

**ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST**

**IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*,
R.S.C. 1985. c. C-36, AS AMENDED**

**IN THE MATTER OF SECTION 191 OF THE *CANADA BUSINESS
CORPORATIONS ACT*, R.S.C. 1985, C-44 AS AMENDED**

**IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF
AIR CANADA AND THE APPLICANTS SET OUT IN SCHEDULE "A"**

**SIXTEENTH REPORT OF THE MONITOR
DATED DECEMBER 16, 2003**

1. On April 1, 2003, Air Canada and certain of its subsidiaries (collectively the "Applicants" or the "Company") filed for and obtained protection from their creditors under the *Companies' Creditors Arrangement Act* R.S.C. 1985 c. C-36, *as amended* (the "CCAA"). The terms of this proceeding are governed by an order of this Court dated April 1, 2003, as amended (the "Amended and Restated Initial Order"). Pursuant to the Amended and Restated Initial Order, Ernst & Young Inc. ("EYI") was appointed as monitor (the "Monitor") of the Applicants during these CCAA proceedings.
2. Capitalized terms not defined in this Report (as defined below) are as defined in the Amended and Restated Initial Order or the First through the Fifteenth Reports of the Monitor. All references to dollars are in Canadian currency unless otherwise noted.
3. The purpose of this Sixteenth Report of the Monitor (the "Report") is to provide this Honourable Court and Air Canada stakeholders with an overview of an agreement reached between Air Canada and Deutsche Lufthansa AG ("Lufthansa") in connection with the Applicants motion for approval by this Honourable Court of the agreement.

BACKGROUND RE: LUFTHANSA RELATIONSHIP

4. Air Canada considers its relationship with Lufthansa to be one of its most important strategic relationships. Air Canada and Lufthansa have been commercial partners since prior to the formation of the Star Alliance network. Currently, Lufthansa, along with United Air Lines, Inc., (“UAL”) is one of Air Canada’s two most significant network partners and is the only Star Alliance partner with extensive operations throughout Europe, the Middle East and Africa. The majority of Air Canada customers wishing to travel to these destinations where Air Canada does not fly directly to, are flown via Air Canada to Frankfurt and then connect via Lufthansa to their final destination.
5. The Air Canada – Lufthansa relationship commenced in 1996 when the parties signed a strategic alliance agreement that provided a framework for additional separate agreements with respect to potential areas of cooperation (the “Strategic Alliance Agreement”) to be entered into. Some of these additional agreements are as follows:
 - The Aeroplan Frequent Flyer Participation Agreement – This agreement allows Aeroplan members who fly on Lufthansa routes to earn Aeroplan points for their travel;
 - The Miles & More International Carrier Participation Agreement – This agreement allows members in the Lufthansa Miles & More Club to earn Miles and More points for travel on Air Canada routes;
 - The Code Sharing Agreement – This agreement allows Air Canada to place its codes (i.e. Air Canada flight numbers) on Lufthansa operated routes and vice versa. This gives Air Canada the ability to sell tickets to destinations it does not serve directly by booking a passenger on an Air Canada flight to either Frankfurt or Munich connecting to a Lufthansa flight under the AC code to their final destination. To the customer, the connection is seamless;

- The Sales Incentive Agreement – This agreement specifies the commission to be payable to either Air Canada or Lufthansa for selling transportation on the other carrier;
 - The Slot Exchange Agreement – Under this agreement, Air Canada provides Lufthansa with the right to use certain of its slots at the Toronto airport; and
 - The Special Pro-Rate Agreement – The Pro Rate agreement specifies the amount to be paid to Lufthansa for placing Air Canada passengers on Lufthansa connecting flights. As a Star Alliance partner, the amount Air Canada pays to put a customer on a Lufthansa flight is on average significantly less than it pays on other carriers such as Air France or British Airways. The chart prepared by management and attached at Appendix A illustrates this by comparing the pro-rate amount charged by each of the three carriers to get an Air Canada passenger from their main hub to the top ten European destinations.
6. In addition to the above formal agreements, Air Canada and Lufthansa participate in a joint venture arrangement that commenced in 1998 with a specific agreement covering flights between Montreal and Frankfurt (the “Montreal JV”). The arrangement provided for the equal sharing of all revenues and expenses on this route, without regard to which carrier operated the flights or sold the tickets. The Montreal JV expired in 1999, and due to its success, Air Canada and Lufthansa agreed to continue the arrangement as well as to expand it to cover flights between Frankfurt and Calgary, Frankfurt and Vancouver, Frankfurt and Toronto, Munich and Toronto and Munich and Montreal, all without any form of written agreement (the “Informal JV”), although they were working to negotiate such a written agreement prior to Air Canada’s filing under the CCAA. Currently, Lufthansa sells approximately 55% of the tickets on the joint venture routes while Air Canada operates approximately 60% of the available seat miles.

