed 'remeasurements' and will be recognized immediately in other comprehensive income ("OCI"). Remeasurements recognized in OCI will not be recycled through profit or loss in subsequent periods. The amendments also accelerate the recognition of past service costs whereby they are recognized in the period of a plan amendment. The annual expense for a funded benefit plan will be computed based on the application of the discount rate to the net defined benefit asset or liability. The amendments to IAS 19 will also impact the presentation of pension expense as benefit cost will be split between (i) the cost of benefits accrued in the current period (service cost) and benefit changes (past-service cost, settlements and curtailments); and (ii) finance expense or income.

A number of other amendments have been made to recognition, measurement and classification, including those re-defining short-term and other long-term benefits guidance on the treatment of taxes related to benefit plans, guidance on risk/cost sharing factors and expanded disclosures.

Air Canada's current accounting policy for employee benefits for the presentation of pension expense and the immediate recognition of actuarial gains and losses in OCI is consistent with the requirements in the new standard, however, additional disclosures and the computation of annual expense based on the application of the discount rate to the net defined benefit asset or liability will be required in relation to the revised standard.

Amendments to IAS 1 - Financial Statement Presentation

The amendments to IAS 1 require entities to separate items presented in OCI into two groups based on whether or not they may be recycled to profit or loss in the future. Items that will not be recycled, such as remeasurements resulting from the amendments to IAS 19, will be presented separately from items that may be recycled in the future, such as deferred gains and losses on cash flow hedges. Entities that choose to present OCI items before tax will be required to show the amount of tax related to the two groups separately.

Amendments to Other Standards

In addition, there have been amendments to existing standards, including IFRS 7 Financial Instruments: Disclosure, IAS 27, Separate Financial Statements, IAS 28, Investments in Associates and Joint Ventures, and IAS 32, Financial Instruments: Presentation. IFRS 7 amendments require disclosure about the effects of offsetting financial assets and financial liabilities and related arrangements on an entity's financial position. IAS 27 addresses accounting for subsidiaries, jointly controlled entities and associates in non-consolidated financial statements. IAS 28 has been amended to include joint ventures in its scope and to address the changes in IFRS 10 – 13. IAS 32 addresses inconsistencies when applying the offsetting requirements, and is effective for annual periods beginning on or after January 1, 2014.

Carbon Emissions Accounting Policy

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 will require aircraft operators to monitor and report on fuel use and emissions data.

Air Canada will adopt the terms of the Emissions Trading Scheme ("ETS") commencing in January 2012. Effective January 1, 2012 Air Canada intends to adopt a cost of settlement accounting model whereby emission allowances granted by the European Union are recorded as an intangible asset and are measured at fair value at the date of initial recognition with an offset to deferred income as a government grant. Purchased emission allowances will be recorded at cost and also recognized as an intangible asset. The intangible assets will subsequently be measured using the cost model of IAS 38, Intangible Assets and will be de-recognized at the end of each emission compliance period as an offset to the Corporation's provision for emission obligations. The intangible assets will be subject to Air Canada's impairment of long-lived assets accounting policy.

The government grant, measured based on the fair value of emission allowances at the date of initial recognition, will be amortized as an offset to other operating expenses over the emission compliance period based on volume of emissions generated during the period compared to the expected volume of emissions during the emission compliance period.

A provision to deliver emissions allowances will be recognized, with an offset to other operating expense, as carbon emissions are made using a weighted average cost model per unit of emission expected to be incurred for the emission compliance period as a whole. This provision will be presented net of emission allowances on Air Canada's consolidated statement of financial position.

Based on current trading prices of European Union CO_2 allowances (EUAs), Air Canada expects to incur operating costs of no more than $4 million in 2012. This amount is subject to change based on the change in the market price of EUAs. Based on current operating plans, no specific European Union ETS surcharges will be implemented, rather a fuel surcharge strategy will be employed.

