Annual Report 2016

AIR CANADA

A STAR ALLIANCE MEMBER

01 Highlights

The financial and operating highlights for Air Canada for the periods indicated are as follows:

Canadian dollars in millions, except where indicated	Fourth quarter			Full year		
	2016	2015	$ Change	2016	2015	$ Change
Financial Performance Metrics						
Operating revenues	3,425	3,182	243	14,677	13,868	809
Operating income	18	158	(140)	1,345	1,496	(151)
Non-operating expense	(196)	(274)	78	(468)	(1,188)	720
Net income (loss)	(179)	(116)	(63)	876	308	568
Adjusted net income (1)	38	116	(78)	1,147	1,222	(75)
Operating margin %	0.5%	5.0%	(4.5 pp)	9.2%	10.8%	(1.6 pp)
EBITDAR (excluding special items) (1)	455	456	(1)	2,768	2,542	226
EBITDAR margin (excluding special items) % (1)	13.3%	14.3%	(1.0 pp)	18.9%	18.3%	0.6 pp
Unrestricted liquidity (2)	3,388	2,968	420	3,388	2,968	420
Net cash flows from operating activities	351	251	100	2,421	2,025	396
Free cash flow (1)	121	(363)	484	(149)	210	(359)
Adjusted net debt (1)	7,090	6,291	799	7,090	6,291	799
Return on invested capital ("ROIC") % (1)	14.7%	18.3%	(3.6 pp)	14.7%	18.3%	(3.6 pp)
Leverage ratio (1)	2.6	2.5	0.1	2.6	2.5	0.1
Diluted earnings per share	$ (0.66)	$ (0.41)	$ (0.25)	$ 3.10	$ 1.03	$ 2.07
Adjusted earnings per share – diluted (1)	$ 0.14	$ 0.40	$ (0.26)	$ 4.06	$ 4.18	$ (0.12)
Operating Statistics (3)			% Change			% Change
Revenue passenger miles ("RPM") (millions)	17,643	15,301	15.3	76,481	67,545	13.2
Available seat miles ("ASM") (millions)	22,091	18,869	17.1	92,726	80,871	14.7
Passenger load factor %	79.9%	81.1%	(1.2 pp)	82.5%	83.5%	(1.0 pp)
Passenger revenue per RPM ("Yield") (cents)	16.9	18.2	(7.2)	16.8	18.0	(6.6)
Passenger revenue per ASM ("PRASM") (cents)	13.5	14.7	(8.6)	13.9	15.1	(7.7)
Operating revenue per ASM (cents)	15.5	16.9	(8.1)	15.8	17.1	(7.7)
Operating expense per ASM ("CASM") (cents)	15.4	16.0	(3.8)	14.4	15.3	(6.0)
Adjusted CASM (cents) (1)	11.4	12.2	(6.1)	10.9	11.3	(2.9)
Average number of full-time equivalent ("FTE") employees (thousands) (4)	26.2	25.1	4.4	26.1	24.9	4.9
Aircraft in operating fleet at period-end	381	370	3.0	381	370	3.0
Average fleet utilization (hours per day)	9.5	9.4	1.4	10.2	10.0	1.6
Seats dispatched (thousands)	13,873	12,623	9.9	57,135	52,359	9.1
Aircraft frequencies (thousands)	137	136	0.3	566	567	(0.3)
Average stage length (miles) (5)	1,592	1,495	6.5	1,623	1,545	5.1
Fuel cost per litre (cents)	59.4	58.6	1.4	53.9	63.0	(14.5)
Fuel litres (millions)	1,160	1,035	12.1	4,837	4,478	8.0
Revenue passengers carried (thousands) (6)	10,719	9,686	10.7	44,849	41,126	9.1

(1) Adjusted net income, EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent), EBITDAR margin, leverage ratio, free cash flow, ROIC and adjusted CASM are each non-GAAP financial measures and adjusted net debt is an additional GAAP measure. Refer to sections 9 and 19 of Air Canada's 2016 MD&A for descriptions of Air Canada's non-GAAP financial measures and additional GAAP measures. As referenced in the table above, special items are excluded from all of Air Canada's reported EBITDAR calculations. Refer to sections 6 and 7 of Air Canada's 2016 MD&A for information on the special items.

(2) Unrestricted liquidity refers to the sum of cash, cash equivalents, short-term investments and the amount of available credit under Air Canada's revolving credit facilities. At December 31, 2016 unrestricted liquidity was comprised of cash and short-term investments of $2,979 million and undrawn lines of credit of $409 million. At December 31, 2015, unrestricted liquidity was comprised of cash and short-term investments of $2,672 million and undrawn lines of credit of $296 million.

(3) Except for the reference to average number of FTE employees, operating statistics in this table include third party carriers (such as Jazz Aviation LP ("Jazz"), Sky Regional Airlines Inc. ("Sky Regional"), Air Georgian Limited ("Air Georgian") and Exploits Valley Air Services Ltd. ("EVAS")) operating under capacity purchase agreements with Air Canada.

(4) Reflects FTE employees at Air Canada. Excludes FTE employees at third party carriers (such as Jazz, Sky Regional, Air Georgian and EVAS) operating under capacity purchase agreements with Air Canada.

(5) Average stage length is calculated by dividing the total number of available seat miles by the total number of seats dispatched.

(6) Revenue passengers are counted on a flight number basis (rather than by journey/itinerary or by leg) which is consistent with the IATA definition of revenue passengers carried.

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Message from the President and Chief Executive Officer

Air Canada achieved outstanding results in 2016, continuing the transformation of our airline into a company well-positioned for long-term, sustainable profitability. We achieved record results on a number of key metrics, including passenger and operating revenue, EBITDAR, liquidity and customers carried. As well, our share price outperformed major stock indexes and those of our North American airline peers.

EBITDAR in 2016 was a record $2.8 billion, an increase from the record of $2.5 billion reported in the previous year. In 2016, Air Canada recorded operating income of $1.3 billion, net income of $876 million and adjusted net income of $1.1 billion or $4.06 per diluted share.

These results, achieved against the backdrop of a challenging geopolitical context, intensifying competition and rising fuel prices late in 2016, confirm our ability to deliver on our commitment to shareholders. We met the 2016 key financial targets we publicly set for ourselves at our 2015 Investor Day. These include an annual EBITDAR margin of 15 to 18 per cent (our actual was 18.9 per cent) and a Return on Invested Capital of 13 to 16 per cent (our actual was 14.7 per cent).

When we released our 2016 results, we also reported that we remain on track to reducing CASM by 21 per cent, excluding the impact of foreign exchange and fuel prices, by the end of 2018 when compared to 2012, as well as to achieving our target leverage ratio of 2.2 by 2018 (it was 2.6 at year-end).

Our revenue performance was particularly strong, with record total revenue of $14.7 billion, an increase of 6 per cent or $809 million from 2015, with our revenue growth outperforming our North American airline peers. Yield declined 6.6 per cent, of which 2.8 percentage points was the result of a 5.1 per cent increase in average stage length, consistent with our strategic plan and long-haul international expansion. This is the seventh consecutive year of total revenue growth and our revenue has now increased over 50 per cent from 2009. Equally important, system passenger revenue and traffic increased in all our markets, speaking to the strength of our global franchise.

Air Canada's unit costs or cost per available seat mile (CASM) decreased 6.0 per cent in 2016. Adjusted CASM, which excludes fuel expense, the cost of ground packages at Air Canada Vacations and special items, fell 2.9 per cent from 2015. Our adjusted CASM improvement surpassed that of our North American airline peers. Overall, total operating expenses of $13.3 billion were up $960 million or 8 per cent on a capacity increase of 14.7 per cent.

We completed the year with unrestricted liquidity of $3.4 billion. Our adjusted net debt was $7.1 billion at year-end, an increase of $799 million. The company's leverage ratio, however, was virtually unchanged year-over-year, despite having invested almost $3 billion in capital during the year, mostly related to ongoing fleet renewal. During 2016, Air Canada completed a $1.25 billion refinancing transaction which, among other benefits, is expected to generate annualized interest expense savings of approximately $60 million. We were also able to free up $650 million in collateral, based on calculations at closing.

We carried a record of nearly 45 million customers and maintained an average passenger load factor of 82.5 per cent. This was up almost 4 million passengers from the previous year and was 43 per cent higher than in 2009 when we embarked on our transformation. The quality of our service was recognized by a number of industry awards, including being named the Best Airline in North America for International Travel by readers of the respected U.S. publication *Business Traveler*. According to Brand Finance, a U.K. brand evaluation firm, the Air Canada brand was the fastest growing among the most valuable Canadian brands. Furthermore, Air Canada continues to be rated by Skytrax as North America's only Four Star international network carrier.

The successful transformation of our company has been the result of much hard work and a deliberate strategy centered on our four core priorities. We are aware that in order to continue to grow successfully, stay competitive and remain profitable, we need to continue to transform in accordance with those core priorities, while remaining flexible.

Our foundational financial priority is Revenue Enhancement and Cost Containment. This provides the stability necessary to achieve the other priorities. Air Canada's focus has been and remains on maintaining and expanding our margins through unit cost reductions, while continuing to grow quality revenue. For example, in 2016 our EBITDAR margin of 18.9 per cent increased 0.6 percentage points and surpassed our 2016 target of 15 to 18 per cent.

Our fleet renewal program is central to this priority. In 2016 and early 2017, the airline took delivery of 12 Boeing 787 Dreamliner aircraft bringing our total to 24. These aircraft are much more efficient than the Boeing 767-300 aircraft they are replacing, particularly from a fuel and maintenance perspective. Six more 787s will be delivered in 2017 and we will have a total of 37 in our fleet within two years. Later in 2017, the first of our 61 Boeing 737 Max aircraft will arrive. Also during 2016, Air Canada took another step towards fleet renewal, finalizing an agreement for a firm order for 45 Bombardier C-Series aircraft.

The greater reliability of new aircraft has also enabled Air Canada to utilize its fleet more effectively, operating aircraft on average 10.2 hours a day, an efficiency gain of more than 10 per cent over 2009.

Along with new aircraft, we also modified the existing fleet to give it a more competitive configuration and in 2016, we introduced two more high-density Boeing 777s. As well, we installed a new Premium Economy service across our wide-body mainline fleet. Air Canada was the first in North America to install this type of separate, bespoke cabin to target this distinct market segment of travellers who desire an upgraded experience.

Augmenting these initiatives are a number of other revenue generating products. This includes onboard Wi-Fi, now available across the mainline narrow-body fleet. Another program recently introduced makes last-minute upgrades available through an online auction to help maximize premium cabin revenue. We are also exploring additional onboard merchandising opportunities to further boost ancillary revenue.

Air Canada's new and expanded wide-body fleet is essential to our second priority of International Expansion. In 2016, Air Canada and Air Canada Rouge started 15 new international routes – including our first scheduled service to Africa. Fully 90 per cent of the airline's growth was in international markets, which we believe we can profitably pursue with our upgraded fleet and lower-cost leisure carrier, Air Canada Rouge. Diversifying the network geographically has the added benefit of lowering the risk of over-dependence on any single market or concentration of markets.

A key contributor to our international flying is our heightened ability to attract international connecting traffic, or so-called Sixth Freedom traffic. Air Canada is tapping into a greater share of global traffic flows, carrying international travellers connecting between two countries, and transiting them through our major hubs in Toronto, Montreal, Vancouver and Calgary.

One area of focus of these efforts is the U.S., where a significantly larger market than Canada is within easy travelling distance of our main hubs which serve as gateways for numerous international destinations. We saw a significant increase in connecting traffic in 2016 and we continue to build our U.S. transborder presence in order both to serve growing origin and destination traffic and to attract a larger share of connecting traffic. We are investing heavily at Toronto Pearson and other airports, working closely with local authorities to streamline connection and baggage processes to make Canada a world-class connection point for international travellers.

To further support our international strategy, we maintain a robust network of alliances and partnerships, primarily through the 28-member Star Alliance and our Atlantic Joint Venture with United Airlines and the Lufthansa Group. We now have 34 codeshare relationships with other carriers of which 24 are Star Alliance members. In January 2017, we concluded a codeshare agreement with Cathay Pacific to give our customers access to onward codeshare connections in Southeast Asia. Following on a memorandum of understanding with Virgin Australia, and subject to government approvals, we will expand offerings in Australia and New Zealand.

Our emphasis on the global marketplace brings us into competition with the best the world has to offer. Recognizing that we must match or surpass these high standards, Air Canada has made Customer Engagement through its products and services another core priority.

To this end, we have invested heavily in new aircraft, refurbished interiors, enhanced food and beverage offerings, built new and renovated airport Premium check-in areas and Maple Leaf Lounges, and bolstered training and support for our employees, including the creation of a new group of airport agents dedicated to assist our premium customers. We have also developed new technology to enable customers to better interact with us through their preferred medium and we have strengthened our social media presence to provide real-time assistance and solutions.

Closely linked to Customer Engagement is our core priority of Culture Change. There is a renewed vigour and sense of confidence at Air Canada that is evident throughout all levels of the organization. Employees are embracing entrepreneurship, demonstrating adaptability and taking accountability for outcomes, all of which in turn foster teamwork and the drive to perform at a high standard. Internal surveys have noted a marked improvement in employee engagement, in part advanced by the commitment of senior executives to be more transparent and accessible. The creation of 1,500 new jobs in 2016, a sign of optimism about the future at a time when very few employers in Canada were hiring, gave another boost to employee engagement.

Early in 2016, Air Canada achieved a 12-year agreement with its flight dispatcher union. The contract was the final of seven long-term agreements concluded over the past year-and-a-half with the company's major unions. Apart from recognizing the important contribution of our employees, these unprecedented agreements underscore the cultural shift that has occurred at Air Canada. Agreements such as this provide us with the cost certainty and stability to confidently invest in and build a successful global competitor.

Throughout the year, Air Canada received third party affirmation of our culture change initiatives. Among other things, for the fourth year in a row we were named one of *Canada's Top 100 Employers* as well as one of the *50 Most Engaged Workplaces* in Canada and as one of Canada's *Best Diversity Employers*.

As Air Canada embarks on its 80th year of existence in 2017, we are very proud that we are doing so with youthful vigour and clarity of purpose. The events and accomplishments of 2016 validate our strategy and demonstrate its effectiveness, drawing together as it does the four elements necessary for long-term, sustainable profitability. At the same time, we are attuned to events and ready to nimbly respond to changing circumstances and new opportunities.

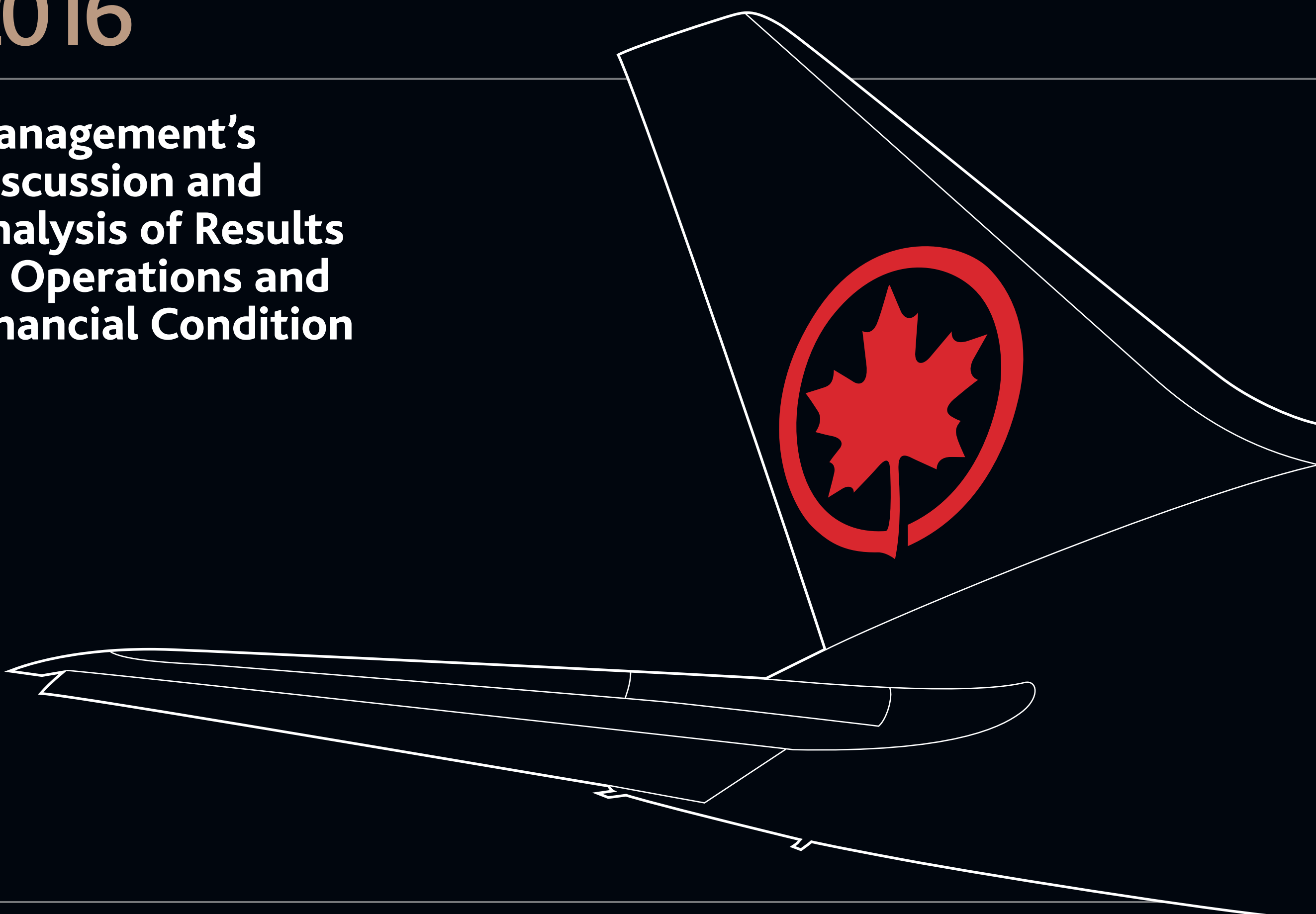
In conclusion, I wish to thank our Board of Directors for their ongoing contributions in the service of the company and its shareholders. In particular, I wish to acknowledge the strong and visionary leadership of David Richardson, who is retiring this year after having been an independent director of Air Canada since September 2004 and Chairman of the Board of Directors since January 2008. David's guidance and his steadfast and courageous support of management have been essential to the success of Air Canada's transformation strategy.

I thank the 30,000 members of the Air Canada team for their dedication, professionalism and commitment to taking care of our customers and delivering them safely to their destinations every day. I also thank our shareholders, customers, partners and other stakeholders for their continued loyalty and support.

Calin Rovinescu
President and Chief Executive Officer

2016

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



02 Introduction and Key Assumptions

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers, as the context may require, to Air Canada and/or one or more of Air Canada's subsidiaries, including its wholly owned operating subsidiaries, Touram Limited Partnership, doing business as Air Canada Vacations® ("Air Canada Vacations") and Air Canada rouge LP, doing business under the brand name Air Canada Rouge® ("Air Canada Rouge"). This MD&A provides the reader with a review and analysis, from the perspective of management, of Air Canada's financial results for the fourth quarter and the full year of 2016. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2016. Except as otherwise noted, all financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the CPA Canada Handbook – Accounting ("CPA Handbook"), which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 20 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of February 16, 2017. Certain comparative figures have been reclassified to conform to the financial statement presentation adopted for the current year.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 17 "Risk Factors" of this MD&A. Air Canada issued a news release dated February 17, 2017 reporting on its results for the fourth quarter and the full year 2016. This news release is available on Air Canada's website at **www.aircanada.com** and on SEDAR's website at **www.sedar.com**. For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult SEDAR at **www.sedar.com**.

Caution regarding forward-looking information

Air Canada's public communications may include written or oral forward-looking statements within the meaning of applicable securities laws. Such statements are included in this MD&A and may be included in other communications, including filings with regulatory authorities and securities regulators. Forward-looking statements may be based on forecasts of future results and estimates of amounts not yet determinable. These statements may involve, but are not limited to, comments relating to strategies, expectations, planned operations or future actions. Forward-looking statements are identified by the use of terms and phrases such as "anticipate", "believe", "could", "estimate", "expect", "intend", "may", "plan", "predict", "project", "will", "would", and similar terms and phrases, including references to assumptions.

Forward-looking statements, by their nature, are based on assumptions, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, our ability to successfully achieve or sustain positive net profitability or to realize our initiatives and objectives, currency exchange, industry, market, credit, economic and geopolitical conditions, energy prices, competition, our ability to successfully implement appropriate strategic initiatives or reduce operating costs, our dependence on technology, cybersecurity risks, our ability to pay our indebtedness and secure financing, war, terrorist acts, epidemic diseases, our dependence on key suppliers including regional carriers and Aeroplan, casualty losses, employee and labour relations and costs, our ability to preserve and grow our brand, pension issues, environmental factors (including weather systems and other natural phenomena and factors arising from man-made sources), limitations due to restrictive covenants, insurance issues and costs, our dependence on the Star Alliance, interruptions of service, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties and our ability to attract and retain required personnel, as well as the factors identified throughout this MD&A and, in particular, those identified in section 17 "Risk Factors" of this MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of February 16, 2017 (or as of the date they are otherwise stated to be made), and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

Key assumptions

Assumptions were made by Air Canada in preparing and making forward-looking statements. As part of its assumptions, Air Canada assumes relatively modest Canadian GDP growth for 2017 and 2018. Air Canada also assumes a continuing relationship between the price of jet fuel and the value of the Canadian dollar whereby increases and decreases in the cost of fuel continue to be respectively associated, to some degree, with increases and decreases in the value of the Canadian dollar. Air Canada also expects that the Canadian dollar will trade, on average, at C$1.32 per U.S. dollar in the first quarter of 2017 and C$1.31 per U.S. dollar for the full year 2017 and that the price of jet fuel (taking the impact of fuel hedging into account) will average 65 CAD cents per litre in the first quarter of 2017 and 66 CAD cents per litre for the full year 2017.

Intellectual property

Air Canada owns or has rights to trademarks, service marks or trade names used in connection with the operation of its business. In addition, Air Canada's names, logos and website names and addresses are owned or licensed by Air Canada. Air Canada also owns or has the rights to copyrights that also protect the content of its products and/or services. Solely for convenience, the trademarks, service marks, trade names and copyrights referred to in this MD&A may be listed without the ©, ® and TM symbols, but Air Canada reserves all rights to assert, to the fullest extent under applicable law, its rights or the rights of the applicable licensors to these trademarks, service marks, trade names and copyrights.

This MD&A may include trademarks, service marks or trade names of other parties. Air Canada's use or display of other parties' trademarks, service marks, trade names or products is not intended to, and does not imply a relationship with, or endorsement or sponsorship of Air Canada by, the trademark, service mark or trade name owners or licensees.

03 About Air Canada

Air Canada is Canada's largest domestic, U.S. transborder and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market and in the international market to and from Canada. In 2016, Air Canada, together with Jazz Aviation LP ("Jazz") and other regional airlines operating flights on behalf of Air Canada under capacity purchase agreements, operated, on average, 1,570 daily scheduled flights to 206 direct destinations on six continents, comprised of 64 Canadian cities, 55 destinations in the United States and a total of 87 cities in Europe, Africa, the Middle East, Asia, Australia, the Caribbean, Mexico and South America. In 2016, Air Canada carried approximately 44.8 million passengers, an increase of 9.1% from 2015.

At December 31, 2016, Air Canada mainline operated a fleet of 168 aircraft, comprised of 75 Airbus narrow-body aircraft, 68 Boeing and Airbus wide-body aircraft and 25 Embraer 190 regional jets, while Air Canada Rouge operated a fleet of 45 aircraft, comprised of 20 Airbus A319 aircraft, five Airbus A321 aircraft and 20 Boeing 767-300 aircraft, for a total fleet of 213 aircraft.

The ongoing renewal and expansion of Air Canada's wide-body fleet remains a key element of its strategy to profitably develop its international network and to become a global champion. In 2016, Air Canada took delivery of nine Boeing 787 aircraft and, since December 31, 2016, Air Canada took delivery of three Boeing 787s (for a total of 24 deliveries out of 37 Boeing 787 aircraft on order). These aircraft, with their lower operating costs, mid-size capacity and longer range, are driving new opportunities for profitable growth at Air Canada and allow the airline to more efficiently operate routes previously operated with Boeing 767 aircraft and to serve new international destinations. Air Canada also has a firm order for 61 Boeing 737 MAX aircraft to replace the existing mainline fleet of Airbus narrow-body aircraft. Deliveries of Boeing 737 MAX aircraft are scheduled to begin in late 2017 with two aircraft, with the remaining firm order deliveries scheduled from 2018 to 2021. Furthermore, Air Canada has a firm order for 45 Bombardier C-Series CS300 aircraft. The first 25 aircraft on delivery are expected to replace Air Canada's existing mainline fleet of Embraer E190 aircraft, with the incremental aircraft supporting Air Canada's hub and network growth. Deliveries are scheduled to begin in late 2019 and extend to 2022.

The Air Canada Leisure Group, created in 2012, to improve profitability and competitiveness in leisure markets, represents a coordinated strategy which leverages the strengths of Air Canada, Air Canada Rouge, the airline's lower-cost leisure airline, and Air Canada Vacations. Through Air Canada Rouge, Air Canada is pursuing opportunities in new international leisure markets made viable by Air Canada Rouge's more competitive cost structure. Air Canada Vacations is a leading Canadian tour operator, developing, marketing and distributing vacation travel packages, operating in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, Central and South America, South Pacific, Australia and Asia) and also offering cruise packages in North America, Europe and the Caribbean.

Air Canada enhances its domestic and transborder network through capacity purchase agreements ("CPAs") with regional airlines, namely Jazz, Sky Regional Airlines Inc. ("Sky Regional"), Air Georgian Limited ("Air Georgian") and Exploits Valley Air Services Limited ("EVAS"), each of which operates flights on behalf of Air Canada. These carriers form an integral part of the airline's international network strategy, providing valuable traffic feed to Air Canada and Air Canada Rouge routes. At December 31, 2016, the Air Canada Express fleet was comprised of 43 Bombardier regional jets, 89 Bombardier Dash-8 turboprop aircraft and 20 Embraer 175 aircraft for a total of 152 aircraft. Air Georgian and EVAS also operate a total of 16 18-passenger Beech 1900 aircraft on behalf of Air Canada.

Air Canada is a founding member of the Star Alliance® network. Through the 28-member airline network, Air Canada offers its customers access to approximately 1,300 destinations in 190 countries, as well as reciprocal participation in frequent flyer programs and the use of airport lounges and other common airport facilities.

Air Canada is able to build customer loyalty through Air Canada Altitude®, its frequent flyer program and through the Aeroplan® loyalty program operated by Aimia Canada Inc. (formerly Aeroplan Canada Inc. and referred to as "Aeroplan" in this MD&A). Air Canada Altitude® recognizes and rewards Aeroplan® members with a range of premium travel privileges and benefits corresponding to their travel activity, such as priority check-in, complimentary checked baggage and upgrades to Business Class, as well as opportunities to earn Aeroplan® Miles on Air Canada flights and those of its other 27 Star Alliance® member airlines. Aeroplan is also Air Canada's single largest customer, purchasing Air Canada seats to be provided to Aeroplan® members who choose to redeem their Aeroplan® Miles for travel on Air Canada. Aeroplan® members also have opportunities to redeem their Aeroplan® Miles for travel with Star Alliance® member airlines.

Air Canada generates revenue from its cargo division, operating as Air Canada Cargo, Canada's largest provider of air cargo services as measured by cargo capacity. Air Canada Cargo provides direct cargo services to over 150 Canadian, U.S. transborder and international destinations and has sales representation in over 50 countries. Air cargo services are provided across the Air Canada network.

04 Strategy

Air Canada's principal objective is to be among the best global airlines, to continually improve customer experience and employee engagement, and to create value for its shareholders. Air Canada is pursuing its principal goal of becoming a global champion through its focus on four core strategies:

- Identifying and implementing cost reduction and revenue generating initiatives;
- Pursuing profitable international growth opportunities and leveraging competitive attributes to appropriately enhance margins, in large part by increasing connecting traffic through existing and new international gateways and expanding and competing effectively in the leisure market to and from Canada;
- Engaging customers by continually enhancing their travel experience and providing a consistently high level of customer service, with additional emphasis on premium and business passengers and products; and
- Fostering positive culture change through employee engagement programs. This includes meaningful investments in training and other tools that support delivering exceptional customer experiences and that also promote improved collaboration and an appreciation of how the airline and its talented employees can better work together in a supportive and enriching environment.

Revenue enhancement and cost transformation

Margin improvement through the implementation of sustainable cost transformation and profitable revenue-generating initiatives remains a key priority at Air Canada. Air Canada continues to seek and implement measures to meaningfully reduce unit costs and enhance margins, including through fleet modernization and greater fleet productivity. Additionally, Air Canada seeks to improve its ability to generate incremental passenger and ancillary revenue.

Key achievements in 2016

- Recorded an EBITDAR margin of 18.9%, an increase of 0.6 percentage points when compared to 2015 and better than the 2016 EBITDAR margin of 15 to 18% forecast in Air Canada's news release dated November 7, 2016. Air Canada's better than projected 2016 EBITDAR margin performance was primarily driven by a December 2016 revenue environment that was more robust than anticipated.
- Reduced CASM by 6.0% from 2015. Adjusted CASM decreased 2.9% from 2015. Had the Canadian-U.S. dollar exchange rate remained at 2015 levels, adjusted CASM would have decreased 3.8% when compared to 2015.
- Continued to successfully expand Air Canada Rouge, the airline's leisure carrier, which has significantly lower operating costs. The Air Canada Rouge fleet is estimated to generate 25% lower CASM when compared to the same aircraft in the mainline fleet.
- Introduced an additional nine Boeing 787 aircraft into the mainline fleet, allowing the airline to more efficiently operate routes previously operated with Boeing 767 aircraft and to serve new international destinations.
- Introduced two higher-density Boeing 777 aircraft into the mainline fleet, deployed on select markets where there is a higher demand for economy travel.
- Converted 12 Boeing 777-300ER and six Boeing 777-200LR aircraft into a more cost effective and competitive configuration, adding a premium economy cabin and refurbishing the international business class cabin to the new Boeing 787 state-of-the-art standard.
- Concluded a purchase agreement with Bombardier Inc. ("Bombardier") which includes a firm order for 45 Bombardier C-Series CS300 aircraft and options for an additional 30 Bombardier C-Series CS300 aircraft. Air Canada estimates that the projected fuel burn and maintenance cost savings (on a per seat basis) of greater than 15% will reduce CASM by approximately 10% compared to the aircraft that will be replaced.
- Completed a private offering of senior secured notes and a new credit facility in connection with a C$1.25 billion refinancing transaction resulting in an improved balance sheet, a reduction in Air Canada weighted average cost of debt, an extension of its senior secured debt maturity, annualized interest expense savings, the release of collateral and generally increasing Air Canada's ability and flexibility to execute on strategic initiatives.

Air Canada is taking tangible steps to pursue its strategy for sustained value creation and profitability through the execution of new and ongoing strategic initiatives. These include:

Air Canada Rouge

The strategic expansion of Air Canada Rouge in conjunction with Air Canada's mainline fleet growth continues. Since its first flight in July 2013, the leisure carrier has been deployed to a growing number of Caribbean destinations and select leisure destinations in the United States and in Canada, as well as in international leisure markets where demand is highly elastic and responds positively to lower-priced, non-stop capacity. Air Canada Rouge offers competitive fares while leveraging such strengths of Air Canada as its brand, extensive network with enhanced connection options, operational expertise and leading loyalty programs. Air Canada Rouge may operate up to 50 aircraft (comprised of 25 narrow-body aircraft and 25 Boeing 767 aircraft). At December 31, 2016, Air Canada Rouge operated 45 aircraft and expects to have a total of 50 aircraft in its fleet by summer of 2018.

Air Canada Rouge operates with a long-term cost structure consistent with that of its leisure market competitors, effectively lowering CASM on leisure routes through increased seat density, lower wage rates, more efficient work standards and reduced overhead costs. This is providing new opportunities for profitable growth in international leisure markets.

Fleet improvement initiatives

Continued introduction of fuel-efficient Boeing 787 aircraft

As of the date of this MD&A, Air Canada has taken delivery of 24 Boeing 787 Dreamliners (from its firm order for 37 Boeing 787 Dreamliners, comprised of eight Boeing 787-8 and 29 Boeing 787-9 aircraft). Air Canada plans to take delivery of the remaining 13 Boeing 787-9 aircraft on firm order by the end of 2019.

Reconfiguration of Airbus A330-300 aircraft

Following the conversion, in 2016, of 12 Boeing 777-300ER and six Boeing 777-200LR aircraft into a more cost effective and competitive configuration, Air Canada began reconfiguring its fleet of eight Airbus A330-300 aircraft to allow the airline to compete more effectively and to offer customers the option of its new Premium Economy cabin. Conversion of the Airbus A330 aircraft started in the fourth quarter of 2016 and is expected to be completed during the first quarter of 2017.

Narrow-body fleet renewal program

In 2014, Air Canada entered into agreements with The Boeing Company ("Boeing") for the acquisition of up to 109 Boeing 737 MAX narrow-body aircraft (61 firm orders, 18 purchase options and certain rights to purchase up to an additional 30 aircraft) to replace the existing mainline fleet of Airbus narrow-body aircraft. Deliveries are scheduled to begin in late 2017 with two aircraft, with the remaining firm aircraft deliveries scheduled from 2018 to 2021. Air Canada estimates that the projected fuel burn and maintenance cost savings on a per seat basis of greater than 20% will generate a CASM reduction of approximately 10% as compared to the airline's existing narrow-body fleet.

In June 2016, Air Canada and Bombardier finalized a purchase agreement for the acquisition of up to 75 Bombardier C-Series CS300 aircraft (45 firm orders plus options to purchase up to an additional 30 aircraft). Deliveries are scheduled to begin in late 2019 and extend to 2022. The first 25 aircraft on delivery are expected to replace Air Canada's existing mainline fleet of Embraer E190 aircraft, with the incremental aircraft supporting Air Canada's hub and network growth. The entry of the C-Series into Air Canada's fleet is expected to yield significant cost savings.

Revenue optimization and cost reduction initiatives

Air Canada is committed to fostering a culture of continuous cost transformation and revenue improvement across the organization. To this end, Air Canada continually drives initiatives through productivity enhancements, process reforms and other measures. Initiatives may entail revising business and operational processes, including supply chain and maintenance operations, improving employee productivity and asset utilization, and promoting workplace policies to add revenue and reduce costs. In 2017, Air Canada aims to increase its ancillary revenue per passenger through branded fares, and other "à la carte" services, such as those related to baggage, ticket changes, seat selection, preferred seating and upgrades. Air Canada is also generating revenues from its onboard offerings, including food, beverage, duty-free shopping and onboard Wi-Fi. To better monetize its ancillary offerings and increase related revenues, Air Canada is further developing its merchandising capabilities to customize, differentiate and combine its product offerings. In addition, Air Canada will also continue to undertake sales and distribution initiatives in an effort to increase revenues and reduce overall costs of sales.

International growth

Air Canada remains focused on identifying new international growth opportunities to generate increased profit and diversify its network which also lowers its risk profile. Part of this strategy focuses on the development of additional synergies offered by alliances with foreign carriers. Consistent with 2016, in 2017, more than 90% of the airline's planned capacity growth is in international markets. International growth is being pursued on a lower-cost basis, primarily through the introduction of new Boeing 787 aircraft, increased seating on Boeing 777 and Airbus A330 aircraft, and by an increase in flights operated by Air Canada Rouge.

Key developments in 2016

- Introduced non-stop Air Canada service from Vancouver to Brisbane and Delhi, from Toronto to Seoul and from Montreal to Lyon.
- Introduced non-stop seasonal Air Canada Rouge service from Montreal to Casablanca, from Toronto to Glasgow, Gatwick, Budapest, Prague and Warsaw and from Vancouver to Dublin.
- Launched 12 transborder routes to the U.S., including Toronto-Washington-Dulles; Toronto-Jacksonville; Toronto-Portland, Oregon; Toronto-Salt Lake City; Toronto-Palm Springs; Vancouver-San Jose; Vancouver-San Diego; Vancouver-Chicago; Montreal-Philadelphia; Montreal-Denver; Montreal-Houston; and Calgary-San Francisco. In addition to solidifying Air Canada's position in the Canada-U.S. transborder market, these new routes serve to channel traffic to and from Air Canada's domestic and international networks through its major airport hubs.

- Introduced new codeshare agreements with EVA Air in support of its Narita and Incheon services and with Avianca Brasil in support of its Sao Paolo services. Air Canada also reinstated its codeshare relationship with Thai Airways.
- Increased meaningfully sixth freedom traffic (international-to-international, including U.S.) connecting at Air Canada's major Canadian hubs when compared to 2015.

In 2017, Air Canada plans to launch additional international services, including:

- Non-stop year-round Air Canada service from Toronto to Mumbai and from Vancouver to Taipei;
- Non-stop seasonal Air Canada Rouge service from Montreal to Algiers and Marseille; Vancouver to Nagoya; and Toronto to Berlin;
- Non-stop daily year-round Air Canada service from Montreal to Shanghai further deepening the airline's strong ties with China; and
- Non-stop seasonal Air Canada service from Montreal to Tel Aviv.

In addition, Air Canada plans to convert its Air Canada Rouge service from Montreal to Casablanca from a seasonal service to a year-round service. The airline also plans to launch six new non-stop U.S. services beginning in May 2017. Three of the routes, Toronto to San Antonio, Memphis and Savannah, bring new destinations into the airline's U.S. network while the addition of Montreal to Dallas-Fort Worth, Vancouver to Denver and the conversion of the Vancouver-Phoenix route to year-round operation will deepen Air Canada's transborder schedule.

Air Canada possesses tools, processes and other competitive attributes to profitably pursue international route opportunities. It has the ability to appreciably increase international-to-international traffic through its strategic international gateways in Toronto, Vancouver, Montreal and Calgary, and is broadening its network appeal through its membership in Star Alliance®, its trans-Atlantic revenue-sharing joint venture with United Air Lines, Inc. ("United Airlines") and Deutsche Lufthansa AG ("Lufthansa"), referred to as A++, and through numerous codeshare and interline agreements. Furthermore, Air Canada has access to Canada's wide portfolio of international route rights, and Canada's multi-ethnic demographic profile provides the airline with further opportunities to profitably capture demand for international travel. These attributes, combined with Air Canada's powerful brand franchise and industry-leading products and services, allow it to leverage its network and benefit from the higher margins generally available in international markets.

In 2017, Air Canada plans to selectively and profitably expand its international services by leveraging its new aircraft and improved cost structure, and by exploiting the following competitive attributes:

- A widely recognized brand and a strong position in the market for trans-Atlantic and trans-Pacific travel to-and-from Canada and to-and-from North and South America via Canada.
- An extensive and expanding global network, enhanced by the airline's membership in Star Alliance, numerous codeshare agreements and participation in the A++ joint venture.
- A flexible fleet mix, including aircraft leases with staggered expiry dates over the next several years and aircraft that are owned and unencumbered which can be temporarily or permanently removed from the fleet, which enables the airline to redeploy or otherwise manage capacity to match changes in demand.
- Air Canada Altitude®, Air Canada's loyalty program, which recognizes frequent flyers by offering them a range of exclusive travel privileges, including the benefits derived from Air Canada's partnership with the Aeroplan® program, which allows all customers to earn and redeem Aeroplan Miles with Canada's leading loyalty program.
- Competitive products and services, including lie-flat beds in the International Business Class cabin, concierge services and Maple Leaf® Lounges.
- Geographically well-positioned hubs (Toronto, Montreal, Vancouver and Calgary) with excellent in-transit facilities, accentuating the advantages of flying Air Canada through an improved travel experience for customers travelling to or from the U.S. from or to Asia and Europe.
- Favourable slot times at busy airports, including Beijing, Shanghai, Hong Kong, Tokyo-Narita, Tokyo-Haneda, Paris-Charles de Gaulle, Frankfurt, London-Heathrow, New York-LaGuardia, and Washington-Ronald Reagan National Airport.

The airline believes that it has the potential to continue to grow sixth freedom traffic over the coming years, particularly from the U.S., with its award-winning products and services, geographically well-positioned Canadian hubs, extensive network and other competitive attributes. Toronto Pearson

International Airport ("Toronto Pearson") offers a strategic advantage due to its proximity to densely populated major U.S. markets and serves a large number of business and leisure travellers to and from Toronto. Air Canada and its Star Alliance partners' operations are consolidated in one terminal at Toronto Pearson, which also has efficient in-transit facilities that allow passengers and their bags to move seamlessly between Canadian and U.S. Customs and Immigration. For several years, Air Canada has worked closely with the Greater Toronto Airports Authority to transform Toronto Pearson into the leading North American airport and gain a greater share of the global sixth freedom market. Air Canada is growing its Vancouver hub into a premier gateway to Asia-Pacific markets and developing Montreal into a complementary and competitive trans-Atlantic hub. With the new flights being introduced between Vancouver and cities across North America, Air Canada is poised to offer some of the shortest elapsed travel time between continental North America and Pacific Asia, providing travellers with a better travel experience. The airline's Montreal hub not only links North America with key markets in France, but also positions Montreal as a premier gateway to the Atlantic. In Calgary, Air Canada has relocated its international and U.S. operations to the new state-of-the-art terminal which now includes connection processes comparable to Air Canada's other hubs. Given the improvements that are being made in Toronto, Vancouver, Montreal and Calgary, the airline is able to build its network from the U.S. to provide increased connection flows to its international flights.

