AIR CANADA

Combined Consolidated Financial Statements
2006

PRICEWATERHOUSECOOPERS

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February 13, 2007

Independent Auditors' Report

To the Shareholders of Air Canada

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

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

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

PricewaterhouseCoopers LLP

Chartered Accountants

Combined Consolidated Statement of Operations and Deficit

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

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

Combined Consolidated Statement of Financial Position

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

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

On behalf of the Board of Directors:

Signed
Robert A. Milton
Chairman

Signed
Richard H. McCoy
Director

Combined Consolidated Statement of Cash Flow

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

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

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

1. BASIS OF PRESENTATION AND NATURE OF OPERATIONS

A) INITIAL PUBLIC OFFERING

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

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

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

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

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

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

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

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

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

B) BASIS OF PRESENTATION

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

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

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

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

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

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

Allocation of Corporate Expenses

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

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

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

Excluded Inter-company Investments

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

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

C) NATURE OF OPERATIONS

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

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

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

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

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A) BASIS OF VALUATION

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

B) PRINCIPLES OF CONSOLIDATION/COMBINATION

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

C) USE OF ESTIMATES

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

D) PASSENGER AND CARGO REVENUES

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

The Corporation performs regular evaluations on the deferred revenue liability which may result in adjustments being recognized as revenue. Due to the complex pricing structures; the complex nature of interline and other commercial agreements used throughout the industry; historical experience over a period of many years; and other factors including refunds, exchanges and unused tickets, certain relatively small amounts are recognized as revenue based on estimates. Events and circumstances may result in actual results that are different from estimates; however these differences have historically not been material.

E) CAPACITY PURCHASE AGREEMENTS

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

F) AEROPLAN LOYALTY PROGRAM

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

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

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

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

G) OTHER REVENUES

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

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

H) EMPLOYEE FUTURE BENEFITS

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

A market-related valuation method is used to value plan assets for the purpose of calculating the expected return on plan assets. Under the selected method, the differences between investment returns during a given year and the expected investment returns are amortized on a straight line basis over 4 years.

Past service costs arising from plan amendments are amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment. This period does not exceed the average remaining service period of such employees up to the full eligibility date. The average remaining service life for the plans is between 7 and 17 years.

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

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

I) EMPLOYEE PROFIT SHARING PLAN

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

J) STOCK-BASED COMPENSATION PLANS

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

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

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

K) MAINTENANCE AND REPAIRS

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

L) OTHER OPERATING EXPENSES

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

M) FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

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

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

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

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

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

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

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

N) FOREIGN CURRENCY TRANSLATION

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

O) INCOME TAXES

The Corporation utilizes the liability method of accounting for income taxes under which future income tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amount and the tax basis of assets and liabilities. Future income tax assets and liabilities are measured using substantively enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date. Future income tax assets are recognized to the extent that realization is considered more likely than not.

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

P) CASH AND CASH EQUIVALENTS

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

Q) SHORT-TERM INVESTMENTS

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

R) RESTRICTED CASH

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

S) SPARE PARTS, MATERIALS AND SUPPLIES

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

T) PROPERTY AND EQUIPMENT

Property and equipment is originally recorded at cost. Property under capital leases and the related obligation for future lease payments are initially recorded at an amount equal to the lesser of fair value of the property or equipment and the present value of those lease payments. On the application of fresh start accounting effective September 30, 2004, the cost of the Corporation's property and equipment was adjusted to fair value. In addition, the estimated useful lives of certain assets were also adjusted, including buildings where useful lives were extended to periods not exceeding 50 years.

Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Property and equipment under capital leases and variable interest entities are depreciated to estimated residual values over the life of the lease. Aircraft and flight equipment are depreciated over 20 to 30 years, with 10% to 20% estimated residual values. Aircraft reconfiguration costs are amortized over 3 years. Betterments to owned aircraft are capitalized and amortized over the remaining service life of the aircraft. Betterments to aircraft on operating leases are amortized over the term of the lease.

Buildings are depreciated over their useful lives not exceeding 40 to 50 years on a straight line basis. An exception to this is where the useful life of the building is greater than the term of the land lease. In these circumstances, the building is depreciated over the life of the lease. Leasehold improvements are amortized over the lesser of the lease term or 5 years. Ground and other equipment is depreciated over 3 to 25 years.

U) INTEREST CAPITALIZED

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

V) DEFERRED FINANCING COSTS

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

W) INTANGIBLE ASSETS

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

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

X) IMPAIRMENT OF LONG-LIVED ASSETS

Long-lived assets are tested for impairment whenever circumstances indicate that the carrying value may not be recoverable. When events or circumstances indicate that the carrying amount of long-lived assets, other than indefinite life intangibles, are not recoverable, the long-lived assets are tested for impairment by comparing the estimate of future expected cash flows to the carrying amount of the assets or groups of assets. If the carrying value is not recoverable from future expected cash flows, any loss is measured as the amount by which the asset's carrying value exceeds fair value. Recoverability is assessed relative to undiscounted cash flows from the direct use and disposition of the asset or group of assets.

