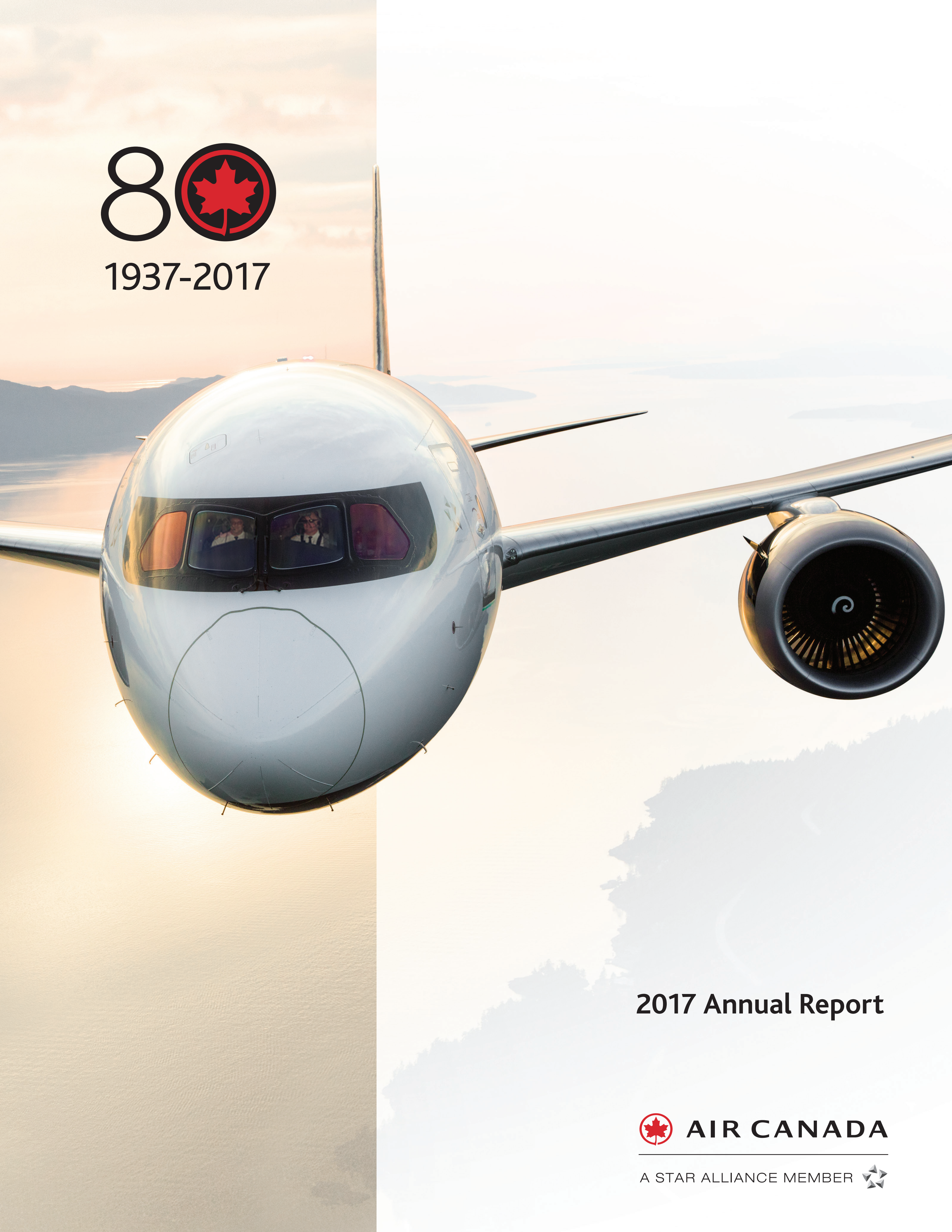

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1937-2017

2017 Annual Report

AIR CANADA

A STAR ALLIANCE MEMBER

1. 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		
	2017	2016	$ Change	2017	2016	$ Change
Financial Performance Metrics						
Operating revenues	3,820	3,425	395	16,252	14,677	1,575
Operating income	133	18	115	1,364	1,345	19
Income (loss) before income taxes	20	(178)	198	1,279	877	402
Net income (loss)	8	(179)	187	2,038	876	1,162
Adjusted pre-tax income (1)	77	39	38	1,158	1,148	10
Adjusted net income (1) (2)	61	38	23	1,142	1,147	(5)
Operating margin %	3.5%	0.5%	3.0 pp	8.4%	9.2%	(0.8) pp
EBITDAR (excluding special items) (1)	521	455	66	2,921	2,768	153
EBITDAR margin (excluding special items) % (1)	13.6%	13.3%	0.3 pp	18.0%	18.9%	(0.9) pp
Unrestricted liquidity (3)	4,181	3,388	793	4,181	3,388	793
Net cash flows from operating activities	389	351	38	2,738	2,421	317
Free cash flow (1)	(43)	121	(164)	1,056	(149)	1,205
Adjusted net debt (1)	6,116	7,090	(974)	6,116	7,090	(974)
Return on invested capital ("ROIC") % (1)	13.9%	16.7%	(2.8) pp	13.9%	16.7%	(2.8) pp
Leverage ratio (1)	2.1	2.6	(0.5)	2.1	2.6	(0.5)
Diluted earnings (loss) per share	$ 0.02	$ (0.66)	$ 0.68	$ 7.34	$ 3.10	$ 4.24
Adjusted earnings per share – diluted (1)	$ 0.22	$ 0.14	$ 0.08	$ 4.11	$ 4.06	$ 0.05
Operating Statistics (4)			% Change			% Change
Revenue passenger miles ("RPM") (millions)	19,396	17,643	9.9	85,137	76,481	11.3
Available seat miles ("ASM") (millions)	24,191	22,091	9.5	103,492	92,726	11.6
Passenger load factor %	80.2%	79.9%	0.3 pp	82.3%	82.5%	(0.2) pp
Passenger revenue per RPM ("Yield") (cents)	17.1	16.9	1.4	16.7	16.8	(1.0)
Passenger revenue per ASM ("PRASM") (cents)	13.7	13.5	1.8	13.7	13.9	(1.3)
Operating revenue per ASM (cents)	15.8	15.5	1.9	15.7	15.8	(0.8)
Operating expense per ASM ("CASM") (cents)	15.2	15.4	(1.2)	14.4	14.4	0.1
Adjusted CASM (cents) (1)	11.3	11.4	(1.2)	10.6	10.9	(3.0)
Average number of full-time equivalent ("FTE") employees (thousands) (5)	28.3	26.2	8.0	27.8	26.1	6.7
Aircraft in operating fleet at period-end	395	381	3.7	395	381	3.7
Average fleet utilization (hours per day)	9.7	9.5	2.4	10.4	10.2	1.8
Seats dispatched (thousands)	14,522	13,873	4.7	60,820	57,135	6.4
Aircraft frequencies (thousands)	138.4	136.7	1.3	569.6	565.5	0.7
Average stage length (miles) (6)	1,666	1,592	4.6	1,702	1,623	4.8
Fuel cost per litre (cents)	67.5	59.4	13.8	62.6	53.9	16.2
Fuel litres (thousands)	1,254,111	1,160,404	8.1	5,331,888	4,837,159	10.2
Revenue passengers carried (thousands) (7)	11,314	10,719	5.6	48,126	44,849	7.3

(1) Adjusted pre-tax income, adjusted net income, adjusted earnings per share – diluted, 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 20 of Air Canada's 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 Air Canada's reported EBITDAR calculations. Refer to sections 6 and 7 of Air Canada's MD&A for information on special items.

(2) Starting as of and including the fourth quarter of 2017, adjusted net income is determined net of tax and includes the income tax effect of adjustments included in the measurement of adjusted net income. Prior to the fourth quarter of 2017, there was no deferred income tax expense recorded because of significant unrecognized deferred tax assets. A tax expense of $16 million affected fourth quarter and full year 2017 adjusted net income results.

(3) 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, 2017, unrestricted liquidity was comprised of cash and short-term investments of $3,804 million and undrawn lines of credit of $377 million. 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.

(4) 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 Limited ("EVAS")) operating under capacity purchase agreements with Air Canada.

(5) 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.

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

(7) Revenue passengers carried 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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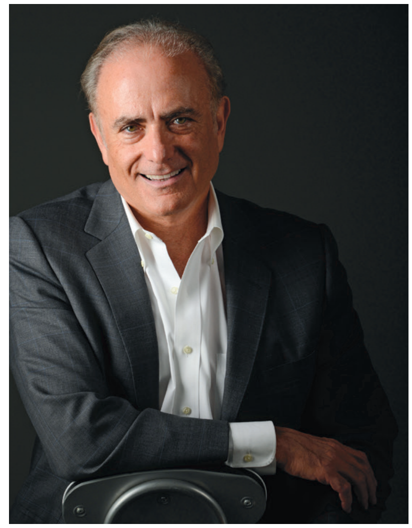
Message from the President and Chief Executive Officer



Calin Rovinescu

I am delighted to report that 2017 was a record year for Air Canada, underscoring the effectiveness of our transformation strategy, our global expansion and the power of our comprehensive network. We reported record results for key metrics, including our fifth consecutive year of record EBITDAR. Beyond this, and of longer-term importance, the consistency of these results is evidence that our strategy has positioned our airline for sustainable profitability into the future. In 2017, our shares appreciated nearly 90%, ahead of all our North American network carrier peers for the second consecutive year and well ahead of the TSX Composite Index.

Along with record EBITDAR of $2.921 billion, for 2017, we also reported records for operating revenue, free cash flow and net cash flows from operating activities. We earned operating income of $1.364 billion, record income before income taxes of $1.279 billion and record adjusted pre-tax income of $1.158 billion.

Propelling our results in 2017 was a strong revenue performance. We achieved record operating revenue of $16.252 billion for the year, up $1.575 billion or 11% from 2016. Passenger revenue grew in each major market where we operate, signaling the strength of our expanded international network.

In 2017, Air Canada's unit costs, or cost per available seat mile (CASM), increased 0.1% when compared to 2016. Adjusted CASM, which excludes fuel expense, the cost of ground packages at Air Canada Vacations and special items, continued to decline. Over the last several years, we have been a North American industry leader in reducing adjusted CASM. In 2017, it decreased 3.0% from 2016, pointedly better than the 3.6% average increase of other major North American carriers. I am also pleased to report that, at year-end, Air Canada's adjusted CASM level was comparable to that of the three largest U.S. carriers, measured in local currency.

The consistency of these results is evidence that our strategy has positioned our airline for sustainable profitability into the future.

We reported record free cash flow of $1.056 billion in 2017, $1.205 billion above the prior year. Record net cash flows from operating activities amounted to $2.738 billion. Total long-term debt and finance leases of $6.119 billion decreased $499 million from December 31, 2016. Adjusted net debt was $6.116 billion, down $974 million, with the company's leverage ratio improving to 2.1 from 2.6 at the end of the previous year. Due to our strengthened financial position, Air Canada's average weighted cost of capital continued to decrease in 2017 and reached 7.6%, significantly below our return on invested capital of 13.9% for the year.

Air Canada carried a record 48.1 million passengers in 2017, with an average load factor of 82.3%. This is approximately 50% more customers than we carried when our transformation began in 2009. During the year, we won important awards recognizing the quality of our service. This included being named Best Airline in North America by Skytrax and Best Long-Haul Airline in the Americas for 2018 by AirlineRatings.com, which also gave Air Canada its top seven-star rating for both safety and product. We remain the only Four Star international network carrier in North America as rated by Skytrax.

These and our other achievements of the past year cannot be appreciated in isolation. They are the result of determined adherence to a long-term strategy developed in 2009 to transform Air Canada into a sustainably profitable, leading global carrier. And while this strategy has proven effective, we are fully cognizant that the nature of our business, with the relentless press of competition against an ever-changing economic and geopolitical backdrop, does not allow for repose. Instead, we must maintain and intensify our focus on the core strategic priorities that have brought us such success so far.

The foundational priority is Revenue Enhancement and Cost Containment. Upon this rest our other priorities, as success here gives us the means to invest in network expansion, new aircraft, enhanced product and service, and people. Our record revenue results during the year were driven by our ability to attract larger volumes of higher-yielding local traffic, the performance of our premium products, an improvement in our overall fare mix and an increase in ancillary revenues which, for the first time, exceeded $1 billion.

Our record revenue results during the year were driven by our ability to attract larger volumes of higher-yielding local traffic, the performance of our premium products, an improvement in our overall fare mix and an increase in ancillary revenues which, for the first time, exceeded $1 billion.

Complementing the revenue performance has been the relentless pursuit of unit cost reductions. For example, through the execution of company-wide initiatives, we realized savings of approximately $90 million and we secured future savings by renegotiating more than 200 agreements with key suppliers to generate savings and avoid cost increases of about $120 million over the life of the agreements. Subsequent to the year-end, to capitalize on this momentum, we launched a new Cost Transformation Program aimed at realizing $250 million in additional savings by the end of 2019.

A strong financial position also enables a company to make investments to further strengthen its business. Air Canada's $10 billion fleet renewal is an example. This program continued in 2017 with the arrival of nine more Boeing 787s and the start of our narrow-body fleet renewal program. We took delivery of the first two of a planned 61 single-aisle Boeing 737 MAX aircraft, which promise an 11% lower CASM than that of the Airbus A320 aircraft they will replace.

Our hard-won financial strength has allowed us to finance the acquisition of new aircraft on attractive terms. For four Boeing 787 and nine 737 MAX aircraft arriving in 2018, we placed a private offering of three investment grade tranches of enhanced equipment trust certificates (EETCs). They have a combined weighted average interest rate of 3.4%, the lowest rate of the four EETC offerings we completed over the last four-and-a-half years. Moreover, our increased liquidity is allowing us to purchase aircraft outright, and where we had no owned aircraft only a few years ago, today we have a pool of 56 unencumbered aircraft, contributing to an unencumbered asset pool valued at over US$2 billion.

Fleet renewal and expansion have allowed us to successfully pursue our second priority, International Expansion. In 2017, Air Canada and Air Canada Rouge started 30 new routes, 15 of them to international destinations. Although the pace of international expansion will taper with the completion of our wide-body renewal program, we will remain attuned to new international growth opportunities to generate increased profit, diversify our network, and further lower our risk profile.

We will also continue to court higher-yielding, international-to-international traffic connecting through our major hubs. In 2017, we saw a 20% increase in such traffic, and we will keep investing in our hubs to streamline processes and add features that will make them even more attractive to global travelers. One such amenity is the Air Canada Signature Suite which opened late in 2017 at our Toronto-Pearson global hub that offers eligible international customers à la carte dining in an exclusive lounge setting.

Another means of competing globally is through mutually beneficial partnerships with other carriers. The 28-member Star Alliance, of which Air Canada is a founding member, and our Atlantic Joint Venture with United Airlines and the Lufthansa Group, remain central to our strategy. In 2018, subject to government and regulatory approvals, we will deepen our relationship with Air China by placing our respective codes on more of each other's flights as a prelude to a full joint venture that would give us greater access to one of the world's largest aviation markets. Finally, we maintain numerous codeshare relationships with non-Star Alliance carriers, including new agreements concluded in 2017 with Cathay Pacific and Virgin Australia.

The new reservation system, scheduled to be fully implemented in 2019, will allow Air Canada to optimize its flight schedule by providing the ability to more easily manage inventory between any given origin and destination and automate rebookings during flight disruptions, such as those caused by extreme weather.

Given that we compete in the global arena, our products and services must match or exceed the very best the industry offers to achieve our third priority, Customer Engagement. During the year, we further invested in the customer experience through new aircraft, airport amenities, training and technology, including enhanced mobile technology, to make it easier for customers to interact with us in their preferred channels.

Work began in 2017 on two major initiatives that will further drive engagement. The first of these is the launch, in 2020, of a new loyalty program upon the expiry of our commercial agreement with Aimia, the operator of Aeroplan, the airline's loyalty program. We are very excited with the opportunity to develop a program that will not only strengthen customer relationships and enhance the customer experience but will also create shareholder value.

A second major customer service initiative was a decision to acquire the Amadeus Altéa Suite passenger service system (PSS), which will modernize our systems for reservations, inventory and departure control. The new reservation system, scheduled to be fully implemented in 2019, will allow Air Canada to optimize its flight schedule by providing the ability to more easily manage inventory between any given origin and destination and automate rebookings during flight disruptions, such as those caused by extreme weather.

The PSS will also advance our final corporate priority of Employee Culture Change by giving employees new tools to deliver customer solutions. There has been a marked increase in employee engagement with our transformation and we continue to foster change through broadened communications – including quarterly town halls with senior executives – training, recognition and performance-based compensation.

We also enjoy unprecedented labour stability as we have contracts with major union groups in place for the next six to eight years. This demonstrates a collaborative partnership supporting our transformation into a global champion. For example, the Air Canada Pilots Association agreed in 2017 to certain new, mutually beneficial arrangements to increase our competitiveness through additional Air Canada Rouge flying.

Respected and independent third parties have recognized the cultural shift at Air Canada. For the fifth consecutive year in 2017, we were chosen one of Canada's Top 100 Employers. During the year, among other awards, we were also named one of the 50 Most Engaged Workplaces in North America, the second most attractive company brand to work for in Canada, and one of Canada's Best Diversity Employers.

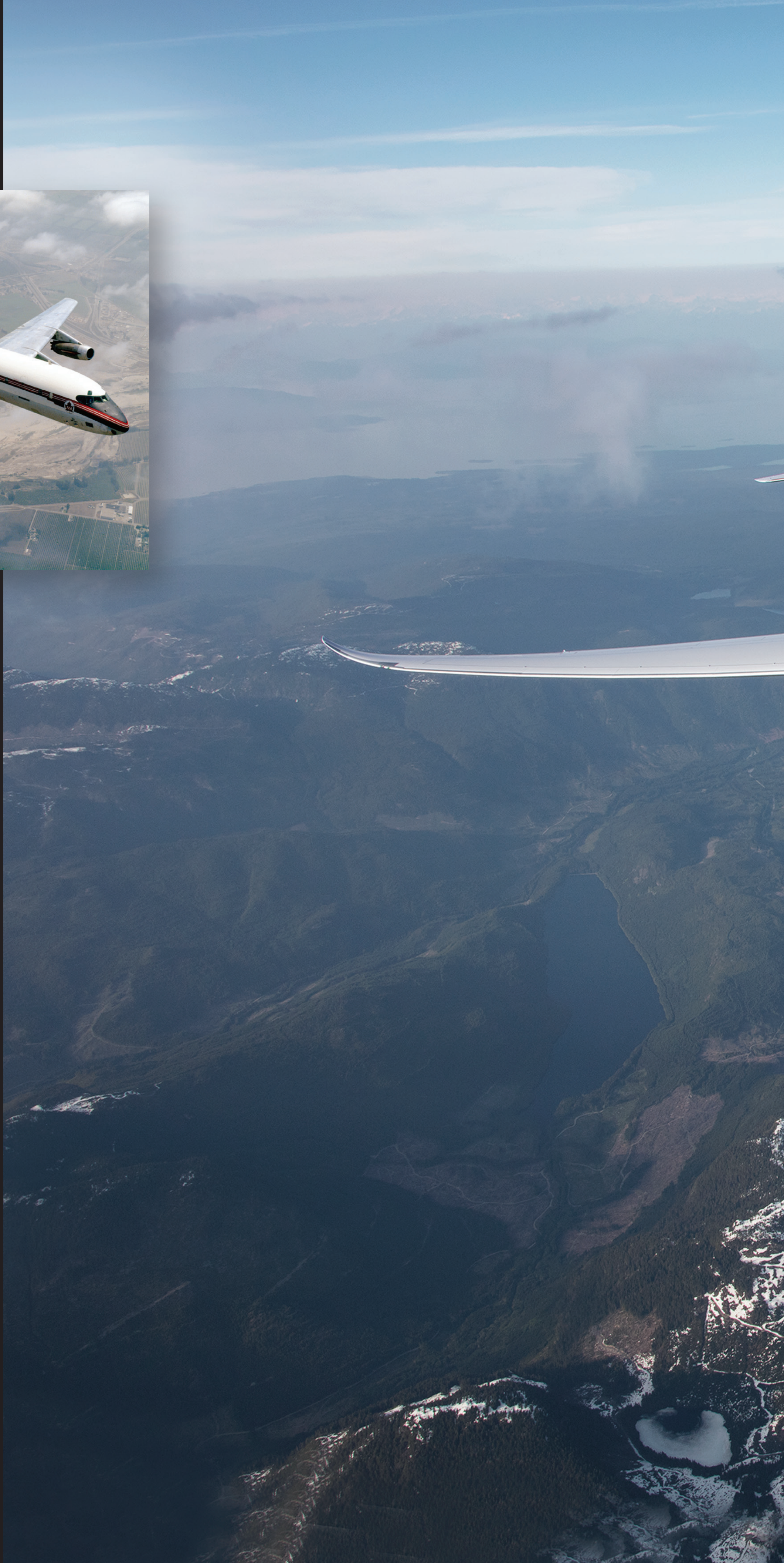
Our brand and business model are tried and tested and we have materially de-risked our company to position it for long-term, sustainable profitability.