The development of commercial alliances with major international carriers is another important element of Air Canada's business strategy. These arrangements provide Air Canada with an effective means to leverage expansion and broaden its network offerings. Air Canada also achieves this through its membership in Star Alliance which is comprised of 28 members and through its participation in a trans-Atlantic revenue sharing joint venture with United Airlines and the Lufthansa Group, referred to as A++. By coordinating pricing, scheduling and sales (under such joint venture), Air Canada is better able to serve customers by offering more travel options, while reducing travel times. It can also achieve greater critical mass and network scope through numerous codeshare and interline agreements.

Subject to agreement of terms and any requisite approvals by the relevant competition authorities, Air Canada and Air China intend to form a comprehensive revenue sharing joint venture in respect of all their flights between China and Canada.

Air Canada has 33 codeshare partners of which 24 are Star Alliance members. Air Canada also code shares with a number of carriers who are not members of Star Alliance. These include Aer Lingus, Central Mountain Air, Etihad, Eurowings, Germanwings, GOL Linhas Aéreas Inteligentes, Jet Airways, Middle East Airlines and SriLankan. In 2016, Air Canada introduced codeshare agreements with EVA Air in support of its Narita and Incheon services and with Avianca Brasil in support of its Sao Paolo services. Air Canada also reinstated its codeshare relationship with Thai Airways. Additionally, and in support of its international expansion, Air Canada expanded the scope of existing codeshare agreements, including with Singapore Airlines with the addition of Air Canada's marketing code to Singapore via Narita and Incheon; with Asiana Airlines with the addition of Air Canada's marketing code to Busan via Incheon and Asiana's code on Air Canada's new Toronto-Incheon operation; with Avianca/Taca Peru with the addition of Air Canada's marketing code beyond Lima to Cusco, Trujillo, Piura, Arequipa and Juliaca; and with Air India with the addition of Air Canada's marketing code to Kochi from both Delhi and Mumbai and timing adjustments for existing code on Air India's domestic network connecting to Air Canada's Delhi services. More specifically in support of its Atlantic growth, Air Canada expanded its codeshare relationship with its A++ partners United Airlines, Lufthansa, Swiss International Air Lines AG, Brussels Airlines SA/NV and Austrian Airlines AG. The codeshare expansion included the addition of Lufthansa's and/or United Airline's code on Vancouver-Dublin, Toronto-Budapest, Toronto-Glasgow, Toronto-Prague, Toronto-Warsaw, Montreal-Lyon, Montreal-Casablanca, Toronto-Gatwick, Montreal-Marseille, Toronto-Berlin, Vancouver-Gatwick and Vancouver-Frankfurt. Lufthansa Group carriers (Swiss International Air Lines, Austrian Airlines and Brussels Airlines) also expanded code on Air Canada on several transatlantic and domestic Canada points. Air Canada is assessing new strategic partnerships in 2017 in support of its business plan and international growth strategy.

In December 2016, Air Canada concluded a strategic cooperation agreement with Cathay Pacific that enhances travel services for customers travelling via Hong Kong to Southeast Asian countries, including the Philippines, Malaysia, Vietnam and Thailand. Air Canada offers codeshare services to an additional eight cities in Southeast Asia on flights operated by Cathay Pacific and Cathay Dragon connecting with Air Canada's double daily service to Hong Kong from Toronto and Vancouver. Air Canada has placed its code on Cathay Pacific and Cathay Dragon flights to Manila, Cebu, Kuala Lumpur, Ho Chi Minh City, Hanoi, Bangkok, Phuket and Chiang Mai. Air Canada has also signed a memorandum of understanding for a strategic cooperation agreement with Virgin Australia, simplifying Canadians' travel throughout Australia and New Zealand and providing Australians with more options for travel to Canada. The first stage of the codeshare agreement is scheduled to be implemented in early 2017 when Air Canada customers will be able to book travel on a single ticket to an additional 10 cities throughout Australia and New Zealand on Virgin Australia-operated flights for connecting with Air Canada's daily year-round service to Sydney and Brisbane. Subject to obtaining the necessary regulatory approvals, Air Canada will place its code on Virgin Australia flights to Adelaide, Canberra, Cairns, Melbourne and Perth as well as to Christchurch and Auckland, New Zealand. Customers will also be able to travel on Virgin Australia flights from Sydney to Brisbane, Sydney to the Gold Coast and Brisbane to Wellington, New Zealand.

Customer engagement

Providing a consistently high level of customer experience and growing the airline's premium customer base are very important aspects of Air Canada's business strategy. Air Canada continually strives to improve customer loyalty and generate positive referrals to new customers. The airline recognizes that its ongoing success is dependent on consistently delivering superior value and innovative products, providing the highest levels of customer service and anticipating the changing needs of customers.

Air Canada is the only international network carrier in North America to receive a Four-Star ranking from Skytrax, placing it among a select group of carriers worldwide to have earned the distinction. In addition, in 2016, according to a report on Canadian brands published by Brand Finance, an independent brand valuation firm, Air Canada's brand value increased 88% to $1.8 billion over 2015 placing it among the Top 50 most valuable Canadian brands. Air Canada was cited by Brand Finance as the fastest growing Canadian brand among Canada's largest corporations, and the only Canadian airline to rank among the Top 50.

In late 2016, Air Canada was named "Best North American Airline for International Travel" by the readers of *Business Traveler*, an independent publication which bills itself as the leading magazine for frequent business travellers. According to *Business Traveler*, winners were selected by its readers as representing top value and superlative service across geographic regions of the world.

Investing in products and services remains pivotal to Air Canada's commitment to customer engagement. The 787 Dreamliner, with its newly designed cabins and next generation in-flight entertainment, has been enthusiastically received and Air Canada has introduced the 787's three-cabin international product and seating standard on all of its 25 Boeing 777 aircraft. The airline's modern fleet, along with other attributes, such as its expansive global network, International Business Class service, Maple Leaf Lounges, concierge service, and Aeroplan and Altitude loyalty programs, are designed to further boost Air Canada's leading position as the carrier of choice among Canadian business travellers.

Air Canada Altitude is designed to enhance the travel experiences of its most frequent flyers. Program members benefit from a wide range of privileges, including priority travel services, upgrades to Business and Premium Economy cabins and recognition across the Star Alliance network. New for 2017, Air Canada aims to optimize the effectiveness of the program by implementing minimum spend requirements, as well as streamlined benefits and policies to better recognize customers' needs, such as granting Altitude status extensions to members who have decreased travel during periods of parental leave.

Altitude members benefit from Air Canada's partnership with the Aeroplan program, which provides a wide range of ways to earn and redeem Aeroplan Miles, including flights and upgrades to over 1,200 destinations worldwide. In the coming year, Air Canada will work with Aeroplan to offer new ways to earn miles, and additional options for members to use their miles for rewards with Air Canada.

In 2016, Air Canada created a more exclusive airport check-in experience for select Altitude members and business class customers with the launch of Business Class Check-in at Toronto Pearson and introduced new concierge offices at Toronto Pearson and Vancouver. To further improve the customer experience for its Altitude Super Elite 100K members and customers travelling in International Business Class, the airline added concierge services in Brisbane, Rome and Lyon and plans to open two new concierge stations in Taipei and Mumbai in 2017. A new concierge office, similar in design to Toronto Pearson, is underway for the Montreal concierge office in 2017 and is planned for Calgary and Ottawa. Additionally, Premium Agent service was launched in most Canadian hubs, offering an elevated level of personalized service at key customer touch points. Air Canada also introduced enhanced self-service bag drop for passengers with checked baggage at Calgary, with planned expansion to Montreal, Toronto and Vancouver, and continues to expand the availability of electronic boarding passes at more destinations.

For the comfort and convenience of premium and business customers, Air Canada operates 22 Maple Leaf Lounges, including three lounges in Europe (London-Heathrow, Paris-Charles de Gaulle and Frankfurt), three lounges in the United States (Los Angeles International Airport, New York LaGuardia and Newark Liberty International) and 16 lounges across Canada. In 2016, Air Canada upgraded several of its international departures lounges (Calgary International Airport, Los Angeles International Airport, Montreal Trudeau and Paris-Charles de Gaulle) and plans to refurbish several more in 2017. Air Canada also plans to open a lounge at Saskatoon Diefenbaker Airport.

Another program, entitled "Air Canada Corporate Rewards", is designed to help businesses of all sizes save on business travel while earning rewards and benefiting from special offers. Members are eligible for flight discounts and can take advantage of exclusive services such as eUpgrade credits, access to Air Canada's Maple Leaf Lounges and preferred seat selection. The program also offers an intuitive online tool to easily book business travel, reserve cars, manage and share itineraries and keep track of both travel expenses and program rewards.

For customers in the U.S., Air Canada has made electronic boarding passes available through mobile devices at all U.S. airports. Air Canada also offers TSA Pre-check, allowing eligible customers to experience expedited, more efficient security screening for flights out of U.S. airports where the service is available.

Air Canada has preferred seats available on its entire mainline fleet and has made it easier for customers to conveniently purchase these seats when booking or at any time prior to boarding, including through its website, its airport kiosks or mobile devices. Most preferred seats are located near the front of the aircraft, enabling customers to disembark more quickly at their destination.

Air Canada offers Wi-Fi connectivity on its mainline narrow-body aircraft and is planning for Wi-Fi connectivity on its mainline wide-body fleet as well as on its Air Canada Rouge narrow-body and wide-body fleets.

To remain competitive within the digital ecosystem, in 2016, Air Canada strengthened its online presence to offer a responsive design experience for traditional web users, while also meeting the increased demands from tablet and mobile device users. Customers, regardless of device and screen size, can seamlessly interact with Air Canada and access its products and services. In 2017, Air Canada will further enhance the digital experience by providing its customers the ability to find the airline's lowest available fares within a 270-day period on its website. Customers will be able to import mobile bookings made via mobile app to make changes to their itinerary on Air Canada's website. Customers will also be able to receive personalized offers and communications throughout the booking flow based on previous purchase history and preferences.

In 2016, Air Canada started leveraging its new customer relationship management system to gain valuable customer insights on travel patterns and preferences and to deliver a more personalized and satisfying customer experience. This new system is allowing Air Canada to more effectively target its product offerings to stimulate traffic, increase yields and improve customer loyalty.

Culture change

A healthy and dynamic corporate culture is a competitive attribute that can significantly affect Air Canada's long-term performance. A cornerstone of Air Canada's business strategy is the transformation of its corporate culture to one that embraces leadership and accountability. Air Canada is fostering positive culture change by promoting entrepreneurship, engagement, empowerment and pay-for-performance. It seeks to create a sense of purpose, shared values and common goals among employees and regularly communicates through multiple channels the rationale behind its strategic initiatives and the importance of adapting to changing market conditions. Recently this includes an increased focus on executive led town hall meetings with employees across the network and through social media. This is reinforced by continual and consistent emphasis on the four corporate priorities at every opportunity since their adoption in 2009.

Air Canada's cultural evolution entails continuous improvement, learning and empowerment, all geared towards ensuring employees feel valued and have a sense of purpose. Employees are more likely to embrace the new culture if they take an active part in Air Canada's evolution. As such, Air Canada encourages employee feedback and ideas as they are in an optimal position to identify improvements and changes necessary for success.

Participation in employee recognition programs such as Shine has increased to almost 90% company-wide. The Shine program offers options for employees to publicly recognize colleagues online and/or offer award points which can be exchanged for merchandise and e-gifts. In addition to Shine, Air Canada's long-established Award of Excellence recognition program honours outstanding employees annually. Employees are nominated by their peers for their outstanding work and community involvement.

Results from employee surveys continue to demonstrate a pronounced improvement in both employee engagement and a sense of pride in working at Air Canada. Air Canada has made substantial progress in 2016 – suggesting a dramatic increase in levels of confidence that the organization is doing well financially, that the culture is moving in the right direction across all employee groups, and that employees feel well informed about changes that impact their work. Staff increasingly view that levels of communication have improved, as have teamwork and cooperation among departments, and there is a growing sense of community. Perceptions are such that a higher proportion of employees agree strongly that Air Canada is on the right track towards stability and sustainability. Employees' perceptions toward senior management have improved significantly since 2014, indicating that senior management actively listens and demonstrates care and concern for employees. This is particularly evident amongst pilots, flight attendants and maintenance workers. A very high proportion of employees feel confident about their skills to do their job. Employees and managers see improvements in their ability to provide direction and support – some of which has been attributed to the expanded training programs – and indications are that they are eager to receive more training and development in the future.

The cross-functional approach of Air Canada's operational excellence team is also driving employee engagement while increasing customer satisfaction levels. Air Canada has initiatives in place to ensure that all employees understand how to work together to deliver on the customer promise. These include a comprehensive employee on-boarding experience, integrated management practices, as well as development programs intended to cultivate Air Canada's leadership behaviours and values. Customer-facing, management and emerging leaders are targeted for various programs – all designed around the principles of customer orientation, innovation and promoting the importance of brand loyalty.

In 2016, key customer service employee training programs were initiated across the system, including virtual classroom technology and racing pit crew-type training in support of improving aircraft turnaround times, safety and process efficiencies. Air Canada expanded both interpersonal skills and technical training to targeted audiences such as concierge and cabin crew. In 2016, Air Canada hired over 1,000 new flight attendants who received additional innovative customer service training. This will be offered to an additional 800 flight attendants in 2017. The airline will also be continuing its training program for premium agents in additional stations, including internationally.

In 2016, Air Canada was named one of the 50 Most Engaged Workplaces in North America for its commitment to employee engagement by Achievers, an employee social recognition company. Achievers reported that it selected companies for their work in setting the benchmark for standards in employee engagement.

In 2016, Air Canada also received the following important awards which further demonstrate that positive culture change is occurring at Air Canada:

- One of "Canada's 10 most admired corporate cultures" by Waterstone Human Capital
- One of "Canada's Top 100 Employers" for the fourth consecutive year in an annual employer survey by Mediacorp Canada Inc.
- One of "Montreal's Top Employers" for the third consecutive year by Mediacorp Canada Inc.
- Canada's third "Most Attractive Employer" by Randstad Canada
- One of Canada's 15 "Top Employers for Canadians Over 40" by Mediacorp Canada Inc.
- One of "Canada's Best Diversity Employers" by Mediacorp Canada Inc.
- Fastest Growing Brand Among Canada's Largest Corporations according to a report on Canadian brands published by Brand Finance

In addition, in recognition of the ongoing significant evolution underway at Air Canada, as announced in the National Post, Air Canada's President and Chief Executive Officer, Calin Rovinescu was named as Canada's Outstanding CEO of the Year for 2016. Calin Rovinescu was also named one of Glassdoor's 20 Highest Rated CEOs for 2016 in Canada and Air Canada as one of Canada's "Best Places to Work" based on employee feedback. Glassdoor reports gathering ratings through its online company review survey which seeks to gain current and former employee sentiment about job and company satisfaction, culture and work environment.

In 2017, Air Canada will continue to expand on employee engagement and leadership development though an enhanced suite of learning initiatives designed to support brand and customer loyalty. This will include various levels of management and customer-facing employees, with a particular focus on leadership, accountability and revitalization of the customer experience. Other improvements are being made to the overall Human Resources experience for employees and managers through developing and implementing client-facing strategies, enabling web and mobile-based technology, and adopting best practice policies and processes.

To encourage the development of a corporate culture, which is focused on transformation and performance, Air Canada has a profit sharing program that rewards eligible employees for their contributions, sharing the financial success of the airline.

As at December 31, 2016, in aggregate, 24,293,473 shares or 8.9% of total issued and outstanding shares of Air Canada were held by Air Canada employees and unions, including 17,647,059 shares held under a trust arrangement in connection with pension arrangements concluded in 2009.

Labour

Starting in 2014, Air Canada entered into multiple long-term labour agreements with unions representing its unionized workforce, a concrete indication of the collaborative partnership supporting its transformation into a global champion. These agreements include the following:

- Unifor (Customer Service and Sales Agents) - In the second quarter of 2015, Air Canada and Unifor, representing the airline's approximately 4,000 customer service and sales agents, concluded a contract providing collective agreement terms for five years, ending February 28, 2020.
- CUPE (Flight Attendants) - In the fourth quarter of 2015, Air Canada and CUPE, representing over 7,000 flight attendants, concluded a contract providing collective agreement terms for 10 years, ending March 31, 2025, subject to certain renegotiation provisions over this period.
- IAMAW (Maintenance, Operations and Baggage) - In the first quarter of 2016, Air Canada and the IAMAW, representing approximately 7,500 technical maintenance, operational support and airport baggage handlers, concluded a contract providing collective agreement terms for 10 years, ending April 1, 2026, subject to certain renegotiation provisions over this period.
- ACPA (Pilots) - In the fourth quarter of 2014, Air Canada and ACPA, representing approximately 3,000 pilots, concluded a contract providing collective agreement terms for 10 years, ending September 29, 2024, subject to certain renegotiation provisions and benchmarks over this period.
- CALDA (Dispatchers) - In the first quarter of 2016, Air Canada and CALDA, representing flight dispatchers, concluded a contract providing collective agreement terms for 12 years, ending February 29, 2028, subject to certain renegotiation provisions over this period.

Corporate Sustainability Report

In 2016, Air Canada released Citizens of the World, the airline's fifth corporate sustainability report ("CSR"), providing an update on Air Canada's performance during 2015 in four key areas of sustainability: safety, the environment, employee well-being and the airline's community involvement. In early 2017, Air Canada was recognized by the Finance and Sustainability Initiative (FSI) with the "2017 Award for Best Corporate Sustainability Report – Transportation" in Canada. FSI reports that this annual competition aims to promote excellence in sustainable development reporting among Canadian public companies.

05 Overview

In 2016, Air Canada generated operating income of $1,345 million and net income of $876 million or $3.10 per diluted share. In 2016, Air Canada recorded adjusted net income of $1,147 million or $4.06 per diluted share and generated record EBITDAR of $2,768 million. EBITDAR, adjusted net income and adjusted earnings per diluted share are non-GAAP financial measures. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

In the fourth quarter of 2016, Air Canada generated operating income of $18 million and a net loss of $179 million or $0.66 per diluted share. In the fourth quarter of 2016, Air Canada recorded adjusted net income of $38 million or $0.14 per diluted share and EBITDAR of $455 million.

Full year 2016 financial summary

The following is an overview of Air Canada's results of operations and financial position for the full year 2016 compared to the full year 2015.

- Record operating revenues of $14,677 million, an increase of $809 million or 6% from 2015. On capacity growth of 14.7%, record passenger revenues of $13,148 million increased $728 million or 5.9% from 2015.
- Operating expenses of $13,332 million, an increase of $960 million or 8% from 2015. Special items, described in section 6 of this MD&A, increased operating expenses by $91 million in 2016 while special items increased operating expenses by $8 million in 2015. In 2016, CASM declined 6.0% from 2015. On an adjusted basis, CASM decreased 2.9% from 2015, in line with the 2.75% to 3.75% decrease forecast in Air Canada's news release dated November 7, 2016. Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Operating income of $1,345 million in 2016 compared to operating income of $1,496 million in 2015.
- Record EBITDAR of $2,768 million in 2016 compared to EBITDAR of $2,542 million in 2015, an increase of $226 million or 8.9% and better than the 6% to 8% increase projected in Air Canada's news release dated November 7, 2016. Air Canada's better than projected 2016 EBITDAR performance was primarily driven by a December 2016 revenue environment that was more robust than anticipated, lower than expected expenses related to lease maintenance return provisions and the airline's success in achieving additional cost reductions. Special items are excluded from all of Air Canada's reported EBITDAR calculations. Refer to sections 6 and 7 of this MD&A for information on the special items.
- Net income of $876 million or $3.10 per diluted share in 2016 versus net income of $308 million or $1.03 per diluted share in 2015.
- Adjusted net income of $1,147 million or $4.06 per diluted share in 2016 compared to adjusted net income of $1,222 million or $4.18 per diluted share in 2015, a decrease of $75 million or $0.12 per diluted share.
- Adjusted net debt of $7,090 million at December 31, 2016, an increase of $799 million from December 31, 2015. Adjusted net debt is an additional GAAP financial measure. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for additional information. The airline's leverage ratio (adjusted net debt to trailing 12-month EBITDAR ratio) was 2.6 at December 31, 2016 versus a ratio of 2.5 at December 31, 2015. Leverage ratio is a non-GAAP financial measure. Refer to section 9.3 "Adjusted Net Debt" and section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Net cash flows from operating activities of $2,421 million in 2016, an improvement of $396 million from 2015. Negative free cash flow of $149 million in 2016 represented a decrease in free cash flow of $359 million from 2015. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for additional information. Free cash flow is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Return on invested capital ("ROIC") for the 12 months ended December 31, 2016 of 14.7% (versus 18.3% for the 12 months ended December 31, 2015), in line with Air Canada's 2016 ROIC target of 13% to 16% forecast in its November 7, 2016 news release. ROIC is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

Fourth quarter 2016 financial summary

The following is an overview of Air Canada's results of operations and financial position for the fourth quarter of 2016 compared to the fourth quarter of 2015.

- Record operating revenues of $3,425 million in the fourth quarter of 2016, an increase of $243 million or 8% from the fourth quarter of 2015. On capacity growth of 17.1%, record passenger revenues of $3,035 million in the fourth quarter of 2016 increased $199 million or 7.0% from the fourth quarter of 2015.
- Operating expenses of $3,407 million in the fourth quarter of 2016, an increase of $383 million or 13% from the fourth quarter of 2015. Special items, described in section 7 of this MD&A, increased operating expenses by $91 million in the fourth quarter of 2016

while special items increased operating expenses by $31 million in the fourth quarter of 2015. CASM declined 3.8% from the fourth quarter of 2015. On an adjusted basis, CASM decreased 6.1% from the fourth quarter of 2015, slightly better than the 5.0% to 6.0% decrease forecast in Air Canada's news release dated November 7, 2016.

- Operating income of $18 million in the fourth quarter of 2016 compared to operating income of $158 million in the fourth quarter of 2015.
- EBITDAR of $455 million in the fourth quarter of 2016 compared to EBITDAR of $456 million in the fourth quarter of 2015, a decrease of $1 million.
- A net loss of $179 million or $0.66 per diluted share in the fourth quarter of 2016 versus a net loss of $116 million or $0.41 per diluted share in the fourth quarter of 2015.
- Adjusted net income of $38 million or $0.14 per diluted share in the fourth quarter of 2016 compared to adjusted net income of $116 million or $0.40 per diluted share in the fourth quarter of 2015, a decrease of $78 million or $0.26 per diluted share.
- Net cash flows from operating activities of $351 million in the fourth quarter of 2016, an improvement of $100 million when compared to the fourth quarter of 2015. Free cash flow of $121 million in the fourth quarter of 2016 represented an increase in free cash flow of $484 million from the same quarter in 2015. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for additional information.

06 Results of Operations – Full Year 2016 versus Full Year 2015

The following table and discussion compares results of Air Canada for 2016 versus 2015:

(Canadian dollars in millions, except per share figures)	Full year		Change	
	2016	2015	$	%
Operating revenues				
Passenger	$ 13,148	$ 12,420	$ 728	6
Cargo	512	506	6	1
Other	1,017	942	75	8
Total revenues	**14,677**	**13,868**	**809**	**6**
Operating expenses				
Aircraft fuel	2,279	2,464	(185)	(8)
Regional airlines expense				
Aircraft fuel	327	359	(32)	(9)
Other	2,081	1,920	161	8
Wages, salaries and benefits	2,510	2,324	186	8
Airport and navigation fees	859	802	57	7
Aircraft maintenance	880	773	107	14
Depreciation, amortization and impairment	816	655	161	25
Sales and distribution costs	703	608	95	16
Ground package costs	489	415	74	18
Aircraft rent	462	353	109	31
Food, beverages and supplies	349	314	35	11
Communications and information technology	242	211	31	15
Special items	91	8	83	1,038
Other	1,244	1,166	78	7
Total operating expenses	**13,332**	**12,372**	**960**	**8**
Operating income	**1,345**	**1,496**	**(151)**	
Non-operating income (expense)				
Foreign exchange loss	(38)	(762)	724	
Interest income	48	46	2	
Interest expense	(374)	(389)	15	
Interest capitalized	58	70	(12)	
Net financing expense relating to employee benefits	(76)	(105)	29	
Gain (loss) on financial instruments recorded at fair value	4	(17)	21	
Gain on sale and leaseback of assets	19	-	19	
Loss on debt settlements	(89)	(13)	(76)	
Other	(20)	(18)	(2)	
Total non-operating expense	**(468)**	**(1,188)**	**720**	
Income before income taxes	**877**	**308**	**569**	
Income taxes	(1)	-	(1)	
Net income	**$ 876**	**$ 308**	**$ 568**	
Diluted earnings per share	**$ 3.10**	**$ 1.03**	**$ 2.07**	
EBITDAR (1)	**$ 2,768**	**$ 2,542**	**$ 226**	
Adjusted net income (1)	**$ 1,147**	**$ 1,222**	**$ (75)**	
Adjusted earnings per share – diluted (1)	**$ 4.06**	**$ 4.18**	**$ (0.12)**	

(1) EBITDAR, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

System passenger revenues

In 2016, system passenger revenues of $13,148 million increased $728 million or 5.9% from 2015 on traffic growth of 13.2% partly offset by a yield decline of 6.6%. Business cabin system revenues increased $113 million or 4.7% on traffic growth of 8.0% partly offset by a yield decline of 3.0%.

The table below provides passenger revenue by geographic region for 2016 versus 2015:

Passenger revenue (Canadian dollars in millions)	Full year		Change	
	2016	2015	$	%
Canada	$ 4,426	$ 4,379	$ 47	1.1
U.S. transborder	2,879	2,685	194	7.2
Atlantic	3,026	2,775	251	9.0
Pacific	1,985	1,762	223	12.7
Other	832	819	13	1.6
System	**$ 13,148**	**$ 12,420**	**$ 728**	**5.9**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for 2016 versus 2015:

Full year 2016 versus full year 2015	Passenger revenue % change	Capacity (ASMs) % change	Traffic (RPMs) % change	Passenger load factor pp change	Yield % change	PRASM % change
Canada	1.1	5.7	5.8	0.1	(4.6)	(4.5)
U.S. transborder	7.2	13.9	13.0	(0.7)	(5.2)	(6.0)
Atlantic	9.0	21.1	17.4	(2.5)	(7.1)	(9.9)
Pacific	12.7	21.1	18.8	(1.6)	(5.1)	(6.9)
Other	1.6	9.6	11.0	1.1	(8.8)	(7.6)
System	**5.9**	**14.7**	**13.2**	**(1.0)**	**(6.6)**	**(7.7)**

A system ASM capacity increase of 14.7% in 2016, when compared to 2015, reflected capacity growth in all markets. The capacity increase was primarily driven by additional Boeing 787 and Boeing 777 aircraft in the mainline fleet, the growth of Air Canada Rouge and additional seats on Boeing 777 aircraft.

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

- The 13.2% traffic increase which reflected traffic growth in all markets. Consistent with the airline's objective of increasing global international-to-international connecting traffic through its major Canadian hubs (sixth freedom traffic), the traffic growth in 2016 reflected an increase in connecting traffic via Canada to international destinations.
- The 6.6% yield decrease, which is consistent with the anticipated yield impact stemming from the implementation of Air Canada's strategic plan, reflected:
  - an increase in average stage length of 5.1%, due to long-haul international expansion, which had the effect of reducing system yield by 2.8 percentage points;
  - a higher proportion of seats into long-haul leisure markets led by an increase in lower-cost flights operated by Air Canada Rouge;
  - a reduction in carrier surcharges relating to lower fuel prices, especially where carrier surcharges are regulated;
  - a higher proportional growth of connecting traffic via Canada to international destinations in support of the airline's international expansion strategy;
  - increased industry capacity and competitive pricing activities affecting certain European and Pacific services; and
  - in the first half of 2016, the impact of increased industry capacity and competitive pricing activities affecting certain domestic markets as well as a decline in higher-yielding oil market-related traffic.

  A favourable currency impact of $193 million was a partly offsetting factor.

Domestic passenger revenues

In 2016, domestic passenger revenues of $4,426 million increased $47 million or 1.1% from 2015.

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

- The 5.8% traffic increase which reflected traffic growth on all major domestic services, including gains in premium cabin traffic. The domestic traffic increase also included incremental connecting traffic to U.S. and international destinations via Canada.
- The 4.6% yield decrease which reflected:
  - higher proportional growth of lower-yielding international and U.S. transborder passenger flows connecting to Air Canada's routes in the domestic market in support of the airline's international expansion strategy;
  - a 1.7% longer average stage length, which had the effect of reducing domestic yield by 1.0 percentage point in 2016;
  - the impact of increased industry capacity and competitive pricing activities affecting certain domestic markets; and
  - a decline in higher-yielding oil market-related traffic, particularly in the first half of 2016.

  A favourable currency impact of $26 million was a partly offsetting factor.

U.S. transborder passenger revenues

In 2016, U.S. transborder passenger revenues of $2,879 million increased $194 million or 7.2% from 2015.

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

- The 13.0% traffic increase which reflected traffic growth on all major U.S. transborder services. The year-over-year increase in traffic was due to strong passenger demand between Canada and the U.S. as well as growth of international-to-international passenger flows from the U.S.
- The 5.2% yield decline which mainly reflected the impact of increased competition and capacity on U.S. short-haul routes, competitive pricing activities on lower-cost Air Canada Rouge-operated U.S. sun routes and on services to California, and growth in international-to-international passenger flows from the U.S. A stronger premium cabin performance and a favourable currency impact of $56 million were partly offsetting factors.

Atlantic passenger revenues

In 2016, Atlantic passenger revenues of $3,026 million increased $251 million or 9.0% from 2015.

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

- The 17.4% traffic increase which reflected traffic growth from local and sixth freedom markets to and from Europe, India, Africa and the Middle East, including on Air Canada's and Air Canada Rouge's new and returning seasonal services. Traffic grew across all three cabins: Business, Premium Economy/Premium Rouge and Economy. This growth was partly offset by traffic declines on certain services, such as Belgium, Istanbul and Germany. Travel concerns in 2016, following terrorist attacks in France, Belgium and Turkey, were contributing factors to the passenger load factor decline.
- The 7.1% yield decline which reflected an increase in average stage length of 3.0%, which had the effect of reducing Atlantic yield by 1.7 percentage points. Increased industry capacity to and from Canada and the U.S., competitive pricing activities affecting certain European services, as well as a higher proportion of seats offered into long-haul leisure markets were also contributing factors to the yield decline. A favourable currency impact of $36 million was a partly offsetting factor.

Pacific passenger revenues

In 2016, Pacific passenger revenues of $1,985 million increased $223 million or 12.7% from 2015.

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

- The 18.8% traffic increase which reflected traffic growth on all major Pacific services with the exception of services to Hong Kong where traffic remained essentially at 2015 levels. The overall traffic increase versus 2015 was largely driven by the launch, in June 2016, of services to Seoul from Toronto and to Brisbane from Vancouver. In addition, Air Canada operated larger aircraft on routes to China and Japan and increased aircraft frequencies on its Vancouver-Osaka route (from five flights per week to six flights per week).
- The 5.1% yield decrease which mainly reflected the impact of increased industry capacity and competitive pricing activities, particularly on routes to China and Australia, as well as a reduction in carrier surcharges relating to lower fuel prices, especially where carrier surcharges are regulated. A favourable currency impact of $60 million was a partly offsetting factor.

Other passenger revenues

In 2016, Other passenger revenues of $832 million increased $13 million or 1.6% from 2015.

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

- The 11.0% traffic increase which reflected traffic growth on all major services, led by lower-cost Air Canada Rouge flying and growth in traffic to and from Brazil relating to the 2016 Summer Olympic Games. Consistent with Air Canada's strategy of growing international-to-international traffic through its Canadian hubs, international connections to and from South America also increased versus 2015.
- The 8.8% yield decrease which mainly reflected the impact of competitive pricing activities, driven by increased industry capacity on services to the Caribbean and Mexico while services to South America were impacted by a weaker economy, particularly in Brazil. A favourable currency impact of $15 million was a partly offsetting factor.

Cargo revenues

In 2016, cargo revenues of $512 million increased $6 million or 1.1% from 2015, reflecting traffic growth of 15.0% largely offset by a yield decline of 12.1%. Traffic increases were recorded in all markets on higher capacity. The overall yield decrease was primarily driven by increased industry capacity, particularly in the first half of 2016, and was partly offset by a favourable foreign currency impact of $12 million.

The table below provides cargo revenue by geographic region for 2016 versus 2015:

Cargo revenue (Canadian dollars in millions)	Full year		Change	
	2016	2015	$	%
Canada	$ 63	$ 67	$ (4)	(7.0)
U.S. transborder	29	24	5	18.3
Atlantic	187	188	(1)	(0.5)
Pacific	193	188	5	3.0
Other	40	39	1	3.2
System	**$ 512**	**$ 506**	**$ 6**	**1.1**

Other revenues

In 2016, other revenues of $1,017 million increased $75 million or 8% from 2015, reflecting, in large part, an increase in ground package revenues at Air Canada Vacations, the result of higher passenger volumes, and growth in passenger and airline-related fees.

CASM and adjusted CASM

In 2016, CASM and adjusted CASM decreased 6.0% and 2.9%, respectively, when compared to 2015. Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

The following table compares Air Canada's CASM and Adjusted CASM for 2016 versus 2015:

	Full year		Change	
(cents per ASM)	2016	2015	cents	%
Aircraft fuel	2.46	3.05	(0.59)	(19.3)
Regional airlines expense				
Aircraft fuel	0.35	0.44	(0.09)	(20.5)
Other	2.25	2.38	(0.13)	(5.5)
Wages and salaries	2.09	2.21	(0.12)	(5.4)
Benefits	0.62	0.66	(0.04)	(6.1)
Airport and navigation fees	0.93	0.99	(0.06)	(6.1)
Aircraft maintenance	0.95	0.96	(0.01)	(1.0)
Depreciation, amortization and impairment	0.88	0.81	0.07	8.6
Sales and distribution costs	0.76	0.75	0.01	1.3
Ground package costs	0.53	0.51	0.02	3.9
Aircraft rent	0.50	0.44	0.06	13.6
Food, beverages and supplies	0.38	0.39	(0.01)	(2.6)
Communications and information technology	0.26	0.26	-	-
Special items	0.10	0.01	0.09	900.0
Other	1.32	1.44	(0.12)	(0.1)
CASM	**14.38**	**15.30**	**(0.92)**	**(6.0)**
Remove:				
Aircraft fuel expense (1), ground package costs at Air Canada Vacations and special items	(3.44)	(4.03)	0.59	14.6
Adjusted CASM (2)	**10.94**	**11.27**	**(0.33)**	**(2.9)**

(1) Includes aircraft fuel expense related to regional airline operations.
(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses

In 2016, operating expenses of $13,332 million increased $960 million or 8% from 2015. This increase was mainly driven by the 14.7% capacity growth and the impact of a weaker Canadian dollar on foreign currency denominated operating expenses which increased operating expenses by $228 million in 2016 (comprised of $71 million related to aircraft fuel expense and $157 million related to non-fuel operating expenses). These increases were partly offset by the impact of lower jet fuel prices (before the impact of foreign exchange).

Aircraft fuel expense

In 2016, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to $2,606 million, a decrease of $217 million or 8% from 2015, reflecting the impact of lower base jet fuel prices (before the impact of foreign exchange) year-over-year, which accounted for a reduction of $519 million. Partly offsetting this decrease were the impact of a higher volume of fuel litres consumed, which accounted for an increase of $219 million, and an unfavourable currency impact of $71 million.

Regional airlines expense

In 2016, regional airlines expense of $2,408 million increased $129 million or 6% from 2015, reflecting the impact of increased flying, which was the result of fleet expansion initiatives in the Air Canada Express fleet operated by Sky Regional and Air Georgian, an unfavourable currency impact of $40 million and an increase in expenses related to end of lease maintenance provisions. Partly offsetting these increases were the impact of lower jet fuel prices year-over-year and lower rates associated with the Jazz CPA.

Wages, salaries and benefits expense

In 2016, wages, salaries and benefits expense of $2,510 million increased $186 million or 8% from 2015.

In 2016, wages and salaries expense of $1,936 million increased $148 million or 8% from 2015. This increase was largely due to a higher number of full-time equivalent (FTE) employees when compared to 2015. On the capacity growth of 14.7%, the average number of FTE employees increased 4.9% year-over-year.

In 2016, employee benefits expense of $574 million increased $38 million or 7% from 2015, in large part due to Air Canada having recorded a credit of $19 million in 2015 which pertained to benefit plan amendments in U.S. post-retirement health plans. This increase in employee benefits expense was higher than the $20 million increase projected in Air Canada's news release dated November 7, 2016, mainly due to the impact of Air Canada having recorded a current service cost expense of $6 million related to its collective agreement with the pilot union, higher defined contribution plan expenses than forecast and other factors.

Airport and navigation fees

In 2016, airport and navigation fees of $859 million increased $57 million or 7% from 2015, reflecting growth in wide-body and international flying and an unfavourable currency impact of $7 million. The favourable impact of Air Canada's agreement with the Greater Toronto Airports Authority, which is allowing the airline to increase international connecting traffic at Toronto Pearson International Airport on a more cost effective basis, and the impact of a 6% Nav Canada rate reduction, which was effective September 1, 2016, were partly offsetting factors.

Aircraft maintenance expense

In 2016, aircraft maintenance expense of $880 million increased $107 million or 14% from 2015, reflecting an increase in expenses related to end of lease maintenance provisions when compared to 2015, an unfavourable currency impact of $49 million and the effect of having additional Boeing 787 and 777 aircraft in the fleet which have engines under power-by-the-hour arrangements. The increase in end of lease maintenance provisions was mainly due to Air Canada having recorded credits in 2015 due to lease extensions. Partly offsetting these increases was the impact of cost reduction initiatives.

The year-over-year $107 million increase in aircraft maintenance expense was lower than the $120 million increase projected in Air Canada's news release dated November 7, 2016. This improvement was mainly due to lower than expected lease maintenance return provisions.

The following table provides a breakdown of the more significant items included in maintenance expense for the periods indicated:

Aircraft maintenance expense (Canadian dollars in millions)	Full year		Change	
	2016	2015	$	%
Technical maintenance	$ 727	$ 715	$ 12	2
Maintenance provision [(1)]	133	27	106	393
Other	20	31	(11)	(35)
Total aircraft maintenance expense	**$ 880**	**$ 773**	**$ 107**	**14**

(1) Maintenance provisions relate to return conditions on aircraft leases which are recorded over the term of the lease.

Depreciation, amortization and impairment expense

In 2016, depreciation, amortization and impairment expense of $816 million increased $161 million or 25% from 2015, reflecting, in large part, the addition of Boeing 787 aircraft to Air Canada's mainline fleet and the airline's aircraft refurbishment programs. The year-over-year increase in depreciation, amortization and impairment expense was essentially in line with the $160 million increase projected in Air Canada's news release dated November 7, 2016.

Sales and distribution costs

In 2016, sales and distribution costs of $703 million increased $95 million or 16% from 2015, reflecting higher commission expenses, in part due to new and enhanced competitive incentive programs, a higher volume of ticket sales, and a higher proportion of sales through international points-of-sales which generally result in higher transaction costs. An increase in credit card expenses (in line with sales and revenue growth) and an unfavourable currency impact of $14 million were also contributing factors to the increase in sales and distribution costs versus 2015.

Ground package costs

In 2016, ground package costs of $489 million increased $74 million or 18% from 2015, reflecting higher passenger volumes year-over-year and an unfavourable currency impact of $26 million.

Aircraft rent

In 2016, aircraft rent expense of $462 million increased $109 million or 31% from 2015, reflecting a greater number of leased aircraft year-over-year, primarily Airbus A321 and Boeing 787 aircraft, the reclassification of certain finance leases to operating leases, and an unfavourable currency impact of $18 million.

Special items

In 2016, a past service cost expense of $91 million was recorded as a special item to reflect the estimated cost of pension increases applicable to members of the Air Canada Pilots Association ("ACPA") who participate in a defined benefit plan. Certain pension plan amendments (related to maximum annual pension per year of service) are conditional on meeting defined business plan targets tied to the number of operating aircraft in the fleet by 2017, 2020 and as of 2023. The past service cost expense of $91 million represents the out-of-period expense associated with benefits granted upon signing of the ACPA collective agreement in 2014 based on management's best estimate of the probability of meeting the defined business plan targets tied to the number of operating aircraft at the respective dates. The special charge does not impact any of the Corporation's prior or current incentive compensation.

In 2015, special items increased operating expenses by $8 million. These special items included:

- One-time payments totalling $26 million related to Air Canada's contract on collective agreement terms with CUPE;
- One-time payments totalling $36 million related to Air Canada's contract on collective agreement terms with the IAMAW;
- A $30 million recovery related to cargo investigations and proceedings which had been previously paid; and
- Favourable tax-related provision adjustments of $23 million.

Other expenses

In 2016, other expenses of $1,244 million increased $78 million or 7% from 2015, reflecting, in large part, the capacity growth, the impact of Air Canada's international expansion strategy and an unfavourable currency impact.

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

Other expenses (Canadian dollars in millions)	Full year		Change	
	2016	2015	$	%
Terminal handling	$ 237	$ 227	$ 10	4
Crew cycle	177	149	28	19
Building rent and maintenance	154	145	9	6
Miscellaneous fees and services	141	137	4	3
Remaining other expenses	535	508	27	5
Total other expenses	**$ 1,244**	**$ 1,166**	**$ 78**	**7**

Non-operating expense

In 2016, non-operating expense of $468 million in 2016 decreased $720 million from 2015.