LUFTHANSA LOAN GUARANTY

7. In 1999, Onex Corporation and AMR Corporation attempted a hostile take-over of Air Canada which would have involved a merger of Air Canada and Canadian Airlines International. It was expected that if the take-over had occurred, Air Canada would have had to withdraw from the Star Alliance as the new merged airline would be part of AMR's oneworld alliance.
8. In defending itself from the take-over bid, Air Canada bought back approximately \$1.1 billion of its own shares. Part of the funding for this buyback was obtained through a loan advanced on December 22, 2000, by Kreditanstalt Für Wiederaufbau ("KfW") to 3838722 Canada Inc. ("3838722"), a wholly-owned subsidiary of Air Canada, incorporated solely for the purposes of the loan transaction (the "KfW Loan"). The original principal amount of the KfW Loan was US\$195 million. Lufthansa and UAL each separately guaranteed a portion of the loan.
9. Principal repayments were to be made on the KfW Loan in 18 consecutive semi-annual instalments commencing June 23, 2001 and ending December 23, 2009, the first 17 installments being for 2.5% of the original principal amount (i.e. U.S.\$4.875 million each) with the last instalment being for the remaining principal balance (i.e. U.S.\$112.125 million). The loan bears interest at a rate equal to the six month London interbank offered rate for deposits in US dollars plus a) the sum of i) 0.525% times the Lufthansa guaranteed portion of the loan and ii) 0.850% times the UAL guaranteed portion of the loan divided by b) the principal amount of the loan. Interest is payable in arrears on each principal repayment date.
10. Lufthansa's guarantee of the KfW Loan was made pursuant to a guarantee agreement with KfW dated December 22, 2000 (the "Guarantee Agreement") which provided that if 3838722 defaulted on any payments due under the loan, Lufthansa would be required to make the payments based on the original loan payment schedule. Lufthansa's guarantee covers 48.08% of the original principal amount of the loan. (The UAL guarantee covered the remaining 51.92%.)

11. On the same date, Air Canada entered into an agreement with Lufthansa and UAL to pay them a fee for having guaranteed the loan (the “Fee Agreement”). The fee is paid semi-annually on each payment instalment date under the KfW Loan and is based on a percentage of the loan balance outstanding, such percentage to fluctuate based on the credit ratings of Air Canada and Lufthansa at the time. As a result, the percentage fee payable may range from 0.215% to 2.835% and was approximately 2.17% as at the date of the CCAA filing based on the credit ratings of the two parties on that date.
12. Also on December 22, 2000, Air Canada entered into a reimbursement agreement with Lufthansa and UAL (the “Reimbursement Agreement”), pursuant to which Air Canada agreed to reimburse them for any payments they were required to make as a result of their guarantees as well as to guarantee payment of the fees payable under the Fee Agreement.
13. It is both Air Canada and Lufthansa’s view that the Guarantee Agreement was entered into by Lufthansa in order to protect the Star Alliance and Lufthansa’s partnership with Air Canada.
14. Immediately prior to Air Canada’s CCAA filing, there remained U.S.\$175,500,000 outstanding on the KfW Loan of which the Lufthansa guaranteed portion represented U.S.\$84,380,400. KfW has since filed a proof of claim in respect of the full amount outstanding under the KfW Loan.
15. The next principal and interest payment due to KfW subsequent to Air Canada’s CCAA filing was to be made on June 23, 2003 in the amount of approximately U.S.\$6.7 million. As payment of the balance owing by 3838722 under the KfW Loan is stayed by the Amended and Restated Initial Order, 3838722 did not make the payment. As a result, on July 3, 2003, KfW demanded payment from Lufthansa of the portion of the instalment due by 3838722 which Lufthansa had guaranteed. Pursuant to the Guarantee Agreement, Lufthansa made the required payment of approximately U.S.\$3.2 million.