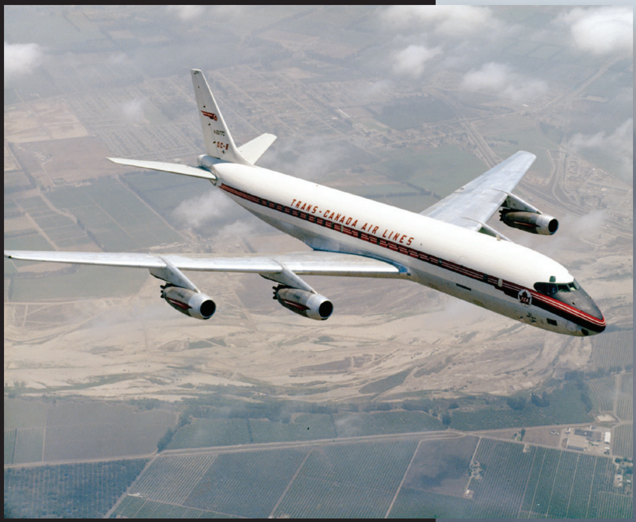
In 2017, Air Canada celebrated its 80th Anniversary and did so with the vigour and agility of a new start-up; we expanded profitably, set numerous financial records and rewarded investors with a nearly 90% return. But unlike a start-up, our brand and business model are tried and tested, and we have materially de-risked our company to position it for long-term, sustainable profitability. We will move forward from here, guided by the four priorities that have so successfully transformed our company, all the while staying nimble so that we can respond swiftly to changing circumstances and emerging opportunities.

I especially wish to thank our Board of Directors for their guidance and ongoing contributions as well as our shareholders, who have shown their steadfast support of our business strategy by investing in our future. In particular, I would like to acknowledge the dedicated service and invaluable contribution of Joseph B. Leonard and Roy J. Romanow to the transformation of Air Canada. Joe retired from the Board of Directors in September 2017 after nearly a decade of service and Roy will retire this year after joining our Board in 2010.

I also thank Air Canada's 30,000 employees for their willingness to adapt to the ever-changing dynamics of our industry and for never losing sight of the top priority, safely delivering customers to their destinations. Finally, I thank our customers for their loyalty, which we at Air Canada are fully committed to earning each and every day.

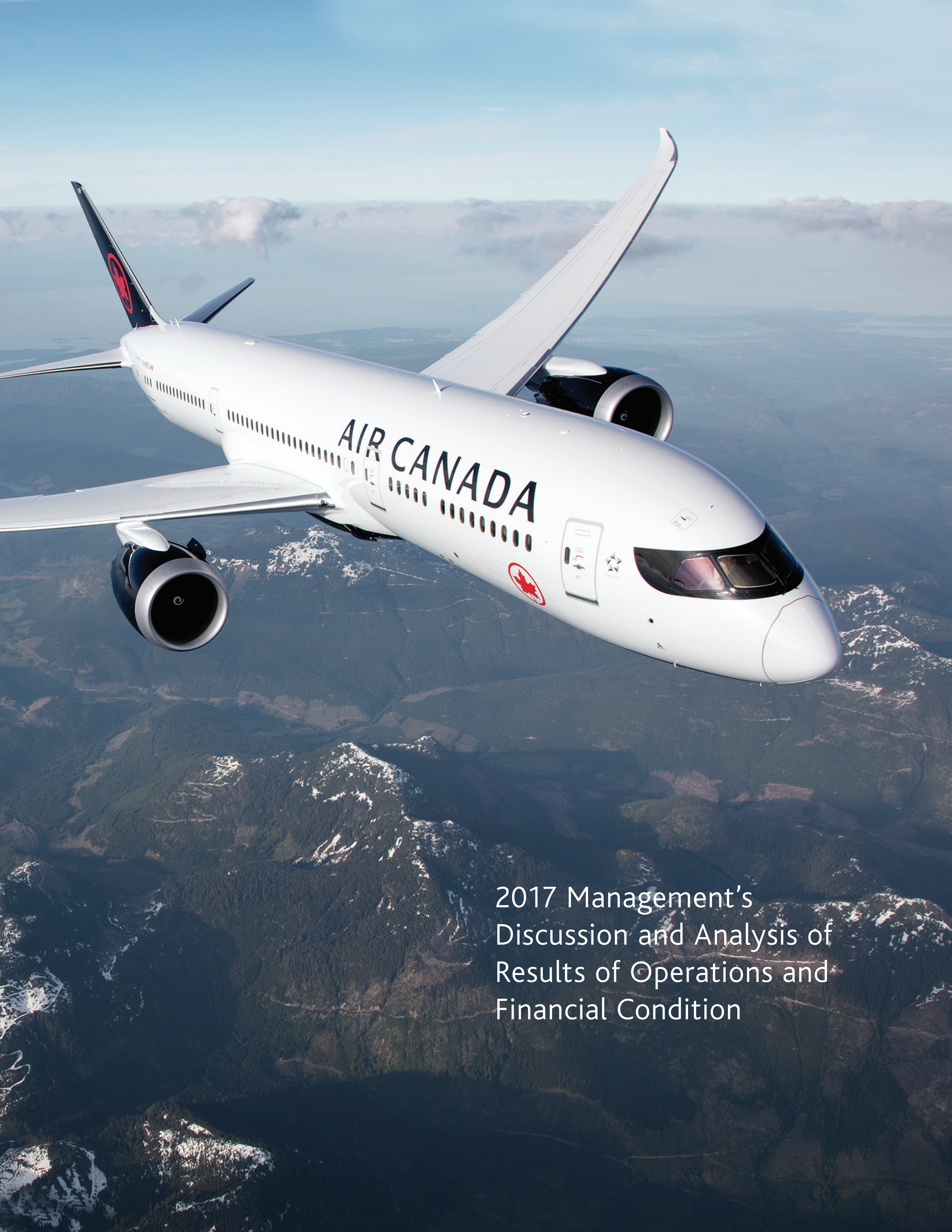
Calin Rovinescu,
President and Chief Executive Officer





On April 12, 1963, TCA said good-bye to the era of piston-powered aircraft and became the first airline in the world with an all-turbine fleet.

80th Anniversary



2017 Management's Discussion and Analysis of Results of Operations and Financial Condition

2. 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 as 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 2017. This MD&A should be read in conjunction with Air Canada's audited consolidated financial statements and notes for 2017. Except for non-GAAP measures and except where otherwise described in this MD&A, all financial information of Air Canada 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 21 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of February 15, 2018. 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 18 "Risk Factors" of this MD&A. Air Canada issued a news release dated February 16, 2018 reporting on its results for the fourth quarter and the full year of 2017. 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 forward-looking statements within the meaning of applicable securities laws. Such forward-looking 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 using 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, industry, market, credit, economic and geopolitical conditions, energy prices, currency exchange, competition, our dependence on technology, cybersecurity risks, our ability to pay our indebtedness and secure financing, our ability to successfully implement appropriate strategic initiatives or reduce operating costs, war, terrorist acts, epidemic diseases, airport user and related fees, high levels of fixed costs, liquidity, our dependence on key suppliers including regional carriers and Aimia Canada Inc., our success in transitioning from the Aeroplan program and launching our new loyalty program, 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 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 in Air Canada's public disclosure file available at www.sedar.com and, in particular, those identified in section 18 "Risk Factors" of this MD&A. The forward-looking statements contained or incorporated by reference in this MD&A represent Air Canada's expectations as of the date of this MD&A (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 because 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 2018 and 2019. Air Canada also expects that the Canadian dollar will trade, on average, at C$1.25 per U.S. dollar in the first quarter of 2018 and the full year 2018 and that the price of jet fuel will average 72 CAD cents per litre in the first quarter of 2018 and 70 CAD cents per litre for the full year 2018.

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 also 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.

3. About Air Canada

Air Canada is 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 2017, Air Canada, together with Jazz Aviation LP ("Jazz"), Sky Regional Airlines Inc. ("Sky Regional") and other regional airlines operating flights on behalf of Air Canada under capacity purchase agreements, operated, on average, 1,602 daily scheduled flights to 217 direct destinations on six continents, comprised of 64 Canadian cities, 57 destinations in the United States and a total of 96 cities in Europe, Africa, the Middle East, Asia, Australia, the Caribbean, Mexico and South America. In 2017, Air Canada carried record 48.1 million passengers, an increase of 7.3% from 2016.

At December 31, 2017, Air Canada mainline operated a fleet of 175 aircraft, comprised of 75 Airbus narrow-body aircraft, 73 Boeing and Airbus wide-body aircraft, two Boeing narrow-body aircraft and 25 Embraer 190 regional jets, while Air Canada Rouge operated a fleet of 49 aircraft, comprised of 20 Airbus A319 aircraft, five Airbus A321 aircraft and 24 Boeing 767-300 aircraft, for a total fleet of 224 aircraft.

Air Canada enhances its domestic and transborder network through capacity purchase agreements ("CPAs") with regional airlines, namely Jazz, 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, 2017, the Air Canada Express fleet was comprised of 45 Bombardier regional jets, 86 Bombardier Dash-8 turboprop aircraft and 25 Embraer 175 aircraft for a total of 156 aircraft. Air Georgian and EVAS also operate a total of 15 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 191 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 the 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. In May 2017, Air Canada announced its decision to launch its own loyalty program in 2020 upon the expiry of its commercial agreement with Aimia Canada Inc.

Air Canada has been pursuing a comprehensive strategy to improve profitability and competitiveness in leisure markets. This strategy 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 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 the inbound leisure travel market to destinations within Canada, and also offering cruise packages in North America, Europe and the Caribbean.

Air Canada generates revenue from its cargo business, 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.

4. Strategy

Air Canada's principal objective is to become one of the world's best global airlines. In pursuing this goal, it seeks to continually improve customer experience and employee engagement, and create value for shareholders, by focusing on four core priorities:

- Identifying and implementing cost reduction and revenue enhancing initiatives;
- Pursuing profitable international growth opportunities and leveraging competitive attributes to appropriately expand margins, in large part by increasing connecting traffic through its strategic international gateways in Toronto, Vancouver and Montreal, and growing and effectively competing 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 is a key priority at Air Canada. Air Canada continues to seek and implement measures to reduce unit costs and expand margins, including through fleet modernization and greater fleet productivity. Additionally, Air Canada seeks to improve its ability to generate incremental passenger and ancillary revenue, including through its improved suite of branded fare products and investments in technology to generate incremental sales.

KEY ACHIEVEMENTS IN 2017

- Record operating revenue of $16,252 million, $1,575 million or 11% above 2016.
- Carried record 48.1 million passengers, 7.3% above 2016.
- EBITDAR margin of 18.0%, consistent with the 2017 EBITDAR margin of 17% to 19% forecasted in Air Canada's news release dated October 25, 2017.
- CASM increased 0.1% from 2016. Adjusted CASM decreased 3.0% from 2016, in line with the 3.0% to 4.0% decrease forecasted in Air Canada's news release dated October 25, 2017.
- Continued to successfully expand Air Canada Rouge, the airline's leisure carrier, which operates at lower CASM when compared to the same aircraft in the mainline fleet.
- Added nine Boeing 787 aircraft into the mainline fleet, allowing the airline to serve new international destinations.
- Introduced its first two Boeing 737 MAX 8 aircraft into the mainline fleet, commencing Air Canada's narrow-body renewal program which will allow the airline to further improve unit costs and provide greater deployment opportunities throughout the network.
- Reconfigured Airbus A330-300 aircraft into a more cost effective and competitive configuration.

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

Since its first flight in July 2013, Air Canada Rouge, Air Canada's leisure carrier, has been deployed to a growing number of Caribbean destinations and select leisure destinations in the U.S. and Canada, as well as in international leisure markets where demand is highly elastic and responds positively to lower priced, non-stop capacity. At December 31, 2017, Air Canada Rouge operated 49 aircraft (24 Boeing 767, 20 Airbus A319 and five Airbus A321 aircraft) and is planning to have a total of 53 aircraft in its fleet (25 Boeing 767, 22 Airbus A319 and six Airbus A321 aircraft) by the summer of 2018.

Air Canada Rouge provides Air Canada with the flexibility to swing capacity between markets as well as between seasons and effectively competes against lower-cost carriers. Air Canada Rouge offers competitive fares while leveraging the strengths of Air Canada, including its powerful brand, award-winning products and services, extensive network with enhanced connection options, distribution capability and operational expertise.

In September 2017, Air Canada concluded amendments to its long-term labour agreement with its pilots, represented by the Air Canada Pilots Association ("ACPA"). The amendments to the original 10-year agreement, reached in October 2014, further support Air Canada's strategic plan for profitable growth for both mainline and Air Canada Rouge in a proportionate manner based on overall growth. This provides Air Canada with abilities to grow its North American narrow-body fleet operated by Air Canada Rouge, enabling the airline to expand its presence in certain regional markets and to compete more effectively against emerging North American ultra-low-cost carriers. Air Canada will not expand into ultra-low-cost markets unless it determines it is appropriate to do so.

Air Canada plans to add one wide-body and three narrow-body aircraft to Air Canada Rouge's fleet in 2018. Refer to section 8 "Fleet" of this MD&A for additional information.

Continued introduction of fuel-efficient Boeing 787 aircraft

To date, Air Canada has taken delivery of 32 Boeing 787 Dreamliner aircraft of its firm order of 37 aircraft (comprised of eight 787-8 and 29 787-9 aircraft). Air Canada plans to take delivery of the remaining five Boeing 787-9 aircraft on firm order by the summer of 2019. The Boeing 787 Dreamliner is driving new opportunities for profitable growth by opening new international destinations made viable by its lower operating costs, mid-size capacity and longer range.

Narrow-body fleet renewal program

To date, Air Canada has taken delivery of four Boeing 737 MAX 8 aircraft of its firm order of 61 737 MAX aircraft (comprised of 50 Boeing 737 MAX 8 and 11 Boeing 737 MAX 9 aircraft). The Boeing 737 MAX aircraft are expected to replace the Airbus narrow-body aircraft in Air Canada's mainline fleet. Air Canada plans to take delivery of the remaining 57 Boeing 737 MAX aircraft on firm order by the end of 2021. Air Canada estimates that the Boeing 737 MAX 8 aircraft will deliver an 11% lower CASM when compared to its Airbus A320 aircraft, mainly driven by greater maintenance and fuel efficiencies. This aircraft will also offer greater deployment opportunities in the domestic, U.S. transborder and certain Atlantic markets.

In 2016, Air Canada and Bombardier Inc. ("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 the Embraer 190 aircraft in Air Canada's mainline fleet, with the incremental aircraft supporting Air Canada's hub and network growth. Air Canada estimates that the Bombardier C-Series CS300 aircraft will deliver a 12% lower CASM when compared to the Embraer 190 aircraft, mainly driven by greater maintenance and fuel efficiencies. This aircraft, with its longer range, will also offer greater deployment opportunities, enabling the airline to serve new markets that may not be as viable with its larger Boeing 737 MAX or Airbus A321 aircraft.

Other revenue optimization and cost reduction initiatives

Air Canada has created a culture of continuous cost transformation and revenue improvement across the organization, continually seeking productivity, process and other improvements. 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 lower costs. In 2017, through the execution of company-wide initiatives, Air Canada realized savings of approximately $90 million. In addition, through the implementation of sourcing best practices, Air Canada entered into agreements generating aggregate savings of $120 million over the life of the agreements.

Air Canada updated its suite of branded fare products to allow it to further segment its customer base and offer a variety of fare options and a customized onboard experience. These new re-bundled fares are designed to provide a wider range of choices and stimulate sales based on specific attributes, driving incremental revenue. The airline has also introduced a program entitled "AC Bid Upgrade" for eligible customers to bid on cabin class upgrades. Air Canada continues to increase its ancillary revenue through *à la carte* services, such as those related to baggage, ticket changes, seat selection, preferred seating and upgrades. Finally, Air Canada generates revenues from its onboard offerings, including food, beverage, duty-free shopping and onboard Wi-Fi Internet. To better monetize its ancillary offerings and increase related revenues, Air Canada intends to further develop its merchandising capabilities to customize, differentiate and combine its *à la carte* services.

Air Canada is also increasing revenues and reducing overall costs through sales and distribution initiatives. In 2017, in conjunction with a new agreement between Amadeus and Air Canada for the full Amadeus Altéa Suite passenger service system (PSS) (which is further described below under "Passenger Service System"), Air Canada renewed its multi-year distribution agreement with Amadeus on more favourable terms and conditions. This agreement supports Air Canada's business strategy for offering a more personalized travel experience across a wider range of sales channels. Amadeus users worldwide will be able to access Air Canada's customizable fare products and availability via the Amadeus global distribution system, as well as the airline's ancillary offerings. Air Canada has also introduced alternative forms of payment and payment wallets on **aircanada.com**, which have removed payment friction for customers within the channel and reduced transaction costs.

Air Canada continues to benefit from its amended and extended capacity purchase agreement with Jazz. The gains from this agreement primarily result from greater network flexibility, fleet economics (as the Jazz fleet transitions to more efficient and larger aircraft), and a pilot mobility agreement that provides Jazz pilots with access to pilot vacancies at Air Canada and reduces Jazz costs passed on to Air Canada. There will be further benefits beginning in 2021 when the compensation paid to Jazz decreases by approximately $55 million per year, bringing the cost of Jazz to Air Canada to a more competitive level in the regional sector.

Air Canada will be introducing a new fuel management system to better manage fuel inventories, optimize transportation logistics and improve the accuracy of fuel invoicing and reconciliation process.

Air Canada is also realizing incremental revenue through investments in digital channels. It is investing in web and mobile platforms, and as a result, saw a significant acceleration in direct channel share and core ancillary revenue sales in 2017. Air Canada continues to experiment and optimize its retail capabilities through new partnerships. For example, recent testing of AI-powered models to optimize customer fare sale and upgrade emails has led to a significant increase in customers engaging with their Air Canada emails, which would be expected to drive a higher volume of sales.

International growth

Air Canada remains focused on identifying new international growth opportunities to generate increased profit, diversify its network, and lower its risk profile. This includes the development of additional synergies offered by alliances with foreign carriers.

KEY DEVELOPMENTS IN 2017

- Introduced non-stop Air Canada service from Vancouver to Frankfurt, Melbourne, Taipei and Boston; from Montreal to Shanghai and Tel Aviv; from Toronto to Mumbai; from Calgary to San Jose del Cabo; and from Ottawa to Puerto Plata.
- Launched non-stop Air Canada Rouge service from Montreal to Algiers, Lima, Marseille and Reykjavík; from Toronto to Belize City, Berlin, Cartagena, Reykjavík, St. Vincent and the Grenadines; Calgary to Huatulco; and from Vancouver to London-Gatwick, Nagoya and Orlando.
- Started non-stop Air Canada Express service from Toronto to San Antonio, Memphis and Savannah; from Vancouver to Dallas-Fort Worth, Denver and Yellowknife; and from Montreal to Dallas-Fort Worth and Washington-Dulles.
- Converted Air Canada Rouge service between Montreal and Casablanca from a seasonal service to a year-round service.
- Expanded a codeshare agreement with Cathay Pacific, further widening the network by connecting Air Canada's services to Hong Kong to many Southeast Asian destinations, including the Philippines, Malaysia, Vietnam and Thailand. As a result, Air Canada now offers codeshare services to destinations such as Manila, Cebu, Kuala Lumpur, Ho Chi Minh City, Hanoi, Bangkok, Phuket and Chiang Mai.
- Implemented a new codeshare agreement with Virgin Australia, connecting Air Canada's services to Australia (Sydney, Brisbane and Melbourne) to destinations in Australia and New Zealand such as Adelaide, Canberra, Cairns, Gold Coast, Perth, Auckland, Christchurch and Wellington.
- Expanded existing codeshare agreements with Lufthansa Group, United Airlines, Croatia Airlines, Asiana Airlines, Thai Airways, Air India and Avianca Brazil.
- Increased sixth freedom traffic (international-to-international, including U.S.) connecting through Air Canada's major Canadian hubs by 20% when compared to 2016.

Air Canada has competitive strengths which allows it 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 and Montreal, and is broadening its network appeal through its membership in Star Alliance®, its trans-Atlantic revenue-sharing joint venture with United Airlines and Deutsche Lufthansa AG, 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 and industry-leading products and services, allow it to leverage its network and benefit from the higher margins generally available in international markets.