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

Non-operating expense (Canadian dollars in millions)	Full year		
	2016	2015	$ Change
Foreign exchange loss	$ (38)	$ (762)	$ 724
Interest expense, net	(268)	(273)	5
Net financing expense relating to employee benefits	(76)	(105)	29
Gain (loss) on financial instruments recorded at fair value	4	(17)	21
Gain on sale and leaseback of assets	19	-	19
Loss on debt settlements	(89)	(13)	(76)
Other	(20)	(18)	(2)
Total non-operating expense	**$ (468)**	**$ (1,188)**	**$ 720**

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

- In 2016, losses on foreign exchange amounted to $38 million compared to losses on foreign exchange of $762 million in 2015. In 2016, foreign exchange losses on foreign currency derivatives of $136 million were partly offset by foreign exchange gains on U.S. denominated long-term debt and finance leases of $126 million. The foreign exchange gains on U.S. denominated long-term debt were attributable to a stronger Canadian dollar at December 31, 2016 when compared to December 31, 2015. The December 31, 2016 closing exchange rate was US$1 = C$1.3427 while the December 31, 2015 closing exchange rate was US$1 = C$1.3840. In 2015, foreign exchange losses on U.S. denominated long-term debt of $876 million were attributable to a weaker Canadian dollar at December 31, 2015 when compared to the December 31, 2014 closing rate of US$1 = C$1.1601. Partially offsetting these losses were gains of $164 million on foreign currency derivatives.
- In 2016, net financing expense relating to employee benefits decreased $29 million which mainly reflected the impact of the lower net defined pension benefit obligation.
- In 2016, Air Canada recorded a gain of $19 million on the sale and operating leaseback of two Boeing 787-9 aircraft. No such gain was recorded in 2015.
- In 2016, Air Canada recorded a loss on debt settlements amounting to $89 million of which $82 million was related to the C$1.25 billion refinancing transaction concluded on October 6, 2016 and further described in section 9.8 "Contractual Obligations" of this MD&A and $7 million was related to the prepayment of debt associated with the disposal of Embraer 190 aircraft. In 2015, Air Canada recorded a loss on debt settlements of $13 million related to the prepayment of debt associated with the disposal of Embraer 190 aircraft.

07 Results of Operations – Fourth Quarter 2016 versus Fourth Quarter 2015

The following table and discussion compares results of Air Canada for the fourth quarter 2016 versus the fourth quarter of 2015:

(Canadian dollars in millions, except per share figures)	Fourth quarter		Change	
	2016	2015	$	%
Operating revenues				
Passenger	$ 3,035	$ 2,836	199	7
Cargo	155	135	20	15
Other	235	211	24	11
Total revenues	**3,425**	**3,182**	**243**	**8**
Operating expenses				
Aircraft fuel	598	527	71	13
Regional airlines expense				
Aircraft fuel	90	81	9	11
Other	532	468	64	14
Wages, salaries and benefits	633	590	43	7
Airport and navigation fees	203	193	10	5
Aircraft maintenance	197	203	(6)	(3)
Depreciation, amortization and impairment	212	160	52	33
Sales and distribution costs	172	145	27	19
Ground package costs	101	87	14	16
Aircraft rent	120	98	22	22
Food, beverages and supplies	82	81	1	1
Communications and information technology	60	50	10	20
Special items	91	31	60	194
Other	316	310	6	2
Total operating expenses	**3,407**	**3,024**	**383**	**13**
Operating income	**18**	**158**	**(140)**	
Non-operating income (expense)				
Foreign exchange loss	(29)	(159)	130	
Interest income	13	13	-	
Interest expense	(83)	(99)	16	
Interest capitalized	8	20	(12)	
Net financing expense relating to employee benefits	(24)	(27)	3	
Gain (loss) on financial instruments recorded at fair value	9	(3)	12	
Loss on debt settlements	(82)	(13)	(69)	
Other	(8)	(6)	(2)	
Total non-operating expense	**(196)**	**(274)**	**78**	
Loss before income taxes	**(178)**	**(116)**	**(62)**	
Income taxes	(1)	-	(1)	
Net loss	**$ (179)**	**$ (116)**	**$ (63)**	
Diluted loss per share	**$ (0.66)**	**$ (0.41)**	**$ (0.25)**	
EBITDAR (1)	**$ 455**	**$ 456**	**$ (1)**	
Adjusted net income (1)	**$ 38**	**$ 116**	**$ (78)**	
Adjusted earnings per share – diluted (1)	**$ 0.14**	**$ 0.40**	**$ (0.26)**	

(1) EBITDAR, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

System passenger revenues

In the fourth quarter of 2016, system passenger revenues of $3,035 million increased $199 million or 7.0% from the fourth quarter of 2015 on traffic growth of 15.3% partly offset by a yield decline of 7.2%. Business cabin system revenues increased $49 million or 8.4% on traffic growth of 13.4% partly offset by a yield decline of 4.5%.

The table below provides passenger revenue by geographic region for the fourth quarter of 2016 versus the fourth quarter of 2015:

Passenger revenue (Canadian dollars in millions)	Fourth quarter		Change	
	2016	2015	$	%
Canada	$ 1,079	$ 1,053	$ 26	2.5
U.S. transborder	697	632	65	10.1
Atlantic	619	572	47	8.3
Pacific	442	394	48	12.1
Other	198	185	13	7.3
System	**$ 3,035**	**$ 2,836**	**$ 199**	**7.0**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the fourth quarter of 2016 versus the fourth quarter of 2015:

Fourth quarter 2016 versus fourth quarter 2015	Passenger revenue % change	Capacity (ASMs) % change	Traffic (RPMs) % change	Passenger load factor pp change	Yield % change	PRASM % change
Canada	2.5	5.5	5.7	0.1	(3.1)	(2.9)
U.S. transborder	10.1	14.1	15.0	0.6	(4.3)	(3.6)
Atlantic	8.3	21.5	19.3	(1.4)	(9.2)	(10.9)
Pacific	12.1	31.9	23.7	(5.3)	(9.3)	(15.0)
Other	7.3	13.2	15.7	1.8	(7.6)	(5.5)
System	**7.0**	**17.1**	**15.3**	**(1.2)**	**(7.2)**	**(8.6)**

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters:

System	Year-over-year by quarter (% change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	3.0	2.8	2.0	10.5	7.0
Capacity (ASMs)	8.4	8.2	11.0	20.9	17.1
Traffic (RPMs)	8.6	7.7	9.3	18.9	15.3
Passenger load factor (pp change)	0.1	(0.3)	(1.2)	(1.5)	(1.2)
Yield	(5.5)	(4.7)	(6.8)	(7.0)	(7.2)
PRASM	(5.3)	(5.1)	(8.2)	(8.6)	(8.6)

A system ASM capacity increase of 17.1% in the fourth quarter of 2016, when compared to the fourth quarter of 2015, reflected capacity growth in all markets. The capacity increase was primarily driven by additional Boeing 787 and Boeing 777 aircraft in the mainline fleet, the growth of Air Canada Rouge and additional seats on Boeing 777 aircraft.

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

- The 15.3% traffic increase which reflected traffic growth in all markets. Consistent with the airline's objective of increasing global international-to-international connecting traffic through its major Canadian hubs (sixth freedom traffic), the traffic growth in the fourth quarter of 2016 reflected an increase in connecting traffic via Canada to international destinations.
- The 7.2% yield decrease which reflected:
  - an increase in average stage length of 6.5%, due to long-haul international expansion, which had the effect of reducing system yield by 3.6 percentage points;

- a higher proportion of seats into long-haul leisure markets led by an increase in lower-cost flights operated by Air Canada Rouge;
- a reduction in carrier surcharges relating to lower fuel prices, especially where carrier surcharges are regulated; and
- a higher proportional growth of connecting traffic via Canada to international destinations in support of the airline's international expansion strategy.

Domestic passenger revenues

In the fourth quarter of 2016, domestic passenger revenues of $1,079 million increased $26 million or 2.5% from the fourth quarter of 2015.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters:

Canada	Year-over-year by quarter (% change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	(4.1)	(2.3)	(1.6)	4.8	2.5
Capacity (ASMs)	4.0	6.3	4.5	6.3	5.5
Traffic (RPMs)	2.4	4.1	4.2	8.2	5.7
Passenger load factor (pp change)	(1.2)	(1.7)	(0.2)	1.5	0.1
Yield	(7.3)	(6.5)	(5.8)	(3.1)	(3.1)
PRASM	(8.7)	(8.4)	(6.1)	(1.4)	(2.9)

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

- The 5.7% traffic increase which reflected traffic growth on all major domestic services and included gains in premium cabin traffic. The domestic traffic increase also included incremental connecting traffic to U.S. and international destinations via Canada.
- The 3.1% yield decrease which reflected:
  - a 1.4% longer average stage length, which had the effect of reducing domestic yield by 0.8 percentage points in the fourth quarter of 2016;
  - higher proportional growth of lower-yielding international and U.S. transborder passenger flows connecting to Air Canada's routes in the domestic market in support of the airline's international expansion strategy; and
  - increased competition on regional routes, particularly in eastern Canada.

U.S. transborder passenger revenues

In the fourth quarter of 2016, U.S. transborder passenger revenues of $697 million increased $65 million or 10.1% from the fourth quarter of 2015.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters:

U.S. transborder	Year-over-year by quarter (% change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	10.5	2.5	2.3	14.0	10.1
Capacity (ASMs)	11.9	10.2	12.3	19.3	14.1
Traffic (RPMs)	11.6	5.8	10.8	20.8	15.0
Passenger load factor (pp change)	(0.2)	(3.3)	(1.1)	1.0	0.6
Yield	(0.9)	(3.3)	(7.9)	(5.6)	(4.3)
PRASM	(1.1)	(7.1)	(9.1)	(4.5)	(3.6)

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

- The 15.0% traffic increase which reflected traffic growth on all major U.S. transborder services. The year-over-year increase in traffic was due to strong passenger demand between Canada and the U.S. as well as growth of international-to-international passenger flows from the U.S.
- The 4.3% yield decline which mainly reflected the impact of increased competition and capacity on U.S. short-haul routes, competitive pricing activities on lower-cost Air Canada Rouge-operated U.S. sun routes, and growth in international-to-international passenger flows from the U.S. A stronger premium cabin performance was a partly offsetting factor.

Atlantic passenger revenues

In the fourth quarter of 2016, Atlantic passenger revenues of $619 million increased $47 million or 8.3% from the fourth quarter of 2015.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters:

Atlantic	Year-over-year by quarter (% change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	9.1	12.9	5.0	10.7	8.3
Capacity (ASMs)	15.3	13.6	16.6	28.1	21.5
Traffic (RPMs)	14.2	15.8	10.9	21.8	19.3
Passenger load factor (pp change)	(0.7)	1.5	(4.0)	(4.4)	(1.4)
Yield	(4.5)	(2.5)	(5.4)	(9.1)	(9.2)
PRASM	(5.4)	(0.6)	(9.9)	(13.6)	(10.9)

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

- The 19.3% traffic increase which reflected traffic growth on all major Atlantic services, led by strong growth on Air Canada's services to Delhi and Dubai, along with the airline's extended services to Spain. Traffic grew across all three cabins: Business, Premium Economy/ Premium Rouge and Economy. The uncertainty following the United Kingdom's referendum vote to withdraw from the European Union had a negative effect on traffic originating from the United Kingdom, which continued through the fourth quarter of 2016.
- The 9.2% yield decline which reflected an increase in average stage length of 3.2%, which had the effect of reducing Atlantic yield by 1.8 percentage points. Increased industry capacity to and from Canada and the U.S., an unfavourable currency impact of $10 million, aggressive competitive pricing activities affecting certain European services, as well as a higher proportion of seats offered into long-haul leisure markets were also contributing factors to the yield decline.

Pacific passenger revenues

In the fourth quarter of 2016, Pacific passenger revenues of $442 million increased $48 million or 12.1% from the fourth quarter of 2015.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters:

Pacific	Year-over-year by quarter (% change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	4.7	7.7	8.8	19.2	12.1
Capacity (ASMs)	3.4	3.1	12.4	34.8	31.9
Traffic (RPMs)	7.9	6.3	13.7	29.0	23.7
Passenger load factor (pp change)	3.6	2.6	1.0	(3.9)	(5.3)
Yield	(2.9)	1.4	(4.2)	(7.6)	(9.3)
PRASM	1.3	4.6	(3.1)	(11.6)	(15.0)

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

- The 23.7% traffic increase which reflected traffic growth on all major Pacific services with the exception of services to Hong Kong where capacity was reduced year-over-year. The traffic increase versus the same quarter in 2015 was largely driven by the launch, in June 2016, of services to Seoul from Toronto and to Brisbane from Vancouver. In addition, Air Canada operated larger aircraft on routes to China and Japan and increased aircraft frequencies on its Vancouver-Osaka route (from five flights per week to six flights per week).
- The 9.3% yield decrease which mainly reflected the impact of increased industry capacity and competitive pricing activities on most major Pacific services as well as a reduction in carrier surcharges relating to lower fuel prices, especially where carrier surcharges are regulated. A favourable currency impact of $6 million was a partly offsetting factor.

Other passenger revenues

In the fourth quarter of 2016, Other passenger revenues of $198 million increased $13 million or 7.3% from the fourth quarter of 2015.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the fourth quarter of 2016 and each of the previous four quarters:

Other	Year-over-year by quarter (% change)				
	Q4'15	Q1'16	Q2'16	Q3'16	Q4'16
Passenger revenues	1.1	(1.5)	(6.4)	8.3	7.3
Capacity (ASMs)	9.5	7.5	6.0	12.5	13.2
Traffic (RPMs)	10.5	8.1	6.5	15.1	15.7
Passenger load factor (pp change)	0.7	0.4	0.3	1.9	1.8
Yield	(8.6)	(9.2)	(12.4)	(6.0)	(7.6)
PRASM	(7.8)	(8.8)	(12.1)	(3.9)	(5.5)

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

- The 15.7% traffic increase which reflected traffic growth on all major services, led by lower-cost Air Canada Rouge flying. International connections to and from South America increased compared to the same quarter in 2015, which is consistent with Air Canada's strategy of growing international-to-international traffic through its Canadian hubs.
- The 7.6% yield decrease which mainly reflected the impact of increased industry capacity and competitive pricing activities on services to traditional sun destinations.

Cargo revenues

In the fourth quarter of 2016, cargo revenues of $155 million increased $20 million or 15.0% from the fourth quarter of 2015, reflecting traffic growth of 27.3% partly offset by a yield decline of 9.7%. Traffic increases were recorded in all markets, led by the Pacific region, on higher capacity. Yields declined in all markets, driven by increased industry capacity, with the exception of Asia where yields were essentially at 2015 levels.

The table below provides cargo revenue by geographic region for the fourth quarter of 2016 versus the fourth quarter of 2015:

Cargo revenue (Canadian dollars in millions)	Fourth quarter		Change	
	2016	2015	$	%
Canada	$ 18	$ 17	$ 1	3.3
U.S. transborder	9	7	2	16.2
Atlantic	52	48	4	7.1
Pacific	63	49	14	29.5
Other	13	14	(1)	3.9
System	**$ 155**	**$ 135**	**$ 20**	**15.0**

Other revenues

In the fourth quarter of 2016, other revenues of $235 million increased $24 million or 11% from the fourth quarter of 2015, reflecting, in large part, an increase in ground package revenues at Air Canada Vacations, the result of higher passenger volumes.

CASM and adjusted CASM

In the fourth quarter of 2016, CASM and adjusted CASM decreased 3.8% and 6.1%, respectively, when compared to the fourth quarter of 2015. Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

The following table compares Air Canada's CASM and Adjusted CASM for the fourth quarter of 2016 to the fourth quarter of 2015:

(cents per ASM)	Fourth quarter		Change	
	2016	2015	cents	%
Aircraft fuel	2.71	2.79	(0.08)	(2.9)
Regional airlines expense				
Aircraft fuel	0.41	0.43	(0.02)	(4.7)
Other	2.41	2.48	(0.07)	(2.8)
Wages and salaries	2.23	2.44	(0.21)	(8.6)
Benefits	0.64	0.68	(0.04)	(5.9)
Airport and navigation fees	0.92	1.02	(0.10)	(9.8)
Aircraft maintenance	0.89	1.08	(0.19)	(17.6)
Depreciation, amortization and impairment	0.96	0.85	0.11	12.9
Sales and distribution costs	0.78	0.77	0.01	1.3
Ground package costs	0.46	0.46	-	-
Aircraft rent	0.54	0.52	0.02	3.8
Food, beverages and supplies	0.37	0.43	(0.06)	(14.0)
Communications and information technology	0.27	0.27	-	-
Special items	0.41	0.16	0.25	156.3
Other	1.42	1.65	(0.23)	(0.1)
CASM	**15.42**	**16.03**	**(0.61)**	**(3.8)**
Remove:				
Aircraft fuel expense (1), ground package costs at Air Canada Vacations and special items	(3.98)	(3.85)	(0.13)	(3.4)
Adjusted CASM (2)	**11.44**	**12.18**	**(0.74)**	**(6.1)**

(1) Includes aircraft fuel expense related to regional airline operations.
(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses

In the fourth quarter of 2016, operating expenses of $3,407 million increased $383 million or 13% from the fourth quarter of 2015 on capacity growth of 17.1%. The more notable components of the year-over-year change in operating expenses are described below.

Aircraft fuel expense

In the fourth quarter of 2016, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to $688 million, an increase of $80 million or 13% from the fourth quarter of 2015, reflecting the impact of a higher volume of fuel litres consumed, which accounted for an increase of $72 million, and the impact of higher base jet fuel prices (before the impact of foreign exchange), which accounted for an increase of $19 million. Partly offsetting these increases was a favourable currency impact of $10 million.

Regional airlines expense

In the fourth quarter of 2016, regional airlines expense of $622 million increased $73 million or 13% from the fourth quarter of 2015, reflecting the impact of increased flying, which was the result of fleet expansion initiatives in the Air Canada Express fleet operated by Sky Regional and Air Georgian. Partly offsetting this increase was the impact of lower rates associated with the Jazz CPA.

Wages, salaries and benefits expense

In the fourth quarter of 2016, wages, salaries and benefits expense of $633 million increased $43 million or 7% from the fourth quarter in 2015.

In the fourth quarter of 2016, wages and salaries expense of $492 million increased $31 million or 7% from the fourth quarter of 2015. This increase was mainly due to a higher number of FTE employees when compared to the same quarter in 2015. On the 17.1% capacity growth, the average number of FTE employees increased 4.4% year-over-year.

In the fourth quarter of 2016, employee benefits expense of $141 million increased $12 million or 9% from the fourth quarter in 2015, reflecting, largely, Air Canada having recorded an expense of $6 million in 2016 related to its collective agreement with its pilot union while no such expense was recorded in the fourth quarter of 2015.

Airport and navigation fees

In the fourth quarter of 2016, airport and navigation fees of $203 million increased $10 million or 5% from the fourth quarter of 2015, reflecting growth in wide-body and international flying. The favourable impact of Air Canada's agreement with the Greater Toronto Airports Authority, which is allowing the airline to increase its share of international connecting traffic at Toronto Pearson International Airport on a more cost effective basis, and the impact of a 6% Nav Canada rate reduction, which was effective on September 1, 2016, were partly offsetting factors.

Aircraft maintenance expense

In the fourth quarter of 2016, aircraft maintenance expense of $197 million decreased $6 million or 3% from the fourth quarter of 2015.

The following table provides a breakdown of the more significant items included in maintenance expense for the periods indicated:

Aircraft maintenance expense (Canadian dollars in millions)	Fourth quarter		Change	
	2016	2015	$	%
Technical maintenance	$ 151	$ 170	$ (19)	11
Maintenance provision (1)	39	17	22	129
Other	7	16	(9)	(56)
Total aircraft maintenance expense	**$ 197**	**$ 203**	**$ (6)**	**(3)**

(1) Maintenance provisions relate to return conditions on aircraft leases which are recorded over the term of the lease.

Depreciation, amortization and impairment expense

In the fourth quarter of 2016, depreciation, amortization and impairment expense of $212 million increased $52 million or 33% from the fourth quarter of 2015, reflecting, in large part, the addition of Boeing 787 aircraft to Air Canada's mainline fleet and the airline's aircraft refurbishment programs.

Sales and distribution costs

In the fourth quarter of 2016, sales and distribution costs of $172 million increased $27 million or 19% from the fourth quarter of 2015, reflecting higher commission expenses, in part due to new and enhanced competitive incentive programs. A higher volume of ticket sales, a higher proportion of sales through international points-of-sales which generally result in higher transaction costs, and an increase in credit card expenses (in line with sales and revenue growth) were also contributing factors to the increase in sales and distribution costs year-over-year.

Ground package costs

In the fourth quarter of 2016, ground package costs of $101 million increased $14 million or 16% from the fourth quarter of 2015, reflecting higher passenger volumes year-over-year, partly offset by a higher cost of ground packages.

Aircraft rent

In the fourth quarter of 2016, aircraft rent expense of $120 million increased $22 million or 22% from the fourth quarter of 2015, reflecting a greater number of leased aircraft, primarily Airbus A321 and Boeing 787 aircraft, and the reclassification of certain finance leases to operating leases.

Special items

In the fourth quarter of 2016, a past service cost expense of $91 million was recorded as a special item to reflect the estimated cost of pension increases applicable to members of the Air Canada Pilots Association ("ACPA") who participate in a defined benefit plan. Certain pension plan amendments (related to maximum annual pension per year of service) are conditional on meeting defined business plan targets tied to the number of operating aircraft in the fleet by 2017, 2020 and as of 2023. The past service cost expense of $91 million represents the out-of-period expense associated with benefits granted upon signing of the ACPA collective agreement in 2014 based on management's best estimate of the probability of meeting the defined business plan targets tied to the number of operating aircraft at the respective dates. Future changes in estimates surrounding the probability of meeting future plan targets will be recorded as actuarial gains (losses). The special charge does not impact any of the Corporation's prior or current incentive compensation.

In the fourth quarter of 2015, special items increased operating expenses by $31 million. These special items included:

- One-time payments totalling $26 million related to Air Canada's contract on collective agreement terms with CUPE;
- One-time payments totalling $36 million related to Air Canada's contract on collective agreement terms with the IAMAW; and
- A $30 million recovery related to cargo investigations which had been previously paid.

Other expenses

In the fourth quarter of 2016, other expenses of $316 million increased $6 million or 2% from the fourth quarter of 2015, reflecting, in large part, the capacity growth and the impact of Air Canada's international expansion strategy.

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

Other expenses (Canadian dollars in millions)	Fourth quarter		Change	
	2016	2015	$	%
Terminal handling	$ 55	$ 53	$ 2	4
Crew cycle	44	35	9	26
Building rent and maintenance	43	39	4	10
Miscellaneous fees and services	40	37	3	8
Remaining other expenses	134	146	(12)	(8)
Total other expenses	**$ 316**	**$ 310**	**$ 6**	**2**

Non-operating expense

In the fourth quarter of 2016, non-operating expense of $196 million decreased $78 million from the fourth quarter of 2015.

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

Non-operating expense (Canadian dollars in millions)	Fourth quarter		
	2016	2015	$ Change
Foreign exchange loss	$ (29)	$ (159)	$ 130
Interest expense, net	(62)	(66)	4
Net financing expense relating to employee benefits	(24)	(27)	3
Gain (loss) on financial instruments recorded at fair value	9	(3)	12
Loss on debt settlements	(82)	(13)	(69)
Other	(8)	(6)	(2)
Total non-operating expense	**$ (196)**	**$ (274)**	**$ 78**

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

- In fourth quarter of 2016, losses on foreign exchange amounted to $29 million compared to losses on foreign exchange of $159 million in the fourth quarter of 2015. In the fourth quarter of 2016, foreign exchange losses on U.S. denominated long-term debt and finance leases of $133 million were partly offset by foreign exchange gains on foreign currency derivatives of $115 million. The foreign exchange losses on U.S. denominated long-term debt were attributable to a weaker Canadian dollar at December 31, 2016 when compared to September 30, 2016. The December 31, 2016 closing exchange rate was US$1 = C$1.3427 while the September 30, 2016 closing exchange rate was US$1 = C$1.3117.
- In the fourth quarter of 2016, Air Canada recorded a loss on debt settlements of $82 million which pertained to the C$1.25 billion refinancing transaction concluded on October 6, 2016. In the fourth quarter of 2015, Air Canada recorded a loss on debt settlements of $13 million related to the prepayment of debt associated with the disposal of Embraer 190 aircraft.

08 Fleet

Mainline and Air Canada Rouge

The following table provides Air Canada's and Air Canada Rouge's operating fleet as at December 31, 2016. Refer to the Air Canada Express section below for information on the fleet of aircraft operated by regional airlines operating flights on behalf of Air Canada under capacity purchase agreements with Air Canada:

	Total seats	Number of operating aircraft	Average age	Owned	Finance lease	Owned – special purpose entities (1)	Operating lease
Mainline							
Wide-body aircraft							
Boeing 787-8	251	8	2.2	8	-	-	-
Boeing 787-9	298	13	0.9	11	-	-	2
Boeing 777-300ER	450/400	19	6.5	10	1	-	8
Boeing 777-200LR	300	6	9.1	4	-	-	2
Boeing 767-300ER	211	14	26.5	6	1	-	7
Airbus A330-300	265	8	16.2	4	-	4	-
Narrow-body aircraft							
Airbus A321	185	15	13.7	-	-	5	10
Airbus A320	146	42	23.2	1	-	-	41
Airbus A319	120	18	18.7	5	-	-	13
Embraer 190	97	25	9.5	25	-	-	-
Total Mainline		**168**	**14.7**	**74**	**2**	**9**	**83**
Air Canada Rouge							
Wide-body aircraft							
Boeing 767-300ER (2)	282	20	18.5	2	2	-	16
Narrow-body aircraft							
Airbus A321	200	5	1.0	-	-	-	5
Airbus A319 (2)	136	20	18.5	17	-	-	3
Total Air Canada Rouge		**45**	**16.6**	**19**	**2**	**-**	**24**
Total Mainline and Air Canada Rouge		**213**	**15.1**	**93**	**4**	**9**	**107**

(1) Aircraft under finance leases and aircraft under lease from special purpose entities that are consolidated by Air Canada are carried on Air Canada's consolidated statement of financial position.
(2) The Boeing 767 aircraft and the Airbus A319 aircraft reflected as owned in the table above are owned by Air Canada and leased to Air Canada Rouge.

The following table provides the number of aircraft in Air Canada's operating fleet as at December 31, 2016 as well as Air Canada's planned operating fleet, including aircraft currently operating and expected to be operated by Air Canada Rouge, as at December 31, 2017 and December 31, 2018:

	Actual	Planned			
	December 31, 2016	**2017 Fleet changes**	**December 31, 2017**	**2018 Fleet changes**	**December 31, 2018**
Mainline					
Wide-body aircraft					
Boeing 787-8	8	-	8	-	8
Boeing 787-9	13	9	22	5	27
Boeing 777-300ER	19	-	19	-	19
Boeing 777-200LR	6	-	6	-	6
Boeing 767-300ER	14	(6)	8	(3)	5
Airbus A330-300	8	-	8	-	8
Narrow-body aircraft					
Boeing 737 MAX-8	-	2	2	16	18
Airbus A321	15	-	15	-	15
Airbus A320	42	-	42	-	42
Airbus A319	18	-	18	(8)	10
Embraer 190	25	-	25	-	25
Total Mainline	**168**	**5**	**173**	**10**	**183**
Air Canada Rouge					
Wide-body aircraft					
Boeing 767-300ER	20	4	24	1	25
Narrow-body aircraft					
Airbus A321	5	-	5	-	5
Airbus A319	20	-	20	-	20
Total Air Canada Rouge	**45**	**4**	**49**	**1**	**50**
Total wide-body aircraft	**88**	**7**	**95**	**3**	**98**
Total narrow-body aircraft	**125**	**2**	**127**	**8**	**135**
Total Mainline and Air Canada Rouge	**213**	**9**	**222**	**11**	**233**

Air Canada expects to introduce five Boeing 787-9 aircraft into its operating fleet in 2018 and the remaining two of the 37 aircraft on order in 2019.

Air Canada expects to introduce 16 Boeing 737 MAX aircraft into its operating fleet in 2018 and the remaining 43 of the 61 aircraft on order between 2019 and 2021.

In June 2016, Air Canada and Bombardier finalized a purchase agreement which includes a firm order for 45 Bombardier C-Series CS300 aircraft and options for an additional 30 Bombardier C-Series CS300 aircraft. Deliveries are scheduled to begin in late 2019 and extend to 2022. The first 25 aircraft on delivery are expected to replace Air Canada's existing mainline fleet of Embraer 190 aircraft, with incremental aircraft supporting Air Canada's hub and network growth.

Air Canada Express

The following table provides, as at December 31, 2016, the number of aircraft operated, on behalf of Air Canada, by Jazz, Sky Regional and other airlines operating flights under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada:

	As at December 31, 2016			
	Jazz	Sky Regional	Air Georgian	Total
Embraer 175	-	20	-	20
Bombardier CRJ-100/200	13	-	14	27
Bombardier CRJ-705	16	-	-	16
Bombardier Dash 8-100	19	-	-	19
Bombardier Dash 8-300	26	-	-	26
Bombardier Dash 8-Q400	39	5	-	44
Total Air Canada Express	**113**	**25**	**14**	**152**

The following table provides the number of aircraft planned, as at December 31, 2017, to be operated, on behalf of Air Canada, by Jazz, Sky Regional and other airlines operating flights under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada:

	As at December 31, 2017			
	Jazz	Sky Regional	Air Georgian	Total
Embraer 175	-	25	-	25
Bombardier CRJ-100/200	10	-	14	24
Bombardier CRJ-705	21	-	-	21
Bombardier Dash 8-100	16	-	-	16
Bombardier Dash 8-300	26	-	-	26
Bombardier Dash 8-Q400	44	-	-	44
Total Air Canada Express	**117**	**25**	**14**	**156**

Other aircraft with CPA carriers

Air Georgian and EVAS also operate a total of 16 18-passenger Beech 1900 aircraft on behalf of Air Canada pursuant to their capacity purchase agreements with Air Canada.

09 Financial and Capital Management

9.1 Liquidity

Air Canada manages its liquidity needs through a variety of strategies including by seeking to sustain and improve cash from operations, sourcing committed financing for new and existing aircraft, and through other financing activities.

Liquidity needs are primarily related to meeting obligations associated with financial liabilities, capital commitments, ongoing operations, contractual and other obligations (including pension funding obligations), which are further discussed in sections 9.6 and 9.7 of this MD&A, as well as covenants in credit card and other agreements, discussed in section 9.8 of this MD&A. Air Canada monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available for use as well as those assets being used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. At December 31, 2016, unrestricted liquidity amounted to $3,388 million (comprised of cash and short-term investments of $2,979 million and undrawn lines of credit of $409 million). In addition, Air Canada monitors its financial leverage as measured by the adjusted net debt to EBITDAR ratio, as further described in section 9.3 of this MD&A.

9.2 Financial position

The following table provides a condensed consolidated statement of financial position of Air Canada as at December 31, 2016 and as at December 31, 2015:

(Canadian dollars in millions)	December 31, 2016	December 31, 2015	$ Change
Assets			
Cash, cash equivalents and short-term investments	$ 2,979	$ 2,672	$ 307
Other current assets	1,368	1,453	(85)
Current assets	4,347	4,125	222
Property and equipment	8,520	7,030	1,490
Pension assets	1,153	851	302
Intangible assets	315	314	1
Goodwill	311	311	-
Deposits and other assets	468	496	(28)
Total assets	**$ 15,114**	**$ 13,127**	**$ 1,987**
Liabilities			
Current liabilities	$ 4,424	$ 3,829	$ 595
Long-term debt and finance leases	5,911	5,870	41
Pension and other benefit liabilities	2,436	2,245	191
Maintenance provisions	922	892	30
Other long-term liabilities	202	251	(49)
Total liabilities	**13,895**	**13,087**	**808**
Total equity	**1,219**	**40**	**1,179**
Total liabilities and equity	**$ 15,114**	**$ 13,127**	**$ 1,987**

Movements in current assets and current liabilities are described in section 9.4 "Working Capital" of this MD&A. Long-term debt and finance leases are discussed in sections 9.3 "Adjusted Net Debt" and 9.5 "Consolidated Cash Flow Movements" of this MD&A.

At December 31, 2016, property and equipment amounted to $8,520 million, an increase of $1,490 million from December 31, 2015. The increase in property and equipment was mainly due to additions to property and equipment of $2,889 million, partly offset by the sale of two Boeing 787 aircraft under a sale and leaseback transaction, the disposal of 12 Embraer 190 aircraft and the impact of depreciation expense of $793 million. In 2016, additions to property and equipment included seven Boeing 787-9 aircraft (excluding the two Boeing 787 aircraft under operating lease) and two Boeing 777-300ER aircraft, progress payments on future aircraft deliveries and capitalized maintenance costs.

The net long-term pension and other benefit liabilities of $1,283 million (comprised of pension and other benefit liabilities of $2,436 million net of pension assets of $1,153 million) decreased $111 million from December 31, 2015. This decrease was mainly due to strong investment returns on pension plan assets, partly offset by the impact of a 20 basis point decrease in the discount rate used to value the liabilities, resulting in a net gain on remeasurements on employee benefit liabilities of $412 million recorded in other comprehensive income for 2016.

9.3 Adjusted net debt

The following table reflects Air Canada's adjusted net debt balances as at December 31, 2016 and as at December 31, 2015:

(Canadian dollars in millions, except where indicated)	December 31, 2016	December 31, 2015	$ Change
Total long-term debt and finance leases	$ 5,911	$ 5,870	$ 41
Current portion of long-term debt and finance leases	707	524	183
Total long-term debt and finance leases, including current portion	6,618	6,394	224
Less cash, cash equivalents and short-term investments	(2,979)	(2,672)	(307)
Net debt	**$ 3,639**	**$ 3,722**	**$ (83)**
Capitalized operating leases (1)	3,451	2,569	882
Adjusted net debt	**$ 7,090**	**$ 6,291**	**$ 799**
EBITDAR (trailing 12 months)	**$ 2,768**	**$ 2,542**	**$ 226**
Adjusted net debt to EBITDAR ratio (2)	**2.6**	**2.5**	**0.1**

(1) Adjusted net debt is an additional GAAP financial measure and a key component of the capital managed by Air Canada and provides management with a measure of its net indebtedness. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7. This definition of capitalized operating leases is used by Air Canada and may not be comparable to similar measures presented by other public companies. Aircraft rent (including aircraft rent expense related to regional airline operations) was $493 million for the 12 months ended December 31, 2016 and $367 million for the 12 months ended December 31, 2015.

(2) Adjusted net debt to trailing 12-month EBITDAR ratio (also referred to as "leverage ratio" in this MD&A) is a non-GAAP financial measure and is used by Air Canada as a means to measure financial leverage. Leverage ratio is calculated by dividing adjusted net debt by trailing 12-month EBITDAR. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

At December 31 2016, total long-term debt and finance leases (including current portion) of $6,618 million increased $224 million from December 31, 2015. In 2016, new borrowings amounting to $2,538 million were partly offset by debt repayments of $2,275 million and the favourable $126 million impact of a stronger Canadian dollar as at December 31, 2016 compared to December 31, 2015, on Air Canada's foreign currency denominated debt and finance leases (mainly U.S. dollars).

In October 2016, Air Canada completed a private offering of senior secured notes and a new credit facility in connection with a $1.25 billion refinancing transaction. In connection with this transaction, new debt was issued and together with cash of $444 million, existing debt of $1,674 million was redeemed (including redemption fees of $61 million). Refer to Note 7 of Air Canada's audited consolidated financial statements for 2016 for additional information. In 2016, remaining borrowings and debt repayments were mainly related to aircraft financings.

Adjusted net debt amounted to $7,090 million at December 31, 2016, an increase of $799 million from December 31, 2015. This increase in adjusted net debt reflected higher long-term debt and financial lease balances as discussed above, as well as a higher capitalized operating lease balance, which was mainly driven by additional aircraft leases and an unfavourable currency impact on aircraft rent expense. These increases were partly offset by the impact of higher cash and short-term investment balances year-over-year. At December 31, 2016, the adjusted net debt to EBITDAR ratio was 2.6 versus 2.5 as at December 31, 2015.

At December 31, 2016, Air Canada's weighted average cost of capital ("WACC"), on a pre-tax basis, was approximately 7.9% (compared to approximately 9.6% at December 31, 2015). WACC is based on an estimate by management and consists of an estimated cost of equity of 21.1% and an average cost of debt and finance leases of 4.6% (compared to an estimated cost of equity of 23.6% and an average cost of debt and finance leases of 5.4% at December 31, 2015).

9.4 Working capital

The following table provides information on Air Canada's working capital balances as at December 31, 2016 and as at December 31, 2015:

(Canadian dollars in millions)	December 31, 2016	December 31, 2015	$ Change
Cash, cash equivalents and short-term investments	$ 2,979	$ 2,672	$ 307
Accounts receivable	707	654	53
Other current assets	661	799	(138)
Total current assets	**$ 4,347**	**$ 4,125**	**$ 222**
Accounts payable and accrued liabilities	1,644	1,487	157
Advance ticket sales	2,073	1,818	255
Current portion of long-term debt and finance leases	707	524	183
Total current liabilities	**$ 4,424**	**$ 3,829**	**$ 595**
Net working capital	**$ (77)**	**$ 296**	**$ (373)**

The net negative working capital of $77 million at December 31, 2016 represented a decrease of $373 million from December 31, 2015. This decrease in net working capital was largely due to the use of $444 million of cash to repay long-term debt in connection with the $1.25 billion refinancing transaction completed in October 2016, as further discussed above. The impact of capital expenditures of $2,921 million resulted in a net cash outflow of $1,262 million (after deducting the financing drawn or sale-leaseback proceeds received relating to the delivery of nine Boeing 787 aircraft and two Boeing 777 aircraft) and was more than offset by the cash flow benefit of positive operating results in 2016.

9.5 Consolidated cash flow movements

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

(Canadian dollars in millions)	Fourth quarter			Full year		
	2016	2015	$ Change	2016	2015	$ Change
Net cash flows from operating activities	**$ 351**	**$ 251**	**$ 100**	**$ 2,421**	**$ 2,025**	**$ 396**
Proceeds from borrowings	1,230	314	916	2,538	905	1,633
Reduction of long-term debt and finance lease obligations	(1,807)	(321)	(1,486)	(2,275)	(707)	(1,568)
Shares purchased for cancellation	(5)	(21)	16	(94)	(63)	(31)
Distributions related to aircraft special purpose leasing entities	-	(42)	42	(32)	(51)	19
Issue of shares	1	1	-	2	4	(2)
Financing fees	-	(9)	9	(2)	(32)	30
Net cash flows from (used in) financing activities	**$ (581)**	**$ (78)**	**$ (503)**	**$ 137**	**$ 56**	**$ 81**
Short-term investments	238	119	119	(99)	(398)	299
Additions to property, equipment and intangible assets	(230)	(614)	384	(2,921)	(1,815)	(1,106)
Proceeds from sale of assets	3	6	(3)	352	23	329
Proceeds from sale and leaseback of assets	-	-	-	351	-	351
Other	(16)	(21)	5	(9)	2	(11)
Net cash flows used in investing activities	**$ (5)**	**$ (510)**	**$ 505**	**$ (2,326)**	**$ (2,188)**	**$ (138)**
Effect of exchange rate changes on cash and cash equivalents	**$ 5**	**$ (1)**	**$ 6**	**$ (17)**	**$ 18**	**$ (35)**
Increase (decrease) in cash and cash equivalents	**$ (230)**	**$ (338)**	**$ 108**	**$ 215**	**$ (89)**	**$ 304**

The following table provides the calculation of free cash flow for Air Canada for the periods indicated:

(Canadian dollars in millions)	Fourth quarter			Full year		
	2016	2015	$ Change	2016	2015	$ Change
Net cash flows from operating activities	**$ 351**	**$ 251**	**$ 100**	**$ 2,421**	**$ 2,025**	**$ 396**
Additions to property, equipment and intangible assets, net of proceeds from sale-leaseback transactions	(230)	(614)	384	(2,570)	(1,815)	(755)
Free cash flow (1)	**$ 121**	**$ (363)**	**$ 484**	**$ (149)**	**$ 210**	**$ (359)**

(1) Free cash flow is a non-GAAP financial measure used by Air Canada as an indicator of the financial strength and performance of its business, indicating how much cash it is able to generate from operations and after capital expenditures. Free cash flow is calculated as net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale-leaseback transactions. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

Net cash flows from operating activities and free cash flow

In 2016, net cash flows from operating activities of $2,421 million increased $396 million from 2015. This improvement was due to higher cash earnings (consistent with the growth in EBITDAR of $226 million) and pension funding payments that were $215 million lower in 2016 versus 2015, as further described in section 9.7 of this MD&A. Negative free cash flow of $149 million represented a decrease in free cash flow of $359 million due to a higher level of capital expenditures year-over-year, partly offset by the impact of higher cash flows from operating activities.

In the fourth quarter of 2016, net cash flows from operating activities of $351 million increased $100 million from the same quarter in 2015, mainly due to higher cash earnings and lower pension funding payments, as further described above. Free cash flow of $121 million represented an increase in free cash flow of $484 million due to a lower level of capital expenditures year-over-year, as well as the impact of higher cash flows from operating activities.