15. 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 23 Air Canada aircraft leases, the difference between the reduced rents as a result of the implementation of the Plan of Reorganization, Compromise and Arrangement under the Companies' Creditors Arrangement Act ("CCAA") on September 30, 2004, and amounts which would have been due under the original lease contracts will be forgiven at the expiry date of the leases if no material default has occurred by such date. In the event of a material default, which does not include any cross defaults to other unrelated agreements (including agreements with the counterparties of these aircraft leases), 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 additional liability would be recorded only at the time management believes the amount is likely to be incurred.

Guarantees in Fuel Facilities Arrangements

Air Canada 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 Air Canada under SIC Interpretation 12 – Consolidation of Special Purpose Entities is approximately $187 million as at December 31, 2011 (2010 - $171 million), which is Air Canada's maximum exposure to loss before taking into consideration the value of the assets that secure the obligations and any cost sharing that would occur amongst the other contracting airlines. Air Canada views this loss potential as remote. Each contracting airline participating in a Fuel Facility Corporation shares pro rata, based on system usage, in the guarantee of this debt. The maturities of these debt arrangements vary but generally extend beyond five years.

Indemnification Agreements

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

Air Canada 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 liabilities that arise out of or relate to Air Canada'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 certain liabilities that arise from third party claims, which may relate to the services performed by the service provider.

Under its general by-laws and pursuant to contractual agreements between Air Canada and each of its officers and directors, Air Canada has indemnification obligations to its directors and officers. Pursuant to such obligations, Air Canada 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 liabilities and certain related contractual indemnities described above.

16. Related Party Transactions

At December 31, 2011, Air Canada had no transactions with related parties as defined in the CICA Handbook – Part 1, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

17. Sensitivity of Results

Air Canada's financial results are subject to many different internal and external factors which can have a significant impact on operating results. The following table describes, on an indicative basis, the financial impact that changes in certain assumptions would generally have had on Air Canada's operating results. These guidelines were derived from 2011 levels of activity and make use of management estimates. The impacts are not additive, do not reflect the interdependent relationship of the elements and actual results may vary significantly due to a wide range of factors many of which are beyond the control of Air Canada.

(Canadian dollars in millions, Except where indicated) Key Variable		2011 Measure	Sensitivity Factor	Favourable/(Unfavourable) Estimated Operating Income Impact
Revenue Measures				
Passenger yield (cents)	System	18.7	1% increase in yield	$ 96
	Canada	25.0		$ 38
Traffic (RPMs) (millions)	System	54,223	1% increase in traffic	$ 91
	Canada	15,971		$ 36
Passenger load factor (%)	System	81.6	1 percentage point increase	$ 111
RASM (cents)	System	15.3	1% increase in RASM	$ 93
Cost Measures				
Fuel – WTI price (US$/barrel) (1)		94	US$1/barrel increase to WTI	$ (24)
Fuel – jet fuel price (CAD cents/litre) (1)		85	1% increase	$ (33)
Cost per ASM (cents)		17.2	1% increase in CASM	$ (114)
Currency Exchange				
C$ to US$		C$1 = US$1.00	1 cent increase in exchange rate (i.e., $1.01 to $1.00 per US dollar)	$ 31

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

(Canadian dollars in millions) Key Variable	2011 Measure	Sensitivity Factor	Favourable/(Unfavourable) Estimated Pre-Tax Income Impact (1)
Currency Exchange			
C$ to US$	C$1 = US$1.00	1 cent increase in exchange rate (i.e., $1.01 to $1.00 per US dollar)	$ 65