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 advantages:

- 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, enabling the airline to redeploy or otherwise manage capacity to match changes in demand.
- Air Canada Altitude®, Air Canada's frequent flyer program, which recognizes the airline's most 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.

- Competitive products and services, including lie-flat beds in the International Business Class cabin, concierge services, Maple Leaf® lounges and, at its Toronto global hub, an exclusive Air Canada Signature Suite offering eligible International Business Class customers exclusive amenities, including *à la carte* meal service in the suite's complimentary restaurant.
- Geographically well-positioned hubs (Toronto, Montreal and Vancouver) with efficient in-transit facilities, accentuating the advantages of flying Air Canada for customers travelling between the U.S. and Asia or 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.

In 2018, Air Canada plans to launch additional international services, including non-stop Air Canada service from Montreal to Tokyo-Narita and Dublin; from Vancouver to Paris and Zurich; and from Toronto to Shannon and Buenos Aires (which had previously been operated as a one-stop service via Santiago). Air Canada also plans to launch non-stop seasonal Air Canada Rouge service from Toronto to Bucharest, Porto and Zagreb; and from Montreal to Bucharest and Lisbon. In addition, Air Canada service between Vancouver and Delhi will be converted from a seasonal service to a year-round service.

Air Canada enhances its domestic and transborder network through capacity purchase agreements with Jazz, Sky Regional, Air Georgian and other airlines (operating under the Air Canada Express banner). Air Canada Express provides a network of local traffic, as well as high volumes of feeder traffic that flow into Air Canada's long-haul network and support its strategy to grow international transit traffic to and from the U.S. A number of new routes were announced, including, beginning in 2018, non-stop Air Canada Express service from Montreal to Baltimore and Pittsburgh; from Toronto to Omaha and Providence; from Edmonton to San Francisco, Kelowna and Victoria; from Calgary to Comox; and from Vancouver to Sacramento.

Air Canada continues to increase sixth freedom traffic, particularly from the U.S., with its award-winning products and services, geographically well-positioned Canadian hubs, extensive network and other competitive advantages.

Lester B. 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 flying to and from Toronto. Air Canada's 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 (GTAA) to transform Toronto Pearson into the leading North American airport and gain a greater share of the global sixth freedom market.

Air Canada is also growing its Vancouver hub into a premier gateway to Asia-Pacific markets and developing Montreal into a complementary 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 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. Given the improvements that are being made in Toronto, Vancouver and Montreal, the airline is able to build its network from the U.S. to provide increased connection flows to its international flights. 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.

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 and broaden its network offerings. Air Canada achieves this through its membership in Star Alliance and through its participation in the A++ joint venture. By coordinating pricing, scheduling and sales (under the joint venture), Air Canada is better able to serve customers by offering more travel options, while reducing travel times.

The airline's numerous codeshare and interline agreements further allow it to achieve greater critical mass and network scope. Air Canada has 34 codeshare partners, of which 24 are Star Alliance members and 10 are non-members (Aer Lingus, Central Mountain Air, Etihad, Eurowings, GOL Linhas Aéreas Inteligentes, Jet Airways, Middle East Airlines, SriLankan Airlines, Cathay Pacific and Virgin Australia). In addition to its new codeshare agreements with Cathay Pacific and Virgin Australia, in 2017, Air Canada also expanded the scope of existing codeshare agreements with Lufthansa Group, United Airlines, Croatia Airlines, Asiana Airlines, Thai Airways, Air India and Avianca Brazil.

In April 2018, subject to government and regulatory approvals, Air Canada will deepen its relationship with Star Alliance partner Air China. Air Canada will place its code on Air China's flights between Beijing and Zhengzhou, Xiamen, Shenzhen and Nanjing, as well as Air China's flight between Montreal and Havana. At the same time, Air China will place its code on Air Canada's new daily Montreal to Shanghai flight, as well as Air Canada's flights from Vancouver to Victoria, Kelowna, Saskatoon and Regina. Beyond this, Air Canada and Air China are working to finalize a planned joint venture which is expected to be implemented in 2018. The planned joint venture would solidify Air Canada's investment in China, which currently consists of five daily flights from Canada, and could facilitate further growth potential from Air Canada's hubs.

Air Canada continues to assess new strategic partnerships in support of its business plan and international growth strategy.

Customer engagement

Providing a consistently high level of customer service and growing the airline's premium customer base are important aspects of Air Canada's business strategy. Air Canada continually strives to improve customer loyalty and generate positive referrals to attract 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.

LOYALTY PROGRAM

Air Canada Altitude is designed to recognize and reward its most frequent travellers with exclusive perks and privileges based on the number of miles or segments customers fly combined with their total spend. These privileges, including priority airport services, lounge access and eUpgrade credits, are designed to enhance the Air Canada experience and encourage loyalty from frequent flyers. Altitude members also 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.

Consistent with its promise of continued investments in the customer experience, in May 2017, Air Canada announced its intention to launch a new loyalty program in 2020 upon the expiry of its commercial agreement with Aimia, the operator of Aeroplan, the airline's loyalty program. By operating its own loyalty program, Air Canada will be better able to strengthen its customer relationships, offer members more flexible rewards and deliver a more consistent end-to-end customer experience. The new program will offer broad earning and redemption opportunities, more personalized service and a better digital experience for Air Canada customers. Like all of Air Canada's North American peers, Air Canada will be able to make decisions in real time that address specific needs, further improving the customer experience.

PASSENGER SERVICE SYSTEM

Air Canada concluded an agreement with Amadeus for the full Amadeus Altéa Suite passenger service system (PSS) including reservations, inventory and departure control solutions. The new reservation system, scheduled to be implemented in 2019, will allow Air Canada to optimize its flight schedule by providing the ability to more easily manage inventory between any given origin and destination and automate rebookings during flight disruptions, such as those caused by extreme weather. It will also support Air Canada's international network through seamless booking and customer handling with Star Alliance and interline partners.

PRODUCTS AND SERVICES

Investing in products and services remains pivotal to Air Canada's commitment to customer engagement. To this end, the airline has partnered with leading brands and introduced premium products that enhance the customer's journey.

The Boeing 787 Dreamliner, with its newly designed cabins and next generation in-flight entertainment, has been enthusiastically received by customers. Air Canada has introduced the 787's three-cabin international product and seating configuration on all 25 of its Boeing 777 aircraft as well. Moreover, the new Boeing 737 MAX and Bombardier C-Series aircraft will be standardized with Air Canada's new interior look, consistent North America business class seating and additional preferred seats.

In 2017, Air Canada launched a Premium Economy cabin on select wide-body flights within North America, offering a service specification aligned to its International Premium Economy product.

In 2017, Air Canada also introduced a new concierge office in Montréal–Pierre Elliott Trudeau International Airport ("Montreal-Trudeau"), similar in design to those at Toronto Pearson and Vancouver International, and added concierge service in Dublin, Mumbai and Taipei to further improve the customer experience for its Altitude Super Elite 100K members and customers travelling in International Business Class. Air Canada plans to introduce new concierge services in Madrid and Melbourne in 2018. Additionally, its Premium Agent service was launched in several 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 International Airport, with planned expansion to Montreal-Trudeau, Toronto Pearson and Vancouver International.

For the comfort and convenience of premium 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 2017, Air Canada upgraded several of its lounges (Edmonton International Airport, Vancouver International Airport and Los Angeles International Airport) and plans to refurbish several more in 2018. It also intends to open a new lounge in Saskatoon Diefenbaker Airport and re-locate its current lounges in New York-LaGuardia and St. John's International Airport.

In late 2017, Air Canada unveiled the Air Canada Signature Suite for its International Business Class customers at its Toronto Pearson global hub. The new suite is an exclusive airport retreat where eligible premium customers can dine *à la carte* at a complimentary, full-service restaurant from a menu created by acclaimed chef David Hawksworth, or enjoy hors d'œuvres, champagne, fine wines and cocktails in an intimate, Canadian-designed and decorated setting.

For customers in the U.S., Air Canada has 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 continues to expand electronic boarding pass functionality around the world, where local regulations allow.

Air Canada has preferred seats available offering additional pitch on its entire mainline fleet. It 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 and Air Canada Rouge offer Wi-Fi connectivity on their narrow-body aircraft fleets and are planning for Wi-Fi connectivity to be installed and operational across their wide-body fleets in 2019. Air Canada also plans to introduce complimentary Wi-Fi service as a reward option for Altitude Elite 75K and Super Elite 100K members, making Air Canada the first airline in North America to offer the choice of complimentary Wi-Fi to its most frequent flyers.

Air Canada launched an all-new website and mobile app in 2017 and further enhanced its digital experience: for example, by providing customers the ability to instantly find the airline's lowest available fares within a 270-day period on its website. To further enhance the booking process, customers can now import mobile bookings made via a mobile app to make changes to their itinerary on Air Canada's website. Air Canada continues to optimize the booking flow to make flight selection, cabin upgrades and ancillary products and services easier to select. Going forward, continuous improvement through Air Canada's new digital test-and-learn practice will further optimize its direct channels.

Air Canada is upgrading its customer relationship management system to gain valuable customer insights on travel patterns and preferences. With better insight into its customers, the airline will be in a better position to serve them. The upgraded system will allow the joining of operational, commercial and digital elements. The customer data platform will be connected to all Air Canada systems and channels to differentiate service and deploy offers in more locations than previously possible, allowing Air Canada to stimulate traffic, increase yields and improve customer loyalty. The improved system is scheduled to be implemented towards the latter half of 2018, with full benefits expected to be realized after Air Canada's new loyalty program launches in 2020.

Additionally, Air Canada was the first airline to have flight information and related content accessible through Alexa, Amazon's AI-powered voice service. It offers customers flight status information, fare quotes, mobile app tips and general information on travel documents, ticket policies, TSA Pre-check availability, as well as baggage carousel information, with more options planned to be added in the future.

Air Canada received a number of awards recognizing its industry-leading products and services in 2017, including being named Best Airline in North America in the 2017 Skytrax World Airline Awards. Skytrax also rates Air Canada as the only Four-Star network carrier in North America.

Air Canada also received the following awards:

- Best Long-Haul Airline in the Americas for 2018 by AirlineRatings.com, an airline safety and product rating agency that promotes excellence in the industry. AirlineRatings.com gave Air Canada its top seven-star rating for both safety and product.
- Winner in Airline Strategy Awards Finance Category by the air transport industry news and analysis provider Flight Airline Business.
- The 2017 Baxter Travel Media Agents' Choice Awards for Best Airline Traditional Service and Best Airline Executive Service for the 8th year in a row.

In early 2018, Air Canada was named the 2018 Eco-Airline of the Year by Air Transport World ("ATW") in its 44th Annual Airline Industry Achievement Awards. In recognizing Air Canada's environmental accomplishments, ATW cited the carrier's commitment to emissions reductions through supporting the development of alternative fuels and its numerous green programs and partnerships, including being the first airline in the world to voluntarily join the World Bank's IMF Carbon Pricing Leadership Coalition.

Culture change

A healthy and dynamic corporate culture is a competitive advantage that can significantly strengthen long-term performance. To this end, Air Canada has made positive culture change, with an emphasis on entrepreneurship, engagement, empowerment and pay-for-performance, a cornerstone of its business strategy.

As a foundational measure, Air Canada placed renewed focus on transparent employee communication. This has included reinforcing corporate priorities at every opportunity since their adoption in 2009 as well as continual explanation of the rationale behind its strategic initiatives and the importance of adapting to changing market conditions. Along with traditional channels, Air Canada continues to develop new methods for reaching out to all levels of the organization, for example with the increased use of executive-led, town hall meetings with employees across the network and through social media. Through these means, Air Canada seeks to create a sense of purpose, shared values and common goals among employees.

Effective communication is two-way, therefore, employee opinions are solicited on matters affecting them. This reflects the view that employees are more likely to embrace culture change if they actively participate in it. Air Canada encourages feedback and ideas from employees who are often best placed to identify improvements and changes necessary for success.

Training is another important element of engagement. It ensures employees have the skills and necessary tools to perform their jobs and it also signals to the individual that Air Canada is willing to invest in the employee's well-being and future development. Air Canada's cultural evolution entails continuous improvement, and learning and empowerment, all geared towards ensuring employees feel valued and have a sense of purpose.

Employees at Air Canada feel confident about their skills to do their job. Much of this is attributed to the expanded training programs, focus groups and workshops specifically designed to facilitate better decision-making, a more effective and personalized approach to communication styles, and a greater appreciation for the value each person can bring to any given situation. Comments from participants indicate that they appreciate the learning and networking opportunities and wish to actively play a role in their own development.

Training also promotes effective collaboration to ensure delivery on the customer promise. For new managers, Air Canada has a comprehensive employee onboarding 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.

Within the management development stream, Air Canada's programs include mentoring, custom development plans and a suite of emerging leadership opportunities for mid-level managers. These programs are designed to enhance leadership skills, provide a path to the employee career planning and to help employees grow through a concept of learning by doing. Air Canada believes in the concept of giving back and many programs allow past participants to become alumni contributors who coach other, newer members. In some cases, participants of the emerging leaders program will continue to work in tandem with other departments based on their casework within the program – allowing them to share their insight, research and innovative ideas.

Air Canada also has a number of customer service training programs, including Concierge Excellence (CGX) Recurrent Program which is a program focused on service excellence skills and personalized service; PIT Training which is a program that fosters enhanced teamwork and communication as well as improved efficiencies in Standard Operating Procedures (SOP) practice; and Project ADL - Airports Digital Learning, which provides a new learning experience by making learning available online for front-line employees in rooms conveniently located to employees' work site and designed to enhance the overall learning experience. The airline also refreshed its customer service training for all new flight attendant recruits.

A final aspect of engagement is recognition. Participation in the employee recognition program, Shine, has increased to almost 95% 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. Award of Excellence recipients are nominated by their peers for their work and community involvement.

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, 2017, in aggregate, 23,243,099 shares or 8.5% of total issued and outstanding shares of Air Canada were held by Air Canada employees and unions, including 17,646,765 shares held under a trust arrangement in connection with pension arrangements concluded in 2009.

Results from Air Canada's engagement and employee satisfaction surveys demonstrate a steadily upward, positive trend in almost every aspect of the employee experience. Staff increasingly view that communication has improved, as have teamwork and cooperation among departments, and there is a growing sense of community. A higher proportion of employees agree strongly that Air Canada is on the right track towards stability and sustainability and the vast majority of employees agree that they understand the business imperatives.

Employees' perceptions toward senior management have also improved significantly since 2014, indicating that senior management actively listens and demonstrates care and concern for employees. This is particularly evident among pilots, flight attendants and maintenance workers. A high proportion of employees feel confident in their skills to do their job. Employees and managers see improvements in their ability to provide direction and support, which is attributed to the expanded training programs available to many front line and management employees.

In 2017, Air Canada was named one of Canada's Top 100 Employers for 2018 in an annual national employer survey by Mediacorp Canada Inc. Canada's Top 100 Employers competition recognizes employers with exceptional human resources programs and forward-thinking workplace policies. Starting with an initial list of more than 90,000 employers, Mediacorp graded those selected on eight criteria: Physical Workplace; Work Atmosphere & Social; Health, Financial & Family Benefits; Vacation & Time-Off; Employee Communications; Performance Management; Training & Skills Development; and Community Involvement.

In addition to being named one of the Top 100 Employers in Canada, Air Canada received other recognitions for employee relations and engagement in 2017, including:

- One of the 50 Most Engaged Workplaces in North America by Achievers, an employee social recognition company;
- The second most attractive company brand to work for in Canada according to the Randstad Employer Brand Research independent survey;
- One of Canada's Best Diversity Employers by Mediacorp Canada Inc.;
- One of Montreal's top employers by Mediacorp Canada Inc.;
- One of North America's Best Candidate Experience by Talent Board.

Furthermore, in recognition of the ongoing significant evolution underway at Air Canada, two officers in the organization were honoured for their outstanding contributions: Michael Rousseau, Executive Vice President and Chief Financial Officer, was named Canada's CFO of the year for 2017 by Financial Executives International Canada and Lucie Guillemette, Executive Vice President and Chief Commercial Officer, was named by the Women's Executive Network as one of Canada's top 100 most powerful women.

Labour

Starting in 2014, Air Canada entered into multiple long-term labour agreements with unions representing its unionized workforce. These agreements provide additional stability and flexibility, as well as demonstrate a collaborative partnership supporting its transformation into a global champion. These agreements include the following:

- ACPA (Pilots) – In 2014, Air Canada and ACPA, representing pilots, ratified a new contract providing collective agreement terms for 10 years, ending September 29, 2024, subject to certain renegotiation provisions and benchmarks over this period. In 2017, Air Canada ratified amendments to its existing long-term labour agreement with ACPA. The amendments to the 10-year agreement provide additional commercial opportunities as well as increased operational flexibility. The next renegotiation period is scheduled to arise in June 2020.
- IAMAW (Maintenance, Operations and Baggage) – In 2016, Air Canada and the IAMAW, representing technical maintenance, operational support and airport baggage handlers, concluded a new contract providing collective agreement terms for 10 years, ending March 31, 2026, subject to certain renegotiation provisions over this period. The next of which is scheduled to arise in January 2019.
- CALDA (Dispatchers) – In 2016, Air Canada and CALDA, representing flight dispatchers, concluded a new contract providing collective agreement terms for 12 years, ending February 29, 2028, subject to certain renegotiation provisions over this period. The next of which is scheduled to arise in November 2018.
- CUPE (Flight Attendants) – In 2015, Air Canada and CUPE, representing flight attendants, concluded a new contract providing collective agreement terms for 10 years, ending March 31, 2025, subject to certain renegotiation provisions over this period. The next of which is scheduled to arise in December 2018.
- Unifor (Customer Service and Sales Agents) – In 2015, Air Canada and Unifor, representing the airline's customer service and sales agents, concluded a new contract providing collective agreement terms for five years, ending February 28, 2020.

5. Overview

Full year 2017 financial summary

The following is an overview of Air Canada's results of operations and financial position for full year 2017 compared to full year 2016.

- Record operating revenues of $16,252 million in 2017, an increase of $1,575 million or 11% from 2016. On capacity growth of 11.6%, record passenger revenues of $14,471 million increased $1,323 million or 10.1% from 2016.
- Operating expenses of $14,888 million in 2017, an increase of $1,556 million or 12% from 2016. CASM increased 0.1% from 2016. Adjusted CASM decreased 3.0% from 2016. Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Operating income of $1,364 million in 2017 compared to operating income of $1,345 million in 2016.
- Record EBITDAR of $2,921 million in 2017 compared to record EBITDAR of $2,768 million in 2016. The airline reported a 2017 EBITDAR margin of 18.0%, in line with the range of 17% to 19% projected in Air Canada's news release dated October 25, 2017. This compared to an EBITDAR margin of 18.9% in 2016. Special items are excluded from all of Air Canada's reported EBITDAR calculations. Refer to section 6 of this MD&A for information on special items. EBITDAR is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Record income before income taxes of $1,279 million in 2017 versus record income before income taxes of $877 million in 2016.
- Record adjusted pre-tax income of $1,158 million in 2017 versus adjusted pre-tax income of $1,148 million in 2016. Adjusted pre-tax income is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Net income of $2,038 million or $7.34 per diluted share in 2017 versus net income of $876 million or $3.10 per diluted share in 2016. In the third quarter of 2017, Air Canada recognized substantially all of its unrecorded deferred income tax assets. Refer to section 13 "Critical Accounting Estimates and Judgments" of this MD&A for additional information.
- Adjusted net income of $1,142 million or $4.11 per diluted share in 2017 versus adjusted net income of $1,147 million or $4.06 per diluted share in 2016. Starting as of and including the fourth quarter of 2017, adjusted net income is determined net of tax and includes the income tax effect of adjustments included in the measurement of adjusted net income. Prior to the fourth quarter of 2017, there was no deferred income tax expense recorded because of significant unrecognized deferred tax assets. A tax expense of $16 million affected fourth quarter and full year 2017 adjusted net income results. Adjusted net income is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Adjusted net debt of $6,116 million at December 31, 2017, a decrease of $974 million from December 31, 2016, reflecting the impact of higher cash and short-term investment balances and the benefit of a stronger Canadian dollar on U.S. dollar denominated debt balances. Adjusted net debt is an additional GAAP 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) was 2.1 at December 31, 2017 versus a ratio of 2.6 at December 31, 2016. Leverage ratio is a non-GAAP financial measure. Refer to section 9.3 "Adjusted Net Debt" of this MD&A for additional information.
- Record net cash flows from operating activities of $2,738 million in 2017, an improvement of $317 million from 2016. Record free cash flow of $1,056 million in 2017 was above the range of $600 million to $900 million projected in Air Canada's news release dated October 25, 2017, mainly as a result of higher cash flows from operations. The free cash flow generated in 2017 also reflected an improvement of $1,205 million from 2016 due to higher cash flows from operating activities and a reduced level of net capital expenditures year-over-year. Free cash flow is a non-GAAP financial measure. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for additional information.
- Return on invested capital ("ROIC") for the 12 months ended December 31, 2017 of 13.9%, in line with the range of 13.5% to 14.5% projected in Air Canada's news release dated October 25, 2017. This compared to ROIC of 16.7% for the 12 months ended December 31, 2016. The decrease in ROIC was mainly due to higher retained earnings. ROIC is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Fourth quarter 2017 financial summary

The following is an overview of Air Canada's results of operations for the fourth quarter of 2017 compared to the fourth quarter of 2016.