9.6 Capital expenditures and related financing arrangements

Boeing 787 aircraft

As of the date of this MD&A, Air Canada had outstanding purchase commitments with Boeing for 13 Boeing 787 aircraft (six of which remain to be delivered in 2017, five in 2018 and two in 2019). Air Canada also has purchase options for 13 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing and delivery positions), and purchase rights for 10 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on Boeing's then current pricing).

Subject to certain conditions, as at the date of this MD&A, Air Canada had various financing or sale and leaseback commitments covering up to 10 of the remaining 13 Boeing 787 firm aircraft orders, which are summarized as follows:

- For seven of the Boeing 787 aircraft, which are scheduled for delivery by 2019, the financing terms are for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments.
- Sale and leaseback transactions with third parties for three Boeing 787 aircraft scheduled for delivery in 2017.

Boeing 737 Aircraft

Air Canada has an agreement with Boeing for the purchase of Boeing 737 MAX aircraft which provides for:

- Firm orders for 33 737 MAX 8 and 28 737 MAX 9 aircraft with substitution rights between them as well as for the 737 MAX 7 aircraft.
- Purchase options for 18 Boeing 737 aircraft.
- Certain rights to purchase an additional 30 Boeing 737 aircraft.

Deliveries of Boeing 737 MAX aircraft are scheduled to begin in 2017 with two aircraft, with the remaining deliveries between 2018 and 2021, subject to deferral and acceleration rights.

Air Canada has financing commitments, subject to certain conditions, covering all 61 of the Boeing 737 MAX firm aircraft orders. The financing terms are for 80% of the aircraft delivery price and the term to maturity is 10 years with mortgage-style repayments.

Bombardier C-Series CS300 aircraft

In June 2016, Air Canada and Bombardier finalized a purchase agreement which includes a firm order for 45 Bombardier C-Series CS300 aircraft and options for an additional 30 Bombardier CS300 aircraft. Deliveries are scheduled to begin in late 2019 and extend to 2022.

Capital commitments

As outlined in the table below, the estimated aggregate cost of the future firm Boeing 787, Boeing 737 MAX and Bombardier C-Series CS300 aircraft deliveries and other capital purchase commitments as at December 31, 2016 approximates $8,433 million:

(Canadian dollars in millions)	2017	2018	2019	2020	2021	Thereafter	Total
Projected committed expenditures	$ 2,142	$ 1,785	$ 1,408	$ 1,438	$ 1,057	$ 603	$ 8,433
Projected planned but uncommitted expenditures	238	283	391	374	443	Not available	Not available
Projected planned but uncommitted capitalized maintenance [(1)]	140	122	114	117	121	Not available	Not available
Total projected expenditures [(2)]	**$ 2,520**	**$ 2,190**	**$ 1,913**	**$ 1,929**	**$ 1,621**	**Not available**	**Not available**

(1) Future capitalized maintenance amounts for 2020 and 2021 and beyond are not yet determinable, however estimates of $117 million and $121 million, respectively, have been made for 2020 and 2021.
(2) U.S. dollar amounts are converted using the December 31, 2016 closing exchange rate of US$1 = C$1.3427. 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 U.S. LIBOR rate at December 31, 2016.

9.7 Pension funding obligations

Air Canada maintains several defined benefit pension plans, including domestic registered pension plans, supplemental pension plans and international pension plans. Air Canada also has several defined contribution pension plans as well as plans providing other retirement and post-employment benefits to its employees.

Total employer pension funding contributions in 2016 amounted to $97 million:

(Canadian dollars in millions)	2016
Past service domestic registered plans	$ 7
Current service domestic registered plans	12
Other pension arrangements [(1)]	78
Total employer pension funding contributions	**$ 97**

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

As at January 1, 2016, the aggregate solvency surplus in the domestic registered pension plans was $1.3 billion. Based on preliminary estimates, including actuarial assumptions, as at January 1, 2017, the aggregate solvency surplus in Air Canada's domestic registered pension plans is projected to be $1.5 billion. The final valuations to be made as at January 1, 2017 will be completed in the first half of 2017. Assuming final valuations confirm that Air Canada's domestic registered pension plans are in a solvency surplus position as at January 1, 2017, Air Canada does not expect any past service cost payments in 2017.

As permitted by applicable legislation and subject to applicable plan rules, amounts in excess of 105% on a solvency basis may be used to reduce current service contributions under the defined benefit component or to fund the employer contribution to a defined contribution component within the same pension plan. As a result, total employer pension funding contributions during 2016 (including the international and supplemental plans) amounted to $97 million. Air Canada does not intend to make current service cost payments for 2017 for plans for which it is allowed to not do so. Taking this into account, on a cash basis, total pension funding contributions for 2017 are forecasted to be $90 million, as described in the table below:

(Canadian dollars in millions)	2017
Past service domestic registered plans	$ -
Current service domestic registered plans	1
Other pension arrangements (1)	89
Total projected employer pension funding contributions	**$ 90**

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

As at December 31, 2016, taking into account the effect of financial instrument risk management tools, approximately 75% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk. Air Canada may continue to increase the percentage of pension liabilities being matched with fixed income products, subject to favourable market conditions.

Refer to the "Pension Plans" discussion in section 17 "Risk Factors" of this MD&A for additional information and a discussion of important risks relating to Air Canada pension funding obligations.

9.8 Contractual obligations

C$1.25 Billion refinancing transaction

On October 6, 2016, Air Canada completed a private offering of senior secured notes and a new credit facility in connection with its C$1.25 billion refinancing transaction. As part of this transaction, Air Canada entered into a purchase agreement with a syndicate of initial purchasers relating to a private offering of C$200 million aggregate principal amount of 4.75% senior secured first lien notes due 2023 (the "2016 Senior Notes"), which were sold at par. Air Canada also received proceeds of a US$800 million term loan, maturing in 2023, and entered into a new, US$300 million revolving credit facility expiring in 2021 (collectively with the term loan, the "2016 Credit Facility"). The revolving credit facility, which remained undrawn as of December 31, 2016, has an initial interest rate of 275 basis points over LIBOR (subject to a LIBOR floor of 75 basis points).

Air Canada used the net proceeds from the sale of the 2016 Senior Notes, together with the borrowings under the term loan under the 2016 Credit Facility, and $444 million of cash on hand, to pay the redemption price for all of Air Canada's then outstanding senior secured notes (the "2013 Secured Notes"), and to repay Air Canada's then outstanding US$300 million term loan.

In conjunction with such repayment and redemption, a loss on debt settlements of $82 million was recorded in the fourth quarter of 2016.

The table below provides Air Canada's contractual obligations as at December 31, 2016, including those relating to interest and principal repayment obligations on Air Canada's long-term debt and finance lease obligations, operating lease obligations and committed capital expenditures:

(Canadian dollars in millions)	2017	2018	2019	2020	2021	Thereafter	Total
PRINCIPAL							
Long-term debt obligations	$ 666	$ 679	$ 514	$ 522	$ 872	$ 3,194	$ 6,447
Finance lease obligations	41	49	46	50	17	72	275
Total principal obligations	**$ 707**	**$ 728**	**$ 560**	**$ 572**	**$ 889**	**$ 3,266**	**$ 6,722**
INTEREST							
Long-term debt obligations	$ 266	$ 222	$ 207	$ 179	$ 134	$ 330	$ 1,338
Finance lease obligations	23	19	15	10	5	20	92
Total interest obligations	**$ 289**	**$ 241**	**$ 222**	**$ 189**	**$ 139**	**$ 350**	**$ 1,430**
Total long-term debt and finance lease obligations	**$ 996**	**$ 969**	**$ 782**	**$ 761**	**$ 1,028**	**$ 3,616**	**$ 8,152**
Operating lease obligations	**$ 572**	**$ 507**	**$ 420**	**$ 305**	**$ 206**	**$ 508**	**$ 2,518**
Committed capital expenditures	**$ 2,142**	**$ 1,785**	**$ 1,408**	**$ 1,438**	**$ 1,057**	**$ 603**	**$ 8,433**
Total contractual obligations (1)	**$ 3,710**	**$ 3,261**	**$ 2,610**	**$ 2,504**	**$ 2,291**	**$ 4,727**	**$ 19,103**

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

Covenants in credit card agreements

Air Canada's principal credit card processing agreements for credit card processing services contain triggering events upon which Air Canada would be required to provide the applicable credit card processor with cash deposits. The obligations to provide cash deposits and the required amount of deposits are each based upon a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for Air Canada and the unrestricted cash and short-term investments of Air Canada. In 2016, Air Canada made no cash deposits under these agreements (nil in 2015).

9.9 Share information

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

	December 31, 2016	December 31, 2015
Issued and outstanding shares		
Class A variable voting shares	86,657,994	98,059,765
Class B voting shares	186,554,808	184,722,413
Total issued and outstanding shares	**273,212,802**	**282,782,178**
Class A variable voting and Class B voting shares potentially issuable		
Stock options	8,985,958	8,735,634
Total shares potentially issuable	**8,985,958**	**8,735,634**
Total outstanding and potentially issuable shares	**282,198,760**	**291,517,812**

Issuer bid

Following receipt of approvals from the Toronto Stock Exchange ("TSX"), in May 2015, Air Canada implemented a normal course issuer bid that expired May 28, 2016, to purchase for cancellation, up to 10 million Class B voting shares and Class A variable voting shares (collectively the "Shares") of Air Canada, and in March 2016, added five million Shares to the normal course issuer bid.

Following the conclusion of this normal course issuer bid, in May 2016, Air Canada received TSX approval and implemented a new normal course issuer bid, authorizing, between May 30, 2016 and May 29, 2017, the purchase of up to 22,785,511 Shares, representing 10% of the public float as at May 16, 2016.

In 2016, pursuant to these normal course issuer bids, the Corporation purchased, for cancellation, 10,768,465 Shares at an average cost of $8.77 per Share for aggregate consideration of $94 million. At December 31, 2016, a total of 18,333,111 Shares remain available for repurchase under the existing normal course issuer bid.

10 Quarterly Financial Data

The following table summarizes quarterly financial results for Air Canada for the last eight quarters:

(Canadian dollars in millions, except where indicated)	2015				2016			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Passenger	$ 2,786	$ 3,082	$ 3,716	$ 2,836	$ 2,864	$ 3,143	$ 4,106	$ 3,035
Cargo	129	123	119	135	116	111	130	155
Other	334	209	188	211	363	204	215	235
Operating revenues	**3,249**	**3,414**	**4,023**	**3,182**	**3,343**	**3,458**	**4,451**	**3,425**
Aircraft fuel	592	648	697	527	446	527	708	598
Regional airlines expense								
Aircraft fuel	86	97	95	81	64	77	96	90
Other	466	497	489	468	505	501	543	532
Wages, salaries & benefits	568	568	598	590	608	611	658	633
Airport and navigation fees	185	201	223	193	198	211	247	203
Aircraft maintenance	188	190	192	203	217	239	227	197
Depreciation, amortization and impairment	153	177	165	160	182	202	220	212
Sales and distribution costs	154	152	157	145	182	170	179	172
Ground package costs	181	84	63	87	231	85	72	101
Aircraft rent	82	84	89	98	112	112	118	120
Food, beverages and supplies	62	80	91	81	77	86	104	82
Communications and IT	57	52	52	50	67	59	56	60
Special items	-	(23)	-	31	-	-	-	91
Other	275	284	297	310	300	301	327	316
Operating expenses	**3,049**	**3,091**	**3,208**	**3,024**	**3,189**	**3,181**	**3,555**	**3,407**
Operating income	**200**	**323**	**815**	**158**	**154**	**277**	**896**	**18**
Foreign exchange gain (loss)	(408)	56	(251)	(159)	50	(17)	(42)	(29)
Interest income	9	12	12	13	10	13	12	13
Interest expense	(90)	(94)	(106)	(99)	(96)	(98)	(97)	(83)
Interest capitalized	9	21	20	20	23	15	12	8
Net financing expense relating to employee benefits	(25)	(25)	(28)	(27)	(18)	(17)	(17)	(24)
Gain (loss) on financial instruments recorded at fair value	1	5	(20)	(3)	(10)	(1)	6	9
Gain on sale and leaseback of assets	-	-	-	-	-	19	-	-
Loss on debt settlements	-	-	-	(13)	(6)	(1)	-	(82)
Other	(5)	(2)	(5)	(6)	(6)	(4)	(2)	(8)
Total non-operating expense	**(509)**	**(27)**	**(378)**	**(274)**	**(53)**	**(91)**	**(128)**	**(196)**
Income (loss) before income taxes	$ (309)	$ 296	$ 437	$ (116)	$ 101	$ 186	$ 768	$ (178)
Income taxes	-	-	-	-	-	-	-	(1)
Net income (loss)	**$ (309)**	**$ 296**	**$ 437**	**$ (116)**	**$ 101**	**$ 186**	**$ 768**	**$ (179)**
Diluted earnings (loss) per share	**$ (1.08)**	**$ 1.00**	**$ 1.48**	**$ (0.41)**	**$ 0.35**	**$ 0.66**	**$ 2.74**	**$ (0.66)**
EBITDAR (1)	**$ 442**	**$ 568**	**$ 1,076**	**$ 456**	**$ 460**	**$ 605**	**$ 1,248**	**$ 455**
Adjusted net income (1)	**$ 122**	**$ 250**	**$ 734**	**$ 116**	**$ 85**	**$ 203**	**$ 821**	**$ 38**
Adjusted earnings per share – diluted (1)	**$ 0.41**	**$ 0.85**	**$ 2.50**	**$ 0.40**	**$ 0.30**	**$ 0.72**	**$ 2.93**	**$ 0.14**

(1) EBITDAR, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.

The following table provides major quarterly operating statistics for Air Canada for the last eight quarters:

System	2015				2016			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Passenger PRASM (cents)	14.9	15.0	15.5	14.7	14.1	13.8	14.2	13.5
CASM (cents)	16.6	15.4	13.6	16.0	16.1	14.2	12.5	15.4
Adjusted CASM (cents) (1)	11.9	11.3	10.0	12.2	12.3	11.2	9.4	11.4
Economic fuel price per litre (cents) (2)	66.3	66.9	61.4	58.6	48.1	52.2	55.2	59.4

(1) Adjusted CASM is a non-GAAP financial measure. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.
(2) Includes aircraft fuel expense related to regional airline operations and fuel handling expenses. Economic fuel price per litre is a non-GAAP financial measure. Refer to section 6 "Results of Operations" of this MD&A for additional information.

The following table provides Air Canada's revenue passenger miles (RPMs), available seat miles (ASMs) and passenger load factors, on a system-basis and by market, for the last eight quarters:

System	2015				2016			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
RPMs (millions)	14,937	16,845	20,462	15,301	16,092	18,418	24,328	17,643
ASMs (millions)	18,335	20,132	23,535	18,869	19,833	22,344	28,458	22,091
Passenger load factor (%)	81.5%	83.7%	86.9%	81.1%	81.1%	82.4%	85.5%	79.9%
Domestic								
RPMs (millions)	3,805	4,525	5,606	4,291	3,960	4,717	6,068	4,534
ASMs (millions)	4,657	5,433	6,649	5,222	4,952	5,678	7,066	5,510
Passenger load factor (%)	81.7%	83.3%	84.3%	82.2%	80.0%	83.1%	85.9%	82.3%
U.S. transborder								
RPMs (millions)	3,191	2,804	2,992	2,768	3,376	3,107	3,613	3,182
ASMs (millions)	3,883	3,384	3,539	3,493	4,278	3,799	4,223	3,985
Passenger load factor (%)	82.2%	82.9%	84.5%	79.2%	78.9%	81.8%	85.6%	79.9%
Atlantic								
RPMs (millions)	2,938	4,864	6,792	3,719	3,401	5,394	8,270	4,437
ASMs (millions)	3,860	5,839	7,640	4,755	4,383	6,805	9,785	5,778
Passenger load factor (%)	76.1%	83.3%	88.9%	78.2%	77.6%	79.3%	84.5%	76.8%
Pacific								
RPMs (millions)	3,026	3,432	3,877	3,202	3,218	3,902	5,002	3,959
ASMs (millions)	3,621	4,000	4,318	3,773	3,732	4,496	5,821	4,977
Passenger load factor (%)	83.6%	85.8%	89.8%	84.9%	86.2%	86.8%	85.9%	79.6%
Other								
RPMs (millions)	1,977	1,220	1,195	1,322	2,137	1,298	1,375	1,531
ASMs (millions)	2,314	1,476	1,389	1,626	2,488	1,566	1,563	1,841
Passenger load factor (%)	85.4%	82.6%	86.0%	81.3%	85.8%	82.9%	87.9%	83.1%

11 Selected Annual Information

The following table provides selected annual information for Air Canada for the years 2014 through to 2016:

(Canadian dollars in millions, except per share figures)	Full year		
	2016	2015	2014
Operating revenues	$ 14,677	$ 13,868	$ 13,272
Operating expenses (1)	13,332	12,372	12,457
Operating income	**1,345**	**1,496**	**815**
Total non-operating expense and income taxes (2)	(469)	(1,188)	(710)
Net income	**876**	**308**	**105**
EBITDAR (3)	**$ 2,768**	**$ 2,542**	**$ 1,660**
Adjusted net income (3)	**$ 1,147**	**$ 1,222**	**$ 531**
Basic earnings per share	**$ 3.16**	**$ 1.06**	**$ 0.35**
Diluted earnings per share	**$ 3.10**	**$ 1.03**	**$ 0.34**
Adjusted earnings per share – diluted (3)	**$ 4.06**	**$ 4.18**	**$ 1.81**
Cash, cash equivalents and short-term investments	**$ 2,979**	**$ 2,672**	**$ 2,275**
Total assets	**$ 15,146**	**$ 13,127**	**$ 10,648**
Total long-term liabilities (4)	**$ 10,178**	**$ 9,782**	**$ 8,728**
Total liabilities	**$ 13,895**	**$ 13,087**	**$ 11,781**

(1) In 2016, Air Canada recorded a special item which increased operating expenses by $91 million. In 2015, Air Canada recorded special items which increased operating expenses by $8 million and recorded impairment charges totalling $14 million. Refer to section 6 of this MD&A for additional information. In 2014, Air Canada recorded special items which reduced operating expenses by $11 million.
(2) In 2016, Air Canada recorded a loss on debt settlements of $89 million of which $82 million was related to a $1.25 billion refinancing transaction and $7 million was related to the prepayment of debt associated with the disposal of Embraer 190 aircraft. In 2015, Air Canada recorded a loss on debt settlements of $13 million related to the prepayment of debt associated with the disposal of Embraer 190 aircraft.
(3) EBITDAR, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 19 "Non-GAAP Financial Measures" of this MD&A for additional information.
(4) Total long-term liabilities include long-term debt (including current portion) and finance leases, pension and other benefit liabilities, maintenance provisions and other long-term liabilities.

12 Financial Instruments and Risk Management

Summary of gain (loss) on financial instruments recorded at fair value

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

(Canadian dollars in millions)	Fourth quarter		Full year	
	2016	2015	2016	2015
Fuel derivatives	$ -	$ -	$ -	$ (11)
Share forward contracts	9	(4)	9	(9)
Prepayment options on senior secured notes	-	1	(5)	1
Interest rate swaps	-	-	-	2
Financial instruments recorded at fair value	**$ 9**	**$ (3)**	**$ 4**	**$ (17)**

Risk management

Under its risk management policy, Air Canada manages its fuel price risk, foreign exchange risk and interest rate risk through the use of various financial derivative instruments. Air Canada uses these instruments solely for risk management purposes and not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows of the relevant risk being hedged.

As noted below, Air Canada uses derivative instruments to provide economic hedges to mitigate certain risks. The fair values of these instruments represent the amount of the consideration that could be exchanged in an arm's-length transaction between willing parties who are under no compulsion to act. The fair value of these derivatives is determined using prices in active markets, where available. When no such market is available, valuation techniques are applied such as discounted cash flow analysis. The valuation techniques incorporate all factors that would be considered in setting a price, including Air Canada's and the counterparty's respective credit risk.

Fuel price risk management

Fuel price risk is the risk that future cash flows will fluctuate because of changes in jet fuel prices. In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, Air Canada enters into derivative contracts with financial intermediaries. Air Canada may use derivative contracts based on jet fuel, heating oil and crude-oil. Air Canada's policy permits hedging of up to 75% of the projected jet fuel purchases required for the next 12 months, 50% for the next 13 to 24 months and 25% for the next 25 to 36 months. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. Air Canada performs regular reviews to assess market conditions and adjust its hedging strategy where management considers it warranted.

In 2016:

- Air Canada recorded hedging gains on the settlement of fuel derivatives of $23 million and the associated premium costs of $46 million, for a net hedging loss of $23 million which was reclassified from other comprehensive income to aircraft fuel expense (net fuel hedging loss of $10 million was reclassified from other comprehensive income to aircraft fuel expense in 2015). No hedge ineffectiveness was recorded. For derivatives not designated under hedge accounting, a loss of $11 million was recorded in gain (loss) on financial instruments recorded at fair value in 2015 on Air Canada's consolidated statement of operations.
- Air Canada purchased crude-oil call options covering a portion of its 2016 and 2017 fuel exposure. The cash premium related to these contracts was $34 million ($39 million in 2015 for 2015 and 2016 exposures).
- Fuel derivative contracts cash settled with a fair value of $23 million in favour of Air Canada ($1 million in favour of Air Canada in 2015).

As of December 31, 2016, approximately 9% of Air Canada's anticipated purchases of jet fuel for 2017 are hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US$52 per barrel for WTI prices up to US$57 per barrel and at an average equivalent capped price of US$57 per barrel for WTI prices above US$63 per barrel. Air Canada's contracts to hedge anticipated jet fuel purchases over the 2017 period are comprised of call options with notional volumes of 2,973,000 barrels. The fair value of the fuel derivatives portfolio at December 31, 2016 is $14 million in favour of Air Canada (2015 – $10 million in favour of Air Canada) and is recorded within prepaid expenses and other current assets on Air Canada's consolidated statement of financial condition.

Foreign exchange risk management

Air Canada's financial results are reported in Canadian dollars, while a large portion of its expenses, debt obligations and capital commitments are in foreign currencies, primarily U.S. dollars. Foreign exchange risk is the risk that fluctuations in foreign exchange rates may have on operating results and cash flows. Air Canada's risk management objective is to reduce cash flow risk related to foreign denominated cash flows.

Air Canada generates certain sales in U.S. dollars and in other foreign currencies which are converted to U.S. dollars under Air Canada's risk management program. In 2016, these net operating cash inflows totalled approximately US$3.2 billion. Also in 2016, U.S. denominated operating costs amounted to approximately US$3.5 billion. Non-operating cash outflows in U.S. dollars, primarily related to interest payments on U.S. dollar denominated debt and net financing outflows amounted to approximately US$1.8 billion. For 2016, this resulted in a U.S. dollar net cash flow exposure of approximately US$2.1 billion. Air Canada has a target coverage of 70% on a rolling 18 month basis to manage the net U.S. dollar cash flow exposure described above utilizing the following risk management strategies:

Air Canada holds U.S. cash reserves as an economic hedge against changes in the value of the U.S. dollar. As at December 31, 2016, U.S. dollar cash and short-term investment balances amounted to $560 million (US$416 million) ($490 million (US$358 million) as at December 31, 2015). A portion of the cash and investment reserves are an economic hedge against long-term U.S. dollar debt while the remainder of the cash is operational cash and investment reserves which are applied against the rolling 18 month net U.S. dollar cash flow exposure. In 2016, a loss of $25 million (gain of $123 million in 2015) was recorded in foreign exchange gain (loss) on Air Canada's consolidated statement of operations reflecting the change in Canadian equivalent market value of the U.S. dollar cash and short-term investment balances held.

The level of foreign exchange derivatives entered into and their related maturity dates are dependent upon a number of factors, including the amount of foreign revenue conversion available, U.S. dollar net cash outflows, as well as the amount attributed to aircraft and debt payments. Based on the notional amount of currency derivatives outstanding at December 31, 2016, as further described below, approximately 80% of net U.S. cash outflows are hedged for 2017 and 29% for 2018, resulting in derivative coverage of 68% over the next 18 months. Operational U.S. dollar cash and investment reserves combined with derivative coverage results in a coverage of 73%.

As at December 31, 2016, Air Canada had outstanding foreign currency options and swap agreements, settling in 2017 and 2018, to purchase at maturity $2,612 million (US$1,946 million) of U.S. dollars at a weighted average rate of $1.2898 per US$1.00 (2015 – $3,234 million (US$2,337 million) with settlements in 2016 and 2017 at a weighted average rate of $1.2683 per US$1.00). Air Canada also has protection in place to sell a portion of its excess Euros, Sterling, Yen, Yuan and AUD (EUR €82 million, GBP £69 million, JPY ¥2,334 million, CNY ¥53 million and AUD $33 million) which settle in 2017 at weighted average rates of €1.1059, £1.2589, ¥0.0096, ¥0.1522 and $0.7500 per US$1.00, respectively (2015 – EUR €42 million, GBP £9 million, JPY ¥2,052 million, CNY ¥288 million and AUD $18 million with settlement in 2016 at weighted average rates of €1.1663, £1.6150, ¥0.0088, ¥0.1562 and $0.7230 respectively per US$1.00).

The hedging structures put in place have various option pricing features, such as knock-out terms and profit cap limitations, and based on the assumed volatility used in the fair value calculation, the net fair value of these foreign currency contracts as at December 31, 2016 was $5 million in favour of Air Canada (2015 – $89 million in favour of Air Canada). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2016, a loss of $136 million was recorded in Foreign exchange gain (loss) related to these derivatives (2015 – $164 million gain). In 2016, foreign exchange derivative contracts cash settled with a net fair value of $51 million in favour of the counterparties ($104 million in 2015 in favour of the Air Canada). The total combined loss, related to U.S. cash, investments and foreign exchange derivatives recorded by Air Canada in 2016 was $160 million ($287 million gain in 2015).

Interest rate risk management

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

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

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in Air Canada's capital structure and is based upon a long-term objective of 60% fixed and 40% floating but allows the flexibility to adjust to prevailing market conditions. The ratio at December 31, 2016, was 76% fixed and 24% floating (79% and 21%, respectively, as at December 31, 2015).

13 Critical Accounting Estimates and Judgments

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

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

Employee future benefits

Air Canada maintains several defined benefit plans providing pension, other retirement and post-employment benefits to its employees. The cost and related liabilities of Air Canada's pensions, other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations involve assumptions, including discount rates, future salary increases, mortality rates and future benefit increases. Also, due to the long-term nature of these programs, such estimates are subject to significant uncertainty.

Assumptions

Management is required to make significant estimates about actuarial and financial assumptions to determine the cost and related liabilities of Air Canada's employee future benefits.

Financial assumptions

Discount rate

The discount rate used to determine the pension obligation was determined by reference to market interest rates on corporate bonds rated "AA" or better with cash flows that approximate the timing and amount of expected benefit payments.

Future increases in compensation are based upon the current compensation policies, labour and employment agreements and economic forecasts.

The significant weighted average assumptions used to determine Air Canada's accrued benefit obligations and cost are as follows:

	Pension benefits		Other employee future benefits	
	2016	2015	2016	2015
Discount rate used to determine:				
Net interest on the net benefit obligation for the year ended December 31	4.1%	4.0%	4.1%	3.9%
Service cost for the year end December 31	4.3%	4.2%	4.3%	4.1%
Accrued benefit obligation as at December 31	3.9%	4.1%	3.9%	4.1%
Rate of future increases in compensation used to determine:				
Accrued benefit cost for the year ended December 31	2.5%	2.5%	not applicable	not applicable
Accrued benefit obligation as at December 31	2.5%	2.5%	not applicable	not applicable

Sensitivity analysis

Sensitivity analysis is based on changing one assumption while holding all other assumptions constant. In practice, this may be unlikely to occur, and changes in some of the assumptions may be correlated. When calculating the sensitivity of the defined benefit obligation to variations in significant actuarial assumptions, the same method (present value of the defined benefit obligation calculated with the projected unit credit method at the end of the reporting period) has been applied as that used for calculating the liability recognized in the consolidated statement of financial position.

Sensitivity analysis on 2016 pension expense and net financing expense relating to pension benefit liabilities, based on different actuarial assumptions with respect to discount rate is set out below. The effects on each pension plan of a change in an assumption are weighted proportionately to the total plan obligation to determine the total impact for each assumption presented.

	0.25 Percentage point	
	Decrease	Increase
Discount rate on obligation assumption		
Pension expense	$ 19	$ (18)
Net financing expense relating to pension benefit liabilities	22	(18)
Total	**$ 41**	**$ (36)**
Increase (decrease) in pension obligation	**$ 678**	**$ (655)**

The increase (decrease) in the pension obligation for a 0.25 percentage point change in the discount rate relates to the gross amount of the pension liabilities and is before the impact of any change in plan assets. As at December 31, 2016, approximately 75% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk.

An increase of one year life expectancy would increase the pension benefit obligation by $465 million.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 5.8% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2016 (2015 – 5.5%). The rate is assumed to decrease to 5% by 2020 (2015 – assumed to decrease gradually to 5% by 2019). A one percentage point increase in assumed health care trend rates would have increased the total of current service and interest costs by $4 million and the obligation by $62 million. A one percentage point decrease in assumed health care trend rates would have decreased the total of current service and interest costs by $4 million and the obligation by $62 million.

A 0.25 percentage point decrease in discount rate would have increased the total of current and interest costs by less than $1 million and the obligation by $55 million. A 0.25 percentage point increase in discount rate would have decreased the total of current and interest costs by less than $1 million and the obligation by $43 million.

Impairment considerations of long-lived assets

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

Depreciation and amortization period for long-lived assets

Air Canada makes estimates about the expected useful lives of long-lived assets and the expected residual value of the assets based on the estimated current fair value of the assets, Air Canada's fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by a variety of factors, including changes to maintenance programs, changes in jet fuel prices and other operating costs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. Estimates and assumptions are evaluated at least annually. Generally, these adjustments are accounted for on a prospective basis, through depreciation and amortization expense. For the purposes of sensitivity analysis on these estimates, a 50% reduction to residual values on aircraft with remaining useful lives greater than five years results in an increase of $16 million to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.

Maintenance provisions

The recording of maintenance provisions related to return conditions on aircraft leases requires management to make estimates of the future costs associated with the maintenance events required under the lease return condition and estimates of the expected future maintenance condition of the aircraft at the time of lease expiry. These estimates take into account current costs of these maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in maintenance expense in the period. The effect of any changes in estimates, including changes in discount rates, inflation assumptions, cost estimates or lease expiries, is also recognized in maintenance expense in the period. Assuming the aggregate cost for return conditions increases by 5%, holding all other factors constant, there would be a cumulative balance sheet adjustment to increase the provision by $51 million at December 31, 2016 and an increase to maintenance expense in 2017 of approximately $7 million. For illustrative purposes, if the discount rates were to increase by 1%, holding all other factors constant, there would be a cumulative balance sheet adjustment to decrease the provision by $17 million at December 31, 2016. Due to low market rates of interest, a 1% decrease in discount rates was not considered a reasonable scenario.

Income taxes

Deferred income tax assets are recognized only to the extent that it is probable that future taxable income will be available to realize them. In making this assessment, consideration is given to available positive and negative evidence and relevant assumptions. Consideration is given to, among other things, future projections of taxable income, overall business environment, historical financial results, and industry-wide trends and outlooks. At December 31, 2016, no deferred income tax assets were recorded. Income for 2016 and the previous year provides positive evidence, however based upon the weight of other factors, in particular historical financial results for Air Canada and the airline industry's historically cyclical results, determination was made that deferred income tax assets could not be recorded at December 31, 2016. Air Canada's income position and income trend will continue to be evaluated to assess the realizability of the deferred income tax assets.

14 Accounting Policies

Accounting standards and amendments issued but not yet adopted

The following is an overview of accounting standard changes that Air Canada will be required to adopt in future years. Air Canada continues to evaluate the impact of these standards on its consolidated financial statements.

IFRS 15 – Revenue from contracts with customers

IFRS 15 replaces IAS 18 Revenue and related interpretations. The core principle of the new standard is to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard is intended to enhance disclosures about revenue, provide more comprehensive guidance for transactions that were not previously addressed and improve guidance for multiple-element arrangements. IFRS 15 is effective for annual periods beginning on January 1, 2018, with early adoption permitted.

Air Canada will apply the standard effective January 1, 2018. The standard will be applied retrospectively with adjustment to the opening consolidated statement of financial position as at January 1, 2017. Under IFRS 15, incremental costs of obtaining passenger revenues, such as credit card fees and global distribution system charges, will be capitalized at time of sale and expensed at the time of passenger revenue recognition. Currently, these costs are expensed as incurred at the time the flight ticket is sold. With this change in accounting policy for contract costs, the timing of expense recognition will be impacted. Air Canada continues to evaluate the financial impact of this expected change to capitalize contract costs along with other possible impacts of this standard on its consolidated financial statements.

IFRS 16 – Leases

IFRS 16 replaces IAS 17 Leases and related interpretations. The core principle is that a lessee recognize assets and liabilities for all leases with a lease term of more than 12 months. A lessee is required to recognize a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments. Assets and liabilities arising from a lease are initially measured on a present value basis. The measurement includes non-cancellable lease payments (including inflation-linked payments), and also includes payments to be made in optional periods if the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease. The new standard is intended to provide a faithful representation of leasing transactions, in particular those that do not currently require the lessees to recognize an asset and liability arising from an operating lease. IFRS 16 is effective for annual periods beginning on January 1, 2019, with early adoption permitted for entities that would also apply IFRS 15 Revenue from Contracts with Customers.

Air Canada continues to evaluate the impact the adoption of this standard will have on its consolidated financial statements, but expects this standard will have a significant impact on its consolidated balance sheet, along with a change to the recognition, measurement and presentation of lease expenses in the consolidated statement of operations. Air Canada expects to apply the standard with its mandatory effective date.

15 Off-Balance Sheet Arrangements

Guarantees

Guarantees in fuel facilities arrangements

Air Canada participates in fuel facility arrangements operated through eight Fuel Facility Corporations, and two aircraft de-icing service facilities, along with other airlines that contract for fuel and de-icing services at various major airports in Canada. These entities operate on a cost recovery basis. The aggregate debt of these entities that has not been consolidated by Air Canada under IFRS 10 Consolidated Financial Statements is approximately $487 million as at December 31, 2016 (December 31, 2015 – $425 million), which is Air Canada's maximum exposure to loss before taking into consideration the value of the assets that secure the obligations and any cost sharing that would occur amongst the other contracting airlines. Air Canada views this loss potential as remote. Each contracting airline participating in these entities shares pro rata, based on system usage, in the guarantee of this debt. The maturities of these debt arrangements vary but generally extend beyond five years.

Indemnification agreements

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

Air Canada expects that it would be covered by insurance for most tort liabilities and certain related contractual indemnities.

16 Related Party Transactions

At December 31, 2016, Air Canada had no transactions with related parties as defined in the CPA Handbook, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

17 Risk Factors

The risks described below should be read carefully when evaluating Air Canada's business and the forward-looking statements contained in this report and other statements Air Canada may make from time to time. Any of these risks could materially and adversely affect Air Canada's business, operating results, financial condition and the actual outcome of matters as to which forward-looking statements are made. In addition, these risks may not be the only risks faced by Air Canada. Other risks of which Air Canada is not aware or which Air Canada currently deems not to be material may surface and have a material and adverse impact on Air Canada, its business, results from operations and financial condition.

Risks relating to air canada

Operating results

Air Canada may sustain significant losses and not be able to successfully achieve and/or sustain positive net profitability or realize the objectives of any or all of its initiatives

A variety of factors, including economic conditions and other factors described in this "Risk Factors" section, may result in Air Canada incurring significant losses (which it has incurred in the past). Despite ongoing strategic and business initiatives, including efforts at securing cost reductions, revenue improvements and international growth as well as efforts relating to its seat capacity expansion and the expansion of Air Canada Rouge, Air Canada may not be able to successfully achieve and/or sustain positive net profitability or realize the objectives of any or all of its initiatives, including those which seek to decrease costs, improve margins, profitably deploy additional capacity, generate sufficient returns on its capital expenditures (including those related to the additional capacity) or offset or mitigate risks facing Air Canada, including those relating to economic conditions, foreign exchange rates, competition, labour issues, liquidity, and volatility in fuel costs and other expenses.

Leverage

Air Canada has, and is expected to continue to incur, a significant amount of indebtedness, and there can be no assurance that it will be able to pay its debts and lease obligations

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

The ability of Air Canada to make scheduled payments under its indebtedness will depend on, among other things, its future operating performance and its ability to refinance its indebtedness, if necessary. In addition, as Air Canada incurs indebtedness which bears interest at floating interest rates, to the extent these interest rates increase, its interest expense will increase. Moreover, Air Canada incurs a significant proportion of its indebtedness in foreign currencies, primarily in U.S. dollars, and as a result future debt servicing repayments are subject to foreign exchange risk and the Canadian equivalent amount of indebtedness may increase. There can be no assurance that Air Canada will at all times be able to generate sufficient cash from its operations to pay its debts and lease obligations. Each of these factors is, to a large extent, subject to economic, financial, competitive, regulatory, operational and other factors, many of which are beyond Air Canada's control.

Foreign exchange

A significant deterioration of the Canadian dollar relative to the U.S. dollar could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada's financial results are sensitive to the fluctuating value of the Canadian dollar. In particular, Air Canada has a significant annual net outflow of U.S. dollars and is affected by fluctuations in the U.S./Canadian dollar exchange rate. Air Canada incurs significant expenses in U.S. dollars for items such as fuel, aircraft maintenance, airport charges, ground package costs, sales and distribution costs, interest and debt servicing payments, while a substantial portion of its revenues are generated in Canadian dollars. Due to the competitive nature of the airline industry and customer sensitivity to travel costs, Air Canada may not be able to pass on increases in foreign exchange costs to its customers by increasing its fares. In addition, Air Canada may be unable to appropriately or sufficiently hedge the risks associated with fluctuations in exchange rates. A significant deterioration of the Canadian dollar relative to the U.S. dollar or other foreign currencies would increase the costs of Air Canada relative to its U.S. or other foreign competitors. Any of these factors could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Economic and geopolitical conditions

Changes in economic and geopolitical conditions could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Airline operating results are sensitive to economic and geopolitical conditions which can have a significant impact on Air Canada. For example, economic and geopolitical conditions may impact demand for air transportation in general or to or from certain destinations, and may also impact Air Canada's operating costs, operating revenues (including by impacting our ability to repatriate funds from foreign jurisdictions), costs and availability of fuel, foreign exchange costs, pension plan contributions, and costs and availability of capital and supplies required by Air Canada. Especially in light of Air Canada's substantial fixed cost structure, any prolonged or significant impact arising from economic and geopolitical conditions, including weakness of the Canadian, U.S. or world economies, or threatened or actual outbreaks of hostilities in or adjacent to regions Air Canada serves or over which it operates flights (or to regions it plans to do so), could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Airline fares and passenger demand have fluctuated significantly in the past and may fluctuate significantly in the future. Air Canada is not able to predict with certainty market conditions and the fares that Air Canada may be able to charge. Customer expectations can change rapidly and the demand for lower fares may limit revenue opportunities. Travel, especially leisure travel, is a discretionary consumer expense. Demand for business and premium travel is also impacted by economic conditions. Depressed economic conditions in areas served by Air Canada, geopolitical instability in various areas of the world and concerns about the environmental impacts of air travel and tendencies towards "green" travel initiatives where customers reduce their travel activities, could each have the effect of reducing demand for air travel in Canada and abroad and could materially adversely impact Air Canada, its business, results of operations and financial condition.

Fuel costs

Significant fluctuations or increases in fuel prices could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Fuel costs constitute one of Air Canada's largest operating cost items. Fuel prices have and may continue to fluctuate widely depending on many factors, including international market conditions, geopolitical events, jet fuel refining costs and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict fuel prices. Due to the competitive nature of the airline industry, Air Canada may not be able to pass on increases in fuel prices to its customers by increasing its fares. In addition, Air Canada may be unable to appropriately or sufficiently hedge the risks associated with fluctuations in fuel prices. Furthermore, the impact of lower jet fuel prices could be offset by increased price competition, and a resulting decrease in revenues, for all air carriers. Significant fluctuations (including increases) in fuel prices could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Competition

Air Canada operates in a highly competitive environment and faces increasing competition in North America and internationally

Air Canada operates within a highly competitive industry and continuously encounters substantial price competition. Carriers, including low-cost carriers, have entered, announced their intention to enter or continue to enter or expand into the domestic (including regional), the U.S. transborder and international markets, as well as leisure-oriented markets in which Air Canada operates or plans to operate.

Carriers against which Air Canada competes, including U.S. carriers, may also undergo (and some have undergone) substantial reorganizations (including by way of merger with or acquisition by another carrier), creating reduced levels of indebtedness and lower operating costs and may therefore be in a position to more effectively compete against Air Canada. Consolidation within the airline industry and carriers increasingly entering into integrated commercial cooperation arrangements, such as joint ventures, which may be able to compete more effectively, could result in increased competition.

The proximity of several American airports in cities close to the Canadian border (such as Plattsburgh, Buffalo and Bellingham) has also presented an additional challenge for Air Canada. Higher taxes, charges and fees for passengers departing from Canada has redirected appreciable passenger traffic away from Canadian airports to airports in the United States. Low-cost carriers based in the United States have and may continue to increase their capacity at these airports and attract Canadian-originating, price-sensitive customers.