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

18. 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, on September 30, 2004, from its restructuring under the *Companies Creditors Arrangement Act*, as amended ("CCAA"), Air Canada had sustained significant losses and Air Canada may sustain significant losses in the future. Since emergence from CCAA to December 31, 2011, Air Canada has accumulated a Deficit of $4,085 million in Shareholders' Equity. A variety of factors, including economic conditions and other factors described in this Risk Factors section, may result in Air Canada incurring significant losses. Despite ongoing strategic and business initiatives, including efforts at securing cost reductions and revenue improvements, 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 decrease costs, improve yield or offset or mitigate risks facing Air Canada, including those relating to economic conditions, labour issues, liquidity, pension funding, competition, and 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 other financings (including under the private offering of senior secured notes completed in 2010), 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, labour issues, 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, U.S. 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 the 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, and may also impact Air Canada's operating costs, pension plan contributions, fuel costs, 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 may fluctuate significantly in the future. Air Canada is not able to predict with certainty market conditions and the fares that Air Canada may be able to charge. Customer expectations can change rapidly and the demand for lower fares may limit revenue opportunities. Travel, especially leisure travel, is a discretionary consumer expense. Demand for business and premium travel are also impacted by economic conditions. 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 or prolonged period of low interest rates may result in significant increases in Air Canada's funding obligations, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Refer to section 9.8 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 2011. Fuel prices fluctuate widely depending on many factors including international market conditions, geopolitical events, jet fuel refining costs and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict fuel prices. During the last five years, 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 2011 volumes, management estimates that a US$1 per barrel movement in the average price of West Texas Intermediate ("WTI") crude oil would have resulted in an approximate $24 million change in 2011 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.

Labour Costs and Labour Relations

Labour costs constituted another one of Air Canada's largest operating cost items in 2011. There can be no assurance that Air Canada will be able to maintain such costs at levels that do not negatively affect its business, results from operations and financial condition. 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 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 expired in 2011. In 2011, collective agreements with the unions representing Air Canada's customer service employees at airports and call centres, as well as with the union representing its flight attendants were, respectively, concluded and imposed through arbitration during 2011. Also in 2011, Air Canada entered into a collective agreement with the union representing the airline's London-Heathrow based employees. Negotiations continue or are expected to soon commence with the remaining bargaining units of Canadian-based union represented employees. 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 otherwise be any labour conflict or action that could also lead 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.

Any labour disruption or work stoppage by any of the unionized work groups of Jazz or other parties with whom Air Canada conducts business could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, labour conflicts at Star Alliance partners 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.

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 U.S./Canada dollar exchange rate. Management estimates that during 2011, a $0.01 strengthening of the Canadian dollar versus the U.S. dollar (i.e., $1.01 to $1.00 per U.S. dollar) would have had an estimated $31 million favourable impact on operating income and a $65 million favourable impact on pre-tax income. Conversely, a corresponding opposite change in the exchange rate would have had the corresponding opposite effect. Air Canada incurs significant expenses in U.S. dollars for items such 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.

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 (including regional), 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 (including regional) 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 competes, including U.S. carriers, may undergo (and some 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 therefore 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. Expansion or new competition by low-cost or other carriers in any of the markets served by Air Canada may adversely affect Air Canada's business results from operations and financial condition.

Air Canada also encounters substantial price competition. The prevalence of low-cost carriers, 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. A 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 commissions/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.

Furthermore, consolidation within the airline industry could result in increased competition as some airlines emerging from such consolidations and entering into integrated commercial cooperation arrangements, such as joint ventures, may be able to compete more effectively, which could have a material adverse effect on Air Canada.

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. As a result of high fixed costs, should Air Canada be required to reduce its overall capacity or the number of flights operated, it may not be able to successfully reduce certain fixed costs 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.

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 asset valuations, 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, lessors or other co-contracting parties, and such defaults could trigger additional defaults under other indebtedness or agreements. In such a situation, Air Canada may not be able to repay the accelerated indebtedness or fulfill its obligations under certain contracts, make required aircraft lease payments or otherwise cover its fixed costs. Also, the lenders under the financing arrangements could foreclose upon all or substantially all of the assets of Air Canada which secure Air Canada's obligations.

Refer to section 9.7 of this MD&A for information on Air Canada's credit card processing agreements.