16. In July 2003, Lufthansa, in turn, sought reimbursement by setting off U.S.\$4,171,197 (comprised of the U.S.\$3.2 million it paid to KfW as well as the U.S.\$0.9 million due to Lufthansa under the Guarantee Agreement) against interline revenues due to Air Canada for July 2003.
17. Lufthansa took the position that it was entitled to exercise set-off to recover amounts due under the Reimbursement Agreement and informed Air Canada that if it did not honour the Reimbursement Agreement, it would not continue discussions with respect to documenting the Informal JV, would no longer treat Air Canada as a strategic partner and would take steps, when entitled to do so, to compete with Air Canada which would potentially have a significant effect on Air Canada's future revenue potential. It is Lufthansa's position that the Reimbursement Agreement is a Star Alliance agreement and that all of Air Canada's Star Alliance agreements must be viewed as a package. In other words, Lufthansa believes that if Air Canada is to continue to receive the benefits of certain of its Star Alliance agreements, it must continue to honour its obligations under the others.
18. In view of the critical nature of the ongoing commercial relationship between Air Canada and Lufthansa and the fact that Air Canada and Lufthansa were in the process of finalizing a new joint venture agreement which was expected to provide significant benefits for both parties, Air Canada did not contest Lufthansa's assertion of set-off.

IMPACT OF TERMINATION OF LUFTHANSA RELATIONSHIP

19. The Monitor is advised by Air Canada management that, subject to the stay of proceedings, current agreements in place with Lufthansa can be terminated, amended unilaterally, or significantly diminished in scope on relatively short notice which would have an extremely detrimental impact on Air Canada's revenues as the benefits received from these agreements are not easily replaceable. Management has noted the following significant areas of risk in the event Lufthansa terminates or amends the agreements:

- The Code Sharing Agreement – Although Lufthansa cannot terminate this agreement, the Monitor is advised that the agreement contains provisions which would allow Lufthansa to ask Air Canada to remove its codes from the Lufthansa operated flights beyond Frankfurt and Munich with as little as 90 days notice, thereby diminishing or eliminating the value provided to AC through this agreement. Currently, Air Canada code shares on approximately 57 Lufthansa routes to 37 cities out of Frankfurt or Munich. Without the code share ability, Air Canada would not be able to offer online products to these markets. While customers could still purchase tickets on an interline basis through travel agents using computerized reservations systems, they are unlikely to do so as the connection would no longer appear to be a seamless one. Instead customers are more likely to purchase tickets on other airlines;
- The Special Pro-Rate Agreement – Under this agreement, Lufthansa can unilaterally change the interline prices it charges Air Canada for the Lufthansa operated flights on 30 days notice. As well, Lufthansa can change the booking classes made available for Air Canada to access. This would result in Air Canada having to pay higher pro-rate amounts to other carriers to get customers to certain destinations, leading in turn to a decrease in Air Canada's revenue on its transatlantic routes; and
- The Informal JV – As this arrangement was not finalized, Lufthansa would be able to terminate it immediately. In addition, Lufthansa has indicated that it would increase the flights on its Canada-Germany routes. As Lufthansa already accounts for 55% of the revenue on these routes, Air Canada would likely lose a significant number of passengers.

20. With the loss of Lufthansa as its major European partner, Air Canada management believes that its international revenue would be severely impacted. The other European partners in the Star Alliance are much smaller than Lufthansa and would not be able to provide access to the same network. Lufthansa is also the largest partner for most of the other Star Alliance

carriers, and therefore, may be able to influence others to mute value or slow growth for Air Canada. In addition, the Star Alliance agreement prohibits Air Canada from seeking an alliance with another major European partner such as Air France, British Airways or KLM as long as it is a member of a competing alliance. Even if Air Canada were to decide to leave the Star Alliance, management advises that it would be faced with the following constraints:

- The Star Alliance agreement prohibits Air Canada from joining another alliance for a period of two years;
- Air Canada would have to reconfigure its entire international network to work with its new partners which would involve significant time and cost;
- Air Canada would have to invest significant resources in technical development with its new partners and/or new alliance;
- Air Canada may have to deal with regulatory restrictions to gain access to new bases; and
- Airport slots in the other major European cities simply may not be available for some time.

21. For all of the above reasons, management of Air Canada believes that the loss of Lufthansa as a strategic partner would have a significant negative financial impact on future revenues and profitability. A significant adverse financial impact may result in material adverse change conditions being triggered under the Trinity Time Investments Limited agreement should the financial impact be material. Accordingly, the loss of the Lufthansa relationship may impair the timely completion of the \$1.1 billion of equity financing.