Given Canada's diverse and multicultural population, Canadian gateways such as Toronto, Montreal and Vancouver are deemed attractive by international carriers. In 2016, foreign carriers such as AeroMexico, Air China, Beijing Capital Airlines, Brussels Airlines, China Airlines, China Eastern Airlines, China Southern Airlines, EVA Air, Hainan Airlines, Hong Kong Airlines, Icelandair, Korean Air, TAP Portugal, Tunisair, WOW Air and Xiamen Air have entered or announced their intention to enter or expand their international operations into Canada.

The prevalence of Internet travel websites and other travel product distribution channels has also resulted in a substantial increase in discounted and promotional fares initiated by Air Canada's competitors. Competitors also continue to pursue commissions/incentive actions and, in many cases, increase these payments.

Air Canada's ability to reduce its fares in order to effectively compete is dependent on Air Canada's ability to achieve acceptable operating margins and may be limited by government policies to encourage competition. A decision by Air Canada to match competitors' fares or react to other competitive actions could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Increased competition, from existing, emerging or new competitors, including competitors utilizing disruptive business models or technologies, and other competitive actions, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Need for additional capital and liquidity

Air Canada may not be able to obtain sufficient funds in a timely way and on acceptable terms to provide adequate liquidity and to finance necessary operating and capital expenditures

Air Canada's liquidity levels may be adversely impacted by risks identified in this MD&A, including economic conditions, foreign exchange rates, increased competition from domestic, international and U.S. transborder carriers, including low-cost carriers, volatile fuel prices, labour issues and contractual covenants (which require Air Canada to maintain minimum cash reserves and which could require Air Canada to deposit cash collateral with third parties). As part of Air Canada's efforts to manage such challenges and to support Air Canada's business strategy, significant liquidity and significant ongoing operating and capital expenditures are required. There can be no assurance that Air Canada will continue to be able to obtain, on a timely basis, sufficient funds on terms acceptable to Air Canada to provide adequate liquidity and to finance the operating and capital expenditures necessary to manage any challenges and support its business strategy if cash flows from operations and liquidity levels are insufficient.

A major decline in the market price of Air Canada's securities may negatively impact Air Canada's ability to raise capital, issue debt, retain employees, make strategic acquisitions or enter into joint arrangements. Differences between Air Canada's actual or anticipated financial results and the published expectations of financial analysts, as well as events affecting our business or operating environment, may contribute to volatility in Air Canada's securities. A major decline in the capital markets in general, or an adjustment in the market price or trading volumes of Air Canada's securities, may negatively affect our ability to raise capital, issue debt, retain senior executives and other key employees, make strategic acquisitions or enter into joint arrangements.

Failure to generate additional funds, whether from operations or additional debt or equity financings, could require Air Canada to delay or abandon some or all of its anticipated expenditures or to modify its business strategy and could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Furthermore, competitors with greater liquidity or the ability to raise money more easily or on less onerous terms could represent a competitive disadvantage to Air Canada.

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

Dependence on technology

Air Canada relies heavily on technology to operate its business and any technology systems failure or data breach could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada relies heavily on technology, including computer and telecommunications equipment and software and Internet-based systems, to operate its business, increase its revenues and reduce its costs. These systems include those relating to Air Canada's telecommunications, websites, computerized airline reservations and its airport customer services and flight operations. Air Canada also depends on the performance of its many suppliers, whose performance is in turn dependent upon their respective technology systems.

As part of regular business operations, Air Canada collects, processes and stores sensitive data, including personal information of our passengers and employees and information of our business partners. The secure operation of the networks and systems on which this type of information is stored, processed and maintained is critical to our business.

Technology systems may be vulnerable to a variety of sources of failure, interruption or misuse, including by reason of human error, third party suppliers' acts or omissions, natural disasters, terrorist attacks, telecommunications failures, power failures, computer viruses, unauthorized or fraudulent users (including cyber-attacks or cyber intrusions, malware, ransomware, computer viruses and the like), and other operational and security issues.

It is generally viewed that cyber-attacks have and will continue to increase in both prevalence and sophistication. Air Canada continually pursues and invests in initiatives, including security initiatives and disaster recovery plans; however these pursuits or initiatives may not be successful or adequate. Any technology systems failure, interruption or misuse, security breach or failure to comply with applicable data confidentiality, privacy or security obligations, whether at Air Canada or a third party on whom Air Canada relies, could adversely affect Air Canada's reputation and expose Air Canada to litigation, claims for contract breach, fines, sanctions or otherwise materially and adversely affect Air Canada's operations, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Strategic, business, technology and other important initiatives

A delay or failure to identify and devise, invest in and implement certain important initiatives could have a material impact on Air Canada, its business, results from operations and financial condition

In order to operate its business, achieve its goals and remain competitive, Air Canada continually seeks to identify and devise, invest in, implement and pursue strategic, business, technology and other important initiatives, such as those relating to participation in the leisure or low-cost market (including the planned growth of Air Canada Rouge), the aircraft fleet renewal program (including the scheduled delivery of Boeing 787 aircraft and the planned re-fleeting of narrow-body aircraft with Boeing 737 MAX aircraft and Bombardier C-Series aircraft), revenue enhancement initiatives, business processes, information technology, revenue management, cost transformation, improving premium passenger revenues, expansion of flying capacity (including in respect of new aircraft and routes), corporate culture transformation, initiatives seeking to ensure a consistently high-quality customer service experience and others. These initiatives, including activities relating to their development and implementation, may be adversely impacted by a wide range of factors, many of which are beyond Air Canada's control. Such factors include the need to seek legal or regulatory approvals, the performance of third parties (including suppliers), the implementation and integration of such initiatives into Air Canada's other activities and processes as well as the adoption and acceptance of these initiatives by Air Canada's customers, suppliers, unions and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement these initiatives could adversely affect Air Canada's ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

For instance, a key component of Air Canada's business plan is the acquisition of new and more efficient aircraft such as Boeing 787, 737 MAX aircraft and Bombardier C-Series aircraft. A delay or failure in the completion of Air Canada's fleet restructuring, including delays by suppliers involved in the delivery of these aircraft, or an inability to remove, as planned, certain aircraft from the fleet in coordination with the planned entry into service of new aircraft, could adversely affect the implementation of Air Canada's business plan which could, in turn, have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Airport user fees and air navigation fees

Increases in airport user fees and air navigation fees could have a material adverse effect on Air Canada, its business, results from operation and financial condition

With the privatization of airports and air navigation authorities in Canada, airport and air navigation authorities have or could significantly increase their fees. Air Canada may not be in a position to prevent or develop alternatives to overcome fee increases. Though certain authorities have implemented some fee reductions, if authorities in Canada or elsewhere were to significantly increase their fees, Air Canada, its business, results from operations and financial condition could be materially adversely affected.

High fixed costs and low margins

The airline industry is characterized by low profit margins and high fixed costs

The airline industry has historically been characterized by low profit margins and high fixed costs. The costs of operating any particular flight do not vary significantly with the number of passengers carried and, therefore, a relatively small change in the number of passengers, fare pricing or traffic mix could have a significant impact on Air Canada's operating and financial results. This condition may be exacerbated by aggressive pricing by competitors, which could have the effect of driving down fares in certain markets. Accordingly, a shortfall from expected revenue levels or profit margins could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Air Canada has sought an improved ability to weather downturns in its business; however such efforts may not be successful. As a result of high fixed costs, should Air Canada be required to reduce its overall capacity or the number of flights operated, it may not be able to successfully reduce certain fixed costs within a time frame required to overcome any downturns, and Air Canada may also be required to incur significant termination or other restructuring costs, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key supplies and suppliers

Air Canada's failure or inability to obtain certain goods and services from key suppliers on favourable terms could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services of desirable quality, in a timely manner, including those available at airports or from airport authorities, or otherwise required for Air Canada's business or operations, such as fuel, aircraft and related parts, aircraft maintenance services, and information technology systems and services. In certain cases, Air Canada may only be able to access goods and services from a limited number of suppliers (or from sole source suppliers) and the transition to new or alternative suppliers, which may be necessitated by reason of such suppliers increasing their rates or by their failure to perform, may not be possible or may take a significant amount of time or require significant resources. A failure, refusal or inability of a supplier may arise as a result of a wide range of causes, many of which are beyond Air Canada's control. Any failure or inability of Air Canada to successfully source goods and services, or to source goods and services of desirable quality on terms and pricing and within the time frames acceptable to Air Canada, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Regional carriers

The failure by regional carriers to fulfill their obligations to Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada seeks to enhance its network through capacity purchase agreements with regional airlines such as Jazz, Sky Regional and other airlines operating flights on behalf of Air Canada. For example, under the Jazz CPA, Jazz provides Air Canada's customers service in lower-density markets and higher-density markets at off-peak times throughout Canada and to and from certain destinations in the United States and also provides valuable traffic feed to Air Canada's mainline and Air Canada Rouge routes. Pursuant to the terms of the Jazz CPA, Air Canada pays Jazz a number of fees, some of which are fixed and others which are determined based upon certain costs incurred by Jazz. Air Canada also reimburses Jazz for certain pass-through costs incurred by Jazz, such as fuel, navigation, landing and terminal fees. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization guarantee which requires Air Canada to utilize Jazz for that amount of flying. Significant increases in Jazz's costs, the failure by Jazz to adequately fulfill its obligations under the Jazz CPA, factors which may reduce the utilization of the Jazz fleet, including economic or market downturns, and unexpected interruptions or cessation of Jazz's services could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

The failure by Air Canada's other regional carriers to fulfill their obligations under their respective agreements, or unexpected interruptions or disruptions of their services, as well as minimum guarantees in capacity purchase agreements which may limit Air Canada's ability to effectively manage regional capacity in response to economic downturns, market pressures or other external events, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Labour costs and labour relations

Air Canada may not be able to maintain labour costs at appropriate levels or secure labour agreements which permit it to successfully pursue its strategic initiatives. There can be no assurance that collective bargaining agreements will be further renewed without labour conflicts and/or disruptions

Labour costs constitute one of Air Canada's largest operating cost items. There can be no assurance that Air Canada will be able to maintain such costs at levels that do not negatively affect its business, results from operations and financial condition. Most of Air Canada's employees are unionized. While Air Canada has established long-term arrangements with unions representing a significant portion of its unionized employees, there can be no assurance that future agreements with employees' unions or the outcome of arbitrations will be on terms consistent with Air Canada's expectations or comparable to agreements entered into by Air Canada's competitors. Any future agreements or outcomes of negotiations or arbitrations, including in relation to wages or other labour costs or work rules, may result in increased labour costs or other charges, or terms and conditions restricting or reducing, Air Canada's ability to sustain its business objectives or pursue its strategic initiatives, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

There can be no assurance that collective agreements will be further renewed without labour conflict or action or that there will not otherwise be any labour conflict or action that could also lead to a degradation, interruption or stoppage in Air Canada's service or otherwise adversely affect the ability of Air Canada to execute on its business plans or operate its business, either of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In respect of the unions for Canadian-based employees, strikes or lock-outs may lawfully occur following the term and negotiations of the renewal of collective agreements once a number of pre-conditions prescribed by the Canada Labour Code have been satisfied.

Any labour disruption or work stoppage by any of the unionized work groups of Jazz or other parties with whom Air Canada conducts business or relies on could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, labour conflicts at Star Alliance® partners or involving the operations of key airports could result in lower demand for connecting traffic with Air Canada, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Air Canada's brand

The failure to preserve or grow the value of Air Canada's brand could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada believes that its success is dependent on the value of its brand and on Air Canada's ability to preserve, grow and leverage that value. The Air Canada brand is recognized throughout the world, and Air Canada has received high ratings in external brand value studies, based in part on consumer perceptions on a variety of subjective qualities. Air Canada believes it has and continues to build an excellent reputation globally for the safety and quality of its services, and for the delivery of a consistently positive passenger experience. Any failure to preserve or grow Air Canada's brand value, including by reason of the conduct of Air Canada or any of its business partners or other external parties, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Pension plans

Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its registered pension plans could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada maintains several defined benefit pension plans, including domestic registered pension plans, supplemental pension plans and international pension plans. Canadian federal pension legislation requires that the funded status of registered pension plans be determined periodically, on both a going concern basis (essentially assuming indefinite plan continuation) and a solvency basis (essentially assuming immediate plan termination).

Air Canada's pension funding obligations (including projected funding obligations) may vary significantly based on a wide variety of factors, including pension plan solvency valuations, regulatory developments, plan demographics, changes to plan provisions, assumptions and methods used and changes in economic conditions (mainly the return on fund assets and changes in interest rates) and other factors, as well as the application of normal past service contribution rules which would generally require one-fifth of any solvency deficit in a domestic registered plan, determined on the basis of an average over the previous three years, to be funded each year. Actual contributions that are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition, current service contributions in respect of a domestic registered plan are required unless they are funded (if permitted subject to applicable plan rules and legislation) through a sufficient surplus in such plan. Deteriorating economic conditions or a prolonged period of low or decreasing interest rates may result in significant increases in Air Canada's funding obligations, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its registered pension plans could have a material adverse effect on Air Canada, its business, results from operations and financial condition. See section 9.7 "Pension Funding Obligations" of this MD&A for additional information.

Limitations due to restrictive covenants

Covenants contained in agreements to which Air Canada is a party affect and, in some cases, significantly limit or prohibit the manner in which Air Canada operates its business

Some of the financing and other major agreements to which Air Canada is a party contain, and in the future may contain, restrictive, financial (including in relation to asset valuations, liquidity, minimum EBITDAR results, fixed charge coverage ratio and debt coverage ratios) and other covenants which affect and, in some cases, significantly limit or prohibit, among other things, the manner in which Air Canada may structure or operate its business, including by reducing Air Canada's liquidity, limiting Air Canada's ability to incur indebtedness, create liens, sell assets, pay dividends, make capital expenditures, and engage in acquisitions, mergers or restructurings or a change of control. Although Air Canada has more recently been able to negotiate more favourable and less restrictive covenants, there can be no assurance that it will be able to continue to do so. Future financing and other significant agreements may be subject to similar or stricter covenants which limit Air Canada's operating and financial flexibility, which could materially and adversely affect Air Canada's ability to operate its business and its profitability.

A failure by Air Canada to comply with its contractual obligations (including restrictive, financial and other covenants), or to pay its indebtedness and fixed costs, could result in a variety of material adverse consequences, including the acceleration of its indebtedness, the withholding of credit card proceeds by the credit card service providers and the exercise of remedies by its creditors, lessors or other co-contracting parties, and such defaults could trigger additional defaults under other indebtedness or agreements. In such a situation, Air Canada may not be able to repay the accelerated indebtedness or fulfill its obligations under certain contracts, make required aircraft lease payments or otherwise cover its fixed costs. Also, the lenders under the financing arrangements could foreclose upon all or substantially all of the assets of Air Canada which secure Air Canada's obligations.

Refer to section 9.8 "Contractual Obligations" of this MD&A for information on Air Canada's credit card processing agreements.

Aeroplan

Failure by Aeroplan to fulfill its obligations to Air Canada or other interruptions of Aeroplan services could have a material adverse effect on Air Canada, its business, results from operations and financial condition

Air Canada and Aeroplan are parties to a Commercial Participation and Services Agreement ("CPSA") which is set to expire in 2020. Through the CPSA, Air Canada offers its customers who are Aeroplan members the opportunity to earn Aeroplan Miles, which management believes is a significant factor in many customers' decision to travel with Air Canada and contributes to building customer loyalty. Aeroplan's failure to adequately operate the Aeroplan program, or to fulfill its obligations under the CPSA, or interruptions or disruptions of Aeroplan services, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Should the term of the CPSA not be extended, Air Canada would seek to implement an alternative program which would involve certain risks and uncertainties, including risks of transitioning Air Canada, as well as its customers who are Aeroplan members, to such other program. Though Air Canada believes it would be able to mitigate and overcome such risks and successfully transition to an alternative program, such a transition may entail risks which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Star Alliance

Departure of a key member from Star Alliance or the failure by a key member to meet its obligations could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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

Interruptions or disruptions in service

Interruptions or disruptions in service could have a material adverse effect on Air Canada, its business, results from operations and financial condition

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

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

Current legal proceedings

Air Canada is involved in or may be subject to legal proceedings which could materially adversely impact Air Canada

Investigations by competition authorities relating to Air Canada Cargo

The European Commission, the United States Department of Justice and the Competition Bureau in Canada investigated alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including Air Canada. Competition authorities in several jurisdictions sought or requested information from Air Canada as part of their investigations. Air Canada cooperated with these investigations, which led to proceedings against Air Canada and a number of airlines and other cargo operators in certain jurisdictions. Air Canada is also named as a defendant or is otherwise involved in, and may become further implicated in, a number of class action lawsuits and other proceedings in Canada, Europe and the United States in connection with these allegations. The investigations instituted by the U.S. Department of Justice and by the Competition Bureau in Canada concluded with no proceedings having been instituted against Air Canada. In 2012, the Corporation entered into a settlement agreement relating to class action proceedings in the United States in connection with these allegations under which Air Canada made a payment of $8 million without any admission of liability.

In 2010, the European Commission rendered a decision finding that 12 air cargo carriers (including groups of related carriers) had infringed European Union competition law in the setting of certain cargo charges and rates for various periods between 1999 and 2006. Air Canada was among the carriers subject to the decision and a fine of 21 million Euros (approximately $29 million) was imposed on Air Canada. Air Canada appealed the decision and filed an application for appeal before the European General Court. In 2011, Air Canada paid the fine, as required, pending the outcome of its appeal. On December 16, 2015, the European General Court granted Air Canada's appeal and annulled the decision of the European Union with regard to Air Canada and certain other airlines. As a result of the European General Court's decision, the European Commission was required to refund Air Canada the fine of 21 million Euros ($30 million), which amount was recorded as a receivable as at December 31, 2015 and received in February 2016. Though the European Commission did not appeal the European General Court's decision, it announced its intention to issue a new decision in 2017. Air Canada cannot be certain of the impact of such decision, including as to whether it will include findings in respect of Air Canada.

As at December 31, 2016, Air Canada has a provision of $17 million ($17 million as at December 31, 2015) relating to outstanding claims in these matters, which is recorded in Accounts payable and accrued liabilities. This provision is an estimate based upon the status of investigations and proceedings at this time and Air Canada's assessment as to the potential outcome for certain of them. The provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Air Canada has determined it is not possible at this time to predict with any degree of certainty the outcome of all remaining proceedings and investigations. Based on the outcome of any developments regarding proceedings and investigations, Air Canada may adjust the provision in its results for subsequent periods as required.

Mandatory retirement

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

Future Legal Proceedings

In the course of conducting their business, airlines are subject to various claims and litigation (including class action claims), including with respect to its contractual arrangements and current or new laws and regulations. Any future claims or litigation could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key personnel

Air Canada is dependent on key employees and could be materially adversely affected by a shortfall or substantial turnover

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

Risks relating to the airline industry

Terrorist attacks and security measures

Terrorist attacks and related consequences could have a material adverse effect on Air Canada, its business, results from operations and financial condition

The potential for terrorist attacks and terrorist activity causes concern and uncertainty in the minds of the travelling public. The occurrence of a terrorist attack, an attempted attack or the perceived threat of one (whether or not involving Air Canada or another carrier, or involving Air Canada's destinations, or other destinations or regions), and restrictive security measures, such as those relating to the content of carry-on baggage, passenger identification document requirements and passenger screening procedures, could have a material adverse effect on passenger demand for air travel and on the number of passengers travelling on Air Canada's flights. It could also lead to a substantial increase in insurance, security and other costs, including higher operating costs to avoid flying over airspace near conflict zones. Any resulting reduction in passenger revenues and/or increases in costs, including insurance, security or other costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Epidemic diseases

Epidemic diseases could impact passenger demand for air travel

Outbreaks or the threat of outbreaks of viruses or other contagions or epidemic diseases, including influenza, SARS, Ebola, Zika, as well as any travel or other advisories relating to same, whether domestic or international or whether relating to Canadian cities or regions or other cities, regions or countries, could have a material adverse effect on demand for air travel and could result in a major negative impact on traffic on Air Canada's network. Any resulting reduction in traffic in the markets served by Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Casualty losses

Air Canada's business makes it subject to large liability claims for serious personal injury or death arising out of accidents or disasters

Due to the nature of its core business, Air Canada may be subject to liability claims arising out of accidents or disasters involving aircraft on which Air Canada's customers are travelling or involving aircraft of other carriers maintained or otherwise serviced by Air Canada or through third parties providing services to Air Canada, including claims for serious personal injury or death. Any such accident or disaster may significantly harm Air Canada's reputation for safety, which would have a material adverse effect on Air Canada, its business, results from operations and financial condition. There can be no assurance that Air Canada's insurance coverage will be sufficient to cover one or more large claims and any shortfall may be material.

Accidents and disasters may occur despite all appropriate measures being taken, and as a result of a variety of factors beyond Air Canada's control including acts of terrorism and sabotage, severe weather, lighting strikes and other natural phenomenon, bird strikes as well as the increasing prevalence of unmanned aerial vehicles.

Regulatory matters

Air Canada is subject to extensive and evolving domestic and foreign regulation

The airline industry is subject to extensive legal, regulatory and administrative controls and oversight, including in relation to taxes, airport fees and operations, route rights, security, passenger and consumer rights, advertising, privacy, data security, licensing, competition, pensions, environment (including noise levels and carbon emissions), foreign exchange controls and, in some measure, pricing.

Compliance with current or future Canadian and international laws, regulations and administrative requirements, including potentially inconsistent or conflicting laws or regulations, or laws or regulations which disproportionally apply to Canadian airlines or Air Canada specifically (such as the *Air Canada Public Participation Act)*, may impose significant costs, impediments and/or competitive disadvantages, and there cannot be any assurance that current or future laws, regulations and administrative requirements will not adversely affect Air Canada, its business, results from operations and financial condition.

The ability of Air Canada to operate flights or otherwise offer air services on international routes between airports in Canada and other countries may be subject to change. Applicable arrangements between Canada and foreign governments, which govern many areas including traffic rights, may be amended from time to time, rules and policies with respect to airport operations may be revised, and the availability of appropriate slots or facilities may change. Air Canada currently operates a number of flights on international routes under government arrangements, regulations or policies that designate the number of carriers permitted to operate on such routes, the capacity of the carriers providing services on such routes, the airports at which carriers may operate international flights, or the number of carriers allowed access to particular airports. Any further limitations, additions or modifications to such arrangements, regulations or policies could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Additionally, if Canada were to adopt a more liberalized approach in relation to air services arrangements with foreign countries, such an approach could have a material adverse impact on Air Canada, its business, results from operations and financial condition and could result in the impairment of material amounts of related tangible and intangible assets.

Air Canada's current and future plans to enter into or expand revenue-sharing joint ventures and other alliance arrangements on various international routes are and may be subject to receipt of approvals from applicable Canadian and international authorities, to their not challenging them, and to satisfying the necessary applicable regulatory requirements. There can be no assurance that such conditions will be met or will continue in effect or that existing, or changes in, regulatory requirements or standards can be satisfied.

Many aspects of Air Canada's operations may also be subject to the proliferation of increasingly stringent laws and regulations relating to environmental reforms, such as in the area of climate change, and including the following:

The European Union ("EU") emissions trading system ("ETS"), which includes carbon emissions from aviation, including for flights between Canada and EU countries. The European Parliament and Council has exempted all flights between Europe and third countries from the EU ETS, pending the creation of a satisfactory International Civil Aviation Organization ("ICAO") led global market-based measure ("MBM"). In 2016, the ICAO Assembly adopted a resolution on a MBM which includes emissions from international flights. The MBM is set to be implemented in phases, with the first two phases (occurring from 2021 to 2023, and 2024 to 2026, respectively) to be voluntary, with the third phase (from 2027 to 2035) to be mandatory. Canada voluntarily adopted the first phase. On the basis of the MBM, the European Commission may continue to extend the exemption of flights between Europe and third countries from the ETS; however, Air Canada cannot predict whether or how long such exemption will continue.

Canadian provincial governments have implemented or are seeking to implement carbon emissions pricing and other initiatives. In 2016, the Canadian federal government also proposed that a carbon emissions initiative be implemented in all Canadian jurisdictions by 2018.

Air Canada cannot predict whether, or the manner in which, these or other initiatives will ultimately be implemented or the impact on Air Canada; however, future developments in Canada and abroad could adversely impact Air Canada, including by increasing its costs. While Air Canada is continually focused on efficiency improvements, including carbon footprint reduction initiatives, the impact to Air Canada of climate change and other environmental initiatives may, in part, depend upon the extent to which the increased costs relating such initiatives, if any, could be recovered, including in the form of higher passenger fares and cargo rates.

Air Canada is also subject to domestic and foreign laws regarding privacy and security of passenger data, employee and other data, including advance passenger information and access to airline reservation systems, which are not consistent in all countries which may assert jurisdiction over Air Canada, including in countries where Air Canada operates or conducts business. The need to comply with these laws and regulatory regimes results in additional operating costs and further regulation in this area or non-compliance, including in relation to data privacy and security requirements, could have a material adverse effect on Air Canada, its business (including by impacting Air Canada's goodwill and reputation), results from operations and financial condition.

Foreign jurisdictions (including the United States, European Union countries and other jurisdictions where Air Canada operates or conducts business) have enacted and implemented, and they and domestic regulators may in the future enact and implement, consumer protection and passenger rights measures. Such measures may impose significant, unique, inconsistent or even conflicting obligations on Air Canada, which may result in increased liability and costs to Air Canada and which could adversely impact Air Canada, its business, results from operations and financial condition.

Availability of insurance coverage and increased insurance costs

Increases in insurance costs or reduction in insurance coverage could have a material adverse effect on Air Canada, its business, results from operations and financial condition

The aviation insurance industry has been continually re-evaluating the terrorism risks that it covers which may adversely affect some of Air Canada's existing insurance carriers or Air Canada's ability to obtain future insurance coverage (including war risk insurance coverage). To the extent that Air Canada's existing insurance carriers are unable or unwilling to provide it with insurance coverage and in the absence of measures by the Government of Canada to provide the required coverage, Air Canada's insurance costs may increase further and may result in Air Canada being in breach of regulatory requirements or contractual arrangements requiring that specific insurance be maintained, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

18 Controls and Procedures

Disclosure controls and procedures and internal controls over financial reporting

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

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

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

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

Management's report on disclosure controls and procedures

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined under National Instrument 52-109) and concluded, as at December 31, 2016, that such disclosure controls and procedures were effective.

Management's report on internal controls over financial reporting

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's internal controls over financial reporting (as defined under National Instrument 52-109). In making this evaluation, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commissions ("COSO") in Internal Control – Integrated Framework (2013). Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2016, the Corporation's internal controls over financial reporting were effective. This evaluation took into consideration the Corporation's Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee.

Changes in internal controls over financial reporting

There have been no changes to the Corporation's internal controls over financial reporting during the quarter ended December 31, 2016 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

19 Non-GAAP Financial Measures

Below is a description of certain non-GAAP financial measures used by Air Canada in an effort to provide readers with additional information on its financial and operating performance. Such measures are not recognized measures for financial statement presentation under GAAP, do not have standardized meanings, may not be comparable to similar measures presented by other entities and should not be considered a substitute for or superior to GAAP results.

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is commonly used in the airline industry and is used by Air Canada as a means to view operating results before interest, taxes, depreciation, amortization, impairment and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Air Canada excludes special items from EBITDAR as such items would distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

EBITDAR is reconciled to operating income as follows:

	Fourth quarter			Full year		
(Canadian dollars in millions)	2016	2015	$ Change	2016	2015	$ Change
Operating income – GAAP	$ 18	$ 158	$ (140)	$ 1,345	$ 1,496	$ (151)
Add back (as reflected on Air Canada's consolidated statement of operations):						
Depreciation, amortization and impairment	212	160	52	816	655	161
Aircraft rent	120	98	22	462	353	109
Add back (included in Regional airlines expense):						
Depreciation, amortization and impairment	6	4	2	23	16	7
Aircraft rent	8	5	3	31	14	17
EBITDAR (including special items)	**$ 364**	**$ 425**	**$ (61)**	**$ 2,677**	**$ 2,534**	**$ 143**
Remove effect of special items	91	31	60	91	8	83
EBITDAR	**$ 455**	**$ 456**	**$ (1)**	**$ 2,768**	**$ 2,542**	**$ 226**

Adjusted net debt to trailing 12-month EBITDAR (Leverage Ratio)

Adjusted net debt to trailing 12-month EBITDAR ratio (also referred to as "leverage ratio" in this MD&A) is commonly used in the airline industry and is used by Air Canada as a means to measure financial leverage. Leverage ratio is calculated by dividing adjusted net debt by trailing 12-month EBITDAR. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP. As mentioned above, Air Canada excludes special items from EBITDAR results (which are used to determine leverage ratio) as such items would distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

Free cash flow

Free cash flow is commonly used in the airline industry and is used by Air Canada as an indicator of the financial strength and performance of its business, indicating the amount of cash Air Canada is able to generate from operations and after capital expenditures. Free cash flow is calculated as net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale-leaseback transactions. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for a reconciliation of this non-GAAP financial measure to the nearest measure under GAAP.

Adjusted CASM

Air Canada uses adjusted CASM as a means to assess the operating and cost performance of its ongoing airline business without the effects of aircraft fuel expense, the cost of ground packages at Air Canada Vacations and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

Aircraft fuel expense is excluded from operating expense results as it fluctuates widely depending on many factors, including international market conditions, geopolitical events, jet fuel refining costs and Canada/U.S. currency exchange rates. Air Canada also incurs expenses related to ground packages at Air Canada Vacations which some airlines, without comparable tour operator businesses, may not incur. In addition, these costs do not generate ASMs and therefore excluding these costs from operating expense results provides for a more meaningful comparison across periods when such costs may vary.

Excluding aircraft fuel expense, the cost of ground packages at Air Canada Vacations and special items from operating expenses generally allows for more meaningful analysis of Air Canada's operating expense performance and a more meaningful comparison to those of other airlines.

Adjusted CASM is reconciled to GAAP operating expense as follows:

(Canadian dollars in millions, except where indicated)	Fourth quarter			Full year		
	2016	2015	$ Change	2016	2015	$ Change
Operating expense – GAAP	**$ 3,407**	**$ 3,024**	**$ 383**	**$ 13,332**	**$ 12,372**	**$ 960**
Adjusted for:						
Aircraft fuel expense (as reflected on Air Canada's consolidated statement of operations)	(598)	(527)	(71)	(2,279)	(2,464)	185
Aircraft fuel expense (included in Regional airlines expense)	(90)	(81)	(9)	(327)	(359)	32
Impairment charges	-	-	-	-	(14)	14
Ground package costs	(101)	(87)	(14)	(489)	(415)	(74)
Special items	(91)	(31)	(60)	(91)	(8)	(83)
Operating expense, adjusted for the above-noted items	**$ 2,527**	**$ 2,298**	**$ 229**	**$ 10,146**	**$ 9,112**	**$ 1,034**
ASMs (millions)	**22,091**	**18,869**	**17.1%**	**92,726**	**80,871**	**14.7%**
Adjusted CASM (cents)	**¢ 11.44**	**¢ 12.18**	**(6.1)%**	**¢ 10.94**	**¢ 11.27**	**(2.9)%**

Adjusted net income and adjusted earnings per share – diluted

Air Canada uses adjusted net income and adjusted earnings per share – diluted as a means to assess the overall financial performance of its business without the effects of foreign exchange, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful. Air Canada also uses adjusted net income as a measure to determine its return on invested capital which is described below:

(Canadian dollars in millions, except per share values)	Fourth quarter			Full year		
	2016	2015	$ Change	2016	2015	$ Change
Net income (loss) attributable to shareholders of Air Canada	$ (179)	$ (117)	$ (62)	$ 876	$ 303	$ 573
Adjusted for:						
Special items	91	31	60	91	8	83
Impairment charges	-	-	-	-	14	(14)
Foreign exchange loss	29	159	(130)	38	762	(724)
Net financing expense relating to employee benefits	24	27	(3)	76	105	(29)
Loss (gain) on financial instruments recorded at fair value	(9)	3	(12)	(4)	17	(21)
Gain on sale and leaseback of assets	-	-	-	(19)	-	(19)
Loss on debt settlements	82	13	69	89	13	76
Adjusted net income	**$ 38**	**$ 116**	**$ (78)**	**$ 1,147**	**$ 1,222**	**$ (75)**
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	279	290	(11)	282	292	(10)
Adjusted earnings per share – diluted	**$ 0.14**	**$ 0.40**	**$ (0.26)**	**$ 4.06**	**$ 4.18**	**$ (0.12)**

The following reflects the share amounts used in the computation of basic and diluted earnings per share on an adjusted earnings per share basis:

(in millions)	Fourth quarter 2016	Fourth quarter 2015	Full year 2016	Full year 2015
Weighted average number of shares outstanding – basic	**273**	**284**	**277**	**285**
Effect of dilution	6	6	5	7
Weighted average number of shares outstanding – diluted	**279**	**290**	**282**	**292**

Return on invested capital

Air Canada uses return on invested capital ("ROIC") as a means to assess the efficiency with which it allocates its capital to generate returns. Return is based on adjusted net income (loss), excluding interest expense and implicit interest on operating leases. Invested capital includes (i) average year-over-year total assets (excluding pension assets), net of average year-over-year non-interest-bearing operating liabilities, and (ii) the value of capitalized operating leases (calculated by multiplying annualized aircraft rent by 7).

(Canadian dollars in millions, except where indicated)	12 Months ended December 31, 2016	12 Months ended December 31, 2015	$ Change
Net income for the period attributable to shareholders of Air Canada	**$ 876**	**$ 303**	**$ 573**
Remove:			
Special items	91	8	83
Impairment charges	-	14	(14)
Foreign exchange loss	38	762	(724)
Net financing expense relating to employee benefits	76	105	(29)
(Gain) loss on financial instruments recorded at fair value	(4)	17	(21)
Gain on sale and leaseback of assets	(19)	-	(19)
Loss on debt settlements	89	13	76
Adjusted net income	**$ 1,147**	**$ 1,222**	**$ (132)**
Adjusted for:			
Interest expense (1)	374	389	(15)
Implicit interest on operating leases (2)	242	180	62
Adjusted income before interest	**$ 1,763**	**$ 1,791**	**$ (85)**
Invested capital:			
Working capital, excluding current portion of long-term debt and finance leases	725	623	102
Long-term assets, excluding pension assets	8,883	7,661	1,222
Maintenance provisions	(907)	(844)	(63)
Other operating long-term liabilities	(177)	(233)	56
Capitalized operating leases (3)	3,451	2,569	882
Invested capital	**$ 11,975**	**$ 9,776**	**$ 2,199**
Return on invested capital (%)	**14.7%**	**18.3%**	**(3.6 pp)**

(1) Interest expense excludes the loss on debt settlements related to the C$1.25 billion refinancing transaction and to the disposal of Embraer 190 aircraft in 2015 and 2016.
(2) Interest implicit on operating leases is equal to 7.0% of 7 times the trailing 12 months of aircraft rent. 7.0% is a proxy and does not necessarily represent the actual implicit interest on operating leases for any given period.
(3) Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totalled $493 million for the 12 months ended December 31, 2016 and $367 million for the 12 months ended December 31, 2015 (includes aircraft rent related to regional operations).

20 Glossary

ACPA – Refers to the Air Canada Pilots Association.

Adjusted CASM – Refers to operating expense per ASM adjusted to remove the effects of aircraft fuel expense, ground packages costs at Air Canada Vacations and special items. Refer to section 19 of this MD&A for additional information.

Adjusted net income (loss) – Refers to the consolidated net income (loss) of Air Canada attributable to the shareholders of Air Canada adjusted to remove the effects of (to the extent included in consolidated net income (loss)) foreign exchange gains or losses, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value and special items. Refer to section 19 of this MD&A for additional information.

Air Georgian – Refers to Air Georgian Limited.

Atlantic passenger and cargo revenues – Refer to revenues from flights that cross the Atlantic Ocean with origins and destinations principally in Europe. Also refers to revenues from flights to and from India, the United Arab Emirates and Morocco.

Available seat miles or ASMs – Refers to a measure of passenger capacity calculated by multiplying the total number of seats available for passengers by the miles flown.

Average stage length – Refers to the average mile per departure seat and is calculated by dividing total ASMs by total seats dispatched.

Boeing – Refers to The Boeing Company.

Bombardier – Refers to Bombardier Inc.

CALDA – Refers to the Canadian Airline Dispatchers Association.

CASM – Refers to operating expense per ASM.

CUPE – Refers to the Canadian Union of Public Employees.

Domestic passenger and cargo revenues – Refer to revenues from flights within Canada.

EBITDAR – Refers to earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent. EBITDAR is a non-GAAP financial measure. Refer to section 19 of this MD&A for additional information. Air Canada excludes special items from EBITDAR.

EVAS – Refers to Exploits Valley Air Services Limited

Free cash flow – Refers to net cash flows from operating activities minus additions to property, equipment and intangible assets, and is net of proceeds from sale-leaseback transactions. Free cash flow is a non-GAAP financial measure. Refer to sections 9.5 and 19 of this MD&A for additional information.

IAMAW – Refers to the International Association of Machinists and Aerospace Workers.

Jazz – Refers to Jazz Aviation LP.

Jazz CPA – Refers to the capacity purchase agreement between Air Canada and Jazz dated January 1, 2015 which became effective on January 1, 2015.

Leverage ratio – Refers to adjusted net debt to trailing 12-month EBITDAR ratio (calculated by dividing adjusted net debt by trailing 12-month EBITDAR). Leverage ratio is a non-GAAP financial measure. Refer to sections 9.3 and 19 of this MD&A for additional information.

Loss on debt settlements – Refer to losses related to debt settlements that, in management's view, are to be separately disclosed by virtue of their size or incidence to enable a fuller understanding of the Corporation's financial performance.

Other passenger and cargo revenues – Refer to revenues from flights with origins and destinations principally in Central and South America and the Caribbean and Mexico.

Pacific passenger and cargo revenues – Refer to revenues from flights that cross the Pacific Ocean with origins and destinations principally in Asia and Australia.

Passenger load factor – Refers to a measure of passenger capacity utilization derived by expressing Revenue Passenger Miles as a percentage of Available Seat Miles.

Passenger revenue per available seat mile or PRASM – Refers to average passenger revenue per ASM (baggage fee revenues, which are included in passenger revenues, are removed for the purposes of calculating PRASM).

Percentage point (pp) – Refers to a measure for the arithmetic difference of two percentages.

Return on invested capital or ROIC – Refers to return on invested capital and is a measure used to assess the efficiency with which a company allocates its capital to generate returns. Refer to section 19 of this MD&A for additional information.

Revenue passenger carried – Refers to IATA's definition of passenger carried whereby passengers are counted on a flight number basis rather than by journey/itinerary or by leg.

Revenue passenger miles or RPMs – Refers to a measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried.

Seats dispatched – Refers to the number of seats on non-stop flights. A non-stop flight refers to a single take off and landing.

Sky Regional – Refers to Sky Regional Airlines Inc.

Special items – Refers to those items that, in management's view, are to be separately disclosed by virtue of their significance to the financial statements, to enable a fuller understanding of the Corporation's financial performance.

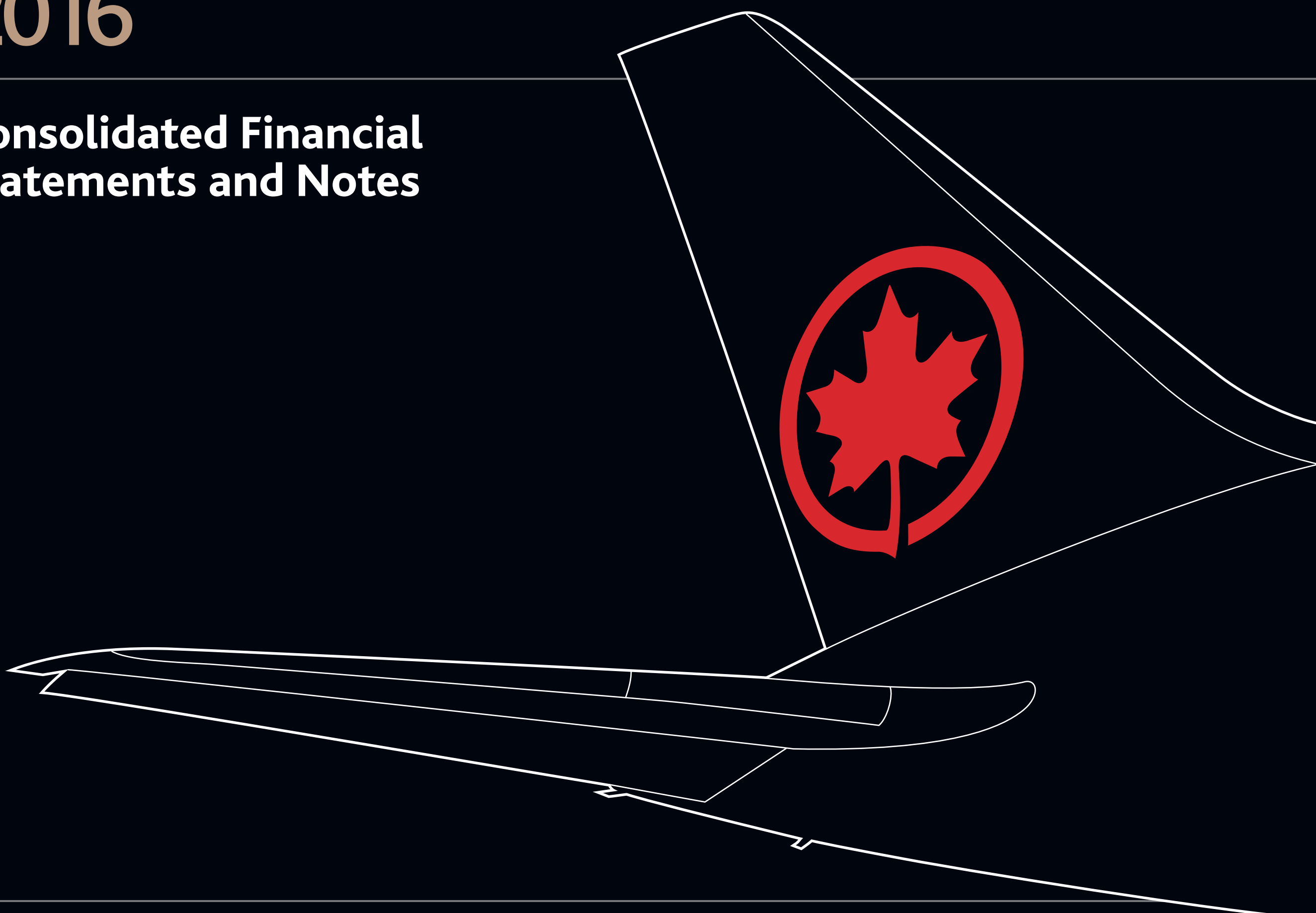
Unifor – Refers to the trade union in Canada, launched in 2013, as a merger of the Canadian Auto Workers and Communications, Energy and Paperworkers unions.