- Record operating revenues of $3,820 million in the fourth quarter of 2017, an increase of $395 million or 12% from the fourth quarter of 2016. On capacity growth of 9.5%, record passenger revenues of $3,381 million increased $346 million or 11.4% from the fourth quarter of 2016.
- Operating expenses of $3,687 million in the fourth quarter of 2017, an increase of $280 million or 8% from the fourth quarter of 2016. CASM decreased 1.2% from the fourth quarter of 2016. Adjusted CASM decreased 1.2% from the fourth quarter of 2016, in line with the 0.5% to 1.5% decrease forecasted in Air Canada's news release dated October 25, 2017.

- Operating income of $133 million in the fourth quarter 2017 compared to fourth quarter 2016 operating income of $18 million.
- Record EBITDAR of $521 million in the fourth quarter of 2017 compared to EBITDAR of $455 million in the fourth quarter of 2016. The airline reported a record fourth quarter 2017 EBITDAR margin of 13.6% versus a fourth quarter 2016 EBITDAR margin of 13.3%. Special items are excluded from all of Air Canada's reported EBITDAR calculations. Refer to section 7 of this MD&A for information on special items.
- Income before income taxes of $20 million in the fourth quarter of 2017 versus a loss before income taxes of $178 million in the fourth quarter of 2016.
- Adjusted pre-tax income of $77 million in the fourth quarter of 2017 versus adjusted pre-tax income of $39 million in the fourth quarter of 2016. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Net income of $8 million or $0.02 per diluted share in the fourth quarter of 2017 versus a net loss of $179 million or $0.66 per diluted share in the fourth quarter of 2016.
- Adjusted net income of $61 million or $0.22 per diluted share in the fourth quarter of 2017 versus adjusted net income of $38 million or $0.14 per diluted share in the fourth quarter of 2016. Starting as of and including the fourth quarter of 2017, adjusted net income is determined net of tax and includes the income tax effect of adjustments included in the measurement of adjusted net income. Prior to the fourth quarter of 2017, there was no deferred income tax expense recorded because of significant unrecognized deferred tax assets. A tax expense of $16 million affected fourth quarter and full year 2017 adjusted net income results. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Record net cash flows from operating activities of $389 million in the fourth quarter of 2017, an improvement of $38 million from the fourth quarter of 2016. Negative free cash flow of $43 million deteriorated by $164 million from the fourth quarter of 2016 due to higher net capital expenditures year-over-year partly offset by the higher cash flows from operating activities versus the same quarter in 2016. Refer to section 9.5 "Consolidated Cash Flow Movements" of this MD&A for additional information.

6. Results of Operations – Full Year 2017 versus Full Year 2016

The following table and discussion provides and compares results of Air Canada for 2017 and 2016:

(Canadian dollars in millions, except per share figures)	Full Year 2017	Full Year 2016	Change $	Change %
Operating revenues				
Passenger	$ 14,471	$ 13,148	$ 1,323	10
Cargo	650	512	138	27
Other	1,131	1,017	114	11
Total revenues	**16,252**	**14,677**	**1,575**	**11**
Operating expenses				
Aircraft fuel	2,927	2,279	648	28
Regional airlines expense				
Aircraft fuel	412	327	85	26
Other	2,205	2,081	124	6
Wages, salaries and benefits	2,671	2,510	161	6
Airport and navigation fees	905	859	46	5
Aircraft maintenance	938	894	44	5
Depreciation, amortization and impairment	956	816	140	17
Sales and distribution costs	777	703	74	11
Ground package costs	538	489	49	10
Aircraft rent	503	462	41	9
Food, beverages and supplies	383	349	34	10
Communications and information technology	254	242	12	5
Special items	30	91	(61)	(67)
Other	1,389	1,230	159	13
Total operating expenses	**14,888**	**13,332**	**1,556**	**12**
Operating income	**1,364**	**1,345**	**19**	
Non-operating income (expense)				
Foreign exchange gain (loss)	120	(38)	158	
Interest income	60	48	12	
Interest expense	(311)	(374)	63	
Interest capitalized	36	58	(22)	
Net financing expense relating to employee benefits	(65)	(76)	11	
Gain on financial instruments recorded at fair value	23	4	19	
Gain on sale and leaseback of assets	52	19	33	
Gain (loss) on debt settlements and modifications	21	(89)	110	
Other	(21)	(20)	(1)	
Total non-operating expense	**(85)**	**(468)**	**383**	
Income before income taxes	**1,279**	**877**	**402**	
Recovery of (provision for) income taxes	759	(1)	760	
Net income	**$ 2,038**	**$ 876**	**$ 1,162**	
Diluted earnings per share	**$ 7.34**	**$ 3.10**	**$ 4.24**	
EBITDAR (1)	**$ 2,921**	**$ 2,768**	**$ 153**	
Adjusted pre-tax income (1)	**$ 1,158**	**$ 1,148**	**$ 10**	
Adjusted net income (1)	**$ 1,142**	**$ 1,147**	**$ (5)**	
Adjusted earnings per share – diluted (1)	**$ 4.11**	**$ 4.06**	**$ 0.05**	

(1) EBITDAR, adjusted pre-tax income, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

System passenger revenues

In 2017, system passenger revenues of $14,471 million increased $1,323 million or 10.1% from 2016 on traffic growth of 11.3% partly offset by a yield decline of 1.0%. On a stage-length adjusted basis, yield increased 1.7% when compared to 2016. Business cabin system revenues increased $334 million or 13.4% from 2016 on traffic and yield growth of 9.8% and 3.3%, respectively. In 2017, the stronger Canadian dollar versus 2016 decreased the Canadian dollar value of sales in foreign countries and had a negative impact of $69 million on system passenger revenues.

The table below provides passenger revenue by geographic region for 2017 and 2016.

Passenger Revenue (Canadian dollars in millions)	Full Year		Change	
	2017	2016	$	%
Canada	$ 4,582	$ 4,426	$ 156	3.5
U.S. transborder	3,164	2,879	285	9.9
Atlantic	3,517	3,026	491	16.2
Pacific	2,192	1,985	207	10.4
Other	1,016	832	184	22.2
System	**$ 14,471**	**$ 13,148**	**$ 1,323**	**10.1**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics by geographic region for 2017 versus 2016.

Full Year 2017 versus Full Year 2016	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	PRASM % Change
Canada	3.5	2.1	2.3	0.1	1.4	1.5
U.S. transborder	9.9	10.5	11.1	0.4	(0.9)	(0.4)
Atlantic	16.2	14.3	14.0	(0.2)	2.0	1.7
Pacific	10.4	17.7	15.6	(1.5)	(4.5)	(6.2)
Other	22.2	18.2	19.6	1.0	2.0	3.3
System	**10.1**	**11.6**	**11.3**	**(0.2)**	**(1.0)**	**(1.3)**

Components of the year-over-year change in full year system passenger revenues in 2017 versus 2016 included:

- The 11.3% traffic increase which reflected traffic growth in all markets. The traffic increase included gains in the business and premium economy cabins as well as incremental connecting traffic via Canada to international destinations.
- The 1.0% yield decrease which reflected:
  - an increase in average stage length of 4.8% which had the effect of reducing system yield by 2.7 percentage points;
  - an unfavourable currency impact of $69 million, mainly attributable to the first and fourth quarters of 2017;
  - the effect of launch pricing to support the introduction of new Pacific services and the impact of increased industry capacity and competitive pricing activities on certain Pacific services, primarily in the first nine months of 2017;
  - a higher proportion of seats into long-haul leisure markets; and
  - a higher proportional growth of lower-yielding sixth freedom traffic in support of the airline's international expansion strategy.
- These factors were largely offset by the following:
  - volume and yield growth in high-yielding business and premium economy passengers;
  - growth in high-yielding local traffic and improvements to the overall fare mix; and
  - an increase in preferred seat/advance seat selection and airport paid upgrade revenues.

Domestic passenger revenues

In 2017, domestic passenger revenues of $4,582 million increased $156 million or 3.5% from 2016.

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

- The 2.3% traffic increase which reflected traffic growth on all major domestic services and included gains in the business cabin. The traffic increase year-over-year was due to strong passenger demand on services within Canada as well as incremental connecting traffic to U.S. and international destinations.
- The 1.4% yield increase which reflected yield improvements on most major domestic services. A greater proportional growth of high-yielding passengers as well as strong growth in point-to-point passengers across all markets also contributed to the yield improvement year-over-year.

U.S. transborder passenger revenues

In 2017, U.S. transborder passenger revenues of $3,164 million increased $285 million or 9.9% from 2016.

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

- The 11.1% traffic increase which reflected traffic growth on all major U.S. transborder services and included gains in the business cabin. The traffic increase year-over-year was mainly driven by the launch of year-round Air Canada Express service from Toronto to San Antonio and Memphis; Vancouver to Dallas-Fort Worth and Denver; and Montreal to Dallas-Fort Worth and Washington-Dulles. Strong passenger demand between Canada and the U.S. and growth of international-to-international connecting passenger flows from the U.S. in support of Air Canada's international expansion strategy were also contributing factors.
- The 0.9% yield decline which reflected the impact of increased industry capacity on U.S. long-haul and short-haul routes and an unfavourable currency impact of $11 million. Yield growth on U.S. sun routes, such as Florida, Hawaii and Las Vegas was a partly offsetting factor.

Atlantic passenger revenues

In 2017, Atlantic passenger revenues of $3,517 million increased $491 million or 16.2% from 2016.

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

- The 14.0% traffic increase which reflected traffic growth on most major Atlantic services, led by the launch of seasonal services from Vancouver to Frankfurt and London-Gatwick; Montreal to Tel Aviv, Marseille, Algiers and Reykjavík; and Toronto to Berlin and Reykjavík. Air Canada also launched year-round service from Toronto to Mumbai. The overall traffic increase included strong gains in the business and premium economy cabins.
- The 2.0% yield increase which reflected yield improvements on most major Atlantic services, led by gains in the business and premium economy cabins. An unfavourable currency impact of $27 million was a partly offsetting factor.

Pacific passenger revenues

In 2017, Pacific passenger revenues of $2,192 million increased $207 million or 10.4% from 2016.

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

- The 15.6% traffic increase which reflected traffic growth on all major Pacific services with the exception of services to Hong Kong where traffic was impacted by increased industry capacity and aggressive pricing activities. The overall traffic increase year-over-year was mainly driven by the launch of year-round services from Toronto to Seoul; Montreal to Shanghai; and Vancouver to Taipei. The launch of seasonal service from Vancouver to Nagoya also contributed to the traffic growth year-over-year.
- The 4.5% yield decline which reflected the effect of launch pricing to support the introduction of new services and the impact of increased industry capacity and competitive pricing activities on certain Pacific services. Growth in lower-yielding international-to-international passenger flows (mainly between Asia and the U.S./Latin America) and an unfavourable currency impact of $20 million were also contributing factors.

Other passenger revenues

In 2017, Other passenger revenues (from routes to and from the Caribbean, Mexico and Central and South America) of $1,016 million increased $184 million or 22.2% from 2016.

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

- The 19.6% traffic increase which reflected traffic growth on routes to traditional sun destinations and on services to South America. The traffic growth included gains in all cabins. The traffic increase year-over-year was largely driven by the use of larger aircraft on routes to Sao Paulo and Santiago and, to a lesser extent, the launch of services from Toronto to Cartagena and from Montreal to Lima.
- The 2.0% yield increase which reflected yield improvements on all major services and included gains in all cabins.

Cargo revenues

In 2017, cargo revenues of $650 million increased $138 million or 27% from 2016 on traffic growth of 29.7% partly offset by a yield decline of 2.1%. Traffic growth was recorded in all markets. The Pacific market turned in a particularly strong performance with traffic growth significantly surpassing capacity growth in 2017 and yield improving year-over-year.

The table below provides cargo revenue by geographic region for the periods indicated.

Cargo Revenue (Canadian dollars in millions)	**Full Year**		**Change**	
	2017	**2016**	**$**	**%**
Canada	$ 75	$ 63	$ 12	19.6
U.S. transborder	35	29	6	24.2
Atlantic	213	187	26	13.9
Pacific	271	193	78	39.8
Other	56	40	16	39.3
System	**$ 650**	**$ 512**	**$ 138**	**27.0**

Other revenues

In 2017, other revenues of $1,131 million increased $114 million or 11% from 2016, mainly due to an increase in ground package revenues at Air Canada Vacations. An increase in passenger and airline-related fees, particularly those related to seat selection, preferred seating and upgrades, was also a contributing factor.

CASM and adjusted CASM

In 2017, CASM increased 0.1% and adjusted CASM decreased 3.0% when compared to 2016.

The following table compares Air Canada's CASM and adjusted CASM for the periods indicated:

(cents per ASM)	**Full Year**		**Change**	
	2017	**2016**	**¢**	**%**
Aircraft fuel	2.83	2.46	0.37	15.0
Regional airlines expense				
Aircraft fuel	0.40	0.35	0.05	14.3
Other	2.13	2.25	(0.12)	(5.3)
Wages and salaries	1.99	2.09	(0.10)	(4.8)
Benefits	0.59	0.62	(0.03)	(4.8)
Airport and navigation fees	0.87	0.93	(0.06)	(6.5)
Aircraft maintenance	0.91	0.96	(0.05)	(5.2)
Depreciation, amortization and impairment	0.92	0.88	0.04	4.5
Sales and distribution costs	0.75	0.76	(0.01)	(1.3)
Ground package costs	0.52	0.53	(0.01)	(1.9)
Aircraft rent	0.49	0.50	(0.01)	(2.0)
Food, beverages and supplies	0.37	0.38	(0.01)	(2.6)
Communications and information technology	0.25	0.26	(0.01)	(3.8)
Special items	0.03	0.10	(0.07)	(70.0)
Other	1.34	1.31	0.03	2.3
CASM	**14.39**	**14.38**	**0.01**	**0.1**
Remove:				
Aircraft fuel expense (1), ground package costs at Air Canada Vacations and special items	(3.78)	(3.44)	(0.34)	(9.9)
Adjusted CASM (2)	**10.61**	**10.94**	**(0.33)**	**(3.0)**

(1) Includes aircraft fuel expense related to regional airline operations.

(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses

In 2017, operating expenses of $14,888 million increased $1,556 million or 12% from 2016 on capacity growth of 11.6%.

In 2017, the favourable impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), when compared to 2016, decreased operating expenses by $152 million (comprised of $83 million relating to aircraft fuel expense and an aggregate of $69 million relating to non-fuel operating expenses).

The more notable components of the year-over-year change in operating expenses are described below.

Aircraft fuel expense

In 2017, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to $3,339 million, an increase of $733 million or 28% from 2016. This increase reflected higher jet fuel prices (before the impact of foreign exchange), which accounted for an increase of $577 million and a higher volume of fuel litres consumed, which accounted for an increase of $260 million. These increases were partly offset by a favourable currency impact of $83 million and hedging gains of $21 million.

Regional airlines expense

In 2017, regional airlines expense of $2,617 million increased $209 million or 9% from 2016. This increase reflected the impact of higher base jet fuel prices year-over-year, increased flying, which was the result of fleet expansion initiatives in the Air Canada Express fleet, and an increase in engine maintenance expense due to timing of events.

The following table provides a breakdown of regional airlines expense for the periods indicated:

	Full Year		Change	
(Canadian dollars in millions)	**2017**	**2016**	**$**	**%**
Capacity purchase fees	$ 1,267	$ 1,199	$ 68	6
Aircraft fuel	412	327	85	26
Airport and navigation	293	290	3	1
Sales and distribution costs	146	142	4	3
Aircraft rent	40	31	9	29
Depreciation, amortization and impairment	28	23	5	22
Other operating expenses	431	396	35	9
Total regional airlines expense	**$ 2,617**	**$ 2,408**	**$ 209**	**9**

Wages, salaries and benefits expense

In 2017, wages and salaries expense of $2,059 million increased $123 million or 6% from 2016. This increase was mainly due to a higher number of full-time equivalent ("FTE") employees to support the airline's international growth. The average number of FTE employees increased 6.7% when compared to 2016.

In 2017, employee benefits expense of $612 million increased $38 million or 7% from 2016, better than the increase of $50 million projected in Air Canada's news release dated October 25, 2017. This better than anticipated performance included the favourable impact of an annual valuation related to workers' compensation, which benefitted from a reduction in overall claims. The increase in employee benefits expense year-over-year was mainly due to the higher level of FTE employees and to the impact of lower discount rates, which increased the current service cost of defined benefit pension plans. In 2016, Air Canada recorded a gain on post-employment liabilities which reduced employee benefits expense by $10 million.

Airport and navigation fees

In 2017, airport and navigation fees of $905 million increased $46 million or 5% from 2016, largely due to 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 international connecting traffic at Toronto Pearson International Airport on a more cost effective basis, a Nav Canada rate reduction (a rate reduction of 6% in the first eight months of 2017 and a rate reduction of 3.9% in the last four months of 2017) and a $15 million one-time refund from Nav Canada were partly offsetting factors.

Aircraft maintenance expense

In 2017, aircraft maintenance expense of $938 million increased $44 million or 5% from 2016, better than the increase of $70 million projected in Air Canada's news release dated October 25, 2017. This better than anticipated performance was mainly due to the favourable impact of having extended Airbus A320 aircraft leases earlier than previously forecasted. The increase in aircraft maintenance expense year-over-year was mainly driven by the impact of having additional Boeing 787 aircraft in the fleet in 2017, which have engines under power-by-the-hour arrangements, and an increase in engine and components maintenance activity. These increases were largely offset by the impact of having a greater number of aircraft leases being extended in 2017 and to more favourable end-of-lease conditions on aircraft lease extensions. The impact of a stronger Canadian dollar on U.S. denominated maintenance expenses was also an offsetting factor.

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

	Full Year		Change	
(Canadian dollars in millions)	**2017**	**2016**	**$**	**%**
Technical maintenance	$ 824	$ 742	$ 82	11
Maintenance provisions [1]	100	133	(33)	(25)
Other	14	19	(5)	(26)
Total aircraft maintenance expense	**$ 938**	**$ 894**	**$ 44**	**5**

(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 2017, depreciation, amortization and impairment expense of $956 million increased $140 million or 17% from 2016, in line with the increase of $145 million projected in Air Canada's news release dated October 25, 2017. The increase in depreciation, amortization and impairment expense year-over-year was mainly due to the addition of Boeing 787 aircraft to Air Canada's mainline fleet and an increase in expenses related to aircraft refurbishment programs.

Sales and distribution costs

In 2017, sales and distribution costs of $777 million increased $74 million or 11% from 2016, reflecting, in large part, a higher volume of ticket sales and an increase in credit card expenses (in line with sales and revenue growth). The favourable impact of new commission programs introduced in North America during 2017 and growth in direct bookings when compared to 2016 were partly offsetting factors.

Ground package costs

In 2017, the cost of ground packages at Air Canada Vacations of $538 million increased $49 million or 10% from 2016. This increase was mainly due to higher passenger volumes partly offset by a decrease in the price of ground packages and, to a lesser extent, a favourable currency impact when compared to 2016.

Aircraft rent expense

In 2017, aircraft rent expense of $503 million increased $41 million or 9% from 2016, reflecting a greater number of leased aircraft, primarily Boeing 787 aircraft. The impact of lower lease rates year-over-year and a favourable currency impact were partly offsetting factors.

Special items

In 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations. Air Canada paid the fine in the second quarter of 2017. Air Canada has appealed the decision. Refer to section 18 "Risk Factors" of this MD&A for additional information.

In 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

Other expenses

In 2017, other expenses of $1,389 million increased $159 million or 13% from 2016, reflecting, in large part, the capacity growth and the impact of Air Canada's international expansion strategy. An increase in customer inconvenience expense, reflecting the impact of operational disruptions caused by severe weather, was also a contributing factor.