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

Y) INVESTMENTS

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

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

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

AA) ASSET RETIREMENT OBLIGATIONS

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

BB) RELATED PARTY TRANSACTIONS

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

CC) VARIABLE INTEREST ENTITIES

Aircraft and Engine Leasing Transactions

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

Fuel Facilities Arrangements

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

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

Jazz

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

DD) FUTURE ACCOUNTING STANDARD CHANGES

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

Financial Instruments and Hedges

The Accounting Standards Board has issued three new standards dealing with financial instruments: (i) Financial Instruments — Recognition and Measurement (ii) Hedges and (iii) Comprehensive Income. The key principles under these standards are that all financial instruments, including derivatives, are to be included on a company's balance sheet and measured, either at their fair values or, in limited circumstances when fair value may not be considered most relevant, at cost or amortized cost. Financial instruments intended to be held-to-maturity should be measured at amortized cost. Existing requirements for hedge accounting are extended to specify how hedge accounting should be performed. Also, a new location for recognizing certain unrealized gains and losses — other comprehensive income — has been introduced. This provides the ability for certain unrealized gains and losses arising from changes in fair value to be temporarily recorded outside the income statement but in a transparent manner. The new standards are effective for the Corporation beginning January 1, 2007. The standards do not permit restatement of prior years' financial statements however the standards have detailed transition provisions. The Corporation has evaluated the consequences of the new standards, which may have a material impact on the Corporation's financial statements. See additional disclosure on the impact of the new standards in Note 16.

EE) COMPARATIVES

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

3. PROPERTY AND EQUIPMENT

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

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

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

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

During 2006:

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

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

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

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

4. DEFERRED CHARGES

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

5. INTANGIBLE ASSETS

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

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

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

6. DEPOSITS AND OTHER ASSETS

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

7. LONG-TERM DEBT AND CAPITAL LEASES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

8. FUTURE INCOME TAXES

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

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

a) Current Taxes Payable

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

b) Valuation Allowance

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

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

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

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

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

c) Future Income Tax Liability

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

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

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

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

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

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

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

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

	Tax losses
2010	$ 9
2014	16
	$ 25

9. PENSION AND OTHER BENEFIT LIABILITIES

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

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

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

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

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

Benefit Obligation and Plan Assets

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

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

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

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

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

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

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

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

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

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

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

Pension and Other Employee Future Benefit Expense

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

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

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

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

Other Benefits — Sensitivity Analysis

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

Pension Plan Cash Funding Obligations

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

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

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

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

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

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

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

Domestic Registered Plans

For the Domestic Registered Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Master Trust Fund. The investment return objective of the fund is to achieve a total annualized rate of return that exceeds inflation by at least 3.75% over the long term.

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

- Equity investments can include convertible securities, and are required to be diversified among industries and economic sectors. Foreign equities can comprise 37% to 43% of the total market value of the trust.

Limitations are placed on the overall allocation to any individual security at both cost and market value. Derivatives are permitted to the extent they are not used for speculative purposes or to create leverage.

- Fixed income investments are oriented toward risk averse, long term, investment grade securities rated "A" or higher. With the exception of Government of Canada securities or a province thereof, in which the plan may invest the entire fixed income allocation, fixed income investments are required to be diversified among individual securities and sectors. The target return is comprised of 40% of the total return of the Scotia Capital Universe Bond Index and 60% of the total return of the Scotia Capital Long Term Bond Index.

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

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

Defined Contribution Plans

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

10. OTHER LONG-TERM LIABILITIES

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

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

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

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

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

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

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

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

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

Special charge for labour restructuring

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

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

11. STOCK-BASED COMPENSATION

ACE Stock Option Plan

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

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

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

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

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

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

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

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

Air Canada Long-Term Incentive Plan

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

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

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

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

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

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

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

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

Jazz Long-Term Incentive Plan

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

Employee Ownership Plans

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

12. SHAREHOLDERS' EQUITY

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

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

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

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

During Quarter 4 2006, as a result of a review of outstanding provisions, it was determined that a portion of the provision amounting to $15 would no longer be required. The amount reversed has been applied against Share capital as these amounts related to provisions established before the application of fresh start reporting.

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

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

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

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

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

Common Shares

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

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

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

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

Special Common Shares and Special Preferred Shares

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

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

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

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

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

Special Common Shares

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

Special Preferred Shares

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

Exchangeable Distressed Preferred Shares

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

Class A Non-voting and Non-voting Shares

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

Contributed Surplus

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

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

13. EARNINGS PER SHARE

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

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

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

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

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

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

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

14. SEGMENT INFORMATION

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

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

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

Geographic Information

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

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

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

Segment Asset Information

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

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

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

Relationship between Air Canada and Jazz

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

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

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

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

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

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

15. COMMITMENTS

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

Embraer

The agreement with Embraer covers firm orders for 15 Embraer 175 series aircraft as well as 45 Embraer 190 series aircraft. The purchase agreement also contains rights to exercise options for up to 60 additional Embraer 190 series aircraft as well as providing for conversion rights to other Embraer models. As at December 31, 2006, 49 options remain exercisable.