Weighted average cost of capital or WACC – Refers to management's estimate of its cost of capital, in which each category of capital is proportionately weighted.

Yield – Refers to average passenger revenue per RPM (baggage fee revenues, which are included in passenger revenues, are removed for the purposes of calculating yield).

2016

Consolidated Financial Statements and Notes



Statement of Management's Responsibility for Financial Reporting

The consolidated financial statements have been prepared by management. Management is responsible for the fair presentation of the consolidated financial statements in conformity with generally accepted accounting principles in Canada which incorporates International Financial Reporting Standards. Management is responsible for the selection of accounting policies and making significant accounting judgments and estimates. Management is also responsible for all other financial information included in management's discussion and analysis and for ensuring that this information is consistent, where appropriate, with the information contained in the consolidated financial statements.

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

The Audit, Finance and Risk Committee, which is comprised entirely of independent directors, reviews the quality and integrity of the Corporation's financial reporting and provides its recommendations, in respect of the approval of the financial statements, to the Board of Directors; oversees management's responsibilities as to the adequacy of the supporting systems of internal controls; provides oversight of the independence, qualifications and appointment of the external auditor; and, pre-approves audit, audit-related, and non-audit fees and expenses. The Board of Directors approves the Corporation's consolidated financial statements and management's discussion and analysis disclosures prior to their release. The Audit, Finance and Risk Committee meets with management, the internal auditors and external auditors at least four times each year to review and discuss financial reporting, disclosures, auditing and other matters.

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

Calin Rovinescu
President and Chief Executive Officer

Michael Rousseau
Executive Vice President and Chief Financial Officer

February 16, 2017

Independent Auditor's Report

To the Shareholders of Air Canada

We have audited the accompanying consolidated financial statements of Air Canada and its subsidiaries, which comprise the consolidated statement of financial position as at December 31, 2016 and December 31, 2015 and the consolidated statement of operations, statement of comprehensive income, statement of changes in equity and statement of cash flow for the years then ended, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Air Canada and its subsidiaries as at December 31, 2016 and December 31, 2015 and their financial performance and their cash flows for the years then ended in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board.

PricewaterhouseCoopers LLP[1]

Montreal, Quebec
February 16, 2017

[1] CPA auditor, Public accountancy permit NO. A113048

PricewaterhouseCoopers LLP, an Ontario limited liability partnership.

Consolidated Statement of Financial Position

(Canadian dollars in millions)		December 31, 2016	December 31, 2015
Assets			
Current			
Cash and cash equivalents		$ 787	$ 572
Short-term investments		2,192	2,100
Total cash, cash equivalents and short-term investments		2,979	2,672
Restricted cash	Note 2P	126	91
Accounts receivable		707	654
Promissory notes receivable	Note 4	-	143
Aircraft fuel inventory		79	68
Spare parts and supplies inventory	Note 2Q	107	114
Prepaid expenses and other current assets		349	383
Total current assets		4,347	4,125
Property and equipment	Note 4	8,520	7,030
Pension assets	Note 8	1,153	851
Intangible assets	Note 5	315	314
Goodwill	Note 6	311	311
Deposits and other assets		468	496
Total assets		**$ 15,114**	**$ 13,127**
Liabilities			
Current			
Accounts payable and accrued liabilities		$ 1,644	$ 1,487
Advance ticket sales		2,073	1,818
Current portion of long-term debt and finance leases	Note 7	707	524
Total current liabilities		4,424	3,829
Long-term debt and finance leases	Note 7	5,911	5,870
Pension and other benefit liabilities	Note 8	2,436	2,245
Maintenance provisions	Note 9	922	892
Other long-term liabilities		202	251
Total liabilities		**$ 13,895**	**$ 13,087**
Equity			
Shareholders' equity			
Share capital	Note 11	797	825
Contributed surplus		83	76
Hedging reserve		3	(11)
Retained earnings (deficit)		336	(877)
Total shareholders' equity		1,219	13
Non-controlling interests		-	27
Total equity		**1,219**	**40**
Total liabilities and equity		**$ 15,114**	**$ 13,127**

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

On behalf of the Board of Directors:

David I. Richardson
Chairman

Christie J.B. Clark
Chair of the Audit, Finance and Risk Committee

Consolidated Statement of Operations

For the year ended December 31 (Canadian dollars in millions except per share figures)		2016	2015
Operating revenues			
Passenger	Note 18	$ 13,148	$ 12,420
Cargo	Note 18	512	506
Other		1,017	942
Total revenues		**14,677**	**13,868**
Operating expenses			
Aircraft fuel		2,279	2,464
Regional airlines expense	Note 19	2,408	2,279
Wages, salaries and benefits		2,510	2,324
Airport and navigation fees		859	802
Aircraft maintenance		880	773
Depreciation, amortization and impairment		816	655
Sales and distribution costs		703	608
Ground package costs		489	415
Aircraft rent		462	353
Food, beverages and supplies		349	314
Communications and information technology		242	211
Special items	Note 20	91	8
Other		1,244	1,166
Total operating expenses		**13,332**	**12,372**
Operating income		**1,345**	**1,496**
Non-operating income (expense)			
Foreign exchange loss		(38)	(762)
Interest income		48	46
Interest expense		(374)	(389)
Interest capitalized		58	70
Net financing expense relating to employee benefits	Note 8	(76)	(105)
Gain (loss) on financial instruments recorded at fair value	Note 15	4	(17)
Gain on sale and leaseback of assets	Note 21	19	-
Loss on debt settlements	Note 7	(89)	(13)
Other		(20)	(18)
Total non-operating expense		(468)	(1,188)
Income before income taxes		**877**	**308**
Income taxes	Note 10	(1)	-
Net income		$ 876	$ 308
Net income attributable to:			
Shareholders of Air Canada		876	303
Non-controlling interests		-	5
Net income		**$ 876**	**$ 308**
Net income per share attributable to shareholders of Air Canada	Note 13		
Basic earnings per share		$ 3.16	$ 1.06
Diluted earnings per share		$ 3.10	$ 1.03

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

Consolidated Statement of Comprehensive Income

For the year ended December 31 (Canadian dollars in millions)		2016	2015
Comprehensive income			
Net income		$ 876	$ 308
Other comprehensive income, net of taxes of nil:			
Items that will not be reclassified to net income			
Remeasurements on employee benefit liabilities	Note 8	412	1,015
Items that will be reclassified to net income			
Fuel derivatives designated as cash flow hedges, net	Note 15	14	(11)
Total comprehensive income		**$ 1,302**	**$ 1,312**
Comprehensive income attributable to:			
Shareholders of Air Canada		$ 1,302	$ 1,307
Non-controlling interests		-	5
Total comprehensive income		**$ 1,302**	**$ 1,312**

Consolidated Statement of Changes in Equity

(Canadian dollars in millions)	Share capital	Contributed surplus	Hedging reserve	Retained earnings (deficit)	Total shareholders' equity	Non-controlling interests	Total equity
January 1, 2015	$ 835	$ 77	-	$ (2,113)	$ (1,201)	$ 68	$ (1,133)
Net income	-	-	-	303	303	5	308
Remeasurements on employee benefit liabilities	-	-	-	1,015	1,015	-	1,015
Fuel derivatives designated as cash flow hedges, net	-	-	(11)	-	(11)	-	(11)
Total comprehensive income	-	-	(11)	1,318	1,307	5	1,312
Share-based compensation	-	1	-	(35)	(34)	-	(34)
Shares issued (Note 11)	6	(2)	-	-	4	-	4
Shares purchased and cancelled under issuer bid (Note 11)	(16)	-	-	(47)	(63)	-	(63)
Distributions	-	-	-	-	-	(46)	(46)
December 31, 2015	$ 825	$ 76	$ (11)	$ (877)	$ 13	$ 27	$ 40
Net income	-	-	-	876	876	-	876
Remeasurements on employee benefit liabilities	-	-	-	412	412	-	412
Fuel derivatives designated as cash flow hedges, net	-	-	14	-	14	-	14
Total comprehensive income	-	-	14	1,288	1,302	-	1,302
Share-based compensation	-	8	-	(12)	(4)	-	(4)
Shares issued (Note 11)	3	(1)	-	-	2	-	2
Shares purchased and cancelled under issuer bid (Note 11)	(31)	-	-	(63)	(94)	-	(94)
Distributions	-	-	-	-	-	(27)	(27)
December 31, 2016	$ 797	$ 83	$ 3	$ 336	$ 1,219	$ -	$ 1,219

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

Consolidated Statement of Cash Flow

For the year ended December 31
(Canadian dollars in millions)

Cash flows from (used for)		2016	2015
Operating			
Net income		$ 876	$ 308
Adjustments to reconcile to net cash from operations			
Depreciation, amortization and impairment		839	671
Foreign exchange (gain) loss	Note 15	(34)	835
Gain on sale and leaseback of assets	Note 21	(19)	-
Loss on debt settlements	Note 7	89	13
Employee benefit funding less than expense	Note 8	299	6
Financial instruments recorded at fair value	Note 15	10	(5)
Change in maintenance provisions		148	42
Changes in non-cash working capital balances		194	191
Other		19	(36)
Net cash flows from operating activities		**2,421**	**2,025**
Financing			
Proceeds from borrowings	Note 7	2,538	905
Reduction of long-term debt and finance lease obligations	Note 7	(2,275)	(707)
Shares purchased for cancellation	Note 11	(94)	(63)
Distributions related to aircraft special purpose leasing entities		(32)	(51)
Issue of shares		2	4
Financing fees	Note 7	(2)	(32)
Net cash flows from financing activities		**137**	**56**
Investing			
Short-term investments		(99)	(398)
Additions to property, equipment and intangible assets		(2,921)	(1,815)
Proceeds from sale of assets	Note 4	352	23
Proceeds from sale and leaseback of assets	Note 21	351	-
Other		(9)	2
Net cash flows used in investing activities		**(2,326)**	**(2,188)**
Effect of exchange rate changes on cash and cash equivalents		**(17)**	**18**
Increase (decrease) in cash and cash equivalents		**215**	**(89)**
Cash and cash equivalents, beginning of year		572	661
Cash and cash equivalents, end of year		**$ 787**	**$ 572**

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

1 General Information

The accompanying audited consolidated financial statements (the "financial statements") are of Air Canada (the "Corporation"). The term "Corporation" also refers to, as the context may require, Air Canada and/or one or more of its subsidiaries, including its principal wholly owned operating subsidiaries, Touram Limited Partnership doing business under the brand name Air Canada Vacations® ("Air Canada Vacations") and Air Canada rouge LP doing business under the brand name Air Canada Rouge® ("Air Canada Rouge"). These financial statements also include certain aircraft leasing entities, which are consolidated under IFRS 10 Consolidated Financial Statements.

Air Canada is incorporated and domiciled in Canada. The address of its registered office is 7373 Côte-Vertu Boulevard West, Saint-Laurent, Quebec.

Air Canada is Canada's largest domestic, U.S. transborder and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market as well as the international markets to and from Canada. Certain of the scheduled passenger services offered on domestic and Canada-U.S. transborder routes are operated under the brand name "Air Canada Express" and operated by third parties such as Jazz Aviation LP ("Jazz") and Sky Regional Airlines Inc. ("Sky Regional") through capacity purchase agreements (each a "CPA"). Air Canada also offers scheduled passenger services on domestic and Canada-U.S. transborder routes through capacity purchase agreements on other regional carriers, including those operating aircraft of 18 seats or less, some of which are referred to as Tier III carriers. Through Air Canada's global route network, virtually every major market throughout the world is served either directly or through the Star Alliance network.

Air Canada Cargo, a division of Air Canada, is Canada's largest provider of air cargo services. Air Canada offers air cargo services on domestic and U.S. transborder routes as well as on international routes between Canada and major markets in Europe, Asia, South America and Australia.

2 Basis of Presentation and Summary of Significant Accounting Policies

The Corporation prepares its financial statements in accordance with generally accepted accounting principles in Canada ("GAAP") as set out in the CPA Canada Handbook – Accounting ("CPA Handbook") which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

These financial statements were approved for issue by the Board of Directors of the Corporation on February 16, 2017.

These financial statements are based on the accounting policies as described below. These policies have been consistently applied to all the periods presented, except as otherwise stated.

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

A) Basis of measurement

These financial statements have been prepared under the historical cost convention, except for the revaluation of cash, cash equivalents and short-term investments, restricted cash and derivative instruments which are measured at fair value.

B) Principles of consolidation

These financial statements include the accounts of Air Canada and its subsidiaries. Subsidiaries are all entities (including structured entities) which Air Canada controls. For accounting purposes, control is established by an investor when it is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. All inter-company balances and transactions are eliminated.

Non-controlling interests represent equity interests in subsidiaries owned by outside parties. The share of net assets of subsidiaries attributable to non-controlling interests is presented as a component of equity. Equity owned by outside parties is nil at December 31, 2016 ($27 as at December 31, 2015).

Structured Entities

The Corporation has aircraft leasing and other agreements with a number of structured entities. Under IFRS 10 Consolidated Financial Statements, the Corporation controls and consolidates leasing entities covering 9 aircraft (12 aircraft as at December 31, 2015). The Corporation has concluded that it controls these entities because the lease or other agreements with these structured entities give Air Canada the power to control the principal economic decision on lease expiry of whether to purchase the aircraft and thereby collapse the structured entity.

C) Passenger and cargo revenues

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, interline agreements and 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. Passenger revenue also includes certain fees and surcharges and revenues from passenger-related services such as seat selection and excess baggage which are recognized as the services are provided.

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

D) Capacity purchase agreements

Air Canada has capacity purchase agreements with Jazz, Sky Regional and certain other regional carriers. Under these agreements, Air Canada markets, tickets and enters into other commercial arrangements relating to these flights and records the revenue it earns under Passenger revenue. Operating expenses under capacity purchase agreements, which are aggregated in a separate line item in the consolidated statement of operations titled Regional airlines expense, include the capacity purchase fees, pass-through costs, which are direct costs incurred by the regional carrier and charged to the Corporation, and other costs incurred by the Corporation which are directly related to regional carrier operations.

E) Aeroplan loyalty program

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

Under the CPSA, Aeroplan purchases passenger tickets from Air Canada, which are accounted for as passenger revenues by Air Canada when transportation is provided. The cost of purchasing Aeroplan Miles® from Aeroplan is accounted for as a sales incentive and charged against passenger revenues when the points are issued, which occurs upon the qualifying air travel being provided to the customer.

F) Other revenues

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

In certain subleases of aircraft to Jazz, for accounting purposes, the Corporation acts as an agent and accordingly reports the sublease revenues net against aircraft rent expense as the terms of the sublease match the terms of the Corporation's lease. The Corporation acts as lessee and sublessor in these matters.

G) Employee benefits

The cost of pensions, other post-retirement and post-employment benefits earned by employees is actuarially determined annually as at December 31. The cost is determined using the projected unit credit method and assumptions including market interest rates, salary escalation, retirement ages of employees, mortality rates and health care costs.

Past service costs are recognized in the period of a plan amendment, irrespective of whether the benefits have vested. Gains and losses on curtailments or settlements are recognized in the period in which the curtailment or settlement occurs.

The current service cost and any past service cost, gains and losses on curtailments or settlements are recorded in Wages, salaries and benefits. The interest arising on the net benefit obligations are presented in Net financing expense relating to employee benefits. Net actuarial gains and losses, referred to as remeasurements, are recognized in other comprehensive income and deficit without subsequent reclassification to income.

The current service cost is estimated utilizing different discount rates derived from the yield curve used to measure the defined benefit obligation at the beginning of the year, reflecting the different timing of benefit payments for past service (the defined benefit obligation) and future service (the current service cost).

The liability in respect of minimum funding requirements, if any, is determined using the projected minimum funding requirements, based on management's best estimates of the actuarially determined funded status of the plan, market discount rates and salary escalation estimates. The liability in respect of the minimum funding requirement and any subsequent remeasurement of that liability are recognized immediately in other comprehensive income and deficit without subsequent reclassification to income.

Recognized pension assets are limited to the present value of any reductions in future contributions or any future refunds.

H) Employee profit sharing plans

The Corporation has employee profit sharing plans. Payments are calculated based on full calendar year results and an expense recorded throughout the year as a charge to Wages, salaries and benefits based on the estimated annual payments under the plans.

I) Share-based compensation plans

Certain employees of the Corporation participate in Air Canada's Long-Term Incentive Plan, which provides for the grant of stock options, performance share units ("PSUs") and restricted share units ("RSUs"), as further described in Note 12. PSUs and RSUs are notional share units which are exchangeable, on a one-to-one basis, as determined by the Board of Directors as described in Note 12, for Air Canada shares, or the cash equivalent.

Options are expensed using a graded vesting model over the vesting period. The Corporation recognizes compensation expense and a corresponding adjustment to Contributed surplus equal to the fair value of the equity instruments granted using the Black-Scholes option pricing model taking into consideration forfeiture estimates. Compensation expense is adjusted for subsequent changes in management's estimate of the number of options that are expected to vest.

Grants of PSUs and RSUs are accounted for as equity settled instruments. Accordingly, the Corporation recognizes compensation expense offset by Contributed surplus equal to the market value of an Air Canada Share at the date of grant on a straight-line basis over the applicable vesting period, taking into consideration forfeiture estimates. Compensation expense is adjusted for subsequent changes in management's current estimate of the number of PSUs and RSUs that are expected to vest. Refer to Note 15 for a description of derivative instruments used by the Corporation to economically hedge the cash flow exposure to PSUs and RSUs.

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

J) Maintenance and repairs

Maintenance and repair costs for both leased and owned aircraft are charged to Aircraft maintenance as incurred, with the exception of maintenance and repair costs related to return conditions on aircraft under operating lease, which are accrued over the term of the lease, and major maintenance expenditures on owned and finance leased aircraft, which are capitalized as described below in Note 2R.

Maintenance and repair costs related to return conditions on aircraft leases are recorded over the term of the lease for the end of lease maintenance return condition obligations within the Corporation's operating leases, offset by a prepaid maintenance asset to the extent of any related power-by-the-hour maintenance service agreements or any recoveries under aircraft subleasing arrangements. The provision is recorded within Maintenance provisions using a discount rate taking into account the specific risks of the liability over the remaining term of the lease. Interest accretion on the provision is recorded in Other non-operating expense. Any changes in the maintenance cost estimate, discount rates, timing of settlement or difference in the actual maintenance cost incurred and the amount of the provision are recorded in Aircraft maintenance.

K) Other operating expenses

Included in Other operating expenses are expenses related to building rent and maintenance, airport terminal handling costs, professional fees and services, crew meals and hotels, advertising and promotion, insurance costs and other expenses. Other operating expenses are recognized as incurred.

L) Financial instruments

Recognition

Financial assets and financial liabilities, including derivatives, are recognized on the consolidated statement of financial position when the Corporation becomes a party to the financial instrument or derivative contract.

Classification

The Corporation classifies its financial assets and financial liabilities in the following measurement categories: i) those to be measured subsequently at fair value (either through other comprehensive income or through profit or loss and ii) those to be measured at amortized cost. The classification of financial assets depends on the business model for managing the financial assets and the contractual terms of the cash flows. Financial liabilities are classified as those to be measured at amortized cost unless they are designated as those to be measured subsequently at fair value through profit or loss (irrevocable election at the time of recognition). For assets and liabilities measured at fair value, gains and losses are either recorded in profit or loss or other comprehensive income.

The Corporation reclassifies financial assets when and only when its business model for managing those assets changes. Financial liabilities are not reclassified.

The Corporation has implemented the following classifications:

- Cash and cash equivalents, Short-term investments, and Restricted cash are classified as assets at fair value and any period change in fair value is recorded through Interest income in the consolidated statement of operations, as applicable.
- Accounts receivable and Aircraft related and other deposits are classified as assets at amortized cost and are measured using the effective interest rate method. Interest income is recorded in the consolidated statement of operations, as applicable.
- Accounts payable, credit facilities and long-term debt are classified as other financial liabilities and are measured at amortized cost using the effective interest rate method. Interest expense is recorded in the consolidated statement of operations, as applicable.

Measurement

All financial instruments are required to be measured at fair value on initial recognition, plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. Transaction costs of financial assets and financial liabilities carried at fair value through profit or loss are expensed in profit or loss. Financial assets and financial liabilities with embedded derivatives are considered in their entirety when determining whether their cash flows are solely payment of principal and interest.

Financial assets that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortized cost at the end of the subsequent accounting periods. All other financial assets including equity investments are measured at their fair values at the end of subsequent accounting periods, with any changes taken through profit and loss or other comprehensive income (irrevocable election at the time of recognition).

Impairment

The Corporation assesses all information available, including on a forward looking basis the expected credit losses associated with its assets carried at amortized cost. The impairment methodology applied depends on whether there has been a significant increase in credit risk. To assess whether there is a significant increase in credit risk, the Corporation compares the risk of a default occurring on the asset as at the reporting date with the risk of default as at the date of initial recognition based on all information available, and reasonable and supportive forward looking information. For trade receivables only, the Corporation applies the simplified approach as permitted by IFRS 9 which requires expected lifetime losses to be recognized from initial recognition of receivables.

Derivatives and hedge accounting

Derivatives are initially recognized at fair value on the date a derivative contract is entered into and are subsequently re-measured to their fair value at the end of each reporting period. The accounting for subsequent changes in fair value depends on whether the derivative is designated as a hedging instrument, and if so, the nature of the item being hedged and the type of hedge relationship designated. The Corporation documents at the inception of the hedging transaction the economic relationship between hedging instruments and hedged items including whether the hedging instrument is expected to offset changes in cash flows of hedged items. The Corporation documents its risk management objective and strategy for undertaking various hedge transactions at the inception of each hedging relationship.

The Corporation began to apply hedge accounting for certain designated fuel derivatives prospectively from April 1, 2015. Crude oil prices, while not contractually specified in the Corporation's jet fuel purchase contracts, are economically related to jet fuel prices. The Corporation enters into option contracts on crude oil and designates the contracts in cash flow hedges of the crude oil component of its future jet fuel purchases. The Corporation has established a hedge ratio of 1:1 for its hedging relationships. Under hedge accounting, to the extent effective, the gain or loss on fuel hedging derivatives is recorded in other comprehensive income. Premiums paid for option contracts and the time value of the option contracts are deferred as a cost of the hedge in other comprehensive income. Amounts accumulated in other comprehensive income are presented as hedging reserve in equity and are reclassified to Aircraft fuel expense when the underlying hedged jet fuel is used. Any ineffective gain or loss on fuel hedging derivatives is recorded in non-operating expense in Fuel and other derivatives. Refer to Note 15 for the results from fuel hedge accounting since the Corporation began applying hedge accounting in 2015.

When a hedging instrument expires, is sold or terminated, or when a hedge no longer meets the criteria for hedge accounting, any cumulative deferred gain or loss and deferred costs of hedging in equity at that time remains in equity until the forecast transaction occurs. When the forecast transaction is no longer expected to occur, the cumulative gain or loss and deferred costs of hedging that were reported in equity are immediately reclassified to profit or loss.

If the hedge ratio for risk management purposes is no longer optimal but the risk management objective remains unchanged and the hedge continues to qualify for hedge accounting, the hedge relationship will be rebalanced by adjusting either the volume of the hedged instrument or the volume of the hedged item so that the hedge ratio aligns with the ratio used for risk management purposes. Any hedge ineffectiveness is calculated and accounted for in profit or loss at the time of the hedge relationship rebalancing.

The Corporation enters into interest rate, foreign currency, fuel derivatives and share forward contracts to manage the associated risks. Derivative instruments are recorded on the consolidated statement of financial position at fair value, including those derivatives that are embedded in financial or non-financial contracts that are required to be accounted for separately. Changes in the fair value of derivative instruments are recognized in Non-operating income (expense), except for effective changes for designated fuel derivatives under hedge accounting as described above. Derivative contracts are included in the consolidated statement of financial position at fair value in Prepaid expenses and other current assets, Deposits and other assets, and Accounts payable and accrued liabilities based on the terms of the contractual agreements. All cash flows associated with purchasing and selling derivatives are classified as operating cash flows in the consolidated statement of cash flow.

M) Foreign currency translation

The functional currency of Air Canada and its subsidiaries is the Canadian dollar. Monetary assets and liabilities denominated in foreign currencies are translated into Canadian dollars at rates of exchange in effect at the date of the consolidated statement of financial position. Non-monetary assets and liabilities, revenues and expenses arising from transactions denominated in foreign currencies, are translated at the historical exchange rate or the average exchange rate during the period, as applicable. Adjustments to the Canadian dollar equivalent of foreign denominated monetary assets and liabilities due to the impact of exchange rate changes are recognized in Foreign exchange gain (loss).

N) Income taxes

The tax expense for the period comprises current and deferred income tax. Tax expense is recognized in the consolidated statement of operations, except to the extent that it relates to items recognized in other comprehensive income or directly in equity, in which case the tax is netted with such items.

The current income tax expense is calculated on the basis of the tax laws enacted or substantively enacted at the balance sheet date in the jurisdictions where the Corporation and its subsidiaries operate and generate taxable income. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulations are subject to interpretation. It establishes provisions where appropriate on the basis of amounts expected to be paid to the tax authorities.

Deferred income tax is recognized, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred income tax is determined using tax rates and laws that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the related deferred income tax asset is realized or the deferred income tax liability is settled.

Deferred income tax assets are recognized only to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

O) Earnings per share

Basic earnings per Share ("EPS") is calculated by dividing the net income (loss) for the period attributable to the shareholders of Air Canada by the weighted average number of Shares outstanding during the period.

Diluted EPS is calculated by adjusting the weighted average number of Shares outstanding for dilutive potential Shares. The Corporation's potentially dilutive Shares are comprised of stock options. The number of Shares included with respect to time vesting options is computed using the treasury stock method unless they are anti-dilutive. Under this method, the proceeds from the exercise of such instruments are assumed to be used to purchase Shares at the average market price for the period and the difference between the number of Shares issued upon exercise and the number of Shares assumed to be purchased is included in the calculation. The number of Shares included with respect to performance-based employee share options is treated as contingently issuable shares because their issue is contingent upon satisfying specified conditions in addition to the passage of time. If the specified conditions are met, then the number of Shares included is also computed using the treasury stock method unless they are anti-dilutive.

P) Restricted cash

The Corporation has recorded Restricted cash under Current assets representing funds held in trust by Air Canada Vacations in accordance with regulatory requirements governing advance ticket sales, as well as funds held in escrow accounts relating to Air Canada Vacations' credit card agreements, recorded under Current liabilities, for certain travel related activities.

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

Q) Aircraft fuel inventory and spare parts and supplies inventory

Inventories of aircraft fuel, spare parts and supplies are measured at cost being determined using a weighted average formula, net of related obsolescence provision, as applicable.

The Corporation did not recognize any write-downs on inventories or reversals of any previous write-downs during the periods presented. Included in Aircraft maintenance is $62 related to spare parts and supplies consumed during the year (2015 – $68).

R) Property and equipment

Property and equipment is recognized using the cost model. Property under finance 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.

The Corporation allocates the amount initially recognized in respect of an item of property and equipment to its significant components and depreciates separately each component. Property and equipment are depreciated to estimated residual values based on the straight-line method over their estimated service lives. Aircraft and flight equipment are componentized into airframe, engine, and cabin interior equipment and modifications. Airframes and engines are depreciated over periods not exceeding 25 years, with residual values initially estimated at 10% of the original cost and updated for changes in estimates over time. Spare engines and related parts ("rotables") are depreciated over the average remaining useful life of the fleet to which they relate with 10% estimated residual values. Cabin interior equipment and modifications are depreciated over the lesser of eight years or the remaining useful life of the aircraft. Cabin interior equipment and modifications to aircraft on operating leases are amortized over the term of the lease. Major maintenance of airframes and engines, including replacement spares and parts, labour costs and/or third party maintenance service costs, are capitalized and amortized over the average expected life between major maintenance events. Major maintenance events typically consist of more complex inspections and servicing of the aircraft. All power-by-the-hour fleet maintenance contract costs are charged to operating expenses in the income statement as incurred. Buildings are depreciated on a straight-line basis over their useful lives not exceeding 50 years or the term of any related lease, whichever is less. Leasehold improvements are amortized over the lesser of the lease term or five years. Ground and other equipment is depreciated over three to 25 years.

Residual values and useful lives are reviewed at least annually and depreciation rates are adjusted accordingly on a prospective basis. Gains and losses on disposals of property and equipment are determined by comparing the proceeds with the carrying amount of the asset and are included as part of non-operating gains and losses in the consolidated statement of operations.

S) Interest capitalized

Borrowing costs are expensed as incurred. For borrowing costs attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use, the costs are capitalized as part of the cost of that asset. Capitalization of borrowing costs commences when expenditures for the asset and borrowing costs are being incurred and the activities to prepare the asset for its intended use are in progress. Borrowing costs are capitalized up to the date when the project is completed and the related asset is available for its intended use.

To the extent that funds are borrowed specifically for the purpose of obtaining such assets, the amount of borrowing costs eligible for capitalization is determined at the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization is determined by applying a capitalization rate to the expenditures on that asset. The capitalization rate is the weighted average of the borrowing costs applicable to the borrowings of the Corporation that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

T) Leases

Leases are classified as finance leases when the lease arrangement transfers substantially all the risks and rewards of ownership to the lessee. All other leases are classified as operating leases.

Total aircraft operating lease rentals over the lease term are amortized to operating expense (aircraft rent) on a straight-line basis. Included in Deposits and other assets and Other long-term liabilities are the differences between the straight-line aircraft rent expense and the payments as stipulated under the lease agreement.

U) Intangible assets

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

	Estimated useful life	Remaining amortization period as at December 31, 2016
International route rights and slots	Indefinite	not applicable
Marketing based trade names	Indefinite	not applicable
Technology based (internally developed)	5 years	1 to 5 years

Air Canada has international route and slot rights which enable the Corporation to provide services internationally. The value of the recorded intangible assets relates to the cost of route and slot rights at Tokyo's Narita International Airport, Washington's Reagan National Airport and London's Heathrow Airport. Air Canada expects to provide service to these international locations for an indefinite period.

Air Canada and certain of its subsidiaries have trade names, trademarks and domain names (collectively, "Trade Names"). These items are marketing based intangible assets as they are primarily used in the sale and promotion of Air Canada's products and services. The Trade Names create brand recognition with customers and potential customers and are capable of contributing to cash flows for an indefinite period of time. Air Canada intends to continually re-invest in, and market, the Trade Names to support classification as indefinite life intangibles. If there were plans to cease using any of the Trade Names, the specific names would be classified as finite and amortized over the expected remaining useful life.

Development costs that are directly attributable to the design, development and testing of identifiable software products are recognized as technology based intangible assets if certain criteria are met, including technical feasibility and intent and ability to develop and use the technology to generate probable future economic benefits; otherwise they are expensed as incurred. Directly attributable costs that are capitalized as part of the technology based intangible assets include software-related, employee and third party development costs and an appropriate portion of relevant overhead.

V) Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Corporation's share of the net identifiable assets of the acquired business at the date of acquisition. Goodwill is tested at least annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. For the purpose of impairment testing, goodwill is tested for impairment at the lowest level within the entity at which the goodwill is monitored for internal management purposes, being the operating segment level (Note AA).

W) Impairment of long-lived assets

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

Long-lived assets, other than goodwill, that suffered an impairment are reviewed for possible reversal of the impairment at each reporting date. Management assesses whether there is any indication that an impairment loss recognized in a prior period no longer exists or has decreased. In assessing whether there is a possible reversal of an impairment loss, management considers the indicators that gave rise to the impairment loss. If any such indicators exist that an impairment loss has reversed, management estimates the recoverable amount of the long-lived asset. An impairment loss recognized in prior periods for an asset other than goodwill shall be reversed only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognized. The carrying amount of any individual asset in the CGU is not increased above the carrying value that would have been determined had the original impairment not occurred. A reversal of an impairment loss is recognized immediately in the consolidated statement of operations.

X) Non-current assets (or disposal groups) held for sale

Non-current assets (or disposal groups) are classified as assets held for sale when their carrying amount is to be recovered principally through a sale transaction, such assets are available for immediate sale in present condition, and a sale is considered highly probable. They are stated at the lower of carrying amount and fair value less costs to dispose.

Y) Provisions

Provisions are recognized when there exists a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate can be made of the obligation. If the effect is significant, the expected cash flows are discounted using a rate that reflects, where appropriate, the risks specific to the liability. Where discounting is used, interest accretion on the provision is recorded in Other non-operating expense.

Z) Special items

Special items are those items that in management's view are to be separately disclosed by virtue of their size or incidence to enable a full understanding of the Corporation's financial performance.

AA) Segment reporting

Air Canada is managed as one operating segment based on how financial information is produced internally for the purposes of making operating decisions. The operating segment is reported in a manner consistent with the internal reporting provided to the chief operating decision maker. The chief operating decision maker, who is responsible for allocating resources and assessing performance of operations, has been identified as the Chief Executive Officer.

BB) Accounting standards and amendments issued but not yet adopted

The following is an overview of accounting standard changes that the Corporation will be required to adopt in future years. The Corporation continues to evaluate the impact of these standards on its consolidated financial statements.

IFRS 15 – Revenue from contracts with customers

IFRS 15 replaces IAS 18 Revenue and related interpretations. The core principle of the new standard is to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard is intended to enhance disclosures about revenue, provide more comprehensive guidance for transactions that were not previously addressed and improve guidance for multiple-element arrangements. IFRS 15 is effective for annual periods beginning on January 1, 2018, with early adoption permitted.

The Corporation will apply the standard effective January 1, 2018. The standard will be applied retrospectively with adjustment to the opening consolidated statement of financial position as at January 1, 2017. Under IFRS 15, incremental costs of obtaining passenger revenues, such as credit card fees and global distribution system charges, will be capitalized at time of sale and expensed at the time of passenger revenue recognition. Currently, these costs are expensed as incurred at the time the flight ticket is sold. With this change in accounting policy for contract costs, the timing of expense recognition will be impacted. The Corporation continues to evaluate the financial impact of this expected change to capitalize contract costs along with other possible impacts of this standard on its consolidated financial statements.

IFRS 16 – Leases

IFRS 16 replaces IAS 17 Leases and related interpretations. The core principle is that a lessee recognize assets and liabilities for all leases with a lease term of more than 12 months. A lessee is required to recognize a right-of-use asset representing its right to use the underlying leased asset and a lease liability representing its obligation to make lease payments. Assets and liabilities arising from a lease are initially measured on a present value basis. The measurement includes non-cancellable lease payments (including inflation-linked payments), and also includes payments to be made in optional periods if the lessee is reasonably certain to exercise an option to extend the lease, or not to exercise an option to terminate the lease. The new standard is intended to provide a faithful representation of leasing transactions, in particular those that do not currently require the lessees to recognize an asset and liability arising from an operating lease. IFRS 16 is effective for annual periods beginning on January 1, 2019, with early adoption permitted for entities that would also apply IFRS 15 Revenue from Contracts with Customers.

The Corporation is still evaluating the impact the adoption of this standard will have on its consolidated financial statements, but expects this standard will have a significant impact on its consolidated balance sheet, along with a change to the recognition, measurement and presentation of lease expenses in the consolidated statement of operations. The Corporation expects to apply the standard with its mandatory effective date.

3 Critical Accounting Estimates and Judgments

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in these financial statements and accompanying notes. These estimates and associated assumptions are based on historical experience, future operating plans and various other factors believed to be reasonable under the circumstances, and the results of such estimates form the basis of judgments about carrying values of assets and liabilities. These underlying assumptions are reviewed on an ongoing basis. Actual results could differ materially from those estimates.

Significant estimates and judgments made in the preparation of these financial statements include, but are not limited to, the following areas, with further information contained in the applicable accounting policy or note:

Employee future benefits

- The cost and related liabilities of the Corporation's pensions, other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations involve assumptions and estimates including discount rates, future salary increases, mortality rates and future benefit increases. Also, due to the long-term nature of these programs, such estimates are subject to significant uncertainty. Refer to Notes 8 and 20 for additional information.

Depreciation and amortization period for long-lived assets

- The Corporation makes estimates about the expected useful lives of long-lived assets and the expected residual value of the assets based on the estimated current fair value of the assets, the Corporation's fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by a variety of factors, including changes to maintenance programs, changes in jet fuel prices and other operating costs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. Estimates and assumptions are evaluated at least annually. Generally, these adjustments are accounted for on a prospective basis, through depreciation and amortization expense. For the purposes of sensitivity analysis on these estimates, a 50% reduction to residual values on aircraft with remaining useful lives greater than five years results in an increase of $16 to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.

Impairment considerations on long-lived assets

- When required, an impairment test is performed by comparing the carrying amount of the asset or cash-generating unit to their recoverable amount, which is calculated as the higher of an asset's or cash-generating unit's fair value less costs to dispose and its value in use. Value in use is calculated based upon a discounted cash flow analysis, which requires management to make a number of significant assumptions including assumptions relating to future operating plans, discount rates and future growth rates. Refer to Notes 5 and 6 for additional information.

Maintenance provisions

- The recording of maintenance provisions related to return conditions on aircraft leases requires management to make estimates of the future costs associated with the maintenance events required under the lease return condition and estimates of the expected future maintenance condition of the aircraft at the time of lease expiry. These estimates take into account current costs of these maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in maintenance expense in the period. The effect of any changes in estimates, including changes in discount rates, inflation assumptions, cost estimates or lease expiries, is also recognized in maintenance expense in the period. Refer to Note 9(a) for additional information.

Income taxes

- Deferred income tax assets are recognized only to the extent that it is probable that future taxable income will be available to realize them. In making this assessment, consideration is given to available positive and negative evidence and relevant assumptions. Consideration is given to, among other things, future projections of taxable income, overall business environment, historical financial results, and industry-wide trends and outlook. At December 31, 2016, no deferred income tax assets have been recorded. Income for 2016, and the previous year, provides positive evidence, however based upon the weight of other factors, in particular historical financial results for the Corporation and the airline industry's historically cyclical results, determination was made that deferred income tax assets could not be recorded at December 31, 2016. The Corporation's income position and income trend will continue to be evaluated to assess the realizability of the deferred income tax assets.

4 Property and Equipment

	Aircraft and flight equipment	Buildings and leasehold improvements	Ground and other equipment	Purchase deposits and assets under development	Total
Year ended December 31, 2015					
At January 1, 2015	$ 4,944	$ 399	$ 168	$ 487	$ 5,998
Additions	1,255	-	34	556	1,845
Reclassifications	199	50	24	(273)	-
Disposals	(181)	-	(1)	-	(182)
Depreciation	(543)	(39)	(35)	-	(617)
Impairment	(14)	-	-	-	(14)
At December 31, 2015	$ 5,660	$ 410	$ 190	$ 770	$ 7,030
At December 31, 2015					
Cost	$ 8,278	$ 791	$ 451	$ 770	$ 10,290
Accumulated depreciation	(2,618)	(381)	(261)	-	(3,260)
At December 31, 2015	$ 5,660	$ 410	$ 190	$ 770	$ 7,030
Year ended December 31, 2016					
At January 1, 2016	$ 5,660	$ 410	$ 190	$ 770	$ 7,030
Additions	2,106	6	30	747	2,889
Reclassifications	585	32	3	(620)	-
Disposals	(605)	-	(1)	-	(606)
Depreciation	(716)	(39)	(38)	-	(793)
At December 31, 2016	$ 7,030	$ 409	$ 184	$ 897	$ 8,520
At December 31, 2016					
Cost	$ 10,037	$ 829	$ 480	$ 897	$ 12,243
Accumulated depreciation	(3,007)	(420)	(296)	-	(3,723)
	$ 7,030	**$ 409**	**$ 184**	**$ 897**	**$ 8,520**

As at December 31, 2016, property and equipment included finance leased assets in respect of 9 aircraft (2015 – 18) with a net book value of $130 (2015 – $170) and facilities with a net book value of $37 (2015 – $39).

Included in aircraft and flight equipment are 21 aircraft and 5 spare engines (2015 – 21 aircraft and 5 spare engines) which are leased to third parties with a cost of $349 (2015 – $349) less accumulated depreciation of $115 (2015 – $97) for a net book value of $234 (2015 – $252). Depreciation expense for 2016 for this aircraft and flight equipment amounted to $18 (2015 – $14).