Airport User Fees and Air Navigation Fees

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

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, implement and pursue strategic, business, technology and other important initiatives, such as those relating to participation in the low-cost market, the aircraft fleet restructuring, business processes, information technology, revenue management, cost transformation, improving premium passenger revenues, expansion of flying capacity (including in respect of new routes), corporate culture transformation, initiatives seeking to ensure a consistently high quality customer service experience and others. These initiatives, including activities relating to their development and implementation, may be adversely impacted by a wide range of factors, many of which are beyond Air Canada's control. Such factors include the performance of third parties, including suppliers, the implementation and integration of such initiatives into Air Canada's other activities and processes as well as the adoption and acceptance of these initiatives by Air Canada's customers, suppliers and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement 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 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 widebody 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

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, 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, 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 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 Jazz 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 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.

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

Current Legal Proceedings

<u>Investigations by Competition Authorities Relating to Cargo</u>

The European Commission, the United States Department of Justice and the Competition Bureau in Canada have investigated or 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 has been 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. Air Canada is also named as a defendant, and may otherwise become implicated, in a number of class action lawsuits and other proceedings that have been filed before the United States District Court in Canada and Europe in connection with these allegations. In the United States, the investigation by the U.S. Department of Justice has concluded with no proceedings having been instituted against Air Canada.

On November 9, 2010, Air Canada announced that the European Commissions issued a decision finding that 12 air cargo carriers (including groups of related carriers) had infringed European Union competition law in the setting of certain cargo charges and rates for various periods between 1999 and 2006. Air Canada was among the carriers subject to the decision and a fine of 21,037,500 Euros (approximately $29.4 million at an exchange rate of $1.3970) was imposed on Air Canada. Air Canada is appealing this decision and has filed an application for appeal before the European General Court. In the first quarter of 2011, Air Canada paid the fine, as required, pending the outcome of its appeal.

As at December 31, 2011, Air Canada has a provision of $37 million relating to outstanding claims in this matter, which is recorded in accounts payable and accrued liabilities on Air Canada's consolidated statement of financial position. This provision is an estimate based upon the status of the investigations and proceedings at this time and Air Canada's assessment as to the potential outcome for certain of them. The provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Air Canada has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings and investigations. As stated above, Air Canada is appealing the decision issued by the European Commission and, if and as appropriate, based on the outcome of any updates regarding this appeal as well as developments regarding proceedings and investigations in other jurisdictions, may record adjustments to the provision and/or its income in subsequent periods as required.

Billy Bishop Toronto City Airport

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 Billy Bishop Toronto City Airport. 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. On October 16, 2009, Jazz discontinued its suit in the Ontario Superior Court against Porter.

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 Billy Bishop Toronto City Airport. The Porter Defendants were granted intervener and party status in these proceedings. In January 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. In March 2010, Jazz discontinued its proceedings in the Federal Court of Canada against the TPA. On May 14, 2010, Porter filed a discontinuance of its counterclaim before the Federal Court of Canada.

The counterclaim filed by Porter in the Ontario Superior Court of Justice against Jazz and Air Canada was stayed pending the outcome of the mirror counterclaim in the Federal Court. This stay has now been lifted and the counterclaim has been reactivated. Management views Porter's counterclaim as being without merit.

In the first quarter of 2010, Air Canada filed legal proceedings with the Federal Court of Canada seeking to challenge the process announced by the TPA to allocate flight capacity or slots at the Billy Bishop Toronto City Airport. On July 21, 2010, the Federal Court of Canada dismissed Air Canada's challenge and Air Canada appealed this decision before the Federal Court of Appeal. On December 12, 2011, the Federal Court of Appeal dismissed Air Canada's appeal, adversely impacting Air Canada's ability to secure new slots at the Billy Bishop Toronto City Airport ("BBTCA") on a fair and equitable basis to effectively compete with Porter.