Deliveries of the 15 Embraer 175 series aircraft commenced in July 2005 and the last aircraft was delivered in January 2006. All Embraer 175 deliveries were 80% financed by a third party as described in Note 7.

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

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

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

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

Boeing

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

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

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

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

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

Aircraft Interior Refurbishment Program

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

Capital Commitments

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

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

Operating Lease Commitments

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

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

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

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

16. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Under its risk management policy, the Corporation manages its exposure to changes in interest rates, foreign exchange rates and jet fuel prices through the use of various derivative financial instruments. The Corporation uses derivative financial instruments only for risk management purposes, not for generating trading profit.

Interest Rate Risk Management

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

During 2005, the Corporation reached a settlement with a third party related to interest rate swaps that were terminated as a result of Air Canada's filing for CCAA on April 1, 2003. A dispute had arisen following termination between Air Canada and the unrelated third party with respect to replacement arrangements for the swaps. The settlement agreement provided for a payment to Air Canada of US$8 related to a portion of the net payments the Corporation would have received had the swaps not been terminated. The replacement swaps that were put in place with another unrelated third party had a fair value of $9 in favour of the Corporation on inception. As a result of these transactions, the Corporation recorded a gain of $17 net of transaction fees of $3, which has been included in Deposits and other assets. The swaps have a term to January 2024 and convert lease payments related to two B767 aircraft leases consolidated under AcG-15, from fixed to floating rates. These have not been designated as hedges for accounting purposes. As at December 31, 2006, these two swaps have a fair value of $4 in favour of the Corporation (December 31, 2005 — $7 in favour of the Corporation).

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

Foreign Exchange Risk Management

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

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

Fuel Price Risk Management

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

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

Hedge accounting was applied prospectively from October 1, 2005. Under hedge accounting, gains or losses on fuel hedging contracts are recognized in earnings as a component of aircraft fuel expense when the underlying jet fuel being hedged is consumed. Prior to the commencement of the Corporation's hedge accounting being applied, an unrealized gain of $2 was recorded in other non-operating expense during the nine months ended September 30, 2005.

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

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

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

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

Concentration of Credit Risk

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

Statement of Combined Consolidated Financial Position Financial Instruments — Fair Values

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

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

Proposed Accounting Policies

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

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

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

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

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

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

17. CONTINGENCIES, GUARANTEES AND INDEMNITIES

Contingencies

Investigation by Competition Authorities Relating to Cargo

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

Pay Equity

Complaints filed in 1991 and 1992 with the Canadian Human Rights Commission against Air Canada and the former Canadian Airlines International on behalf of flight attendants at the two airlines alleging discrimination in negotiated wages were referred to the Canadian Human Rights Tribunal in 1996 for inquiry. By agreement of all parties, the inquiry before the Tribunal was limited to whether flight attendants at each airline were in the same establishment as pilots and technical operations personnel. Under the applicable legislation, a complaint can only compare the value of employees work and their wages if they work in the same establishment. In December 1998 the Tribunal found that pilots, flight attendants and technical operations personnel were in different establishments at each airline. This decision was upheld on judicial review by the Federal Court Trial Division, but overturned by the Federal Court of Appeal in 2004. The Supreme Court of Canada in January 2006 dismissed Air Canada's appeal from this latter decision and has remitted the complaints to the Commission for investigation. The parties are awaiting instructions from the Commission on how to proceed with the complaints. The value of each employee's work will be assessed on the basis of the skill, effort and responsibility it demands as well as the conditions under which it is performed. During the restructuring under CCAA, it was agreed that any resolution of the complaints would have no retroactive financial impact prior to September 30, 2004. Air Canada, upon consultation with legal counsel, considers that any investigation will show that it is complying with the equal pay provisions of the Canadian Human Rights Act; however, management is not able to determine the final outcome of the Commission's investigation.

Claim by the Air Canada Pilots Association

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

Other

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

Guarantees

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

Guarantees in Fuel Facilities Arrangements

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

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

Guarantees of Related Parties

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

Indemnification Agreements

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

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

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

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

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

18. RELATED PARTY TRANSACTIONS

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

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

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

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

Revenues and expenses with related parties are summarized as follows:

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

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

Summary of significant related party agreements

The Relationship between the Corporation and Aeroplan

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

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

Aeroplan Commercial Participation and Services Agreement (CPSA)

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

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

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

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

Aeroplan Database Agreement

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

Aeroplan Master Services Agreement (MSA)

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

Aeroplan General Services Agreement (GSA)

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

Trademark License Agreement

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

The Relationship between the Corporation and ACTS

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

ACTS Maintenance Agreements

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

ACTS Master Services Agreement (MSA)

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

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

ACTS Trademark License Agreement

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

General Services Agreements

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

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

Building Sale to ACTS

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

The Relationship between Corporation and ACE

Master Services Agreement

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

Cash Management System

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

19. JAZZ IPO

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

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

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

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

20. SPECIAL CHARGE FOR AEROPLAN MILES

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

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

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