Promissory notes receivable of $143 at December 31, 2015 represented certain proceeds from the sale of Embraer 190 aircraft, with each of the notes due within 90 days of delivery of the aircraft. All were collected in 2016.

In 2015, an impairment charge of $14 was recorded in Depreciation, amortization and impairment expense related to two A340-300 aircraft (neither of which was operated by Air Canada). The lease agreements relating to these aircraft expired in 2015, with one aircraft returned while the other was purchased and resold in 2016. The impairment charge was calculated on the amount the carrying value exceeded the net proceeds expected upon disposal of the aircraft.

Certain property and equipment are pledged as collateral as further described under the applicable debt instrument in Note 7. There are no non-operating aircraft or impairment values recorded as at December 31, 2016.

5 Intangible Assets

	International route rights and slots	Marketing based trade names	Contract and customer based	Technology based (internally developed)	Total
Year ended December 31, 2015					
At January 1, 2015	$ 97	$ 88	-	$ 120	$ 305
Additions	-	-	-	38	38
Amortization	-	-	-	(29)	(29)
At December 31, 2015	$ 97	$ 88	-	$ 129	$ 314
At December 31, 2015					
Cost	$ 97	$ 88	20	$ 419	$ 624
Accumulated amortization	-	-	(20)	(290)	(310)
	$ 97	$ 88	-	$ 129	$ 314
Year ended December 31, 2016					
At January 1, 2016	$ 97	$ 88	-	$ 129	$ 314
Additions	-	-	-	36	36
Amortization	-	-	-	(35)	(35)
At December 31, 2016	$ 97	$ 88	-	$ 130	$ 315
At December 31, 2016					
Cost	$ 97	$ 88	-	$ 455	$ 640
Accumulated amortization	-	-	-	(325)	(325)
	$ 97	$ 88	-	$ 130	$ 315

In 2015, technology based assets with cost of $15 and accumulated amortization of $15 were retired. There were no technology based asset retirements in 2016. In 2016, contract and customer based intangible assets with a cost of $20 and accumulated amortization of $20 were retired.

Certain international route rights and slots are pledged as security for senior secured notes as described in Note 7.

An annual impairment review is conducted on all intangible assets that have an indefinite life. International route rights and slots and marketing based trade names are considered to have an indefinite life. The impairment review is carried out at the level of a cash-generating unit. On this basis, an impairment review was performed at the North American and international fleet levels for aircraft and related assets supporting the operating fleet. The allocation of the indefinite lived intangible assets to the cash-generating units was $144 to international and $41 to North American.

The recoverable amount of the cash-generating units has been measured based on their value in use, using a discounted cash flow model. Cash flow projections are based on the annual business plan approved by the Board of Directors of Air Canada. In addition, management-developed projections are made covering a three-year period. These cash flows are management's best estimate of future events taking into account past experience and future economic assumptions, such as the forward curves for crude-oil and the applicable exchange rates. Cash flows beyond the three-year period are projected to increase consistent with the long-term growth assumption of the airline considering various factors such as the Corporation's fleet plans and industry growth assumptions. The discount rate applied to the cash flow projections is derived from the Corporation's weighted average cost of capital adjusted for taxes and specific risks associated with the cash-generating unit being tested.

Due to the recoverable amount exceeding the cash generating units carrying value by a significant margin, the most recent calculation from the 2014 period was carried forward and used in the impairment test in the current period. Key assumptions used for the value in use calculations in fiscal 2014 were as follows:

	2004
Discount rate	10.7%
Long-term growth rate	2.5%
Jet fuel price range per barrel	$128 – $133

The recoverable amount of both cash-generating units based on value in use exceeded their respective carrying values by approximately $3,900. If the discount rate were increased by 240 basis points, the excess of recoverable amount over carrying value would be reduced to nil for one of the cash-generating units.

6 Goodwill

Goodwill is tested at least annually for impairment. For the purpose of impairment testing, goodwill is tested for impairment using the fair value less cost to dispose model at the operating segment level. Air Canada is managed as one operating segment based on how financial information is produced internally for the purposes of making operating decisions, and it is the lowest level at which goodwill is monitored for internal management purposes.

In assessing the goodwill for impairment, the Corporation compares the aggregate recoverable amount consisting of the sum of its quoted equity market capitalization and the fair value of its debt to the carrying value of its net assets excluding long-term debt. An impairment charge is recognized to the extent that the carrying value exceeds the recoverable amount. No impairment losses have been recorded against the value of goodwill since its acquisition.

No impairment charges have arisen as a result of the reviews performed as at December 31, 2016 and 2015. Reasonably possible changes in key assumptions would not cause the recoverable amount of goodwill to fall below the carrying value.

7 Long-Term Debt and Finance Leases

	Final maturity	Weighted average interest rate (%)	2016	2015
Aircraft financing (a)				
Fixed rate U.S. dollar financing	2017 – 2027	4.59	$ 3,598	$ 2,718
Floating rate U.S. dollar financing	2017 – 2026	2.05	457	573
Floating rate CDN dollar financing	2026 – 2027	1.56	366	398
Floating rate Japanese yen financing	2020	0.10	70	91
Senior secured notes – U.S. dollar (b)	-	7.61	-	968
Senior secured notes – CDN dollar (b)	-	7.63	-	300
Senior secured notes – CDN dollar (b)	2023	4.75	200	-
Senior unsecured notes – U.S. dollar (c)	2021	7.75	537	554
Other secured financing – U.S. dollar (b) and (d)	2018 – 2023	3.87	1,175	513
Other secured financing – CDN dollar (e)	2018	8.15	44	45
Long-term debt		**4.35**	**6,447**	**6,160**
Finance lease obligations (f)	2018 – 2033	9.61	275	330
Total debt and finance leases		**4.57**	**6,722**	**6,490**
Unamortized debt issuance costs			(104)	(96)
Current portion			(707)	(524)
Long-term debt and finance leases			**$ 5,911**	**$ 5,870**

(a) Aircraft financing (US$3,021, CDN $366 and JPY ¥6,079) (2015 – US$2,379, CDN $398 and JPY ¥7,878) is secured primarily by specific aircraft with a carrying value of $5,523 (2015 – $4,335). For the majority of the financing, principal and interest is repayable quarterly until maturity and can be repaid at any time with the payment of applicable fees. US$365, CDN $366 and JPY ¥6,079 of the financing is supported by a loan guarantee by the Export-Import Bank of the United States ("EXIM").

In 2016, in connection with the financing of seven Boeing 787 aircraft and two Boeing 777, principal of US$1,004 is included in fixed rate U.S. dollar financing in the table above. The acquisition of these aircraft was financed with proceeds from the sale of the enhanced equipment trust certificates that were issued through two private offerings in 2015. The equipment notes that were issued following each of the drawdowns are secured by the respective aircraft delivered and the security interest in each aircraft is structured to benefit from the protections of the Cape Town Convention on International Interests in Mobile Equipment and the Protocol thereto on Matters Specific to Aircraft Equipment, as enacted in Canada.

Financing fees paid in conjunction with the offerings in 2015 were $18 and are reported in Financing on the consolidated statement of cash flow.

During 2016, principal of US$49 was prepaid relating to the financing of six Embraer 190 aircraft. An amount of $7 is included in Loss on debt settlements related to the prepayment of fixed rate debt (2015 – principal of US$126 prepaid relating to the financing of 14 Embraer 190 aircraft with amount of $13 included in Loss on debt settlements).

(b) In October 2016, Air Canada completed a private offering of senior secured notes and a new credit facility in connection with its $1.25 billion refinancing transaction.

As part of its refinancing transaction, Air Canada entered into a purchase agreement with a syndicate of initial purchasers relating to a private offering of $200 aggregate principal amount of 4.75% senior secured first lien notes due 2023 (the "2016 Senior Notes"), which were sold at par. Air Canada also received proceeds of a US$800 term loan, maturing in 2023, and entered into a new US$300 revolving credit facility expiring in 2021 (collectively with the term loan, the "2016 Credit Facility"). The revolving credit facility, which remained undrawn as of December 31, 2016, has an initial interest rate of 275 basis points over LIBOR (subject to a LIBOR floor of 75 basis points).

Air Canada may redeem some or all of the 2016 Senior Notes at any time on or after October 6, 2019 at certain established redemption prices, plus accrued and unpaid interest. At any time prior to October 6, 2019, Air Canada may redeem some or all of the 2016 Senior Notes at a price equal to 100% of their principal amount redeemed plus a "make-whole" premium and accrued and unpaid interest. At any time prior to October 6, 2019, Air Canada may redeem up to 35% of the aggregate principal amount of the 2016 Senior Notes with the proceeds of certain equity offerings, at established redemption prices, plus accrued and unpaid interest. In addition, at any time and from time to time prior to

October 6, 2021, Air Canada may redeem, during any 12-month period, up to 10% of the original aggregate principal amount of the 2016 Senior Notes at a redemption price of 103% of the principal amount, plus accrued and unpaid interest.

Air Canada used the net proceeds from the sale of the 2016 Senior Notes, together with the borrowings under the term loan under the 2016 Credit Facility, and $444 of cash on hand, to pay the redemption price for all of Air Canada's then outstanding senior secured notes, and to repay Air Canada's then outstanding US$300 term loan.

In conjunction with such repayment and redemption, $61 in premium costs were paid, and a write-off of transaction costs and discounts of $21 was recorded as a loss on debt settlements in the fourth quarter of 2016.

The 2016 Senior Notes and the Corporation's obligations under the 2016 Credit Facility are senior secured obligations of Air Canada, secured on a first lien basis, subject to certain permitted liens and exclusions, by certain real estate interests, ground service equipment, certain airport slots and gate leaseholds, and certain Pacific routes and the airport slots and gate leaseholds utilized in connection with those Pacific routes.

(c) Private offering of US$400 of 7.75% senior unsecured notes due 2021, with interest payable semi-annually.

(d) Other U.S. dollar secured financings are fixed and floating rate financings that are secured by certain assets including assets described in b) above relating to the 2016 Credit Facility. As at December 31, 2016, the Corporation had not drawn on the revolving credit facility and the outstanding term loan principal was US$800 (2015 – US$296 principal on then outstanding term loan).

(e) Other CDN dollar secured financing is a revolving credit facility for the financing of jet fuel. Financial covenants under that fuel facility require the Corporation to maintain certain minimum operating results and cash balances.

(f) Finance leases, related to facilities and aircraft, total $275 ($68 and US$154) (2015 – $330 ($71 and US$187)). During 2016, the Corporation recorded interest expense on finance lease obligations of $27 (2015 – $27). The carrying value of aircraft and facilities under finance leases amounted to $130 and $37 respectively (2015 – $170 and $39).

Air Canada has aircraft leasing transactions with a number of structured entities (Note 2). The debt amount of these leasing transactions includes any guarantee by Air Canada of the residual value of the aircraft upon expiry of the lease. The related aircraft are collateral against the debt by the owners thereof. The creditors under these leasing arrangements have recourse to Air Canada, as lessee, in the event of default or early termination of the lease.

Certain aircraft and other secured finance agreements contain collateral fair value tests. Under the tests, Air Canada may be required to provide additional collateral or prepay part of the financings. The maximum amount payable in 2017, assuming the collateral is worth nil, is $22 (US$17) (2015 – $135 (US$98)). The maximum amount payable declines over time in relation to the outstanding principal. Total collateral as at December 31, 2016 is $22 (US$17) (2015 – $4(US$3)) in the form of cash deposits, included in Deposits and other assets, has been provided under the fair value test for certain of these aircraft leases.

Cash interest paid on Long-term debt and finance leases in 2016 by the Corporation was $331 (2015 – $315).

Maturity analysis

Principal and interest repayment requirements as at December 31, 2016 on Long-term debt and finance lease obligations are as follows. U.S. dollar amounts are converted using the December 31, 2016 closing rate of CDN$1.3427.

	2017	2018	2019	2020	2021	Thereafter	Total
Principal							
Long-term debt obligations	$ 666	$ 679	$ 514	$ 522	$ 872	$ 3,194	$ 6,447
Finance lease obligations	41	49	46	50	17	72	275
	$ 707	**$ 728**	**$ 560**	**$ 572**	**$ 889**	**$ 3,266**	**$ 6,722**
Interest							
Long-term debt obligations	$ 266	$ 222	$ 207	$ 179	$ 134	$ 330	$ 1,338
Finance lease obligations	23	19	15	10	5	20	92
	$ 289	**$ 241**	**$ 222**	**$ 189**	**$ 139**	**$ 350**	**$ 1,430**

Principal repayments in the table above exclude transaction costs of $104 which are offset against Long-term debt and finance leases in the consolidated statement of financial position.

8 Pensions and Other Benefit Liabilities

The Corporation maintains several defined benefit and defined contribution plans providing pension, other post-retirement and post-employment benefits to its employees.

The Corporation is the administrator and sponsoring employer of nine Domestic Registered Plans ("Domestic Registered Plans") with defined benefit commitments registered under the Pension Benefits Standard Act, 1985 (Canada). The U.S. plan, U.K. plan and Japan plan are international plans covering members 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. Benefit payments are from trustee-administered funds, however there are also a number of unfunded plans where the Corporation meets the benefit payment obligation as it falls due. Plan assets held in trusts are governed by regulations. The governance of the plans, overseeing all aspects of the plans including investment decisions and contributions, lies primarily with the Corporation. The Pension Committee, a committee of the Board of Directors, assists in the monitoring and oversight of the plans to ensure pension liabilities are appropriately funded, pension assets are prudently invested, risk is managed at an acceptable level and retirement benefits are administered in a proper and effective manner.

Other employee benefits include 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.

Pension plan cash funding obligations

Pension funding obligations (including projected funding obligations) may vary significantly based on a wide variety of factors, including the assumptions used in the most recently filed actuarial valuation reports (including the applicable discount rate used or assumed in the actuarial valuation), the plan demographics at the valuation date, the existing plan provisions, legislative and regulatory developments and changes in economic conditions (mainly the return on plan assets and changes in interest rates) and other factors. Actual contributions that are determined on the basis of future valuation reports may vary significantly from projections. In addition to changes in plan demographics and experience, actuarial assumptions and methods may be changed from one valuation to the next, including due to changes in plan experience, financial markets, future expectations, legislation and other factors.

As at January 1, 2016, the aggregate solvency surplus in the domestic registered pension plans was $1.3 billion. The next required valuation to be made as at January 1, 2017 will be completed in the first half of 2017. With the Corporation's domestic registered pension plans in a solvency surplus position as at January 1, 2016, past service cost payments were not required in 2016. In addition, in accordance with legislation and applicable plan rules, the excess over 105% on a solvency basis can be used to reduce current service contributions under the defined benefit component or to fund the employer contribution to a defined contribution component within the same pension plan. Based on that, and including the international and supplemental plans, the total employer pension funding contributions during 2016 amounted to $97 ($101 employer contribution net of $4 used to fund employer contribution in defined contribution components of the same plans). Pension funding obligations for 2017 are expected to be $90.

Special charge

In 2016, a past service cost expense of $91 was recorded as a Special Item to reflect the estimated cost of pension increases applicable to members of the Air Canada Pilots Association ("ACPA") who participate in a defined benefit plan. Certain pension plan amendments (related to maximum annual pension per year of service) are conditional on meeting defined business plan targets tied to the number of operating aircraft in the fleet by 2017, 2020 and as of 2023. The past service cost expense of $91 represents the out of period expense associated with benefits granted upon signing of the ACPA collective agreement in 2014 based on management's best estimate of the probability of meeting the defined business plan targets tied to the number of operating aircraft at the respective dates. Future changes in estimates surrounding the probability of meeting future plan targets will be recorded as actuarial gains (losses).

In addition, during the year ended December 31, 2016, actuarial losses of $52 were recognized in other comprehensive income related to changes in assumptions associated with cost of pension increases applicable to affected members of ACPA. Furthermore, a current service cost of $6 was recorded in Wages, salaries and benefits in respect of current period benefits earned related to such amendments.

Benefit obligation and plan assets

These consolidated financial statements include all of the assets and liabilities of all Corporation-sponsored plans. The amounts recorded in the statement of financial position are as follows:

	Pension benefits		Other employee future benefits		Total	
	2016	2015	2016	2015	2016	2015
Non-current assets						
Pension assets	$ 1,153	$ 851	$ -	$ -	$ 1,153	$ 851
Current liabilities						
Accounts payable and accrued liabilities	-	-	62	64	62	64
Non-current liabilities						
Pension and other benefit liabilities	1,197	1,021	1,239	1,224	2,436	2,245
Net benefit obligation	**$ 44**	**$ 170**	**$ 1,301**	**$ 1,288**	**$ 1,345**	**$ 1,458**

Certain pension plans are in a net asset position and, as a result, those plans are required to be reported as Pension assets on the consolidated statement of financial position. The current portion of the net benefit obligation represents an estimate of other employee future benefits claims to be paid during 2017.

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

	Pension benefits		Other employee future benefits	
	2016	2015	2016	2015
Change in benefit obligation				
Benefit obligation at beginning of year	$ 18,286	$ 18,352	$ 1,288	$ 1,285
Current service cost	255	249	32	37
Past service cost	3	3	(8)	(19)
Past service cost - special item	91	-	-	-
Interest cost	750	731	52	51
Employees' contributions	82	78	-	-
Benefits paid	(845)	(886)	(49)	(49)
Remeasurements:				
Experience loss (gain)	(54)	4	(45)	(29)
Loss (gain) from change in demographic assumptions	8	(11)	(4)	(1)
Loss (gain) from change in financial assumptions	668	(338)	41	(21)
Plan settlements	(1)	-	-	-
Foreign exchange loss (gain)	(108)	104	(6)	34
Total benefit obligation	19,135	18,286	1,301	1,288
Change in plan assets				
Fair value of plan assets at beginning of year	18,438	17,433	-	-
Return on plan assets, excluding amounts included in Net financing expense	1,049	734	-	-
Interest income	739	687	-	-
Employer contributions	97	312	49	49
Employees' contributions	82	78	-	-
Benefits paid	(845)	(886)	(49)	(49)
Administrative expenses paid from plan assets	(11)	(10)	-	-
Foreign exchange gain (loss)	(111)	90	-	-
Total plan assets	19,438	18,438	-	-
(Surplus) deficit at end of year	**(303)**	**(152)**	**1,301**	**1,288**
Asset ceiling / additional minimum funding liability	347	322	-	-
Net benefit obligation	**$ 44**	**$ 170**	**$ 1,301**	**$ 1,288**

The actual return on plan assets was $1,788 (2015 – $1,421).

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

	2016	2015
Domestic registered plans	$ 1	$ 2
U.S., U.K., and Japan	92	80
Supplementary plans	1,104	939
	$ 1,197	**$ 1,021**

The weighted average duration of the defined benefit obligation is 14.2 years (2015 – 13.9 years).

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	
	2016	**2015**	**2016**	**2015**
Consolidated Statement of Operations				
Components of cost:				
Current service cost	$ 255	$ 249	$ 32	$ 37
Past service cost	3	3	(8)	(19)
Past service cost – special item	91	-	-	-
Gain on settlements	(1)	-	-	-
Administrative and other expenses	11	10	-	-
Actuarial gains	-	-	(14)	(18)
Total cost recognized in wages, salaries and benefits	**$ 359**	**$ 262**	**$ 10**	**$ -**
Net financing expense relating to employee benefits	**$ 24**	**$ 54**	**$ 52**	**$ 51**
Total cost recognized in statement of operations	**$ 383**	**$ 316**	**$ 62**	**$ 51**
Consolidated Other Comprehensive (Income) Loss				
Remeasurements:				
Experience loss (gain), including foreign exchange	(51)	18	(37)	24
Loss (gain) from change in demographic assumptions	8	(11)	(4)	(1)
Loss (gain) from change in financial assumptions	668	(338)	41	(21)
Return on plan assets	(1,049)	(734)	-	-
Minimum funding liability	12	48	-	-
Total cost (income) recognized in OCI	**$ (412)**	**$ (1,017)**	**$ -**	**$ 2**

The funding of employee benefits as compared to the expense recorded in the consolidated statement of operations is summarized in the table below:

	2016	**2015**
Net defined pension and other future employee benefits expense recorded in the consolidated statement of operations		
Wages, salaries and benefits	$ 369	$ 262
Net financing expense relating to employee benefit liabilities	76	105
	$ 445	**$ 367**
Employee benefit funding by Air Canada		
Pension benefits	$ 97	$ 312
Other employee benefits	49	49
	$ 146	**$ 361**
Employee benefit funding less than expense	**$ 299**	**$ 6**

Composition of pension plan assets

Domestic Registered Plans

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

	2016	2015	Target Allocation
Bonds	60%	60%	60%
Canadian equities	7%	6%	7%
Foreign equities	13%	14%	13%
Alternative investments	20%	20%	20%
	100%	**100%**	**100%**

For the Domestic Registered Plan assets, approximately 80% of assets as of December 31, 2016 have a quoted market price in an active market. Assets that do not have a quoted market price in an active market are mainly investments in privately held entities. The asset composition in the table represents the allocation of plan assets to each asset type.

Included in plan assets, for determining the net benefit obligation for accounting purposes, are 17,647,059 Shares of Air Canada which were issued to a trust in 2009 in connection with pension funding agreements reached with all of the Corporation's Canadian-based unions. The trust arrangement provides that proceeds of any sale of the trust Shares will be retained and applied to reduce future pension solvency deficits, if any should materialize. With the Corporation's domestic registered pension plans now in a surplus position on a solvency basis, the accounting rules prevent the recognition of the value of the Shares held in trust as part of the pension assets. The Shares held in trust have a fair value of $241 at December 31, 2016 (2015 – $180), however after giving effect to the asset ceiling, the recognized accounting value of the trust asset is nil.

For the Domestic Registered Plans, the investments conform to the Statement of Investment Policy and Objectives of the Air Canada Pension Funds. The investment return objective is to achieve a total annualized rate of return that exceeds by a minimum of 1.0% before investment fees on average over the long-term (i.e. 10 years) the total annualized return that could have been earned by passively managing the Liability Replicating Portfolio. The Liability Replicating Portfolio, which is referenced to widely used Canadian fixed income indices (FTSE TMX Canada), closely matches the characteristics of the pension liabilities.

Recognizing the importance of surplus risk management, Air Canada manages the Domestic Registered Plans in an effort to mitigate surplus risk (defined as the difference between asset value and pension liability value), which is considered to be the key risk to be minimized and monitored. In addition, the objective of the investment strategy is to invest the plan assets in a prudent and diversified manner to mitigate the risk of price fluctuation of asset classes and individual investments within those asset classes and to combine those asset classes and individual investments in an effort to reduce overall risk.

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

- Equities are required to be diversified among regions, industries and economic sectors. Limitations are placed on the overall allocation to any individual security.
- Alternative investments are investments in non-publicly traded securities and in non-traditional asset classes. They may comprise, but are not limited to investments in real estate, agriculture, timber, private equity, venture capital, infrastructure, emerging markets debt, high yield bonds and commodity futures. Alternative investments are required to be diversified by asset class, strategy, sector and geography.
- Canadian bonds are oriented toward long-term investment grade securities rated "BBB" or higher. With the exception of Government of Canada securities or a province thereof or the U.S. Government, in which the plan may invest the entire fixed income allocation, these investments are required to be diversified among individual securities and sectors.

Derivatives are permitted provided that they are used for managing a particular risk (including interest rate risk related to pension liabilities) or to create exposures to given markets and currencies and that counterparties have a minimum credit rating of A. The Corporation manages interest rate risk related to its actuarial liabilities through a combination of financial instruments including, but not limited to, bonds, bond repurchase and reverse repurchase agreements, bond forwards, bond futures and interest rate swaps. As at December 31, 2016, taking into account the effect of such financial instrument risk management tools, approximately 75% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk. Counterparty credit risk associated with such financial instruments is mitigated by receiving collateral from counterparties based on collateralization agreements, as well as by monitoring the counterparties' credit ratings and ensuring compliance with the investment policy. The fair value of these derivative instruments is included in the Bonds in the asset composition table and is not a significant component of the aggregate bond fair values of the portfolio.

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

Risks

Through its defined benefit pension plans, the Corporation is exposed to a number of risks, the most significant of which are detailed below:

Asset risk

Asset risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market price. Asset risk comprises currency risk, credit risk and other price risk. Currency risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. This risk is mitigated through implementation of hedging strategies. Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. This risk is mitigated by receiving collateral from counterparties based on collateralization agreements and by monitoring the issuers' credit risk. Other price risk is the risk the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market. This risk is mitigated through proper diversification of plan assets.

Interest rate risk

Interest rate risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates. A decrease in corporate and/or government bond yields will increase plan liabilities, which will be partially offset by an increase in the value of the plans' bond holdings. As at December 31, 2016, approximately 75% of Air Canada's pension liabilities (including the effect of financial instrument risk management tools) were matched with fixed income products to mitigate a significant portion of the interest rate risk (discount rate risk).

Funding risk

Adverse changes in the value of plan assets or in interest rates, and therefore in the discount rate used to value liabilities, could have a significant impact on pension plan solvency valuations and future cash funding requirements.

Life expectancy

The majority of the plans' obligations are to provide benefits for the life of the member, so increases in life expectancy will result in an increase in the plans' liabilities.

Assumptions

Management is required to make significant estimates about actuarial and financial assumptions to determine the cost and related liabilities of the Corporation's employee future benefits.

Discount rate

The discount rate used to determine the pension obligation was determined by reference to market interest rates on corporate bonds rated "AA" or better with cash flows that approximate the timing and amount of expected benefit payments.

Future Increases in compensation

Estimates surrounding assumptions of future increases in compensation are based upon the current compensation policies, the Corporation's long range-plans, labour and employment agreements and economic forecasts.

The significant weighted average assumptions used to determine the Corporation's accrued benefit obligations and cost are as follows:

	Pension benefits		Other employee future benefits	
	2016	2015	2016	2015
Discount rate used to determine:				
Net interest on the net defined benefit obligation for the year ended December 31	4.1%	4.0%	4.1%	3.9%
Service cost for the year end December 31	4.3%	4.2%	4.3%	4.1%
Accrued benefit obligation as at December 31	3.9%	4.1%	3.9%	4.1%
Rate of future increases in compensation used to determine:				
Accrued benefit cost and service cost for the year ended December 31	2.5%	2.5%	not applicable	not applicable
Accrued benefit obligation as at December 31	2.5%	2.5%	not applicable	not applicable

Sensitivity analysis

Sensitivity analysis is based on changing one assumption while holding all other assumptions constant. In practice, this may be unlikely to occur, and changes in some of the assumptions may be correlated. When calculating the sensitivity of the defined benefit obligation to variations in significant actuarial assumptions, the same method (present value of the defined benefit obligation calculated with the projected unit credit method at the end of the reporting period) has been applied as for calculating the liability recognized in the consolidated statement of financial position.

Sensitivity analysis on 2016 pension expense and net financing expense relating to pension benefit liabilities, based on different actuarial assumptions with respect to discount rate is set out below. The effects on each pension plan of a change in an assumption are weighted proportionately to the total plan obligation to determine the total impact for each assumption presented.

	0.25 percentage point	
	Decrease	Increase
Discount rate on obligation assumption		
Pension expense	$ 19	$ (18)
Net financing expense relating to pension benefit liabilities	22	(18)
	$ 41	**$ (36)**
Increase (decrease) in pension obligation	**$ 678**	**$ (655)**

The increase (decrease) in the pension obligation for a 0.25 percentage point change in the discount rate relates to the gross amount of the pension liabilities and is before the impact of any change in plan assets. As at December 31, 2016, approximately 75% of Air Canada's pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk.

An increase of one year in life expectancy would increase the pension benefit obligation by $465.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 5.8% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2016 (2015 – 5.5%). The rate is assumed to decrease gradually to 5% by 2020 (2015 – assumed to decrease gradually to 5% by 2019). A one percentage point increase in assumed health care trend rates would have increased the total of current service and interest costs by $4 and the obligation by $62. A one percentage point decrease in assumed health care trend rates would have decreased the total of current service and interest costs by $4 and the obligation by $62.

A 0.25 percentage point decrease in discount rate would have increased the total of current and interest costs by less than $1 and the obligation by $55. A 0.25 percentage point increase in discount rate would have decreased the total of current and interest costs by less than $1 and the obligation by $43.

Defined contribution pension plans

Certain of the Corporation's management, administrative and unionized employees participate in a defined contribution pension plan, a defined contribution component of a plan which also includes a defined benefit component or a multi-employer plan which are accounted for as defined contribution plans. The Corporation contributes an amount expressed as a percentage of employees' contributions with such percentage varying by group and for some groups, based on the number of years of service. As permitted by legislation and applicable plan rules, surplus in the defined benefit component can be used to cover the employer contributions in the defined contribution component of such plan. As such, $4 of surplus in the defined benefit components of the domestic registered pension plans was used to cover the employer contributions in the defined contribution components during 2016.

The Corporation's expense for these pension plans amounted to $15 for the year ended December 31, 2016 (2015 – $10). Taking into account available surplus in the defined benefit components of applicable plans which may be expected to be used, expected total employer contributions for 2017 are $8.

9 Provisions for Other Liabilities

The following table provides a continuity schedule of all recorded provisions. Refer to Note 16 for additional information on Litigation provisions. Current provisions are recorded in Accounts payable and accrued liabilities:

	Maintenance [(a)]		Asset retirement [(b)]		Litigation		Total provisions	
At December 31, 2015								
Current	$	-	$	-	$	19	$	19
Non-current	$	892	$	21		-	$	913
	$	**892**	**$**	**21**	**$**	**19**	**$**	**932**
Provisions arising during the year	$	143	$	-	$	-	$	143
Amounts disbursed		(8)		-		-		(8)
Changes in estimated costs		(1)		4		(1)		2
Accretion expense		14		-		-		14
Foreign exchange loss		(25)		-		-		(25)
At December 31, 2016	**$**	**1,015**	**$**	**25**	**$**	**18**	**$**	**1,058**
Current	$	93	$	-	$	18	$	111
Non-current		922		25		-		947
	$	1,015	$	25	$	18	$	1,058

(a) Maintenance provisions relate to the provision for the costs to meet the contractual return conditions on aircraft under operating leases. The provision relates to leases with expiry dates ranging from 2017 to 2028 with the average remaining lease term of approximately three years. The maintenance provisions take into account current costs of maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Assuming the aggregate cost for return conditions increases by 5%, holding all other factors constant, there would be a cumulative balance sheet adjustment to increase the provision by $51 at December 31, 2016 and an increase to maintenance expense in 2017 of approximately $7. If the discount rates were to increase by 1%, holding all other factors constant, there would be a cumulative balance sheet adjustment to decrease the provision by $17 at December 31, 2016. Due to low market rates of interest, a 1% decrease in discount rates was not considered a reasonable scenario.

(b) Under the terms of certain land and facilities leases, the Corporation has an obligation to restore the land to vacant condition at the end of the lease and to rectify any environmental damage for which it is responsible. The related leases expire over terms ranging from 2017 to 2072. These provisions are based on numerous assumptions including the overall cost of decommissioning and remediation and the selection of alternative decommissioning and remediation approaches. The non-current provision is recorded in Other long-term liabilities.

10 Income Taxes

Income tax expense

	2016	2015
Current income tax	$ 1	$ -
Deferred income tax	-	-
Income tax expense	**$ 1**	**$ -**

The income tax expense differs from the amount that would have resulted from applying the statutory income tax rate to income before income tax expense as follows:

	2016	2015
Income before income taxes	$ 877	$ 308
Statutory income tax rate based on combined federal and provincial rates	27.03%	26.87%
Income tax expense based on statutory tax rates	**237**	**83**
Effects of:		
Non-deductible portion of capital (gains) losses	(17)	97
Non-deductible expenses	15	10
Income not subject to tax	(3)	(17)
Tax rate changes on deferred income taxes	(3)	(9)
Recognition of previously unrecognized deferred income tax assets	(228)	(155)
Adjustment in respect of deferred income tax of prior years	-	(8)
Other	-	(1)
Income tax expense	**$ 1**	**$ -**

The applicable statutory tax rate is 27.03% (2015 – 26.87%). The Corporation's applicable tax rate is the Canadian combined rates applicable in the jurisdictions in which the Corporation operates. The increase is mainly due to changes in the level of activity by province.

In 2016, there was no income tax expense recorded in Other comprehensive income.

Deferred income tax

Certain intangible assets with nominal tax cost and a carrying value of $185 have indefinite lives and accordingly, the associated deferred income tax liability of $49 (2015 – $49) is not expected to reverse until the assets are disposed of, become impaired or amortizable. In addition, the Corporation has other deferred income tax liabilities in the amount of $539 (2015 – $42), against which a deferred income tax asset of similar amount has been recognized. The recognized net deferred income tax liability of $49 is included in Other long-term liabilities.

Deferred income tax assets are recognized to the extent that the realization of the related tax benefit is probable. The Corporation has temporary differences and tax loss carryforwards for which no deferred income tax assets could be recognized. However, the future tax deductions underlying these deferred income tax assets remain available for use in the future to reduce taxable income. The following are the temporary differences and tax loss carryforwards for which no deferred income tax assets could be recognized:

	2016	2015
Total non-capital losses carryforwards	$ 3,061	$ 316
Less: Recognized property and equipment book basis over tax basis	(1,853)	-
Less: Recognized other taxable temporary differences	(148)	(160)
Plus: Recognized property and equipment tax basis over book basis	-	160
Unrecognized non-capital losses carryforwards	1,060	316
Unrecognized property and equipment tax basis over book basis	-	1,866
Post-employment obligations	1,334	1,447
Accounting provisions not currently deductible for tax	271	170
Unrealized foreign exchange losses	266	493
Unrecognized net capital losses carryforwards	171	24
Other	304	373
Total unrecognized temporary differences	**$ 3,406**	**$ 4,689**

The following are the Federal non-capital tax losses expiry dates, for which no deferred income tax assets could be recognized:

	Tax Losses
2032	$ 484
2033	328
2034	3
2035	245
Unrecognized non-capital losses carryforwards	**$ 1,060**

Cash income taxes paid in 2016 by the Corporation were nil (2015 – nil).

11 Share Capital

	Number of Shares	Value
At January 1, 2015	**286,489,294**	**$ 835**
Shares issued on the exercise of stock options	1,876,819	6
Shares purchased and cancelled under issuer bid	(5,583,935)	(16)
At December 31, 2015	**282,782,178**	**$ 825**
Shares issued on the exercise of stock options	1,199,089	3
Shares purchased and cancelled under issuer bid	(10,768,465)	(31)
At December 31, 2016	**273,212,802**	**$ 797**

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

		2016	2015
Issued and outstanding			
Class A variable voting shares		86,657,994	98,059,765
Class B voting shares		186,554,808	184,722,413
Total issued and outstanding		273,212,802	282,782,178
Potential shares			
Stock options	Note 12	8,985,958	8,735,634
Total outstanding and potentially issuable shares		**282,198,760**	**291,517,812**

Shares

As at December 31, 2016, the 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", and along with the Variable Voting Shares the "Shares"). The two classes of Shares have equivalent rights as shareholders except for voting rights. Holders of Variable Voting Shares are entitled to one vote per Share unless (i) the number of Variable Voting Shares outstanding, as a percentage of the total number of voting Shares of Air Canada exceeds 25% or (ii) the total number of votes cast by or on behalf of holders of Variable Voting Shares at any meeting exceeds 25% of the total number of votes that may be cast at such meeting. If either of the above noted thresholds would otherwise be surpassed at any time, the vote attached to each Variable Voting Share will decrease proportionately such that: (i) the Variable Voting Shares as a class do not carry more than 25% of the aggregate votes attached to all issued and outstanding Voting Shares of Air Canada and (ii) the total number of votes cast by or on behalf of holders of Variable Voting Shares at any meeting do not exceed 25% of the votes that may be cast at such meeting.

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

Voting Shares may only be held, beneficially owned and controlled, directly or indirectly, by Canadians. An issued and outstanding Voting Share is converted into one Variable Voting Share automatically and without any further act of Air Canada or the holder, if such Voting Share becomes held, beneficially owned or controlled, directly or indirectly, otherwise than by way of security only, by a person who is not a Canadian.

Shareholder rights plan

Under the terms of the shareholder rights plan agreement (the "Rights Plan"), effective until the day after Air Canada's 2017 annual meeting of shareholders, one right (a "Right") has been issued with respect to each Share of Air Canada issued and outstanding as of the close of business on March 30, 2011 or subsequently issued. These Rights would become exercisable only when a person, including any party related to it, acquires or announces its intention to acquire 20% or more of the outstanding Shares of Air Canada calculated on a combined basis, without complying with the "Permitted Bid" provisions of the Rights Plan or, in certain cases, without the approval of the Board. Until such time, the Rights are not separable from the Shares, are not exercisable and no separate rights certificates are issued. To qualify as a "Permitted Bid" under the Rights Plan, a bid must, among other things: (i) be made to all holders of Shares, (ii) remain open for a period of not less than 60 days, (iii) provide that no Shares shall be taken up unless more than 50% of the then outstanding Shares, other than the Shares held by the person pursuing the acquisition and parties related to it, have been tendered and not withdrawn, and (iv) provide that if such 50% condition is satisfied, the bid will be extended for at least 10 business days to allow other shareholders to tender.

Following the occurrence of an event which triggers the right to exercise the Rights and subject to the terms and conditions of the Rights Plan, each Right would entitle the holders thereof, other than the acquiring person or any related persons, to exercise their Rights and purchase from Air Canada two hundred dollars' worth of Shares for one hundred dollars (i.e. at a 50% discount to the market price at that time). Upon such exercise, holders of rights beneficially owned and controlled by Qualified Canadians would receive Class B Voting Shares and holders of rights beneficially owned or controlled by persons who are not Qualified Canadians would receive Class A Variable Voting Shares.

Issuer bid

Following receipt of approvals from the Toronto Stock Exchange ("TSX"), in May 2015, the Corporation implemented a normal course issuer bid that expired May 28, 2016, to purchase for cancellation, up to 10 million Shares of the Corporation, and in March 2016, added 5 million Shares to the normal course issuer bid.

Following the conclusion of this normal course issuer bid, in May 2016, the Corporation received TSX approval and implemented a new normal course issuer bid, authorizing, between May 30, 2016 and May 29, 2017, the purchase of up to 22,785,511 Shares, representing 10 percent of the public float as at May 16, 2016.

In 2016, pursuant to these normal course issuer bids, the Corporation purchased, for cancellation, 10,768,465 Shares at an average cost of $8.77 per Share for aggregate consideration of $94. The excess of the cost over the average book value of $63 was charged to the deficit. At December 31, 2016, a total of 18,333,111 Shares remain available for repurchase under the existing normal course issuer bid.

12 Share-Based Compensation

Air Canada long-term incentive plan

Certain of the Corporation's employees participate in the Air Canada Long-term Incentive Plan (the "Long-term Incentive Plan"). The Long-term Incentive Plan provides for the grant of options, performance share units and restricted share units to senior management and officers of Air Canada. 20,011,623 Shares are authorized for issuance under the Long-term Incentive Plan of which 11,025,665 remain available for future issuance after taking into account the issued and outstanding stock options. The outstanding performance share units and restricted share units will not result in the issuance of new Shares as these share units will be redeemed for Shares purchased on the secondary market (and not issued from treasury) and/or equivalent cash, at the discretion of the Corporation.

Stock options

The options to purchase Shares granted under the Long-term Incentive Plan have a maximum term of seven years and an exercise price based on the fair market value of the Shares at the time of the grant of the options. Fifty percent of options are time-based and vest over four years. The remaining options vest based upon performance conditions, which are based on operating margin (operating income over operating revenues) targets established by the Air Canada Board over the same time period. Each option entitles the employee to purchase one Share at the stated exercise price. The terms of the Long-term Incentive Plan specify that following retirement an employee may exercise options granted with the rights to exercise continuing for the three years after the retirement date.

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

	2016	2015
Compensation expense ($ millions)	$ 5	$ 4
Number of stock options granted to Air Canada employees	1,570,720	984,878
Weighted average fair value per option granted ($)	$ 3.71	$ 5.65
Aggregated fair value of options granted ($ millions)	$ 6	$ 6
Weighted average assumptions:		
Share price	$ 9.12	$ 12.48
Risk-free interest rate	0.42%-0.98%	0.57%-1.10%
Expected volatility	50.0%-52.0%	52.0%-58.5%
Dividend yield	0%	0%
Expected option life (years)	5.25	5.25

Expected volatility was determined at the time of grant using the Share price on a historical basis. It reflects the assumption that the historical volatility is indicative of future trends, which may not necessarily be the actual outcome.

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

	2016		2015	
	Options	Weighted Average Exercise Price/Share	Options	Weighted Average Exercise Price/ Share
Beginning of year	8,735,634	$ 3.69	10,002,975	$ 2.54
Granted	1,570,720	9.27	984,878	12.57
Exercised	(1,169,436)	1.84	(1,906,472)	2.13
Expired	(65,441)	1.35	(5,500)	8.51
Forfeited	(85,519)	4.25	(340,247)	4.30
Outstanding options, end of year	**8,985,958**	**$ 4.92**	**8,735,634**	**$ 3.69**
Options exercisable, end of year	**3,737,782**	**2.42**	**2,854,413**	**2.30**

The weighted average Share price on the date of exercise for options exercised in 2016 was $12.04 (2015 – $11.80).