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

	Full Year		Change	
(Canadian dollars in millions)	**2017**	**2016**	**$**	**%**
Terminal handling	$ 296	$ 237	$ 59	25
Crew cycle	197	177	20	11
Building rent and maintenance	167	154	13	8
Miscellaneous fees and services	164	141	23	16
Remaining other expenses	565	521	44	8
Total other expenses	**$ 1,389**	**$ 1,230**	**$ 159**	**13**

Non-operating income (expense)

In 2017, non-operating expense of $85 million improved $383 million from 2016.

Components of the year-over-year change in full year non-operating income (expense) included:

- In 2017, gains on foreign exchange amounted to $120 million compared to losses on foreign exchange of $38 million in 2016. Foreign exchange gains on long-term debt of $402 million were largely offset by foreign exchange losses on foreign currency derivatives of $274 million. The foreign exchange gains on long-term debt in 2017 were attributable to a stronger Canadian dollar at December 31, 2017 when compared to December 31, 2016. The December 31, 2017 closing exchange rate was US$1=C$1.2571 while the December 31, 2016 closing exchange rate was US$1=C$1.3427.
- In 2017, interest expense decreased $63 million, reflecting, in large part, the impact of a $1.25 billion refinancing transaction concluded in October 2016 and, to a lesser extent, the benefit of lower debt balances.
- In 2017, Air Canada recorded a gain of $52 million on the sale and leaseback of four Boeing 787-9 aircraft. In 2016, Air Canada recorded a gain of $19 million on the sale and leaseback of two Boeing 787-9 aircraft.
- Air Canada recorded a $27 million gain on debt modifications in 2017 related to the repricing of the US$1.1 billion senior secured credit facility concluded in June 2017.
- In 2016, Air Canada recorded a loss on debt settlements of $89 million of which $82 million was related to the $1.25 billion refinancing transaction concluded in October 2016 and $7 million was related to the prepayment of debt associated with the disposal of Embraer 190 aircraft.

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, including historical financial results, and expectations relating to future taxable income, the overall business environment, and industry-wide trends.

In 2017, Air Canada determined that it was probable that substantially all of the unrecorded deferred income tax assets, which include non-capital losses, would be realized. Accordingly, a tax recovery of $759 million was recorded, representing the initial recognition of previously unrecognized tax assets of $787 million in the third quarter of 2017. Air Canada also recorded a deferred tax provision of $12 million in the fourth quarter and a current income tax expense of $16 million for the year.

7. Results of Operations – Fourth Quarter 2017 versus Fourth Quarter 2016

The following table and discussion provides and compares results of Air Canada for the fourth quarter of 2017 and the fourth quarter of 2016:

	Fourth Quarter		Change	
(Canadian dollars in millions, except per share figures)	**2017**	**2016**	**$**	**%**
Operating revenues				
Passenger	$ 3,381	$ 3,035	$ 346	11
Cargo	183	155	28	18
Other	256	235	21	9
Total revenues	**3,820**	**3,425**	**395**	**12**
Operating expenses				
Aircraft fuel	735	598	137	23
Regional airlines expense				
Aircraft fuel	112	90	22	24
Other	563	532	31	6
Wages, salaries and benefits	674	633	41	6
Airport and navigation fees	201	203	(2)	(1)
Aircraft maintenance	243	200	43	22
Depreciation, amortization and impairment	245	212	33	16
Sales and distribution costs	169	172	(3)	(2)
Ground package costs	106	101	5	5
Aircraft rent	126	120	6	5
Food, beverages and supplies	89	82	7	9
Communications and information technology	62	60	2	3
Special items	-	91	(91)	(100)
Other	362	313	49	16
Total operating expenses	**3,687**	**3,407**	**280**	**8**
Operating income	**133**	**18**	**115**	
Non-operating income (expense)				
Foreign exchange loss	(62)	(29)	(33)	
Interest income	18	13	5	
Interest expense	(79)	(83)	4	
Interest capitalized	9	8	1	
Net financing expense relating to employee benefits	(18)	(24)	6	
Gain (loss) on financial instruments recorded at fair value	(1)	9	(10)	
Gain (loss) on debt settlements and modifications	24	(82)	106	
Other	(4)	(8)	4	
Total non-operating expense	**(113)**	**(196)**	**83**	
Income (loss) before income taxes	**20**	**(178)**	**198**	
Recovery of (provision for) income taxes	(12)	(1)	(11)	
Net income (loss)	**$ 8**	**$ (179)**	**$ 187**	
Diluted earnings (loss) per share	**$ 0.02**	**$ (0.66)**	**$ 0.68**	
EBITDAR (1)	**$ 521**	**$ 455**	**$ 66**	
Adjusted pre-tax income (1)	**$ 77**	**$ 39**	**$ 38**	
Adjusted net income (1)	**$ 61**	**$ 38**	**$ 23**	
Adjusted earnings per share – diluted (1)	**$ 0.22**	**$ 0.14**	**$ 0.08**	

(1) EBITDAR, adjusted pre-tax income, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

System passenger revenues

In the fourth quarter of 2017, system passenger revenues of $3,381 million increased $346 million or 11.4% from the fourth quarter of 2016 on traffic growth of 9.9% and a yield improvement of 1.4%. On a stage-length adjusted basis, yield increased 4.0% when compared to the same quarter in 2016. Business cabin system revenues increased $96 million or 15.3% from the fourth quarter of 2016 on traffic and yield growth of 8.2% and 6.6%, respectively. In the fourth quarter of 2017, the stronger Canadian dollar versus the fourth quarter of 2016 decreased the Canadian dollar value of sales in foreign countries and had a negative impact of $41 million on system passenger revenues.

The table below provides passenger revenue by geographic region for the fourth quarter of 2017 and the fourth quarter of 2016.

Passenger Revenue (Canadian dollars in millions)	**Fourth Quarter**		**Change**	
	2017	**2016**	**$**	**%**
Canada	$ 1,137	$ 1,079	$ 58	5.4
U.S. transborder	740	697	43	6.3
Atlantic	757	619	138	22.2
Pacific	502	442	60	13.5
Other	245	198	47	23.7
System	**$ 3,381**	**$ 3,035**	**$ 346**	**11.4**

The table below provides year-over-year percentage changes in passenger revenues and operating statistics by geographic region for the fourth quarter of 2017 and the fourth quarter of 2016.

Fourth Quarter 2017 versus Fourth Quarter 2016	**Passenger Revenue % Change**	**Capacity (ASMs) % Change**	**Traffic (RPMs) % Change**	**Passenger Load Factor pp Change**	**Yield % Change**	**PRASM % Change**
Canada	5.4	1.4	1.6	0.2	3.5	3.8
U.S. transborder	6.3	6.7	7.1	0.3	(0.7)	(0.3)
Atlantic	22.2	13.9	14.4	0.3	6.8	7.3
Pacific	13.5	12.2	13.7	1.0	(0.2)	1.1
Other	23.7	18.7	17.9	(0.6)	4.8	4.1
System	**11.4**	**9.5**	**9.9**	**0.3**	**1.4**	**1.8**

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

	Year-Over-Year by Quarter (% Change)				
System	**Q4'16**	**Q1'17**	**Q2'17**	**Q3'17**	**Q4'17**
Passenger revenues	7.0	8.1	11.9	9.1	11.4
Capacity (ASMs)	17.1	15.4	13.5	9.1	9.5
Traffic (RPMs)	15.3	14.0	13.6	8.8	9.9
Passenger load factor (pp change)	(1.2)	(1.0)	0.1	(0.2)	0.3
Yield	(7.2)	(5.1)	(1.4)	0.4	1.4
PRASM	(8.6)	(6.3)	(1.2)	0.1	1.8

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

- The 9.9% traffic increase which reflected traffic growth in all markets and included gains in the business and premium economy cabins. 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 2017 reflected an increase in connecting traffic via Canada to international destinations.

- The 1.4% system yield increase which reflected:
  - Yield increases in the domestic, Atlantic and Other markets, in large part due to:
    - greater proportional growth of high-yielding business and premium economy passengers;
    - yield growth in both the business and premium economy cabins;
    - growth in high-yielding local traffic and an improvement in the overall fare mix;
    - the introduction of seat selection fees on certain international markets; and
    - an increase in airport paid upgrade revenues.

  These factors were partly offset by the following:
  - an increase in average stage length of 4.6%, due to long-haul international expansion, which had the effect of reducing system yield by 2.6 percentage points;
  - an unfavourable currency impact of $41 million;
  - the impact of increased industry capacity on U.S. long-haul and short-haul routes;
  - a higher proportion of seats into long-haul leisure markets, led by an increase in lower-cost flights operated by Air Canada Rouge; and
  - a higher proportional growth of lower-yielding sixth freedom traffic in support of the airline's international expansion strategy.

Domestic passenger revenues

In the fourth quarter of 2017, domestic passenger revenues of $1,137 million increased $58 million or 5.4% from the fourth quarter of 2016.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

	Year-Over-Year by Quarter (% Change)				
Canada	**Q4'16**	**Q1'17**	**Q2'17**	**Q3'17**	**Q4'17**
Passenger revenues	2.5	1.7	4.0	3.0	5.4
Capacity (ASMs)	5.5	3.2	2.8	1.5	1.4
Traffic (RPMs)	5.7	3.6	3.3	1.0	1.6
Passenger load factor (pp change)	0.1	0.3	0.5	(0.4)	0.2
Yield	(3.1)	(1.7)	0.8	2.2	3.5
PRASM	(2.9)	(1.3)	1.4	1.7	3.8

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

- The 3.5% yield increase which reflected yield improvements on most major domestic services. Rapidair® routes, linking Toronto and Montreal/Ottawa recorded a particularly strong yield performance versus the same quarter in 2016. The overall yield increase included gains in the business cabin and on connecting traffic.
- The 1.6% traffic increase which included gains in the business cabin. The traffic increase year-over-year was due to strong passenger demand on services within Canada as well as incremental connecting traffic to U.S. and international destinations.

U.S. transborder passenger revenues

In the fourth quarter of 2017, U.S. transborder passenger revenues of $740 million increased $43 million or 6.3% from the fourth quarter of 2016.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

	Year-Over-Year by Quarter (% Change)				
U.S. Transborder	**Q4'16**	**Q1'17**	**Q2'17**	**Q3'17**	**Q4'17**
Passenger revenues	10.1	9.5	16.3	8.0	6.3
Capacity (ASMs)	14.1	9.6	15.2	10.9	6.7
Traffic (RPMs)	15.0	12.0	16.2	9.3	7.1
Passenger load factor (pp change)	0.6	1.8	0.7	(1.2)	0.3
Yield	(4.3)	(2.2)	0.3	(1.0)	(0.7)
PRASM	(3.6)	-	1.2	(2.4)	(0.3)

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

- The 7.1% traffic increase which reflected traffic growth on all major U.S. transborder services and included gains in the business cabin. The traffic increase year-over-year was mainly driven by the launch of year-round Air Canada Express service from Toronto to San Antonio and Memphis; Vancouver to Dallas-Fort Worth and Denver; and Montreal to Dallas-Fort Worth and Washington-Dulles. Strong passenger demand between Canada and the U.S. and growth of international-to-international connecting passenger flows from the U.S. in support of Air Canada's international expansion strategy were also contributing factors.
- The 0.7% yield decline which reflected an unfavourable currency impact of $11 million, increased industry capacity on U.S. long-haul and short-haul routes, and growth in lower-yielding international-to-international connecting traffic from and to the U.S. Yield growth on U.S. sun routes, such as Florida, Hawaii and Las Vegas was a partly offsetting factor.

Atlantic passenger revenues

In the fourth quarter of 2017, Atlantic passenger revenues of $757 million increased $138 million or 22.2% from the fourth quarter of 2016.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

	Year-Over-Year by Quarter (% Change)				
Atlantic	**Q4'16**	**Q1'17**	**Q2'17**	**Q3'17**	**Q4'17**
Passenger revenues	8.3	8.3	14.3	17.7	22.2
Capacity (ASMs)	21.5	19.7	12.6	13.3	13.9
Traffic (RPMs)	19.3	14.4	13.7	13.7	14.4
Passenger load factor (pp change)	(1.4)	(3.5)	0.8	0.3	0.3
Yield	(9.2)	(5.3)	0.6	3.5	6.8
PRASM	(10.9)	(9.5)	1.5	3.9	7.3

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

- The 14.4% traffic increase which reflected traffic growth on all major Atlantic services with the exception of services to the United Arab Emirates where capacity was reduced year-over-year. The traffic increase year-over-year was mainly driven by the launch of seasonal services from Vancouver to Frankfurt and London-Gatwick; Montreal to Tel Aviv, Marseille, Algiers and Reykjavík; and Toronto to Berlin and Reykjavík. Air Canada also launched year-round service from Toronto to Mumbai. The overall traffic increase included strong gains in the business and premium economy cabins.
- The 6.8% yield increase which reflected yield improvements on all major Atlantic services, led by gains in the business and premium economy cabins.

Pacific passenger revenues

In the fourth quarter of 2017, Pacific passenger revenues of $502 million increased $60 million or 13.5% from the fourth quarter of 2016.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

	Year-Over-Year by Quarter (% Change)				
Pacific	**Q4'16**	**Q1'17**	**Q2'17**	**Q3'17**	**Q4'17**
Passenger revenues	12.1	12.5	12.5	5.7	13.5
Capacity (ASMs)	31.9	30.3	23.2	10.1	12.2
Traffic (RPMs)	23.7	22.5	19.7	9.4	13.7
Passenger load factor (pp change)	(5.3)	(5.1)	(2.5)	(0.6)	1.0
Yield	(9.3)	(8.1)	(6.0)	(3.4)	(0.2)
PRASM	(15.0)	(13.6)	(8.7)	(4.0)	1.1

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

- The 13.7% traffic increase which reflected traffic growth on all major Pacific services and included gains in the business and premium economy cabins. The traffic increase year-over-year was mainly driven by the launch of year-round services from Montreal to Shanghai, Vancouver to Taipei and, to a much lesser extent, Vancouver to Melbourne. The launch of seasonal service from Vancouver to Nagoya and the use of a larger aircraft on services from Toronto to Seoul also contributed to the traffic growth year-over-year.
- The 0.2% yield decline which reflected a yield decline on services to Hong Kong offset by yield improvements on services to China, Japan, Korea and the South Pacific. The yield decline on services to Hong Kong reflected the impact of increased industry capacity and competitive pricing activities.

Other passenger revenues

In the fourth quarter of 2017, Other passenger revenues (from routes to and from the Caribbean, Mexico and Central and South America) of $245 million increased $47 million or 23.7% from the fourth quarter of 2016.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the fourth quarter of 2017 and each of the previous four quarters.

	Year-Over-Year by Quarter (% Change)				
Other	**Q4'16**	**Q1'17**	**Q2'17**	**Q3'17**	**Q4'17**
Passenger revenues	7.3	18.8	34.7	15.3	23.7
Capacity (ASMs)	13.2	20.1	24.1	8.4	18.7
Traffic (RPMs)	15.7	22.8	26.4	10.1	17.9
Passenger load factor (pp change)	1.8	1.9	1.5	1.4	(0.6)
Yield	(7.6)	(3.4)	6.5	4.4	4.8
PRASM	(5.5)	(1.2)	8.4	6.1	4.1

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

- The 17.9% traffic increase which reflected traffic growth on services to South America and on routes to traditional sun destinations. The traffic growth included gains in all cabins. The traffic increase year-over-year was largely driven by the use of larger aircraft on routes to Sao Paulo and Santiago and, to a lesser extent, the launch of services from Toronto to Cartagena and from Montreal to Lima.
- The 4.8% yield increase which reflected yield improvements on all major services and included gains in all cabins.

Cargo revenues

In the fourth quarter of 2017, cargo revenues of $183 million increased $28 million or 18.4% from the fourth quarter of 2016 on traffic growth of 19.0% partly offset by a yield decline of 0.5%. Traffic growth was recorded in all markets and was in part due to the introduction of new international routes. In the fourth quarter of 2017, both the Atlantic and Pacific markets reflected yield increases versus the same quarter in 2016.

The table below provides cargo revenue by geographic region for the periods indicated.

Cargo Revenue (Canadian dollars in millions)	**Fourth Quarter**		**Change**	
	2017	**2016**	**$**	**%**
Canada	$ 20	$ 18	$ 2	13.3
U.S. transborder	9	9	-	9.9
Atlantic	58	52	6	12.5
Pacific	79	63	16	23.7
Other	17	13	4	28.1
System	**$ 183**	**$ 155**	**$ 28**	**18.4**

Other revenues

In the fourth quarter of 2017, other revenues of $256 million increased $21 million or 9% from the same quarter in 2016, mainly due to an increase in ground package revenues at Air Canada Vacations and an increase in passenger and airline-related fees.

CASM and adjusted CASM

In the fourth quarter of 2017, both CASM and adjusted CASM decreased 1.2% when compared to the same quarter in 2016.

The following table compares Air Canada's CASM and adjusted CASM for the periods indicated:

(cents per ASM)	**Fourth Quarter**		**Change**	
	2017	**2016**	**¢**	**%**
Aircraft fuel	3.04	2.71	0.33	12.2
Regional airlines expense				
Aircraft fuel	0.46	0.41	0.05	12.2
Other	2.33	2.41	(0.08)	(3.3)
Wages and salaries	2.26	2.23	0.03	1.3
Benefits	0.53	0.64	(0.11)	(17.2)
Airport and navigation fees	0.83	0.92	(0.09)	(9.8)
Aircraft maintenance	1.01	0.90	0.11	12.2
Depreciation, amortization and impairment	1.01	0.96	0.05	5.2
Sales and distribution costs	0.70	0.78	(0.08)	(10.3)
Ground package costs	0.44	0.46	(0.02)	(4.3)
Aircraft rent	0.52	0.54	(0.02)	(3.7)
Food, beverages and supplies	0.37	0.37	-	-
Communications and information technology	0.26	0.27	(0.01)	(3.7)
Special items	-	0.41	(0.41)	(100.0)
Other	1.48	1.41	0.07	5.0
CASM	**15.24**	**15.42**	**(0.18)**	**(1.2)**
Remove:				
Aircraft fuel expense (1), ground package costs at Air Canada Vacations and special items	(3.94)	(3.98)	0.04	1.0
Adjusted CASM (2)	**11.30**	**11.44**	**(0.14)**	**(1.2)**

(1) Includes aircraft fuel expense related to regional airline operations.

(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses

In the fourth quarter of 2017, operating expenses of $3,687 million increased $280 million or 8% from the fourth quarter of 2016 on capacity growth of 9.5%.

In the fourth quarter of 2017, the favourable impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), when compared to the fourth quarter of 2016, decreased operating expenses by $67 million (comprised of $35 million relating to aircraft fuel expense and an aggregate of $32 million relating to non-fuel operating expenses).

The more notable components of the year-over-year change in operating expenses are described below.

Aircraft fuel expense

In the fourth quarter of 2017, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to $847 million, an increase of $159 million or 23% from the fourth quarter of 2016. This increase mainly reflected higher jet fuel prices (before the impact of foreign exchange), which accounted for an increase of $151 million and a higher volume of fuel litres consumed, which accounted for an increase of $55 million. These increases were partly offset by a favourable currency impact of $35 million and hedging gains of $12 million.

Regional airlines expense

In the fourth quarter of 2017, regional airlines expense of $675 million increased $53 million or 9% from the fourth quarter of 2016. This increase reflected the impact of higher base jet fuel prices year-over-year, an increase in engine maintenance expense due to timing of events, and increased flying, which was the result of fleet expansion initiatives in the Air Canada Express fleet.

The following table provides a breakdown of regional airlines expense for the periods indicated:

	Fourth Quarter		Change	
(Canadian dollars in millions)	**2017**	**2016**	**$**	**%**
Capacity purchase fees	$ 330	$ 304	$ 26	9
Aircraft fuel	112	90	22	24
Airport and navigation	71	72	(1)	(1)
Sales and distribution costs	35	36	(1)	(3)
Aircraft rent	10	8	2	25
Depreciation, amortization and impairment	7	6	1	17
Other operating expenses	110	106	4	4
Total regional airlines expense	**$ 675**	**$ 622**	**$ 53**	**9**

Wages, salaries and benefits expense

In the fourth quarter of 2017, wages and salaries expense of $546 million increased $54 million or 11% from the fourth quarter of 2016. This increase was mainly due to a higher number of FTE employees to support the airline's international growth. The average number of FTE employees increased 8.0% in the fourth quarter of 2017 when compared to the fourth quarter in 2016.

In the fourth quarter of 2017, employee benefits expense of $128 million decreased $13 million or 9% from the fourth quarter of 2016, reflecting the favourable impact of an annual valuation related to workers' compensation, which benefitted from a reduction in overall claims, and lower expenses associated with disability benefit plans. The higher level of FTE employees and lower discount rates, which increased the current service cost of defined benefit pension plans, were partly offsetting factors.