THE CANADA – GERMANY COOPERATION AGREEMENT

22. As discussed in paragraph 6, Air Canada and Lufthansa were working towards finalizing a formal written agreement with respect to their joint venture arrangements prior to the CCAA filing. These efforts have continued post-filing and the two parties have recently completed negotiation of a new Canada – Germany Cooperation Agreement (“CGCA”). The CGCA provides, among other things, that:

- Both parties will work together to develop routes and flight schedules and to utilize aircraft on the joint venture routes;
- Net profits from the joint venture routes (defined as joint venture revenue less joint venture expenses) will be shared equally between Lufthansa and Air Canada. In addition, Air Canada will pay Lufthansa certain amounts as set out in Appendix 11 to the CGCA, a copy of which is attached at Appendix B, (the “Minimum Amount”) on the dates specified commencing December 23, 2003 and ending on December 23, 2009; and
- The initial term will extend to December 31, 2009 with automatic extensions for periods of two years each unless specific notice of termination is provided no later than 90 days prior to the expiration date. Either party may terminate the CGCA early on twelve months notice, however, if Lufthansa does so, it will lose the right to receive any further Minimum Amount payments.

23. The Minimum Amount payments that AC is required to pay to Lufthansa pursuant to the CGCA are intended to compensate Lufthansa for the amounts it would have otherwise been entitled to receive under the Reimbursement Agreement and Fee Agreement. Accordingly, the thirteen individual payment amounts are comprised of the following:

- Repayment instalments of U.S.\$6,310,500 on an opening amount of U.S.\$82,036,500 (the “Principal”), being the balance currently outstanding under the Lufthansa guaranteed portion of the KfW Loan;

- Interest, payable in arrears (with interest on the first instalment calculated from June 23, 2003), on the principal outstanding balance as at each payment date at a fixed rate of 4.495%;
- A fee of 2.0% of the Principal outstanding as at each payment date.

24. As a result, the quantum of the semi-annual Minimum Amount payments decline over time, from approximately U.S.\$9.0 million on December 23, 2003 to approximately U.S.\$6.5 million on December 23, 2009.

25. For the reasons discussed above, Lufthansa has advised that it considers the Minimum Amount payments to be made by AC to be a necessary component of the CGCA and that without it, Lufthansa will not agree to any formalization of the Informal JV and will take steps to terminate its current strategic relationship with Air Canada as described in paragraph 17.

FINANCIAL IMPACT OF THE LOSS OF THE LUFTHANSA PARTNERSHIP

26. The Applicants have prepared a financial analysis of the impact of the termination by Lufthansa of the Informal JV and any other actions which may be taken by Lufthansa to terminate the current strategic partnership between the two entities. This financial analysis indicates that the loss to Air Canada, in the event the joint venture arrangement was terminated and the Code Sharing was eliminated, would be significantly in excess of the Minimum Amounts payments to be made to Lufthansa pursuant to the CGCA.

THE KfW CLAIM

27. As discussed in paragraph 14, KfW has filed a proof of claim in respect of the total amount outstanding under the KfW Loan (the “KfW Claim”) on the basis that its claim against 3838722 will be compromised through the Applicants’ Plan of Arrangement and that at the

present time, KfW does not know with certainty whether Lufthansa will fulfill its obligations under the Reimbursement Agreement through to the end of 2009.

28. The Monitor is of the view that it would be inequitable to the Applicants other creditors for the KfW claim to be admitted if KfW is to be reimbursed by Lufthansa and Lufthansa is to receive the Minimum Amount payments under the CGCA as it would, in effect, allow KfW and/or Lufthansa a double recovery.

29. The Monitor has since been in discussions with KfW and Lufthansa with respect to the KfW Claim and has been advised of the following:

- KfW has provided written confirmation to the Monitor that, upon approval by this Honourable Court of the CGCA, the KfW Claim will be subrogated to Lufthansa; and
- Lufthansa has provided written confirmation to the Monitor that, upon approval by this Honourable Court of the CGCA, it will waive its right to vote or receive any distribution in respect of the subrogated claim.

30. Copies of the above noted confirmations are attached at Appendix C.

CONCLUSION

31. Based on management's representations to the Monitor and after considering the financial analysis prepared by management, the Monitor is of the view that the Lufthansa relationship is of significant importance to Air Canada. The CGCA provides significantly better treatment for Lufthansa relative to the treatment likely to be provided to the Applicants' other affected creditors under its plan of arrangement since the Minimum Amount payments under the CGCA provide Lufthansa the opportunity to recover the full amount owed to it under the Reimbursement Agreement over time. Air Canada is of the strong view that the benefits provided to it under the CGCA outweigh the cost of not compromising the Reimbursement

Agreement under the plan of arrangement. Nothing has come to the Monitor's attention that would cause the Monitor to have a contrary view.