Range of exercise prices	Expiry dates	2016 Outstanding options: Number of options outstanding	Weighted average remaining life (years)	Weighted average exercise price/ share	2016 Exercisable options: Number of exercisable options	Weighted average exercise price/ share
$1.78 – $1.91	2017	-	1	$ -	-	$ -
$2.34	2018	1,046,799	2	2.34	1,046,799	2.34
$0.96	2019	1,371,845	3	0.96	1,371,845	0.96
$2.49 – $5.69	2020	3,120,172	4	2.92	1,005,890	2.91
$5.35 – $8.27	2021	955,885	5	5.42	221,155	5.42
$12.27 – $12.64	2022	924,037	6	12.57	92,093	12.64
$9.23 – $9.61	2023	1,567,220	7	9.27	-	-
		8,985,958		**$ 4.92**	**3,737,782**	**$ 2.42**

Range of exercise prices	Expiry dates	2015 Outstanding options: Number of options outstanding	Weighted average remaining life (years)	Weighted average exercise price/ share	2015 Exercisable options: Number of exercisable options	Weighted average exercise price/ share
$1.59	2016	18,750	1	$ 1.59	18,750	$ 1.59
$1.78 – $1.91	2017	-	2	-	-	-
$2.34	2018	1,222,059	3	2.34	1,222,059	2.34
$0.96 – $1.28	2019	2,154,196	4	0.96	705,515	0.97
$2.49 – $5.69	2020	3,386,598	5	2.94	784,898	2.96
$5.35 – $8.27	2021	1,013,522	6	5.42	123,191	5.42
$12.27 – $12.64	2022	940,509	7	12.57	-	-
		8,735,634		**$ 3.69**	**2,854,413**	**$ 2.30**

Performance and restricted share units

The Long-term Incentive Plan also includes performance share units ("PSUs") and restricted share units ("RSUs"), which are accounted for as equity settled instruments. The vesting of PSUs is based on the Corporation achieving its cumulative annual earnings target over a three-year period, while RSUs will vest after three years from their date of grant. The terms of the plan specify that upon the retirement of an employee, the number of units that vest are prorated based on the total number of completed months of active service during the vesting term. The PSUs and RSUs granted may only be redeemed for Air Canada Shares purchased on the secondary market and/or equivalent cash at the discretion of the Board of Directors.

The compensation expense related to PSUs and RSUs in 2016 was $9 (2015 – $9).

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

	2016	2015
Beginning of year	3,930,051	7,553,010
Granted	1,198,745	778,154
Settled	(2,021,095)	(4,114,133)
Forfeited	(55,673)	(286,980)
Outstanding share units, end of year	**3,052,028**	**3,930,051**

Refer to Note 15 for a description of derivative instruments used by the Corporation to mitigate the cash flow exposure to the PSUs and RSUs granted.

Employee share purchase plan

Eligible employees can participate in the employee share purchase plan under which employees can invest between 2% and 10% of their base salary for the purchase of Shares on the secondary market. For 2016 contributions, Air Canada will match 33.3% of the contributions made by employees who were in their first year of participation in the program, with a 50% match in respect of 2016 contributions made after 12 months of continuous participation in the program. During 2016, the Corporation recorded compensation expense of $10 (2015 – $7) related to the Employee Share Purchase Plan.

13 Earnings per Share

The following table outlines the calculation of basic and diluted EPS:

(in millions, except per share amounts)	2016	2015
Numerator:		
Numerator for basic and diluted earnings per share:		
Net income attributable to shareholders of Air Canada	$ 876	$ 303
Denominator:		
Weighted-average shares	**277**	**285**
Effect of potential dilutive securities:		
Stock options	5	7
Total potential dilutive securities	5	7
Adjusted denominator for diluted earnings per share	**282**	**292**
Basic EPS	**$ 3.16**	**$ 1.06**
Diluted EPS	**$ 3.10**	**$ 1.03**

The calculation of EPS 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.

Excluded from the 2016 calculation of diluted EPS were 1,352,000 (2015 – 1,512,000) outstanding options where the options' exercise prices were greater than the average market price of the Shares for the year.

14 Commitments

Capital commitments and operating leases

Capital commitments consist of the future firm aircraft deliveries and commitments related to the acquisition of other property and equipment. 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 U.S. LIBOR rate at December 31, 2016. The Corporation has various operating lease agreements for aircraft, equipment and other property. U.S. dollar amounts are converted using the December 31, 2016 closing rate of CDN$1.3427. Minimum future commitments under these contractual arrangements are shown below:

	2017	2018	2019	2020	2021	Thereafter	Total
Capital commitments	$ 2,142	$ 1,785	$ 1,408	$ 1,438	$ 1,057	$ 603	**$ 8,433**
Operating leases							
Aircraft	482	434	362	255	166	308	**2,007**
Other property	90	73	58	50	40	200	**511**
Total	**$ 2,714**	**$ 2,292**	**$ 1,828**	**$ 1,743**	**$ 1,263**	**$ 1,111**	**$ 10,951**

Flow-through Leases

For accounting purposes, the Corporation acts as an agent and subleases certain aircraft to Jazz on a flow-through basis, which are reported net on the consolidated statement of operations. These subleases relate to five Bombardier Q400 aircraft, 13 Bombardier CRJ-200 aircraft, and 15 Bombardier CRJ-705 aircraft which have final maturities ranging from 2017 to 2024. The sublease revenue and lease expense related to these aircraft each amounted to $81 in 2016 (2015 – $95). The operating lease commitments under these aircraft, which are recovered from Jazz, are not included in the aircraft operating lease commitments table above but are summarized, with U.S. dollar amounts converted using the December 31, 2016 closing rate of CDN$1.3427, as follows:

	2017	2018	2019	2020	2021	Thereafter	Total
Jazz flow-through leases	$ 84	$ 80	$ 80	$ 80	$ 71	$ 120	**$ 515**

The subleases with Jazz have the same terms and maturity as the Corporation's corresponding lease commitments to the lessors.

The Corporation leases and subleases certain aircraft to Sky Regional and Air Georgian, which are charged back to Air Canada through the CPAs with Sky Regional and Air Georgian. These are reported net on the consolidated statement of operations. The leases and subleases relate to five Bombardier Q400 aircraft, 12 CRJ-200 aircraft, and twenty Embraer 175 aircraft. The lease and sublease revenue and expense related to these aircraft each amount to $77 in 2016 (2015 – $48).

Other contractual commitments

The CPSA between the Corporation and Aeroplan imposes a requirement for the Corporation to purchase a minimum number of Aeroplan Miles® from Aeroplan. The estimated minimum requirement for 2017 is $210. The annual commitment is based on 85% of the average total Aeroplan Miles® actually issued in respect of Air Canada flights or Air Canada airline affiliate products and services in the three preceding calendar years. During 2016, the Corporation purchased $247 of Aeroplan Miles® from Aeroplan.

The future minimum non-cancellable commitment for the next 12 months under the Jazz CPA is approximately $1,180 and under the capacity purchase agreements with other regional carriers is $196.

15 Financial Instruments and Risk Management

Summary of financial instruments

	Carrying Amounts				
	December 31, 2016				
	Financial instruments classification				
	Fair value through profit and loss	Assets at amortized cost	Liabilities at amortized cost	Total	December 31, 2015
Financial Assets					
Cash and cash equivalents	$ 787	$ -	$ -	**$ 787**	**$ 572**
Short-term investments	2,192	-	-	**2,192**	**2,100**
Restricted cash	126	-	-	**126**	**91**
Accounts receivable	-	707	-	**707**	**654**
Promissory notes receivable	-	-	-	**-**	**143**
Deposits and other assets					
Restricted cash	188	-	-	**188**	**209**
Aircraft related and other deposits	-	145	-	**145**	**138**
Prepayment option on senior secured notes	-	-	-	**-**	**5**
Derivative instruments					
Fuel derivatives	14	-	-	**14**	**10**
Share forward contracts	40	-	-	**40**	**41**
Foreign exchange derivatives	26	-	-	**26**	**94**
Interest rate swaps	-	-	-	**-**	**4**
	$ 3,373	**$ 852**	**$ -**	**$ 4,225**	**$ 4,061**
Financial Liabilities					
Accounts payable	$ -	$ -	$ 1,545	**$ 1,545**	**$ 1,399**
Foreign exchange derivatives	21	-	-	**21**	**5**
Current portion of long-term debt and finance leases	-	-	707	**707**	**524**
Long-term debt and finance leases	-	-	5,911	**5,911**	**5,870**
	$ 21	**$ -**	**$ 8,163**	**$ 8,184**	**$ 7,798**

Summary of gain (loss) on financial instruments recorded at fair value

	2016	2015
Fuel derivatives	$ -	$ (11)
Share forward contracts	9	(9)
Prepayment option on senior secured notes	(5)	1
Interest rate swaps	-	2
Financial instruments recorded at fair value	**$ 4**	**$ (17)**

Risk management

Under its risk management policy, the Corporation manages its market risk through the use of various financial derivative instruments. The Corporation uses these instruments solely for risk management purposes, not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows of the relevant risk being hedged.

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

Market risks

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk can be further divided into the following sub-classifications related to the Corporation: fuel price risk, foreign exchange risk, interest rate risk and share-based compensation risk.

Fuel price risk

Fuel price risk is the risk that future cash flows will fluctuate because of changes in jet fuel prices. In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, the Corporation enters into derivative contracts with financial intermediaries. The Corporation may use derivative contracts based on jet fuel, heating oil and crude-oil based contracts. The Corporation's policy permits hedging of up to 75% of the projected jet fuel purchases for the next 12 months, 50% for the next 13 to 24 months and 25% for the next 25 to 36 months. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. There are regular reviews to adjust the strategy in light of market conditions.

During 2016:

- In 2016, hedging gains on the settlement of fuel derivatives of $23 and the associated premium costs of $46, for a net hedging loss of $23 were reclassified from other comprehensive income to Aircraft fuel expense (net fuel hedging loss of $10 was reclassified from other comprehensive income to Aircraft fuel expense in 2015). No hedge ineffectiveness was recorded. For derivatives not designated under hedge accounting a loss of $11 was recorded in Gain (loss) on financial instruments recorded at fair value in 2015.
- The Corporation purchased crude-oil call options covering a portion of 2016 and 2017 fuel exposure. The cash premium related to these contracts was $34 ($39 in 2015 for 2015 and 2016 exposures).
- Fuel derivative contracts cash settled with a fair value of $23 in favour of the Corporation ($1 in favour of the Corporation in 2015).

A summary of amounts related to fuel derivatives designated as hedging instruments at December 31, 2016 is presented below.

As of December 31, 2016, approximately 9% of the Corporation's anticipated purchases of jet fuel for 2017 are hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US$52 per barrel for WTI prices up to US$57 per barrel and an average equivalent capped price of US$57 per barrel for WTI prices above US$63 per barrel. The Corporation's contracts to hedge anticipated jet fuel purchases over the 2017 period are comprised of call options with notional volumes of 2,973,000 barrels. The fair value of the fuel derivatives portfolio at December 31, 2016 is $14 in favour of the Corporation ($10 in favour of the Corporation in 2015) and is recorded within Prepaid expenses and other current assets.

Foreign exchange risk

The Corporation's financial results are reported in Canadian dollars, while a large portion of its expenses, debt obligations and capital commitments are in foreign currencies, primarily in U.S. dollars. Foreign exchange risk is the risk that fluctuations in foreign exchange rates may have on operating results and cash flows. The Corporation's risk management objective is to reduce cash flow risk related to foreign denominated cash flows.

Air Canada generates certain sales in U.S. dollars and in other foreign currencies which are converted to U.S. dollars under the Corporation's risk management program. In 2016, these net operating cash inflows totalled approximately US$3.2 billion. Also in 2016, U.S. denominated operating costs amounted to approximately US$3.5 billion. Non-operating cash outflows in U.S. dollars, primarily related to interest payments on U.S. dollar denominated debt and net financing outflows, amounted to approximately US$1.8 billion. For 2016, this resulted in a U.S. dollar net cash flow exposure of approximately US$2.1 billion.

The Corporation has a target coverage of 70% on a rolling 18 month basis to manage the net U.S. dollar cash flow exposure described above utilizing the following risk management strategies:

- Holding U.S. dollar cash reserves as an economic hedge against changes in the value of the U.S. dollar. U.S. dollar cash and short-term investment balances as at December 31, 2016 amounted to $560 (US$416) ($490 (US$358) as at December 31, 2015). A portion of the cash and investment reserves are an economic hedge against long-term U.S. dollar debt while the remainder of the cash is operational cash and investment reserves which are applied against the rolling 18 month net U.S. dollar cash flow exposure. In 2016, a loss of $25 (gain of $123 in 2015) was recorded in Foreign exchange gain (loss) reflecting the change in Canadian equivalent market value of the U.S. dollar cash and short-term investment balances held.
- Locking in the foreign exchange rate through the use of a variety of foreign exchange derivatives which have maturity dates corresponding to the forecasted dates of U.S. dollar net outflows.

The level of foreign exchange derivatives entered into and their related maturity dates are dependent upon a number of factors, which include the amount of foreign revenue conversion available, U.S. dollar net cash outflows, as well as the amount attributed to aircraft and debt payments. Based on the notional amount of currency derivatives outstanding at December 31, 2016, as further described below, approximately 80% of net U.S. cash outflows are hedged for 2017 and 29% for 2018, resulting in derivative coverage of 68% over the next 18 months. Operational U.S. dollar cash and investment reserves combined with derivative coverage results in 73% coverage.

As at December 31, 2016, the Corporation had outstanding foreign currency options and swap agreements, settling in 2017 and 2018, to purchase at maturity $2,612 (US$1,946) of U.S. dollars at a weighted average rate of $1.2898 per US$1.00 (2015 – $3,234 (US$2,337) with settlements in 2016 and 2017 at a weighted average rate of $1.2683 per US$1.00). The Corporation also has protection in place to sell a portion of its excess Euros, Sterling, Yen, Yuan and AUD (EUR €82, GBP £69, JPY ¥2,334, CNY ¥53, and AUD $33) which settle in 2017 at weighted average rates of €1.1059, £1.2589, ¥0.0096, ¥0.1522 and $0.7500 per US$1.00, respectively (2015 – EUR €42, GBP £9, JPY ¥2,052, CNY ¥288, and AUD $18 with settlement in 2016 at weighted average rates of €1.1663, £1.6150, ¥0.0088, ¥0.1562 and $0.7230 respectively per US$1.00).

The hedging structures put in place have various option pricing features, such as knock-out terms and profit cap limitations, and based on the assumed volatility used in the fair value calculation, the net fair value of these foreign currency contracts as at December 31, 2016 was $5 in favour of the Corporation (2015 – $89 in favour of the Corporation). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2016, a loss of $136 was recorded in Foreign exchange gain (loss) related to these derivatives (2015 – $164 gain). In 2016, foreign exchange derivative contracts cash settled with a net fair value of $51 in favour of the counterparties ($104 in 2015 in favour of the Corporation). The total combined loss, related to U.S. cash, investments and foreign exchange derivatives recorded by the Corporation in 2016 was $160 ($287 gain in 2015).

Interest rate risk

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

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

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in the Corporation's capital structure and is based upon a long-term objective of 60% fixed and 40% floating but allows flexibility to adjust to prevailing market conditions. The ratio at December 31, 2016 is 76% fixed and 24% floating (79% and 21%, respectively as at December 31, 2015).

Share-based compensation risk

The Corporation issues share-based compensation to certain of its employees in the form of stock options, RSUs and PSUs as described in Note 12. Each RSU and PSU entitles the employees to receive a payment in the form of one Share, cash in the amount equal to market value of one Share, or a combination thereof, at the discretion of the Board of Directors.

Share-based compensation risk refers to the risk that future cash flows to settle the RSUs and PSUs will fluctuate because of changes in the Corporation's Share price. To hedge the exposure, the Corporation entered into share forward contracts to hedge PSUs and RSUs that may vest between 2017 and 2019, subject to the terms of vesting including realization of performance vesting criteria. The contracts were prepaid by the Corporation. The forward dates for the share forward contracts coincide with the vesting terms and planned settlement dates of 2,938,913 PSUs and RSUs from 2017 to 2019. These contracts were not designated as hedging instruments for accounting purposes. Accordingly, changes in the fair value of these contracts are recorded in Gain (loss) on financial instruments recorded at fair value in the period in which they arise. During 2016, a gain of $9 was recorded (2015 – loss of $9). Share forward contracts cash settled with a fair value of $10 in favour of the Corporation in 2016 (2015 – $35). As at December 31, 2016, the fair value of the share forward contracts is $40 in favour of the Corporation (2015 – $41 in favour of the Corporation), with those contracts maturing in 2017 valued at $17 recorded in Prepaid expenses and other current assets and the remainder of $23 is recorded in Deposits and other assets.

Liquidity risk

The Corporation manages its liquidity needs through a variety of strategies including by seeking to sustain and improve cash from operations, sourcing committed financing for new and existing aircraft, and through other financing activities.

Liquidity needs are primarily related to meeting obligations associated with financial liabilities, capital commitments, ongoing operations, contractual and other obligations, including pension funding obligations as described in Note 8 and covenants in credit card and other agreements as described below. The Corporation monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as well as those assets being used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. At December 31, 2016, unrestricted liquidity was $3,388 comprised of Cash and cash equivalents and Short-term investments of $2,979 and undrawn lines of credit of $409. Another important aspect of managing liquidity risk relates to managing the Corporation's financial leverage. Refer to Note 17 Capital Disclosures for a discussion on financial leverage targets.

Cash and cash equivalents include $110 pertaining to investments with original maturities of three months or less at December 31, 2016 ($91 as at December 31, 2015).

A maturity analysis of the Corporation's principal and interest repayment requirements on long-term debt is set out in Note 7, and fixed operating commitments and capital commitments are set out in Note 14.

Credit risk

Credit risk is the risk of loss due to a counterparty's inability to meet its obligations. As at December 31, 2016, the Corporation's credit risk exposure consists mainly of the carrying amounts of Cash and cash equivalents, Short-term investments, Accounts receivable and derivative instruments. Cash and cash equivalents and Short-term investments are in place with major financial institutions, various levels of the Canadian government, and major corporations. Accounts receivable are generally the result of sales of tickets to individuals, often through the use of major credit cards, through geographically dispersed travel agents, corporate outlets, or other airlines. Credit rating guidelines are used in determining derivative counterparties. In order to manage its exposure to credit risk and assess credit quality, the Corporation reviews counterparty credit ratings on a regular basis and sets credit limits when deemed necessary.

Sensitivity analysis

The following table is a sensitivity analysis for each type of market risk relevant to the significant financial instruments recorded by the Corporation as at December 31, 2016. The sensitivity analysis is based on certain movements in the relevant risk factor. These assumptions may not be representative of actual movements in these risks and may not be relied upon. Given potential volatility in the financial and commodity markets, the actual movements and related percentage changes may differ significantly from those outlined below. Changes in income generally cannot be extrapolated because the relationship of the change in assumption to the change in income may not be linear. Each risk is contemplated independent of other risks; however, changes in one factor may result in changes in one or more several other factors, which may magnify or counteract the sensitivities.

The sensitivity analysis related to derivative contracts is based on the estimated fair value change applicable to the derivative as at December 31, 2016 considering a number of variables including the remaining term to maturity and does not consider the fair value change that would be applicable to the derivative assuming the market risk change was applicable to the maturity date of the derivative contract.

	Interest rate risk (1)	Foreign exchange rate risk (2)		Other price risk (3)	
	Income	Income		Income	
	1% Increase	5% Increase	5% Decrease	10% Increase	10% Decrease
Cash and cash equivalents	$ 8	$ (10)	$ 10	$ -	$ -
Short-term investments	$ 22	$ (18)	$ 18	$ -	$ -
Aircraft related deposits	$ -	$ (6)	$ 6	$ -	$ -
Long-term debt and finance leases	$ (21)	$ 302	$ (302)	$ -	$ -
Fuel derivatives	$ -	$ -	$ -	$ 13	$ (9)
Share forward contracts	$ -	$ -	$ -	$ 4	$ (4)
Foreign exchange derivatives	$ -	$ (7)	$ 5	$ -	$ -

(1) Due to currently low market rates of interest, a 1% decrease in interest rates was not considered a reasonable scenario within the forecast period, being one year.
(2) Increase (decrease) in foreign exchange relates to a strengthening (weakening) of the Canadian dollar versus the U.S. dollar. The impact on long-term debt and finance leases includes $3 related to the Canadian dollar versus the Japanese yen. The impact of changes in other currencies is not significant to the Corporation's financial instruments.
(3) The sensitivity analysis for fuel derivatives is based upon a 10% increase or decrease in the price of the underlying commodity. Under hedge accounting, the effective gain or loss would be recorded in other comprehensive income. The sensitivity analysis for share forward contracts is based upon a 10% increase or decrease in the Air Canada Share price.

Covenants in credit card agreements

The Corporation's principal credit card processing agreements for credit card processing services contain triggering events upon which the Corporation is required to provide the applicable credit card processor with cash deposits. The obligations to provide cash deposits and the required amount of deposits are each based upon a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for the Corporation and the unrestricted cash and short-term investments of the Corporation. In 2016, the Corporation made no cash deposits under these agreements (nil in 2015).

Financial instrument fair values in the consolidated statement of financial position

The carrying amounts reported in the consolidated statement of financial position for short-term financial assets and liabilities, which includes Accounts receivable and Accounts payable and accrued liabilities, approximate fair values due to the immediate or short-term maturities of these financial instruments. Cash equivalents and Short-term investments are classified as held for trading and therefore are recorded at fair value.

The carrying amounts of derivatives are equal to fair value, which is based on the amount at which they could be settled based on estimated current market rates.

Management estimated the fair value of its long-term debt based on valuation techniques including discounted cash flows, taking into account market information and traded values where available, market rates of interest, the condition of any related collateral, the current conditions in credit markets and the current estimated credit margins applicable to the Corporation based on recent transactions. Based on significant unobservable inputs (Level 3 in the fair value hierarchy), the estimated fair value of debt and finance leases is $6,675 compared to its carrying value of $6,618.

Following is a classification of fair value measurements recognized in the consolidated statement of financial position using a fair value hierarchy that reflects the significance of the inputs used in making the measurements.

Recurring measurements	December 31, 2016	Fair value measurements at reporting date using: Quoted prices in active markets for identical assets (level 1)	Significant other observable inputs (level 2)	Significant unobservable inputs (level 3)
Financial assets				
Held-for-trading securities				
Cash equivalents	$ 110	$ -	$ 110	$ -
Short-term investments	2,192	-	2,192	-
Derivative instruments				
Fuel derivatives	14	-	14	-
Share forward contracts	40	-	40	-
Foreign exchange derivatives	26	-	26	-
Total	**$ 2,382**	**$ -**	**$ 2,382**	**$ -**

Recurring measurements	December 31, 2016	Fair value measurements at reporting date using: Quoted prices in active markets for identical assets (level 1)	Significant other observable inputs (level 2)	Significant unobservable inputs (level 3)
Financial liabilities				
Derivative instruments				
Foreign exchange derivatives	$ 21	$ -	$ 21	-
Total	**$ 21**	**$ -**	**$ 21**	**$ -**

Financial assets held by financial institutions in the form of cash and restricted cash have been excluded from the fair value measurement classification table above as they are not valued using a valuation technique.

The Corporation's policy is to recognize transfers into and transfers out of fair value hierarchy levels as of the date of the event or change in circumstances that caused the transfer. There were no transfers within the fair value hierarchy during 2016.

Offsetting of financial instruments in the consolidated statement of financial position

Financial assets and liabilities are offset and the net amount reported in the consolidated statement of financial position where the Corporation has a legally enforceable right to set-off the recognized amounts and there is an intention to settle on a net basis or realize the asset and settle the liability simultaneously. In the normal course of business, the Corporation enters into various master netting arrangements or other similar arrangements that do not meet the criteria for offsetting in the consolidated statement of financial position but still allow for the related amounts to be set off in certain circumstances, such as the termination of the contracts or in the event of bankruptcy or default of either party to the agreement.

Air Canada participates in industry clearing house arrangements whereby certain accounts receivable balances related to passenger, cargo and other billings are settled on a net basis with the counterparty through the clearing house. These billings are mainly the result of interline agreements with other airlines, which are commercial agreements that enable the sale and settlement of travel and related services between the carriers. Billed and work in process interline receivables are presented on a gross basis and amount to $81 as at December 31, 2016 ($65 as at December 31, 2015). These balances will be settled at a net value at a later date; however such net settlement amount is unknown until the settlement date.

The following table presents the recognized financial instruments that are offset, or subject to enforceable master netting arrangements or other similar arrangements but not offset, as at December 31, 2016 and 2015, and shows in the Net column what the net impact would be on the consolidated statement of financial position if all set-off rights were exercised.

	Amounts offset			Amounts not offset	
	Gross assets	Gross liabilities offset	Net amounts presented	Financial instruments	Net
Financial assets					
December 31, 2016					
Derivative assets	$ 58	$ (32)	$ 26	$ 52	$ 78
Accounts receivable	103	(47)	56	-	$ 56
	$ 161	**$ (79)**	**$ 82**	**$ 52**	**$ 134**
December 31, 2015					
Derivative assets	$ 121	$ (27)	$ 94	$ 55	$ 149
Accounts receivable	97	(45)	52	-	$ 52
	$ 218	**$ (72)**	**$ 146**	**$ 55**	**$ 201**

	Amounts offset			Amounts not offset	
	Gross liabilities	Gross assets offset	Net amounts presented	Financial instruments	Net
Financial liabilities					
December 31, 2016					
Derivative liabilities	$ 32	$ (11)	$ 21	$ (2)	$ 19
	$ 32	$ (11)	$ 21	$ (2)	$ 19
December 31, 2015					
Derivative liabilities	$ 12	$ (7)	$ 5	$ -	$ 5
	$ 12	**$ (7)**	**$ 5**	**$ -**	**$ 5**

16 Contingencies, Guarantees and Indemnities

Contingencies and litigation provisions

Investigations by competition authorities relating to cargo

The European Commission, the United States Department of Justice and the Competition Bureau in Canada investigated alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including Air Canada. Competition authorities in several jurisdictions sought or requested information from Air Canada as part of their investigations. Air Canada cooperated with these investigations, which led to proceedings against Air Canada and a number of airlines and other cargo operators in certain jurisdictions. Air Canada is also named as a defendant or is otherwise involved in, and may become further implicated in, a number of class action lawsuits and other proceedings in Canada, Europe and the United States in connection with these allegations. The investigations instituted by the U.S. Department of Justice and by the Competition Bureau in Canada concluded with no proceedings having been instituted against Air Canada. In 2012, the Corporation entered into a settlement agreement relating to class action proceedings in the United States in connection with these allegations under which Air Canada made a payment of $8 without any admission of liability.

In 2010, the European Commissions rendered a decision finding that 12 air cargo carriers (including groups of related carriers) had infringed European Union competition law in the setting of certain cargo charges and rates for various periods between 1999 and 2006. Air Canada was among the carriers subject to the decision and a fine of 21 Euros (approximately $29) was imposed on Air Canada. Air Canada appealed the decision and filed an application for appeal before the European General Court. In 2011, Air Canada paid the fine, as required, pending the outcome of its appeal. On December 16, 2015, the European General Court granted Air Canada's appeal and annulled the decision of the European Union with regard to Air Canada and certain other airlines. As a result of the European General Court's decision, the European Commissions was required to refund to Air Canada the fine of 21 Euros ($30), which amount was recorded as a receivable as at December 31, 2015 and received in February 2016. Though the European Commission did not appeal the European General Court's decision, it announced its intention to issue a new decision in 2017. Air Canada cannot be certain of the impact of such decision, including as to whether it will include findings in respect of Air Canada.

As at December 31, 2016, Air Canada has a provision of $17 ($17 as at December 31, 2015) relating to outstanding claims in these matters, which is recorded in Accounts payable and accrued liabilities. The provision was reduced by $10 in 2015 reflecting a change in estimated costs. This provision is an estimate based upon the status of investigations and proceedings at this time and Air Canada's assessment as to the potential outcome for certain of them. The provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Air Canada has determined it is not possible at this time to predict with any degree of certainty the outcome of all remaining proceedings and investigations. Based on the outcome of any developments regarding proceedings and investigations, Air Canada may adjust the provision in its results for subsequent periods as required.

Mandatory retirement

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

Other contingencies

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

Guarantees

Guarantees in fuel facilities and de-icing arrangements

The Corporation participates in fuel facility arrangements operated through eight Fuel Facility Corporations, and two aircraft de-icing service facilities, along with other airlines that contract for fuel and de-icing services at various major airports in Canada. These entities operate on a cost recovery basis. The aggregate debt of these entities that has not been consolidated by the Corporation under IFRS 10 Consolidated Financial Statements is approximately $487 as at December 31, 2016 (December 31, 2015 – $425), which is the Corporation's maximum exposure to loss before taking into consideration the value of the assets that secure the obligations and any cost sharing that would occur amongst the other contracting airlines. The Corporation views this loss potential as remote. Each contracting airline participating in these entities shares pro rata, based on system usage, in the guarantee of this debt. The maturities of these debt arrangements vary but generally extend beyond five years.

Indemnification agreements

In the ordinary course of the Corporation's business, the Corporation enters into a variety of agreements, such as real estate leases or operating agreements, aircraft financing or leasing agreements, technical service agreements, and director/officer contracts, and other commercial agreements, some of which may provide for indemnifications to counterparties that may require the Corporation to pay for costs and/or losses incurred by such counterparties. The Corporation cannot reasonably estimate the potential amount, if any, it could be required to pay under such indemnifications. Such amount would also depend on the outcome of future events and conditions, which cannot be predicted. While certain agreements specify a maximum potential exposure, certain others do not specify a maximum amount or a limited period. Historically, the Corporation has not made any significant payments under these indemnifications.

The Corporation expects that it would be covered by insurance for most tort liabilities and certain related contractual indemnities.

17 Capital Disclosures

The Corporation views capital as the sum of Long-term debt and finance leases, capitalized operating leases, Non-controlling interests, and the market value of the Corporation's outstanding Shares ("market capitalization"). The Corporation includes capitalized operating leases, which is a measure commonly used in the industry ascribing a value to obligations under operating leases. The value is based on annualized aircraft rent expense, including aircraft rent expense related to regional carrier operations, multiplied by 7.0, which is a factor commonly used in the airline industry. The measure used may not necessarily reflect the fair value or net present value related to the future minimum lease payments as the measure is not based on the remaining contractual payments and the factor may not recognize discount rates implicit in the actual leases or current rates for similar obligations with similar terms and risks. Market capitalization is based on the closing price of Air Canada's Shares multiplied by the number of outstanding Shares. This definition of capital is used by management and may not be comparable to measures presented by other public companies.

The Corporation also monitors its adjusted net debt and financial leverage ratio. Adjusted net debt is calculated as the sum of Long-term debt and finance lease obligations and capitalized operating leases less Cash and cash equivalents and Short-term investments. Financial leverage is calculated as adjusted net debt over 12 months trailing earnings before interest, taxes, depreciation, amortization and aircraft rent.

The Corporation's main objectives when managing capital are:

- To maintain financial leverage at or below a target leverage ratio of 2.2 by 2018 as set by the Corporation;
- To structure repayment obligations in line with the expected life of the Corporation's principal revenue generating assets;
- To ensure the Corporation has access to capital to fund contractual obligations as they become due and to ensure adequate cash levels to withstand deteriorating economic conditions;
- To maintain an appropriate balance between debt supplied capital versus investor supplied capital; and
- To monitor the Corporation's credit ratings to facilitate access to capital markets at competitive interest rates.

In order to maintain or adjust the capital structure, the Corporation may adjust the type of capital utilized, including purchase versus lease decisions, defer or cancel aircraft expenditures by not exercising available options or selling aircraft options, redeeming or issuing debt securities, issuing equity securities, and repurchasing outstanding Shares, all subject to market conditions and the terms of the underlying agreements (or any consents required) or other legal restrictions.

The total capital and adjusted net debt as at December 31 is calculated as follows:

	2016	2015
Long-term debt and finance leases	$ 5,911	$ 5,870
Current portion of long-term debt and finance leases	707	524
	6,618	6,394
Capitalized operating leases	3,451	2,569
Adjusted debt	10,069	8,963
Non-controlling interests	-	27
Market capitalization	3,735	2,887
Total Capital	**$ 13,804**	**$ 11,877**
Adjusted debt	$ 10,069	$ 8,963
Less Cash and cash equivalents and Short-term investments	(2,979)	(2,672)
Adjusted net debt	**$ 7,090**	**$ 6,291**

18 Geographic Information

A reconciliation of the total amounts reported by geographic region for Passenger revenues and Cargo revenues on the consolidated statement of operations is as follows:

	2016	2015
Passenger revenues		
Canada	$ 4,426	$ 4,379
U.S. Transborder	2,879	2,685
Atlantic	3,026	2,775
Pacific	1,985	1,762
Other	832	819
	$ 13,148	**$ 12,420**
Cargo revenues		
Canada	$ 63	$ 67
U.S. Transborder	29	24
Atlantic	187	188
Pacific	193	188
Other	40	39
	$ 512	**$ 506**

Passenger and cargo revenues are based on the actual flown revenue for flights with an origin and destination in a specific country or region. Atlantic refers to flights that cross the Atlantic Ocean with origins and destinations principally in Europe. Pacific refers to flights that cross the Pacific Ocean with origins and destinations principally in Asia and Australia. Other passenger and cargo revenues refer to flights with origins and destinations principally in South America and the Caribbean.

Other operating revenues are principally derived from customers located in Canada and consist primarily of revenues from the sale of the ground portion of vacation packages, buy on board and related passenger ancillary services and charges, and other airline-related services.

19 Regional Airlines Expense

The Corporation has capacity purchase agreements with Jazz, Sky Regional and certain other regional carriers. Expenses associated with these arrangements are classified as regional airlines expense on the consolidated statement of operations. Regional airlines expense consists of the following:

	2016	2015
Capacity purchase fees	$ 1,199	$ 1,156
Aircraft fuel	327	359
Airport and navigation fees	290	278
Sales and distribution costs	142	126
Other operating expenses	450	360
Regional airlines expense	**$ 2,408**	**$ 2,279**

20 Special Items

Special items recorded within operating expenses consist of the following:

	2016	2015
Labour agreements	$ 91	$ 62
Litigation	-	(40)
Other, net	-	(14)
Special items	**$ 91**	**$ 8**

In 2016, $91 was recorded to reflect the estimated cost of pension increases applicable to members of ACPA as further described in Note 8 Pensions and Other Benefit Liabilities.

In 2015, the Corporation recorded $62 in labour agreement costs related to one-time payments for Air Canada's collective agreements with CUPE and IAMAW. Litigation is related to cargo investigations, as described in Note 16, and includes a favourable provision adjustment of $10 related to a change in estimated costs and recovery of the $30 fine previously paid to the European Commission. Other, net items are mainly related to a tax-related provision adjustment of $23.

21 Sale-Leaseback

During 2016, the Corporation took delivery of two 787 aircraft that were financed under sale-leaseback transactions with proceeds of $351. The sales were at fair value and accordingly the resulting gain on sale of $19 was recognized in non-operating income. The leases are accounted for as operating leases with 12 year terms, paid monthly.

22 Related Party Transactions

Compensation of key management

Key management includes Air Canada's Board of Directors, President and Chief Executive Officer, Executive Vice-President and Chief Operating Officer, Executive Vice-President and Chief Financial Officer, and the President, Passenger Airlines. Compensation awarded to key management is summarized as follows:

	2016	2015
Salaries and other benefits	$ 11	$ 10
Pension and post-employment benefits	3	2
Share-based compensation [a]	10	5
	$ 24	**$ 17**

(a) The increase in share-based compensation expense is mainly related to the increase in the Air Canada Share price during 2016 and its impact on the share unit compensation plans.

Officers

David I. Richardson	Chairman of the Board
Calin Rovinescu	President and Chief Executive Officer
Benjamin M. Smith	President, Passenger Airlines
Klaus Goersch	Executive Vice President and Chief Operating Officer
Lucie Guillemette	Executive Vice President and Chief Commercial Officer
Michael Rousseau	Executive Vice President and Chief Financial Officer
Marcel Forget	Senior Vice President, Commercial Strategy
Lise Fournel	Senior Vice President and Chief Information Officer
Kevin C. Howlett	Senior Vice President, Regional Markets and Government Relations
Amos Kazzaz	Senior Vice President, Financial Planning and Analysis
Craig Landry	Senior Vice President, Revenue Optimization
David J. Shapiro	Senior Vice President and Chief Legal Officer
Duncan Bureau	Vice President, Global Sales
Eddy Doyle	Vice President, Flight Operations
Yves Dufresne	Vice President, Alliances and Regulatory Affairs
Mark Galardo	Vice President, Network Planning
Carolyn M. Hadrovic	Corporate Secretary
Chris Isford	Vice President and Controller
John MacLeod	Vice President, Commercial Strategy
Arielle Meloul-Wechsler	Vice President, Human Resources
Leslie Quinton	Vice President, Corporate Communications
Renee Smith-Valade	Vice President, In-Flight Service
Mark D. Southern	Vice President, Airports – North America
Richard Steer	Vice President, Air Canada Maintenance and Engineering
Jim Tabor	Vice President, System Operations Control
Lise-Marie Turpin	Vice President, Cargo

Directors

David I. Richardson	Corporate Director and Chairman of the Board, Air Canada, Grafton, Ontario
Christie J.B. Clark	Corporate Director, Toronto, Ontario
Michael M. Green	Chief Executive Officer and Managing Director, Tenex Capital Management, Radnor, Pennsylvania
Jean Marc Huot	Partner, Stikeman Elliott LLP, Montréal, Quebec
Joseph B. Leonard	Corporate Director, Minneapolis, Minnesota
Madeleine Paquin	President and Chief Executive Officer, Logistec Corporation, Montréal, Quebec
Roy J. Romanow	Senior Fellow, Public Policy, University of Saskatchewan, Saskatoon, Saskatchewan
Calin Rovinescu	President and Chief Executive Officer, Air Canada, Montréal, Quebec
Vagn Sørensen	Corporate Director, London, United Kingdom
Kathleen Taylor	Corporate Director, Toronto, Ontario
Annette Verschuren	Chair and Chief Executive Officer, NRStor Inc., Toronto, Ontario
Michael M. Wilson	Corporate Director, Bragg Creek, Alberta

AIR CANADA

Investor and Shareholder Information

TSX price range and trading volume of Air Canada variable voting shares and voting shares (AC)

2016	High	Low	Volume traded
1st Quarter	$ 10.10	$ 6.81	150,211,010
2nd Quarter	$ 10.49	$ 8.05	92,664,902
3rd Quarter	$ 10.65	$ 8.56	74,269,983
4th Quarter	$ 14.85	$ 10.65	96,402,227
			413,548,122

Effective as of July 29, 2016, Air Canada Class A variable voting shares and Class B voting shares also started trading on OTCQX International Premier in the United States under the single ticker symbol "ACDVF".

Restrictions on voting securities

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

On November 3, 2016, the Minister of Transport announced the Canadian government's intention to pursue legislation to increase the non-Canadian ownership limit of Canadian carriers to 49% of voting interests (from the current 25% limit) with a cap of 25% for any single non-Canadian investor. Management cannot predict the outcome or timing of any such initiative.

For further information

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

TRANSFER AGENT AND REGISTRAR
CST Trust Company
Telephone: 1-800-387-0825

DUPLICATE COMMUNICATION
Shareholders receiving more than one copy are requested to call 1-800-387-0825 or write to the Transfer Agent and Registrar at the following address:

2001 Robert-Bourassa Boulevard, Suite 1600,
Montréal, Quebec H3A 2A6

Inquiries may also be submitted by email to:
inquiries@canstockta.com

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English or French, it's the client's choice

Official Languages at Air Canada

For Air Canada, offering service in the language chosen by its customers is essential. Verbal exchanges with clients, public-address announcements at the airport and on board as well as briefing of passengers with special needs all constitute the very heart of customer service and call upon our employees' linguistic skills at all times. Our consideration to bilingualism not only makes good sense customerwise, but also supports our legal obligations to serve the public in the two official languages of Canada.

Air Canada puts great efforts to better serve clients in the language of their choice. It is through reach-out activities with the minority language communities as well as ongoing employee awareness and training that we can face the daily challenges, whether it is the growing difficulty to recruit bilingual candidates outside the province of Quebec and the national capital region, or for our employees to maintain their language skills with very little opportunities to practice the acquired language in some regions of the country.

DESIGNED AND PRODUCED IN-HOUSE BY THE AIR CANADA MULTIMEDIA COMMUNICATIONS CENTRE

AIR CANADA

Corporate profile

Air Canada is Canada's largest domestic, U.S. transborder and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market and in the international market to and from Canada. In 2016, Air Canada, together with Jazz and other regional airlines operating flights on behalf of Air Canada under capacity purchase agreements, operated, on average, 1,570 daily scheduled flights to 206 direct destinations on six continents, comprised of 64 Canadian cities, 55 destinations in the U.S. and a total of 87 cities in Europe, Africa, the Middle East, Asia, Australia, the Caribbean, Mexico and South America. Air Canada is among the 20 largest airlines in the world and in 2016 served close to 45 million customers.

Air Canada is a founding member of the Star Alliance® network. Through the 28-member airline network, Air Canada offers its customers access to approximately 1,300 destinations in 190 countries, as well as reciprocal participation in frequent flyer programs and the use of airport lounges and other common airport facilities.

Air Canada is the only international network carrier in North America to receive a Four-Star ranking according to independent U.K. research firm Skytrax, placing it among a select group of carriers worldwide to have earned the distinction.

aircanada.com