Airport and navigation fees

In the fourth quarter of 2017, airport and navigation fees of $201 million decreased $2 million or 1% from the fourth quarter in 2016, reflecting 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, a $15 million one-time refund from Nav Canada, and the effect of a 3.9% Nav Canada rate reduction effective September 1, 2017. The impact of increased wide-body and international flying was an offsetting factor.

Aircraft maintenance expense

Aircraft maintenance expense of $243 million in the fourth quarter of 2017 increased $43 million or 22% from the fourth quarter of 2016, reflecting, in large part, the impact of having additional Boeing 787 aircraft in the fleet in 2017, which have engines under power-by-the-hour arrangements. A favourable currency impact was a partly offsetting factor.

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

	Fourth Quarter		Change	
(Canadian dollars in millions)	**2017**	**2016**	**$**	**%**
Technical maintenance	$ 206	$ 154	$ 52	34
Maintenance provisions [1]	31	39	(8)	(21)
Other	6	7	(1)	(14)
Total aircraft maintenance expense	**$ 243**	**$ 200**	**$ 43**	**22**

(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 2017, depreciation, amortization and impairment expense of $245 million increased $33 million or 16% from the fourth quarter in 2016, mainly due to the addition of Boeing 787 aircraft to Air Canada's mainline fleet.

Sales and distribution costs

In the fourth quarter of 2017, sales and distribution costs of $169 million decreased $3 million or 2% from the fourth quarter in 2016, reflecting, in large part, the favourable impact of new commission programs in North America during 2017 and growth in direct bookings when compared to the same quarter in 2016. A higher volume of ticket sales and an increase in credit card expenses (in line with sales and revenue growth) were offsetting factors.

Ground package costs

In the fourth quarter of 2016, the cost of ground packages at Air Canada Vacations of $106 million increased $5 million or 5% from the fourth quarter in 2016. This increase was mainly due to higher passenger volumes partly offset by a decrease in the prices of ground packages and a favourable currency impact when compared to the fourth quarter of 2016.

Aircraft rent expense

In the fourth quarter of 2017, aircraft rent expense of $126 million increased $6 million or 5% from the fourth quarter in 2016, reflecting a greater number of leased aircraft, primarily Boeing 787 aircraft. A favourable currency impact and lower lease rates year-over-year were partly offsetting factors.

Special items

In the fourth quarter of 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

Other expenses

In the fourth quarter of 2017, other expenses of $362 million increased $49 million or 16% from the fourth quarter in 2016, reflecting, in large part, the capacity growth and the impact of Air Canada's international expansion strategy. An increase in customer inconvenience expense, reflecting the impact of operational disruptions caused by severe weather, was also a contributing factor.

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

	Fourth Quarter		Change	
(Canadian dollars in millions)	**2017**	**2016**	**$**	**%**
Terminal handling	$ 69	$ 55	$ 14	25
Crew cycle	51	44	7	16
Building rent and maintenance	41	40	1	3
Miscellaneous fees and services	45	43	2	5
Remaining other expenses	156	131	25	19
Total other expenses	**$ 362**	**$ 313**	**$ 49**	**16**

Non-operating income (expense)

In the fourth quarter of 2017, non-operating expense of $113 million improved $83 million from the fourth quarter of 2016.

Components of the year-over-year change in fourth quarter non-operating income (expense) included:

- In the fourth quarter of 2017, losses on foreign exchange amounted to $62 million compared to losses on foreign exchange of $29 million in the fourth quarter of 2016. Foreign exchange losses of $49 million were recorded on long-term debt and foreign exchange losses of $8 million were recorded on maintenance provisions.
- Air Canada recorded a $27 million gain on debt modifications in the fourth quarter of 2017 related to the repricing of the US$1.1 billion senior secured credit facility concluded in June 2017.
- In the fourth quarter of 2016, Air Canada recorded a loss on debt settlements of $82 million related to the $1.25 billion refinancing transaction concluded in October 2016.

8. Fleet

Mainline and Air Canada Rouge

The following table provides Air Canada's and Air Canada Rouge's operating fleet as at December 31, 2017. Refer to the Air Canada Express section 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	Operating Lease
Mainline						
Wide-body aircraft						
Boeing 787-8	251	8	3.2	8	-	-
Boeing 787-9	298	22	1.4	16	-	6
Boeing 777-300ER	450/400	19	7.5	10	1	8
Boeing 777-200LR	300	6	10.1	4	-	2
Boeing 767-300ER	211	10	28.8	6	1	3
Airbus A330-300	292	8	17.2	8	-	-
Narrow-body aircraft						
Boeing 737 MAX 8	169	2	0.1	2	-	-
Airbus A321	185/190	15	14.7	5	-	10
Airbus A320	146	42	24.2	1	-	41
Airbus A319	120	18	19.7	5	-	13
Embraer 190	97	25	10.5	25	-	-
Total Mainline		**175**	**14.5**	**90**	**2**	**83**
Air Canada Rouge						
Wide-body aircraft						
Boeing 767-300ER (1)	282	24	20.3	2	2	20
Narrow-body aircraft						
Airbus A321	200	5	2.0	-	-	5
Airbus A319 (1)	136	20	19.5	17	-	3
Total Air Canada Rouge		**49**	**18.1**	**19**	**2**	**28**
Total Mainline and Air Canada Rouge		**224**	**15.3**	**109**	**4**	**111**

(1) 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, 2017 as well as Air Canada's planned operating fleet, including aircraft operating and expected to be operated by Air Canada Rouge, as at December 31, 2018 and December 31, 2019:

	Actual	Planned			
	December 31, 2017	2018 Fleet Changes	December 31, 2018	2019 Fleet Changes	December 31, 2019
Mainline					
Wide-body aircraft					
Boeing 787-8	8	-	8	-	8
Boeing 787-9	22	5	27	2	29
Boeing 777-300ER	19	-	19	-	19
Boeing 777-200LR	6	-	6	-	6
Boeing 767-300ER	10	(4)	6	(5)	1
Airbus A330-300	8	-	8	4	12
Narrow-body aircraft					
Boeing 737 MAX 8	2	16	18	18	36
Airbus A321	15	-	15	-	15
Airbus A320	42	-	42	(11)	31
Airbus A319	18	(2)	16	(2)	14
Embraer 190	25	(6)	19	(5)	14
Bombardier C-Series CS300	-	-	-	1	1
Total Mainline	**175**	**9**	**184**	**2**	**186**
Air Canada Rouge					
Wide-body aircraft					
Boeing 767-300ER	24	1	25	-	25
Narrow-body aircraft					
Airbus A321	5	1	6	-	6
Airbus A319	20	2	22	-	22
Total Air Canada Rouge	**49**	**4**	**53**	**-**	**53**
Total wide-body aircraft	**97**	**2**	**99**	**1**	**100**
Total narrow-body aircraft	**127**	**11**	**138**	**1**	**139**
Total Mainline and Air Canada Rouge	**224**	**13**	**237**	**2**	**239**

In addition to the above-referenced 36 Boeing 737 MAX aircraft that Air Canada plans to have in its operating fleet by the end of 2019, Air Canada expects to introduce an additional 25 Boeing 737 MAX aircraft between 2020 and 2021 (for a total of 61 aircraft). These aircraft are replacing existing Airbus narrow-body aircraft in Air Canada's mainline fleet.

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 existing Embraer 190 aircraft in the mainline fleet, with incremental aircraft supporting Air Canada's hub and network growth.

Air Canada Express

The following table provides, as at December 31, 2017, 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, 2017			
	Jazz	Sky Regional	Other	Total
Embraer 175	-	25	-	25
Bombardier CRJ-100/200	10	-	14	24
Bombardier CRJ-705/900	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**

The following table provides the number of aircraft planned, as at December 31, 2018, 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, 2018			
	Jazz	Sky Regional	Other	Total
Embraer 175	-	25	-	25
Bombardier CRJ-100/200	10	-	14	24
Bombardier CRJ-705/900	21	-	-	21
Bombardier Dash 8-100	15	-	-	15
Bombardier Dash 8-300	26	-	-	26
Bombardier Dash 8-Q400	44	-	-	44
Total Air Canada Express	**116**	**25**	**14**	**155**

Other aircraft with CPA carriers

Air Georgian and EVAS also operate a total of 15 18-passenger Beech 1900 aircraft on behalf of Air Canada pursuant to their capacity purchase agreements with Air Canada.

9. 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 and free cash flow, sourcing committed financing, as necessary, 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 and covenants in credit card agreements), which are further discussed in sections 9.6, 9.7 and 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, 2017, unrestricted liquidity amounted to $4,181 million (comprised of cash and short-term investments of $3,804 million and undrawn lines of credit of $377 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, 2017 and as at December 31, 2016:

(Canadian dollars in millions)	December 31, 2017	December 31, 2016	$ Change
Assets			
Cash, cash equivalents and short-term investments	$ 3,804	$ 2,979	$ 825
Other current assets	1,493	1,368	125
Current assets	5,297	4,347	950
Deposits and other assets	465	468	(3)
Property and equipment	9,252	8,520	732
Pension assets	1,583	1,153	430
Deferred income tax	472	-	472
Intangible assets	318	315	3
Goodwill	311	311	-
Total assets	**$ 17,698**	**$ 15,114**	**$ 2,584**
Liabilities			
Current liabilities	$ 5,060	$ 4,424	$ 636
Long-term debt and finance leases	5,448	5,911	(463)
Pension and other benefit liabilities	2,592	2,436	156
Maintenance provisions	1,003	922	81
Other long-term liabilities	216	202	14
Total liabilities	**$ 14,319**	**$ 13,895**	**$ 424**
Total shareholders' equity	**$ 3,379**	**$ 1,219**	**$ 2,160**
Total liabilities and shareholders' equity	**$ 17,698**	**$ 15,114**	**$ 2,584**

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, 2017, property and equipment amounted to $9,252 million, an increase of $732 million from December 31, 2016. The increase in property and equipment was mainly due to additions of $2,379 million, including nine Boeing 787-9 aircraft (four of which were financed under sale and operating leaseback transactions), two Boeing 737 MAX aircraft, progress payments on future aircraft deliveries and capitalized maintenance costs. These were largely offset by the sale of four Boeing 787 aircraft under sale and operating leaseback transactions and the impact of depreciation expense of $934 million.

As described in section 6 "Results of Operations – Full Year 2017 versus Full Year 2016" of this MD&A, in 2017, Air Canada began recognizing the value of substantially all of its unrecorded deferred income tax assets. As at December 31, 2017 the deferred income tax asset amounted to $472 million.

The net long-term pension and other benefit liabilities of $1,009 million (comprised of pension and other benefit liabilities of $2,592 million net of pension assets of $1,583 million) decreased $274 million from December 31, 2016. This decrease was mainly due to strong investment returns on pension plan assets, partially offset by the impact of a 30 basis point decrease in the discount rate used to value the liabilities, resulting in a net gain on remeasurements on employee benefit liabilities of $511 million (before the impact of income taxes - $189 million, net of tax) recorded on Air Canada's consolidated statement of comprehensive income.

9.3. Adjusted net debt

The following table reflects Air Canada's adjusted net debt balances as at December 31, 2017 and as at December 31, 2016:

(Canadian dollars in millions, except where indicated)	December 31, 2017	December 31, 2016	$ Change
Total long-term debt and finance leases	$ 5,448	$ 5,911	$ (463)
Current portion of long-term debt and finance leases	671	707	(36)
Total long-term debt and finance leases, including current portion	6,119	6,618	(499)
Less cash, cash equivalents and short-term investments	(3,804)	(2,979)	(825)
Net debt	**$ 2,315**	**$ 3,639**	**$ (1,324)**
Capitalized operating leases (1)	3,801	3,451	350
Adjusted net debt	**$ 6,116**	**$ 7,090**	**$ (974)**
EBITDAR (trailing 12 months)	**$ 2,921**	**$ 2,768**	**$ 153**
Adjusted net debt to EBITDAR ratio (2)	**2.1**	**2.6**	**(0.5)**

(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 $543 million for the 12 months ended December 31, 2017 and $493 million for the 12 months ended December 31, 2016.

(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 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

At December 31, 2017, total long-term debt and finance leases (including current portion) of $6,119 million decreased $499 million from December 31, 2016. In 2017, new borrowings of $733 million were more than offset by debt repayments of $808 million and the favourable impact of a stronger Canadian dollar of $402 million, as at December 31, 2017 compared to December 31, 2016, on Air Canada's foreign currency denominated debt (mainly U.S. dollars). As noted in section 9.4 "Working Capital" of this MD&A, debt repayments included the exercise of end of lease purchase options which increased Air Canada's owned and encumbered aircraft and reduced outstanding debt. In addition, Air Canada purchased one Boeing 787 and two Boeing 737 aircraft with cash.

Adjusted net debt amounted to $6,116 million at December 31, 2017, a decrease of $974 million from December 31, 2016, reflecting the impact of higher cash and short-term investment balances of $825 million and lower long-term debt and finance lease balances of $499 million. The impact of a higher capitalized operating lease balance of $350 million was a partly offsetting factor.

At December 31, 2017, the adjusted net debt to EBITDAR ratio was 2.1 versus 2.6 as at December 31, 2016.

At December 31, 2017, Air Canada's weighted average cost of capital ("WACC"), on a pre-tax basis, was approximately 7.6% (compared to approximately 7.9% at December 31, 2016). WACC is based on an estimate by management and consists of an estimated cost of equity of 20.0% and an average cost of debt and finance leases of 4.5% (compared to an estimated cost of equity of 21.1% and an average cost of debt and finance leases of 4.6% at December 31, 2016).

9.4. Working capital

The following table provides information on Air Canada's working capital balances as at December 31, 2017 and as at December 31, 2016:

(Canadian dollars in millions)	December 31, 2017	December 31, 2016	$ Change
Cash, cash equivalents and short-term investments	$ 3,804	$ 2,979	$ 825
Accounts receivable	814	707	107
Other current assets	679	661	18
Total current assets	**$ 5,297**	**$ 4,347**	**$ 950**
Accounts payable and accrued liabilities	1,961	1,644	317
Advance ticket sales	2,428	2,073	355
Current portion of long-term debt and finance leases	671	707	(36)
Total current liabilities	**$ 5,060**	**$ 4,424**	**$ 636**
Net working capital	**$ 237**	**$ (77)**	**$ 314**

The net working capital of $237 million at December 31, 2017 represented an improvement of $314 million from December 31, 2016. The net cash flows from operating activities of $2,738 million more than offset the impact of capital expenditures of $2,422 million (which resulted in a net cash outflow of $949 million after deducting the financing drawn or sale-leaseback proceeds received relating to the delivery of eight Boeing 787 aircraft). In 2017, Air Canada purchased one Boeing 787 and two Boeing 737 MAX aircraft using cash and exercised purchase and early termination options on four financed Airbus A330 aircraft and five financed Airbus A321 aircraft, increasing the number of owned and unencumbered aircraft. The growth in advance ticket sales of $355 million was largely driven by Air Canada's capacity growth.

9.5. Consolidated cash flow movements

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

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	2017	2016	$ Change	2017	2016	$ Change
Net cash flows from operating activities	**$ 389**	**$ 351**	**$ 38**	**$ 2,738**	**$ 2,421**	**$ 317**
Proceeds from borrowings	-	1,230	(1,230)	733	2,538	(1,805)
Reduction of long-term debt and finance lease obligations	(240)	(1,807)	1,567	(814)	(2,275)	1,461
Shares purchased for cancellation	(35)	(5)	(30)	(71)	(94)	23
Distributions related to aircraft special purpose leasing entities	-	-	-	-	(32)	32
Issue of shares	2	1	1	9	2	7
Financing fees	(11)	-	(11)	(26)	(2)	(24)
Net cash flows from (used in) financing activities	**$ (284)**	**$ (581)**	**$ 297**	**$ (169)**	**$ 137**	**$ (306)**
Short-term investments	(167)	238	(405)	(998)	(99)	(899)
Additions to property, equipment and intangible assets	(432)	(230)	(202)	(2,422)	(2,921)	499
Proceeds from sale of assets	2	3	(1)	5	352	(347)
Proceeds from sale-leaseback of assets	-	-	-	740	351	389
Other	(24)	(16)	(8)	(16)	(9)	(7)
Net cash flows used in investing activities	**$ (621)**	**$ (5)**	**$ (616)**	**$ (2,691)**	**$ (2,326)**	**$ (365)**
Effect of exchange rate changes on cash and cash equivalents	**$ 12**	**$ 5**	**$ 7**	**$ (23)**	**$ (17)**	**$ (6)**
Increase (decrease) in cash and cash equivalents	**$ (504)**	**$ (230)**	**$ (274)**	**$ (145)**	**$ 215**	**$ (360)**

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

	Fourth Quarter			Full Year		
(Canadian dollars in millions)	**2017**	**2016**	**$ Change**	**2017**	**2016**	**$ Change**
Net cash flows from operating activities	**$ 389**	**$ 351**	**$ 38**	**$ 2,738**	**$ 2,421**	**$ 317**
Additions to property, equipment and intangible assets, net of proceeds from sale-leaseback transactions	(432)	(230)	(202)	(1,682)	(2,570)	888
Free cash flow (1)	**$ (43)**	**$ 121**	**$ (164)**	**$ 1,056**	**$ (149)**	**$ 1,205**

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

FREE CASH FLOW

In the fourth quarter of 2017, net cash flows from operating activities of $389 million increased $38 million when compared to the same quarter in 2016. This increase was mainly due to the impact of stronger cash operating results and higher net cash inflows from working capital. In the fourth quarter of 2017, negative free cash flow of $43 million deteriorated by $164 million from the fourth quarter of 2016 due to a higher level of net capital expenditures year-over-year partly offset by higher cash flows from operating activities versus the same quarter in 2016.

In 2017, net cash flows from operating activities of $2,738 million increased $317 million when compared to 2016. This increase in net cash flows from operating activities was mainly due to the impact of stronger cash operating results, the impact of higher cash inflows from working capital and the impact of lower pension funding payments. The higher cash inflows from working capital was mainly due to the impact of the growth in advance ticket sales which is consistent with the capacity growth. In 2017, free cash flow of $1,056 million improved $1,205 million from 2016 due to a lower level of net capital expenditures year-over-year and the impact of higher cash flows from operating activities versus 2016.

NET CASH FLOWS FROM FINANCING ACTIVITIES

In the fourth quarter of 2017, reduction of long-term debt and finance lease obligations amounted to $240 million.

In 2017, proceeds from borrowings amounted to $733 million and reduction of long-term debt and finance lease obligations amounted to $814 million.

Refer to sections 9.4 "Working Capital", 9.2 "Financial Position" and 9.3 "Adjusted Net Debt" of this MD&A for additional information.

9.6. Capital expenditures and related financing arrangements

BOEING 787 AIRCRAFT

As of the date of this MD&A, Air Canada has outstanding purchase commitments with The Boeing Company ("Boeing") for five Boeing 787 aircraft (three of which remain to be delivered in 2018 and two of which remain to be delivered 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 and available delivery positions).

In December 2017, Air Canada completed a private offering of enhanced equipment trust certificates ("EETCs") covering nine Boeing 737 MAX 8 aircraft and four Boeing 787-9 aircraft. Two of the four Boeing 787-9 aircraft covered under the EETC transaction were delivered in early 2018 and the remaining two are scheduled for delivery in the first half of 2018. Refer to section 9.8 "Contractual Obligations" of this MD&A for additional information.

Subject to certain conditions, Air Canada has financing commitments covering up to three of the remaining five Boeing 787 firm aircraft orders, 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.

BOEING 737 AIRCRAFT

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

- Firm orders for 61 737 MAX aircraft, initially consisting of 737 MAX 8 and 737 MAX 9 aircraft with substitution rights between them as well as for the 737 MAX 7 aircraft.
- Purchase options for 18 Boeing 737 MAX aircraft.
- Certain rights to purchase an additional 30 Boeing 737 MAX aircraft.

As of the date of this MD&A, the remaining firm order for the 737 MAX aircraft consists of 46 737 MAX 8 aircraft and 11 737 MAX 9 aircraft.

In December 2017, Air Canada completed a private offering of EETCs covering nine Boeing 737 MAX 8 aircraft and four Boeing 787-9 aircraft scheduled for delivery in 2018. Two of the nine Boeing 737 MAX 8 aircraft covered under the EETC transaction completed in December 2017 were delivered in early 2018 and the remaining seven are scheduled for delivery in the first half of 2018. Refer to section 9.8 "Contractual Obligations" of this MD&A for additional information.

Subject to certain conditions, Air Canada also has financing commitments covering all of the remaining Boeing 737 MAX firm aircraft order. 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 C-Series 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, 2017 approximates $6,089 million.