All of which is respectfully submitted by:

ERNST & YOUNG INC.

In its capacity as Court Appointed Monitor of Air Canada
and certain of its subsidiaries

Per:

A handwritten signature in black ink, appearing to read "Murray A. McDonald". The signature is written in a cursive style with a long horizontal stroke extending to the left.

Murray A. McDonald
President

SCHEDULE “A”

3838722 Canada Inc.

Air Canada Capital Ltd.

Jazz Air Inc.

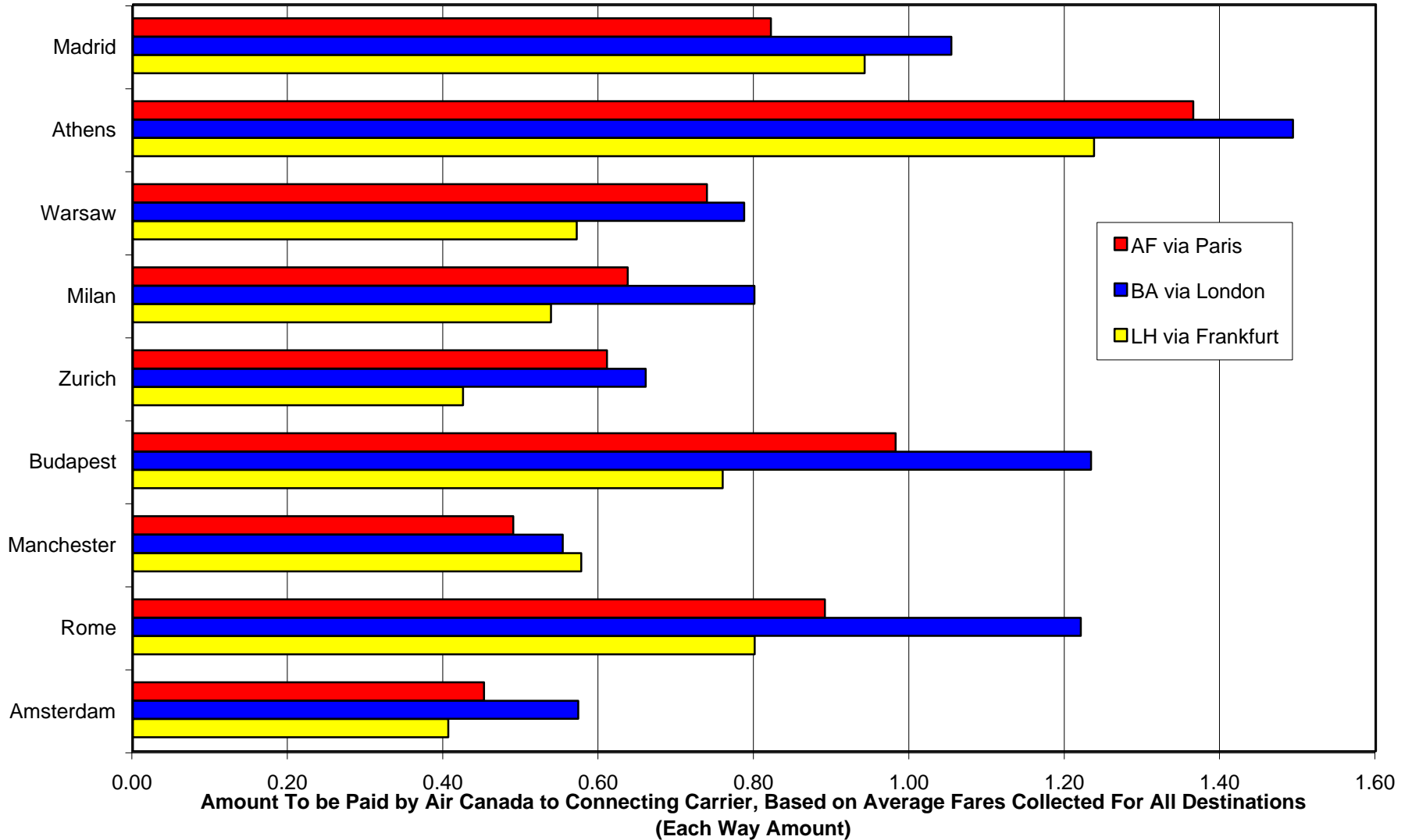
Manoir Int'l Finance Inc.