Pay Equity

The Canadian Union of Public Employees ("CUPE"), which represents Air Canada's flight attendants, 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 was not 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 to 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 and an investigation proceeded and was concluded in 2011 with the determination that the complaint will not be referred to the Canadian Human Rights Tribunal for inquiry. CUPE has initiated proceedings before the Federal Court to challenge this determination, which Air Canada will seek to have upheld. Air Canada considers that any proceedings 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 proceedings.

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 ("ACPA") collective agreement which incorporate provisions of the pension plan terms and conditions applicable to pilots requiring them to retire at age 60. Air Canada has fully or partially resolved some of these complaints and is defending others. At this time, it is not possible to determine with any degree of certainty the extent of any financial liability that may arise from Air Canada being unsuccessful in its defence of these proceedings.

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 potential for terrorist attacks and terrorist activity 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 those relating to the content of carry-on baggage, passenger identification document requirements, and passenger screening procedures could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada's flights. It could also lead to a substantial increase in insurance, airport security and other costs. Any resulting reduction in passenger revenues and/or increases in costs, including insurance, security or other costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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. An outbreak of influenza, SARS, H1N1 influenza virus or of another epidemic disease (whether domestic or international) or any WHO or similar 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 an 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, consumer rights, 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 theses 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 requires aircraft operators to monitor and report on fuel use and emissions data. While this legislation is expected to result in increased costs relating to the purchase of emissions allowances, the net financial impact will, in part, depend upon how much of such cost, if any, will be recovered, including in the form of higher passenger fares and cargo rates. Refer to section 14.1 of this MD&A for additional information.

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 and 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.

Availability of Insurance Coverage and Increased Insurance Costs

The aviation insurance industry has been continually reevaluating 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 until December 31, 2013. 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 US$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.

19. Controls and Procedures

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

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

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

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

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

Management's Report on Disclosure Controls and Procedures

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined under National Instrument 52-109) and concluded, as at December 31, 2011, that such disclosure controls and procedures were effective.

Management's Report on Internal Controls over Financial Reporting

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's internal controls over financial reporting (as defined under National Instrument 52-109). In making this evaluation, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commissions ("COSO") in Internal Control - Integrated Framework. Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2011, the Corporation's internal controls over financial reporting were effective. This evaluation took into consideration the Corporation's Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee.

Changes in Internal Controls over Financial Reporting

As a result of the transition from Canadian GAAP to IFRS effective January 1, 2011, there have been material changes in internal controls over financial reporting in the following process areas:

- Accounting policy selection (including controls over changes in accounting policies)
- Property and equipment
- Provisions (lease return conditions)
- Impairment of long-lived assets
- Employee benefits

Management has considered the control risks of the transition to IFRS and has performed procedures to obtain reasonable assurance on the design and operation of internal controls over financial reporting that are new or significantly modified as a result of the transition.

20. Non-GAAP Financial Measures

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation, amortization and impairment, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. EBITDAR is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning, and therefore may not be comparable to similar measures presented by other public companies.

EBITDAR before a provision adjustment for cargo investigations and EBITDAR are reconciled to operating income (loss) as follows:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2011**	**2010**	**Change $**	**2011**	**2010**	**Change $**
GAAP operating income (loss) before a provision adjustment for cargo investigations, net (1)	$ (98)	$ 15	$ (113)	$ 179	$ 232	$ (53)
Add back:						
Aircraft rent	86	86	-	335	353	(18)
Depreciation, amortization and impairment	174	227	(53)	728	801	(73)
EBITDAR before a provision adjustment for cargo investigations, net (1)	**$ 162**	**$ 328**	**$ (166)**	**$ 1,242**	**$ 1,386**	**$ (144)**
Add back:						
Provision adjustment for cargo investigations, net (1)	-	46	(46)	-	46	(46)
EBITDAR	**$ 162**	**$ 374**	**$ (212)**	**$ 1,242**	**$ 1,432**	**$ (190)**

(1) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of $125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of $46 million to this provision.