(Canadian dollars in millions)	2018	2019	2020	2021	2022	Thereafter	Total
Projected committed expenditures	$ 1,821	$ 1,353	$ 1,334	$ 1,016	$ 565	$ -	$ 6,089
Projected planned but uncommitted expenditures	303	572	373	343	298	Not available	Not available
Projected planned but uncommitted capitalized maintenance (1)	129	167	163	49	98	Not available	Not available
Total projected expenditures (2)	**$ 2,253**	**$ 2,092**	**$ 1,870**	**$ 1,408**	**$ 961**	**Not available**	**Not available**

(1) Future capitalized maintenance amounts for 2021 and 2022 and beyond are not yet determinable, however estimates of $49 million and $98 million, respectively, have been made for 2021 and 2022.

(2) U.S. dollar amounts are converted using the December 31, 2017 closing exchange rate of US$1=C$1.2571. 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 29, 2017.

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.

As at January 1, 2017, the aggregate solvency surplus in the domestic registered pension plans was $1.9 billion. Based on preliminary estimates, including actuarial assumptions, as at January 1, 2018, the aggregate solvency surplus in Air Canada's domestic registered pension plans is projected to be $2.5 billion. The final valuations to be made as at January 1, 2018 will be completed in the first half of 2018. Based on preliminary estimates, Air Canada does not expect to make any past service payments in 2018.

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.

On a cash basis, total employer pension funding contributions (including the international and supplemental plans) amounted to $90 million in 2017, as described in the table below.

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

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

On a cash basis, total pension funding contributions (including the international and supplemental plans) are forecasted to be $90 million in 2018, as described in the table below.

(Canadian dollars in millions)	2018
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, 2017, 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 18 "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

PRIVATE OFFERING OF ENHANCED EQUIPMENT TRUST CERTIFICATES

In December 2017, in connection with the financing of four new Boeing 787-9 aircraft and nine new Boeing 737 MAX 8 aircraft, Air Canada completed the closing of a private offering of three tranches of EETCs with a combined aggregate face amount of approximately US$719 million.

The private offering was comprised of Class AA certificates, Class A certificates and Class B certificates.

- The Class AA certificates, with a US$400 million face amount, have an interest rate of 3.300% per annum and a final expected distribution date of January 15, 2030.
- The Class A certificates, with a US$172 million face amount, have an interest rate of 3.550% per annum and a final expected distribution date of January 15, 2030.
- The Class B certificates, with US$147 million face amount, have an interest rate of 3.700% per annum and a final expected distribution date of January 15, 2026.

The three tranches of certificates have a combined weighted average interest rate of 3.422% per annum.

The table below provides Air Canada's contractual obligations as at December 31, 2017, 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. The table below also includes the impact of the financing associated with four new Boeing 787-9 aircraft and nine new Boeing 737 MAX-8 aircraft as described above, the proceeds of which are held in escrow and drawn upon the delivery of these aircraft.

(Canadian dollars in millions)	2018	2019	2020	2021	2022	Thereafter	Total
Principal							
Long-term debt obligations	$ 624	$ 487	$ 523	$ 853	$ 243	$ 3,269	$ 5,999
Finance lease obligations	47	44	47	16	14	55	223
Total principal obligations	**$ 671**	**$ 531**	**$ 570**	**$ 869**	**$ 257**	**$ 3,324**	**$ 6,222**
Interest							
Long-term debt obligations	$ 230	$ 210	$ 191	$ 148	$ 127	$ 277	$ 1,183
Finance lease obligations	18	14	9	6	5	14	66
Total interest obligations	**$ 248**	**$ 224**	**$ 200**	**$ 154**	**$ 132**	**$ 291**	**$ 1,249**
Total long-term debt and finance lease obligations	**$ 919**	**$ 755**	**$ 770**	**$ 1,023**	**$ 389**	**$ 3,615**	**$ 7,471**
Operating lease obligations	**$ 606**	**$ 520**	**$ 397**	**$ 288**	**$ 210**	**$ 882**	**$ 2,903**
Committed capital expenditures	**$ 1,821**	**$ 1,353**	**$ 1,334**	**$ 1,016**	**$ 565**	**$ -**	**$ 6,089**
Total contractual obligations (1)	**$ 3,346**	**$ 2,628**	**$ 2,501**	**$ 2,327**	**$ 1,164**	**$ 4,497**	**$ 16,463**
EETC financing (principal and interest)	**$ 12**	**$ 86**	**$ 84**	**$ 82**	**$ 80**	**$ 808**	**$ 1,152**
Total obligations, including the impact of the EETC financing	**$ 3,358**	**$ 2,714**	**$ 2,585**	**$ 2,409**	**$ 1,244**	**$ 5,305**	**$ 17,615**

(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 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 Air Canada and the unrestricted cash and short-term investments of Air Canada. In 2017, Air Canada made no cash deposits under these agreements (nil in 2016).

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, 2017	December 31, 2016
Issued and outstanding shares		
Variable voting shares	115,986,084	86,657,994
Voting shares	157,090,562	186,554,808
Total issued and outstanding shares	**273,076,646**	**273,212,802**
Class A variable voting and Class B voting shares potentially issuable		
Stock options	6,121,252	8,985,958
Total shares potentially issuable	**6,121,252**	**8,985,958**
Total outstanding and potentially issuable shares	**279,197,898**	**282,198,760**

ISSUER BID

In May 2017, Air Canada received approval from the Toronto Stock Exchange ("TSX") for the renewal of its normal course issuer bid for its Class A variable voting shares and Class B voting shares (collectively the "Shares"), authorizing, between May 31, 2017 and May 30, 2018, the purchase of up to 22,364,183 Shares, representing 10% of the public float as at May 17, 2017. The renewal followed the conclusion of the 2016 normal course issuer bid which expired on May 29, 2017.

In 2017, Air Canada purchased, for cancellation, 4,042,818 Shares at an average cost of $17.49 per Share for aggregate consideration of $71 million. The excess of the cost over the average book value of $59 million was charged to retained earnings. At December 31, 2017, a total of 20,718,565 Shares remain available for repurchase under the existing 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 per share figures)	2016				2017			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Passenger	$ 2,864	$ 3,143	$ 4,106	$ 3,035	$ 3,095	$ 3,517	$ 4,478	$ 3,381
Cargo	116	111	130	155	134	154	179	183
Other	363	204	215	235	413	239	223	256
Operating revenues	**3,343**	**3,458**	**4,451**	**3,425**	**3,642**	**3,910**	**4,880**	**3,820**
Aircraft fuel	446	527	708	598	659	701	832	735
Regional airlines expense								
Aircraft fuel	64	77	96	90	95	96	109	112
Other	505	501	543	532	537	552	553	563
Wages, salaries & benefits	608	611	658	633	644	663	690	674
Airport and navigation fees	198	211	247	203	210	230	264	201
Aircraft maintenance	221	243	230	200	228	226	241	243
Depreciation, amortization and impairment	182	202	220	212	228	242	241	245
Sales and distribution costs	182	170	179	172	205	199	204	169
Ground package costs	231	85	72	101	256	103	73	106
Aircraft rent	112	112	118	120	122	130	125	126
Food, beverages and supplies	77	86	104	82	85	97	112	89
Communications and information technology	67	59	56	60	71	58	63	62
Special items	-	-	-	91	30	-	-	-
Other	296	297	324	313	326	332	369	362
Operating expenses	**3,189**	**3,181**	**3,555**	**3,407**	**3,696**	**3,629**	**3,876**	**3,687**
Operating income (loss)	**154**	**277**	**896**	**18**	**(54)**	**281**	**1,004**	**133**
Foreign exchange gain (loss)	50	(17)	(42)	(29)	70	68	44	(62)
Interest income	10	13	12	13	12	14	16	18
Interest expense	(96)	(98)	(97)	(83)	(79)	(80)	(73)	(79)
Interest capitalized	23	15	12	8	9	9	9	9
Net financing expense relating to employee benefits	(18)	(17)	(17)	(24)	(16)	(16)	(15)	(18)
Gain (loss) on financial instruments recorded at fair value	(10)	(1)	6	9	-	7	17	(1)
Gain on sale and leaseback of assets	-	19	-	-	26	26	-	-
Gain (loss) on debt settlements and modifications	(6)	(1)	-	(82)	-	-	(3)	24
Other	(6)	(4)	(2)	(8)	(5)	(6)	(6)	(4)
Total non-operating income (expense)	**(53)**	**(91)**	**(128)**	**(196)**	**17**	**22**	**(11)**	**(113)**
Income (loss) before income taxes	101	186	768	(178)	(37)	303	993	20
Recovery of (provision for) income taxes	-	-	-	(1)	-	(3)	774	(12)
Net income (loss)	**$ 101**	**$ 186**	**$ 768**	**$ (179)**	**$ (37)**	**$ 300**	**$ 1,767**	**$ 8**
Diluted earnings (loss) per share	**$ 0.35**	**$ 0.66**	**$ 2.74**	**$ (0.66)**	**$ (0.14)**	**$ 1.08**	**$ 6.37**	**$ 0.02**
EBITDAR (1)	**$ 460**	**$ 605**	**$ 1,248**	**$ 455**	**$ 342**	**$ 670**	**$ 1,388**	**$ 521**
Adjusted pre-tax income (loss) (1)	**$ 85**	**$ 203**	**$ 821**	**$ 39**	**$ (87)**	**$ 218**	**$ 950**	**$ 77**
Adjusted net income (loss) (1) (2)	**$ 85**	**$ 203**	**$ 821**	**$ 38**	**$ (87)**	**$ 218**	**$ 950**	**$ 61**
Adjusted earnings (loss) per share – diluted (1)	**$ 0.30**	**$ 0.72**	**$ 2.93**	**$ 0.14**	**$ (0.32)**	**$ 0.78**	**$ 3.43**	**$ 0.22**

(1) EBITDAR, adjusted pre-tax income (loss), adjusted net income (loss) and adjusted earnings (loss) per share – diluted are non-GAAP financial measures. Reconciliations of these measures to comparable GAAP measures can be found in "Non-GAAP Financial Measures" of this MD&A and in Air Canada's MD&A reports, available at aircanada.com.

(2) In the first nine months of 2017, Air Canada recorded a tax recovery of $790 million, which was revised to $771 million with $19 million reclassified directly to retained earnings in the fourth quarter of 2017. This tax recovery is excluded from adjusted net income as it reflects a one-time recognition of previously unrecognized income tax assets.

The following table provides a breakdown of the most significant items included in regional airlines expense for the last eight quarters:

	2016				2017			
(Canadian dollars in millions)	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Capacity purchase fees	$ 293	$ 289	$ 313	$ 304	$ 308	$ 314	$ 315	$ 330
Aircraft fuel	64	77	96	90	95	96	109	112
Airport and navigation	68	71	79	72	69	73	80	71
Sales and distribution costs	35	35	36	36	37	40	34	35
Aircraft rent	7	8	8	8	10	10	10	10
Depreciation, amortization and impairment	5	6	6	6	6	7	8	7
Other operating expenses	97	92	101	106	107	108	106	110
Total regional airlines expense	**$ 569**	**$ 578**	**$ 639**	**$ 622**	**$ 632**	**$ 648**	**$ 662**	**$ 675**

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

	2016				2017			
System	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
Passenger PRASM (cents)	14.1	13.8	14.2	13.5	13.2	13.6	14.2	13.7
CASM (cents)	16.1	14.2	12.5	15.4	16.1	14.3	12.5	15.2
Adjusted CASM (cents) (1)	12.3	11.2	9.4	11.4	11.6	10.8	9.2	11.3
Fuel cost per litre (cents) (2)	48.1	52.2	55.2	59.4	63.2	61.3	59.4	67.5

(1) Adjusted CASM is a non-GAAP financial measure. A reconciliation of this measure to a comparable GAAP measure can be found in "Non-GAAP Financial Measures" of this MD&A and in Air Canada's MD&A reports, available at aircanada.com.

(2) Includes aircraft fuel expense related to regional airline operations. Includes fuel handling expenses.

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:

	2016				2017			
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
System								
RPMs (millions)	16,092	18,418	24,328	17,643	18,341	20,928	26,472	19,396
ASMs (millions)	19,833	22,344	28,458	22,091	22,894	25,357	31,050	24,191
Passenger load factor (%)	81.1%	82.4%	85.5%	79.9%	80.1%	82.5%	85.3%	80.2%
Domestic								
RPMs (millions)	3,960	4,717	6,068	4,534	4,101	4,875	6,130	4,607
ASMs (millions)	4,952	5,678	7,066	5,510	5,108	5,837	7,173	5,584
Passenger load factor (%)	80.0%	83.1%	85.9%	82.3%	80.3%	83.5%	85.4%	82.5%
U.S. Transborder								
RPMs (millions)	3,376	3,107	3,613	3,182	3,782	3,609	3,951	3,408
ASMs (millions)	4,278	3,799	4,223	3,985	4,687	4,376	4,683	4,252
Passenger load factor (%)	78.9%	81.8%	85.6%	79.9%	80.7%	82.5%	84.4%	80.1%
Atlantic								
RPMs (millions)	3,401	5,394	8,270	4,437	3,891	6,131	9,406	5,076
ASMs (millions)	4,383	6,805	9,785	5,778	5,248	7,661	11,087	6,582
Passenger load factor (%)	77.6%	79.3%	84.5%	76.8%	74.1%	80.0%	84.8%	77.1%
Pacific								
RPMs (millions)	3,218	3,902	5,002	3,959	3,943	4,671	5,471	4,501
ASMs (millions)	3,732	4,496	5,821	4,977	4,862	5,540	6,412	5,586
Passenger load factor (%)	86.2%	86.8%	85.9%	79.6%	81.1%	84.5%	85.3%	80.6%
Other								
RPMs (millions)	2,137	1,298	1,375	1,531	2,624	1,642	1,514	1,804
ASMs (millions)	2,488	1,566	1,563	1,841	2,989	1,943	1,695	2,187
Passenger load factor (%)	85.8%	82.9%	87.9%	83.1%	87.8%	84.5%	89.3%	82.5%

11. Selected Annual Information

The following table provides selected annual information for Air Canada for the years 2015 through 2017.

(Canadian dollars in millions, except per share figures)	Full Year		
	2017	2016	2015
Operating revenues	$ 16,252	$ 14,677	$ 13,868
Operating expenses (1)	14,888	13,332	12,372
Operating income	**1,364**	**1,345**	**1,496**
Income before income taxes	1,279	877	308
Recovery of (provision for) income taxes (2)	759	(1)	-
Net income	**$ 2,038**	**$ 876**	**$ 308**
EBITDAR (3)	**$ 2,921**	**$ 2,768**	**$ 2,542**
Adjusted pre-tax income (3)	**$ 1,158**	**$ 1,148**	**$ 1,222**
Adjusted net income (3)	**$ 1,142**	**$ 1,147**	**$ 1,222**
Basic earnings per share	**$ 7.48**	**$ 3.16**	**$ 1.06**
Diluted earnings per share	**$ 7.34**	**$ 3.10**	**$ 1.03**
Adjusted earnings per share – diluted (3)	**$ 4.11**	**$ 4.06**	**$ 4.18**
Cash, cash equivalents and short-term investments	**$ 3,804**	**$ 2,979**	**$ 2,672**
Total assets (4)	**$ 17,698**	**$ 15,114**	**$ 13,127**
Total long-term liabilities (5)	**$ 9,930**	**$ 10,178**	**$ 9,782**
Total liabilities	**$ 14,319**	**$ 13,895**	**$ 13,087**

(1) In 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations. In 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan. In 2015, Air Canada recorded special items which increased operating expenses by $8 million. These special items included one-time payments totaling $26 million related to Air Canada's contract on collective agreement terms with CUPE; one-time payments totaling $36 million related to Air Canada's contract on collective agreement terms with the IAMAW; a $30 million recovery related to cargo investigations which was previously paid; and favourable tax-related provision adjustments of $23 million.

(2) In 2017, Air Canada recorded a net income tax recovery of $759 million, representing a one-time recognition of previously unrecognized income tax assets of $787 million in the third quarter of 2017, a tax provision of $12 million recorded based on fourth quarter of 2017 results and a current income tax expense of $16 million.

(3) EBITDAR, adjusted pre-tax income, adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

(4) In 2017, Air Canada recorded a deferred income tax asset of $472 million. Refer to section 13 "Critical Accounting Estimates and Judgments" of this MD&A for additional information.

(5) 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:

	Fourth Quarter		Full Year	
(Canadian dollars in millions)	**2017**	**2016**	**2017**	**2016**
Share forward contracts	$ -	$ 9	$ 26	$ 9
Fuel derivatives	(1)	-	(3)	-
Prepayment options on senior secured notes	-	-	-	(5)
Financial instruments recorded at fair value	**$ (1)**	**$ 9**	**$ 23**	**$ 4**

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 an economic hedge and offset by changes in cash flows of the relevant risk being hedged.

The fair values of derivative 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 such as discounted cash flow analysis are applied. 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 2017:

- Hedging gains on the settlement of fuel derivatives amounted to $26 million with associated premium costs of $28 million, for a net hedging loss of $2 million which was reclassified from other comprehensive income to aircraft fuel expense (net fuel hedging loss of $23 million was reclassified from other comprehensive income to aircraft fuel expense in 2016).
- Air Canada purchased crude-oil call options covering a portion of its 2017 fuel exposure. The cash premium related to these contracts was $18 million ($34 million in 2016 for 2016 and 2017 exposures).
- Fuel derivative contracts cash settled with a fair value of $26 million in favour of Air Canada ($23 million in favour of Air Canada in 2016).

As at December 31, 2017, there are no outstanding fuel derivatives. The fair value of the fuel derivatives portfolio was $14 million in favour of Air Canada as at December 31, 2016 and 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 2017, these net operating cash inflows totaled approximately US$3.6 billion. Also in 2017, U.S. denominated operating costs amounted to approximately US$5.4 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$1.6 billion. For 2017, this resulted in a U.S. dollar net cash flow exposure of approximately US$3.4 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, 2017, U.S. dollar cash and short-term investment balances amounted to $686 million (US$542 million) ($560 million (US$416 million) as at December 31, 2016). 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 2017, a loss of $58 million (loss of $25 million in 2016) 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, 2017, as further described below, approximately 74% of net U.S. cash outflows are hedged for 2018 and 38% for 2019, resulting in derivative coverage of 64% over the next 18 months. Operational U.S. dollar cash and investment reserves combined with derivative coverage results in a coverage of 69%.

As at December 31, 2017, Air Canada had outstanding foreign currency options and swap agreements, settling in 2018 and 2019, to purchase at maturity $3,400 million (US$2,704 million) of U.S. dollars at a weighted average rate of $1.2703 per US$1.00 (2016 – $2,612 million (US$1,946 million) with settlements in 2017 and 2018 at a weighted average rate of $1.2898 per $1.00 U.S. dollar). Air Canada also has protection in place to sell a portion of its excess Euros, Sterling, Yen, Yuan and AUD (EUR €101 million, GBP £105 million, JPY ¥8,623 million, CNY ¥41 million, and AUD $32 million) which settle in 2017 at weighted average rates of €1.1664, £1.3259, ¥0.0090, ¥0.1468 and $0.7576 per $1.00 U.S. dollar, respectively (2016 – EUR €82 million, GBP £69 million, JPY ¥2,334 million, CNY ¥53 million, and AUD $33 million with settlement in 2017 at weighted average rates of €1.1059, £1.2589, ¥0.0096, ¥0.1522 and $0.7500, respectively, per $1.00 U.S. dollar).

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, 2017 was $215 million in favour of the counterparties (2016 – $5 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 2017, a loss of $274 million was recorded in Foreign exchange gain (loss) related to these derivatives (2016 – $136 million loss). In 2017, foreign exchange derivative contracts cash settled with a net fair value of $55 million in favour of the counterparties ($51 million in 2016 in favour of Air Canada). The total combined loss, related to U.S. cash, investments and foreign exchange derivatives recorded by Air Canada in 2017 was $332 million ($160 million loss in 2016).

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, 2017, was 73% fixed and 27% floating (76% and 24%, respectively, as at December 31, 2016).

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	
	2017	2016	2017	2016
Discount rate used to determine:				
Net interest on the net benefit obligation for the year ended December 31	3.9%	4.1%	3.9%	4.1%
Service cost for the year end December 31	4.1%	4.3%	4.1%	4.3%
Accrued benefit obligation as at December 31	3.6%	3.9%	3.6%	3.9%
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 2017 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	
(Canadian dollars in millions)	**Decrease**	**Increase**
Discount rate on obligation assumption		
Pension expense	$ 19	$ (18)
Net financing expense relating to pension benefit liabilities	23	(17)
Total	**$ 42**	**$ (35)**
Increase (decrease) in pension obligation	**$ 723**	**$ (699)**

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, 2017, 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 $492 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 2017 (2016 – 5.8%). The rate is assumed to decrease gradually to 5% by 2020 (2016 – assumed to decrease gradually to 5% by 2020). A one percentage point increase in assumed health care trend rates would have increased the total of current service and interest costs by $5 million and the obligation by $64 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 $65 million.