Simco Leasing Ltd.

Wingco Leasing Inc.

Zip Air Inc.

Appendix A
Examples of Differences in Pro-Rate Agreements Between Lufthansa and Other Airlines
Based on 2003 YTD Top Markets Toronto - Europe not served by Air Canada on a non-stop basis year-round



APPENDIX 11
MINIMUM AMOUNT PAYMENT
SCHEDULE

<u>PAYMENT DATE</u>	<u>MINIMUM AMOUNT (\$US)</u>
1. DECEMBER 23, 2003	\$9,019,037.59
2. JUNE 23, 2004	\$8,810,688.55
3. DECEMBER 23, 2004	\$8,602,339.50
4. JUNE 23, 2005	\$8,393,990.46
5. DECEMBER 23, 2005	\$8,185,641.41
6. JUNE 23, 2006	\$7,977,292.37
7. DECEMBER 23, 2006	\$7,768,943.32
8. JUNE 23, 2007	\$7,560,594.27
9. DECEMBER 23, 2007	\$7,352,245.23
10. JUNE 23, 2008	\$7,143,896.18
11. DECEMBER 23, 2008	\$6,935,547.14
12. JUNE 23, 2009	\$6,727,198.09
13. DECEMBER 23, 2009	\$6,518,849.05



Deutsche Lufthansa Aktiengesellschaft
Flughafen-Börsich West, D 60546 Frankfurt/Main

Ihre Zeichen
Your Ref.

Unsere Zeichen / Datum
Our Ref. / Date

Telefon / Telefax
Telephone / Telefax

December 16, 2003

Ernst & Young Inc.
Monitor of Air Canada
222 Bay Street, 16th Floor
Box 251, Toronto-Dominion Centre
Toronto, Ontario
M5K 1J7

Attention: Murray McDonald

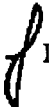
Dear Sirs:

Re: 3838722 Canada Inc.

We refer to the letter from KfW (the "KfW Letter") attached to this letter, and to the Lufthansa Subrogated Claim in the amount of US\$82,036,500 referred to in that letter.

This letter confirms our agreement that, for valuable consideration, effective upon final court approval of the Canada-Germany Co-operation Agreement between Air Canada and Lufthansa we will irrevocably waive the Lufthansa Subrogated Claim. We will not seek to file a proof of claim, vote or receive any distribution on the Lufthansa Subrogated Claim.

Yours truly,

 Deutsche Lufthansa Aktiengesellschaft

 
Attachment

1999
Geschäftsrechtliche Angaben,
Anschritt und weitere Informationen
auf der Rückseite.
For corporate details, address
and further information please turn over.



Kreditanstalt für Wiederaufbau - Postfach 111141 - 60046 Frankfurt am Main

Ernst & Young Inc.
Monitor of Air Canada
222 Bay Street, 16th Floor
Box 251, Toronto-Dominion Centre
Toronto, Ontario
M5K 1J7

Martin Kloster
our ref.: /Koe
phone: +49 69 7431-3476
email: Martin.Kloster@kfw.de
Date: 12-16-2003

Canada

Attention: Murray McDonald

Dear Sirs,

Re: 3838722 Canada Inc.


We refer to the proof of claim ("Claim") we filed against 3838722 Canada Inc. in respect of its liabilities to us under the loan agreement between 3838722 Canada Inc. and us dated December 22, 2000.

We hold a guaranty from Deutsche Lufthansa AG for originally 46.08% (the "Lufthansa Portion") of this debt. This letter confirms that, for valuable consideration, effective upon final court approval of the Canada-Germany Co-operation Agreement between Air Canada and Lufthansa, Lufthansa will be subrogated to USD 82,036,500 of this debt and will have the exclusive right to deal with Air Canada, 3838722 Canada Inc. and the Monitor with respect to USD 82,036,500 of the Claim (the "Lufthansa Subrogated Claim"), including the right to waive or withdraw the same and we will have no further right to deal with the Lufthansa Subrogated Claim.

Nothing in this letter affects any of our rights in respect of the remaining portion (the "United Portion") of our Claim.

Yours truly,
KfW


Kloster


Dr. Jaggy