Operating Expense, Excluding Fuel Expense and Excluding the Cost of Ground Packages at Air Canada Vacations

Air Canada uses operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, to assess the operating performance of its ongoing airline business as such expenses may distort the analysis of certain business trends and render comparative analyses to other airlines less meaningful. Fuel expense fluctuates widely depending on many factors, including international market conditions, geopolitical events, jet fuel refining costs, the Canada/U.S. currency exchange rate, and excluding this expense from GAAP expense results, allows Air Canada to more effectively compare its operating performance. Air Canada incurs expenses related to ground packages at Air Canada Vacations, which some airlines generally do not incur, and excluding these expenses from GAAP results, allows its operating expense performance to be more comparable to those of other airlines. In addition, these costs do not generate ASMs and therefore excluding these costs from GAAP expense results, provides for a more meaningful comparison across periods when ground package costs are changing. Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations, is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning and therefore may not be comparable to similar measures presented by other public companies.

Operating expense, excluding the cost of ground packages at Air Canada Vacations and fuel expense, is reconciled to operating expense as follows:

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2011**	**2010**	**Change $**	**2011**	**2010**	**Change $**
GAAP operating expense	$ 2,797	$ 2,601	$ 196	$ 11,433	$ 10,554	$ 879
Remove:						
Cost of ground packages at Air Canada Vacations	(57)	(49)	(8)	(307)	(272)	(35)
Operating expense, excluding fuel expense	**$ 2,740**	**$ 2,552**	**$ 188**	**$ 11,126**	**$ 10,282**	**$ 844**
Remove:						
Aircraft fuel	(808)	(640)	(168)	(3,375)	(2,652)	(723)
Operating expense, excluding fuel expense and excluding the cost of ground packages at Air Canada Vacations	**$ 1,932**	**$ 1,912**	**$ 20**	**$ 7,751**	**$ 7,630**	**$ 121**

Adjusted Net Income (Loss) Per Share - Diluted

Air Canada uses adjusted net income (loss) per share – diluted to assess the performance of its business without the effects of foreign exchange and exceptional items. Such measure is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning and therefore may not be comparable to similar measures presented by other public companies.

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2011**	**2010**	**Change $**	**2011**	**2010**	**Change $**
Net income (loss) for the period attributable to shareholders of Air Canada	$ (62)	$ 87	$ (149)	$ (255)	$ (33)	$ (222)
Remove:						
Foreign exchange (gain) loss	(114)	(136)	22	54	(184)	238
Provision adjustment for cargo provisions, net	-	(46)	46	-	(46)	46
Impairment charge on aircraft	-	49	(49)	-	49	(49)
Interest expense charge on repayment of term credit facility	-	-	-	-	54	(54)
Adjusted net loss	**$ (176)**	**$ (46)**	**$ (130)**	**$ (201)**	**$ (160)**	**$ (41)**
Adjusted weighted average number of outstanding shares used in computing diluted loss per share (in millions)	277	278	(1)	278	278	-
Adjusted net loss per share - diluted	**$ (0.64)**	**$ (0.17)**	**$ (0.47)**	**$ (0.72)**	**$ (0.58)**	**$ (0.14)**

21. Glossary

Atlantic passenger and cargo revenues — Refers to revenues from flights that cross the Atlantic Ocean with origins and destinations principally in Europe.

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

CASM — Operating expense per ASM.

EBITDAR — EBITDAR is earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent and is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation, amortization and impairment, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Refer to section 20 of this MD&A for additional information.

Effective Ton Miles or ETMs — Refers to the mathematical product of tonnage capacity times distance hauled.

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

Pacific passenger and cargo revenues — Refers to revenues from flights that cross the Pacific Ocean with origins and destinations principally in Asia.

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.

Percentage point (pp) — A measure for the arithmetic difference of two percentages.

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.

Revenue Ton Miles or RTMs — Refers to the mathematical product of weight in tons of a shipment being transported by the number of miles that it is transported.

Yield — Average passenger revenue per RPM.