A 0.25 percentage point decrease in discount rate for other employee future benefits 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 $44 million.

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 and future fair values 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 $13 million to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.

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 is at the narrow-body and wide-body 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. Fair value less costs to dispose may be calculated based upon a discounted cash flow analysis, which requires management to make a number of significant market participant 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.

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 $52 million at December 31, 2017 and an increase to maintenance expense in 2018 of approximately $7 million. Expected future cash flows to settle the obligation are discounted. 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 $16 million at December 31, 2017. An equivalent but opposite movement in the discount rate would result in a similar impact in the opposite direction.

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, including historical financial results, and expectations relating to future taxable income, the overall business environment, and industry-wide trends.

In 2017, Air Canada determined that it was probable that substantially all of the unrecorded deferred income tax assets, which include non-capital losses, would be realized. Accordingly, a tax recovery of $759 million was recorded, representing the initial recognition of previously unrecognized tax assets of $787 million in the third quarter of 2017. Air Canada also recorded a deferred tax provision of $12 million in the fourth quarter and a current income tax expense of $16 million for the year.

Income tax recorded in Air Canada's consolidated statement of operations is presented below.

	Fourth Quarter		Full Year	
(Canadian dollars in millions)	**2017**	**2016**	**2017**	**2016**
Current income tax expense	$ -	$ 1	$ 16	$ 1
Deferred income tax expense (recovery)	12	-	(775)	-
Income tax expense (recovery)	**$ 12**	**$ 1**	**$ (759)**	**$ 1**

14. Accounting Policies

Accounting standard 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 is applying 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 anticipated impact on Air Canada's consolidated statement of financial position as at January 1, 2017 is an increase to prepaid expenses and other current assets of $58 million and an equivalent increase to opening retained earnings. In addition, deferred commission costs in the amount of $40 million as at December 31, 2016, currently recorded net against the advance ticket sales liability, will be reclassified to prepaid expenses and other current assets. The amount of deferred contract cost asset will fluctuate on a quarterly basis in line with changes in the advance ticket sales liability. The anticipated impact on the consolidated statement of financial position as at December 31, 2017 is an increase to prepaid expenses and other current assets of $64 million and an equivalent increase to opening retained earnings.

In addition, certain passenger and cargo related fees and surcharges will be reclassified from other to passenger revenue and to cargo revenue on Air Canada's consolidated statement of operations. Based on Air Canada's full year 2017 results, the amount expected to be reclassified on the adoption of IFRS 15 is $122 million to passenger revenue and $58 million to cargo revenue. This reclassification will not have an impact on total operating revenues.

No other material impacts on Air Canada's financial statements were identified from the adoption of IFRS 15.

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 an improved 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 has the option of adopting a full retrospective approach or a modified retrospective approach on transition to IFRS 16.

Air Canada is 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. Air Canada has identified that, under IFRS 16, it has a lease in respect of aircraft used by CPA carriers providing services under the respective capacity purchase agreements, and Air Canada expects to record such aircraft as right of use assets and lease liabilities of Air Canada in accordance with the requirements of the new standard.

Air Canada will apply the standard effective January 1, 2019 and has not yet determined which method of transition to apply.

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 three 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 $529 million as at December 31, 2017 (December 31, 2016 - $487 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, 2017, 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. Sensitivity of Results

Air Canada's financial results are subject to many different internal and external factors which can have a significant impact on operating results. The following table describes, on an indicative basis, the financial impact that changes in fuel prices and the value of the Canadian dollar would generally have had on Air Canada's past operating results. An equivalent but opposite movement of the sensitivity factor in the table below would have generally resulted in a similar but opposite impact. These guidelines were derived from 2017 levels of activity and make use of management estimates. The impacts are not additive, do not reflect the interdependent relationship of the elements and may not be indicative of future trends or results which may vary significantly due to a wide range of factors, many of which are beyond the control of Air Canada.

(Canadian dollars in millions)	2017 Measure	Sensitivity Factor	Favourable/ (Unfavourable) Estimated Operating Income Impact
Fuel			
Fuel – Jet fuel price (US$/barrel) [1]	71.4	US$1/barrel increase	$ (43)
Fuel – Jet fuel price (CAD cents/litre) [1]	62.6	1% increase	$ (31)
Currency Exchange			
C$ to US$	C$1 = US$1.25	1 cent increase (i.e. $1.25 to $1.24 per US$)	
		Operating income [2]	**$ 18**
		Net interest expense	2
		Revaluation of long-term debt, U.S. dollar cash and short-term investments and other long-term monetary items, net	45
		Remeasurement of outstanding currency derivatives	(27)
		Pre-tax Income Impact	**$ 38**

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

(2) The operating income impact of currency exchange movements is before the impact of hedging activities, such as through the use of foreign currency derivatives and holding U.S. dollar cash reserves. The gains and losses related to these hedging activities are recorded in non-operating income (expense) on Air Canada's consolidated statement of operations.

18. 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 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, financial condition and the outcome of matters as to which forward-looking statements are made.

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 (as has incurred in the past). Despite ongoing strategic and business initiatives, 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 increase revenues, 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 described in this "Risk Factors" section.

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, changes to political or economic arrangements among or between jurisdictions where Air Canada operates, 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 operate), 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 less environmentally impactful travel where customers may reduce or alter 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, or may not 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.

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.

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 and ultra-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, lower operating costs and other competitive advantages, and may therefore be able 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. Lower 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 2017, foreign carriers such as Aer Lingus, Aeroméxico, Air China, Azores Airlines, Beijing Capital Airlines, British Airways, Brussels Airlines, Cathay Pacific Airways, China Eastern Airlines, China Southern Airlines, Condor Flugdienst, Edelweiss Air, Ethiopian Airlines, EVA Air, Hainan Airlines, Hong Kong Airlines, Icelandair, Korean Air, Interjet, LEVEL, LOT, Lufthansa, Philippines Airlines, Primera Air, Saudi Arabian Airlines, Sichuan Airlines, TAP Air Portugal, Tunisair, Ukraine International Airlines, WOW Air and Xiamen Airlines 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 applicable laws or 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 entering into new or expanded joint ventures and other arrangements, or 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.

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, reservations, 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 invests in initiatives, including security initiatives and disaster recovery plans; however, these initiatives may not be successful or adequately address a highly dynamic and continually evolving threat landscape. Any technology systems failure, interruption or misuse, security breach or failure to comply with applicable data confidentiality, privacy, security or other related 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.

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 satisfy its debts, lease and other 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 satisfy its debts, lease and other 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.

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 its aircraft fleet renewal program (including the scheduled delivery of Boeing 787 aircraft and the planned re-fleeting of its narrow-body aircraft with Boeing 737 MAX aircraft and Bombardier C-Series aircraft and disposal of aircraft that are being replaced), the planned implementation of Amadeus Altéa Suite to replace its existing passenger services system, the launch of its new loyalty program, participation in the leisure or lower cost market (including through Air Canada Rouge), joint venture arrangements, 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 and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement any of 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.

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 operations and financial condition

Airport and air navigation authorities have or could significantly increase their fees. The Canadian government has also announced its intention to study airport privatization. Airport privatization may increase overall aviation costs and Air Canada may not be in a position to prevent or develop alternatives to overcome cost 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 a 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 timeframes acceptable to Air Canada, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

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"). 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.

Air Canada has decided not to renew the CPSA and it is scheduled to expire in June 2020. Air Canada is seeking to implement a new loyalty program which involves significant investments as well as certain risks and uncertainties, including risks relating to attracting members, implementing the required information technology and loyalty management systems, successfully concluding strategic commercial arrangements, and transitioning Air Canada from the Aeroplan program to its new loyalty program. Though Air Canada believes it would be able to mitigate and overcome risks and successfully create and launch its new loyalty program, the transition from Aeroplan's program and the launch and operation of Air Canada's new loyalty program entail risks which 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 lower 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 business 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.

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 (or arranges to provide the related supplies to 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 key suppliers, or of 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 may 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, fixed charge coverage ratio) 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, in the last few years, 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.

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 in 2010. Air Canada appealed the decision and the European General Court granted Air Canada's appeal in 2015 and annulled the decision of the European Union with regard to Air Canada and certain other airlines, following which the European Commission refunded 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.

In March 2017, the Commission issued a new decision, based on the same allegations and imposed the same fine (21 million Euros; approximately $30 million) on Air Canada as it had in 2010. Air Canada recorded the charge as a special item in the first quarter of 2017 and paid the fine, as required, in the second quarter of 2017, pending an outcome of an appeal it made in 2017 to the European General Court. While Air Canada cannot predict with certainty the outcome of its appeal or any related proceedings, Air Canada believes it has reasonable grounds to challenge the European Commission's ruling.

As at December 31, 2017, Air Canada has a provision of $17 million ($17 million as at December 31, 2016) 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 has been engaged in a number of proceedings involving challenges to the mandatory retirement provisions of certain of its collective agreements. The remaining cases relate to retirement which occurred pursuant to 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 prevailed in defending some of these complaints and is defending the remaining ones. 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.

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, flight crew and other labour rules, 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 International Civil Aviation Organization ("ICAO") global market-based measure ("GMBM"), adopted in 2016, includes emissions from international flights. The GMBM 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 and with the third phase (from 2027 to 2035) to be mandatory. Canada voluntarily adopted the first phase. On the basis of the GMBM, the European Parliament and Council has continued exempting flights between Europe and third countries from the European Union ("EU") emissions trading system ("ETS").

In 2016, the Canadian Federal Government proposed a pan-Canadian benchmark for carbon pricing to be implemented in all Canadian jurisdictions by 2018, with pricing to be based on greenhouse gas emissions from all fossil fuels sources including jet fuel and other fuels used by Air Canada in ground operations and stationary combustion equipment. Canadian provinces may either apply an explicit price-based system, such as a carbon tax or levy, or a cap and trade system. Certain provinces, such as Alberta, British Columbia, Ontario and Québec have implemented a carbon pricing system. As of 2017, Air Canada and regional carriers operating flights on behalf of Air Canada are subject to a carbon tax for flights operating in British Columbia and in Alberta.

Air Canada cannot predict whether, or the manner in which, these or other initiatives will ultimately be implemented or their 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, 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. These laws and regulations are proliferating, are becoming increasingly stringent and may conflict with one another. The need to comply with these laws and regulatory regimes results in additional operating costs and complexities, 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 which are being increasingly adopted, such as those in the proposed Transportation Modernization Act tabled by the Canadian Federal Government in 2017. 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.

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.

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.

19. Controls and Procedures

Disclosure controls and procedures and internal controls over financial reporting

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

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

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

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

Management's report on disclosure controls and procedures

Management, under the supervision of and with the participation of the Corporation's CEO and CFO, evaluated the effectiveness of the Corporation's disclosure controls and procedures (as defined under National Instrument 52-109) and concluded, as at December 31, 2017, 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 Commission ("COSO") in Internal Control – Integrated Framework (2013). Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2017, 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, 2017 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

20. 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)	**2017**	**2016**	**$ Change**	**2017**	**2016**	**$ Change**
Operating income – GAAP	$ 133	$ 18	$ 115	$ 1,364	$ 1,345	$ 19
Add back (as reflected on Air Canada's consolidated statement of operations):						
Depreciation, amortization and impairment	245	212	33	956	816	140
Aircraft rent	126	120	6	503	462	41
Add back (included in Regional airlines expense):						
Depreciation, amortization and impairment	7	6	1	28	23	5
Aircraft rent	10	8	2	40	31	9
EBITDAR (including special items)	$ 521	$ 364	$ 157	$ 2,891	$ 2,677	$ 214
Remove effect of special items [1]	-	91	(91)	30	91	(61)
EBITDAR (excluding special items)	$ 521	$ 455	$ 66	$ 2,921	$ 2,768	$ 153

(1) In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

In the fourth quarter of 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

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		
	2017	2016	$ Change	2017	2016	$ Change
Operating expense – GAAP	$ 3,687	$ 3,407	$ 280	$ 14,888	$ 13,332	$ 1,556
Adjusted for:						
Aircraft fuel expense (as reflected on Air Canada's consolidated statement of operations)	(735)	(598)	(137)	(2,927)	(2,279)	(648)
Aircraft fuel expense (included in Regional airlines expense)	(112)	(90)	(22)	(412)	(327)	(85)
Ground package costs	(106)	(101)	(5)	(538)	(489)	(49)
Special items [1]	-	(91)	91	(30)	(91)	61
Operating expense, adjusted for the above-noted items	$ 2,734	$ 2,527	$ 207	10,981	$ 10,146	$ 835
ASMs (millions)	24,191	22,091	9.5%	103,492	92,726	11.6%
Adjusted CASM (cents)	¢ 11.30	¢ 11.44	(1.2%)	¢ 10.61	¢ 10.94	(3.0%)

(1) In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

In the fourth quarter of 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

Adjusted pre-tax income (loss)

Adjusted pre-tax income (loss) is used by Air Canada to assess the overall pre-tax financial performance of its business without the effects of 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, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications and special items. Air Canada uses adjusted pre-tax income (loss) to determine return on invested capital.

(Canadian dollars in millions)	Fourth Quarter			Full Year		
	2017	2016	$ Change	2017	2016	$ Change
Income (loss) before income taxes	$ 20	$ (178)	$ 198	$ 1,279	$ 877	$ 402
Adjusted for:						
Special items [1]	-	91	(91)	30	91	(61)
Foreign exchange (gain) loss	62	29	33	(120)	38	(158)
Net financing expense relating to employee benefits	18	24	(6)	65	76	(11)
Loss (gain) on financial instruments recorded at fair value	1	(9)	10	(23)	(4)	(19)
Gain on sale and leaseback of assets	-	-	-	(52)	(19)	(33)
Loss (gain) on debt settlements and modifications	(24)	82	(106)	(21)	89	(110)
Adjusted pre-tax income	$ 77	$ 39	$ 38	$ 1,158	$ 1,148	$ 10

(1) In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

In the fourth quarter of 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

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 after-tax effects of 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, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications, and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful. Starting as of and including the fourth quarter of 2017, adjusted net income is determined net of tax and includes the income tax effect of adjustments included in the measurement of adjusted net income. Prior to the fourth quarter of 2017, there was no deferred income tax expense recorded because of significant unrecognized deferred tax assets. A tax expense of $16 million affected fourth quarter and full year 2017 adjusted net income results.

(Canadian dollars in millions, except per share figures)	Fourth Quarter			Full Year		
	2017	2016	$ Change	2017	2016	$ Change
Net income	$ 8	$ (179)	$ 187	$ 2,038	$ 876	$ 1,162
Adjusted for:						
Special items (1)	-	91	(91)	30	91	(61)
Recovery of income taxes (2)	-	-	-	(771)	-	(771)
Foreign exchange (gain) loss	57	29	28	(125)	38	(163)
Net financing expense relating to employee benefits	13	24	(11)	60	76	(16)
Loss (gain) on financial instruments recorded at fair value	1	(9)	10	(23)	(4)	(19)
Gain on sale and leaseback of assets	-	-	-	(52)	(19)	(33)
Loss (gain) on debt settlements and modifications	(18)	82	(100)	(15)	89	(104)
Adjusted net income	$ 61	$ 38	$ 23	$ 1,142	$ 1,147	$ (5)
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	278	279	(1)	278	282	(4)
Adjusted earnings per share – diluted	$ 0.22	$ 0.14	$ 0.08	$ 4.11	$ 4.06	$ 0.05

(1) In the first quarter of 2017, Air Canada recorded a provision of $30 million relating to a fine which was reinstated by a decision of the European Commission pertaining to cargo investigations.

In the fourth quarter of 2016, Air Canada recorded a past service cost expense of $91 million to reflect the estimated cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

(2) In the first nine months of 2017, Air Canada recorded a tax recovery of $790 million, which was revised to $771 million with $19 million reclassified directly to retained earnings in the fourth quarter of 2017. This tax recovery is excluded from adjusted net income as it reflects a one-time recognition of previously unrecognized income tax assets.

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		Full Year	
	2017	2016	2017	2016
Weighted average number of shares outstanding – basic	274	273	273	277
Effect of dilution	4	6	5	5
Weighted average number of shares outstanding – diluted	278	279	278	282

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 pre-tax income (or loss, as applicable), excluding interest expense and implicit interest on operating leases. Invested capital includes (i) average year-over-year long-term debt, average year-over-year finance lease obligations, average year-over-year shareholders' equity and (ii) the value of capitalized operating leases (calculated by multiplying annualized aircraft rent by 7). Air Canada previously calculated invested capital based on an asset less operating liabilities approach. Following a significant increase in Air Canada's invested capital and book value of its equity, Air Canada decided to change the methodology to a book value-based method of calculating ROIC, as described above. Refer to the definition of adjusted pre-tax income for a discussion of why Air Canada uses this measure to assess the overall pre-tax financial performance of its business.

(Canadian dollars in millions, except where indicated)	12 Months Ended		
	December 31, 2017	December 31, 2016	$ Change
Income before income taxes	**$ 1,279**	**$ 877**	**$ 402**
Remove:			
Special items [1]	30	91	(61)
Foreign exchange (gain) loss	(120)	38	(158)
Net financing expense relating to employee benefits	65	76	(11)
Gain on financial instruments recorded at fair value	(23)	(4)	(19)
Gain on sale and leaseback of assets	(52)	(19)	(33)
(Gain) loss on debt settlements and modifications [2]	(21)	89	(110)
Adjusted pre-tax income	**$ 1,158**	**$ 1,148**	**$ 10**
Adjusted for:			
Interest expense	311	374	(63)
Implicit interest on operating leases [3]	266	242	24
Adjusted pre-tax income before interest	**$ 1,735**	**$ 1,764**	**$ (29)**
Invested capital:			
Average long-term debt and finance lease obligations	6,369	6,506	(137)
Average shareholders' equity	2,299	616	1,683
Capitalized operating leases [4]	3,801	3,451	350
Invested capital	**$ 12,469**	**$ 10,573**	**$ 1,896**
Return on invested capital (%)	**13.9**	**16.7**	**(2.8) pp**

(1) Special items for the 12 months ended December 31, 2017 included a provision of $30 million related to cargo investigations.

Special items for the 12 months ended December 31, 2016 included a past service cost expense of $91 million related to the cost of pension increases applicable to ACPA-represented pilots who participate in a defined benefit plan.

(2) Gain on debt settlements and modifications for the 12 months ended December 31, 2017 of $21 million included a gain of $27 million related to the repricing of its US$1.1 billion senior secured credit facility, a loss of $3 million related to the early exercise of a purchase option for an Airbus 330 aircraft and a loss of $2 million related to the prepayment of fixed rate debt on four Embraer 190 aircraft.

Loss on debt settlements and modifications for the 12 months ended December 31, 2016 of $89 million included $82 million related to a $1.25 billion refinancing transaction and $7 million related to the early exercise of a purchase option for an Airbus A330 aircraft.

(3) 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.

(4) Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totaled $543 million for the 12 months ended December 31, 2017 and $493 million for the 12 months ended December 31, 2016 (includes aircraft rent related to regional operations).

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 and 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.

21. Glossary

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 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Adjusted net income (loss) – Refers to the consolidated net income (loss) of Air Canada adjusted to remove the after-tax effects of 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, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications, and special items. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Adjusted pre-tax income (loss) – Refers to the consolidated income (loss) of Air Canada before income taxes and adjusted to remove the effects of 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, gain on sale and leaseback of assets, gains or losses on debt settlements and modifications, and special items. Refer to section 20 "Non-GAAP Financial Measures" 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, India, the Middle East and North Africa.

ATW – Refers to Air Transport World.

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 20 "Non-GAAP Financial Measures" 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 and leaseback transactions. Free cash flow is a non-GAAP financial measure. Refer to sections 9.5 and 20 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 20 of this MD&A for additional information.

Loss (gain) on debt settlements and modifications – Refer to gains or losses related to debt settlements and modifications 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, 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 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

Revenue passenger carried – Refers to the International Air Transport Association's (IATA) 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 takeoff and landing.

Sky Regional – Refers to Sky Regional Airlines Inc.

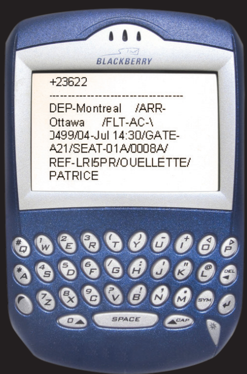
Special items – Refer to those items that, in management's view, are to be separately disclosed by virtue of their significance to the financial statements, to enable a fuller understanding of the Corporation's financial performance.

Toronto Pearson – refers to Lester B. Pearson International Airport.

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.

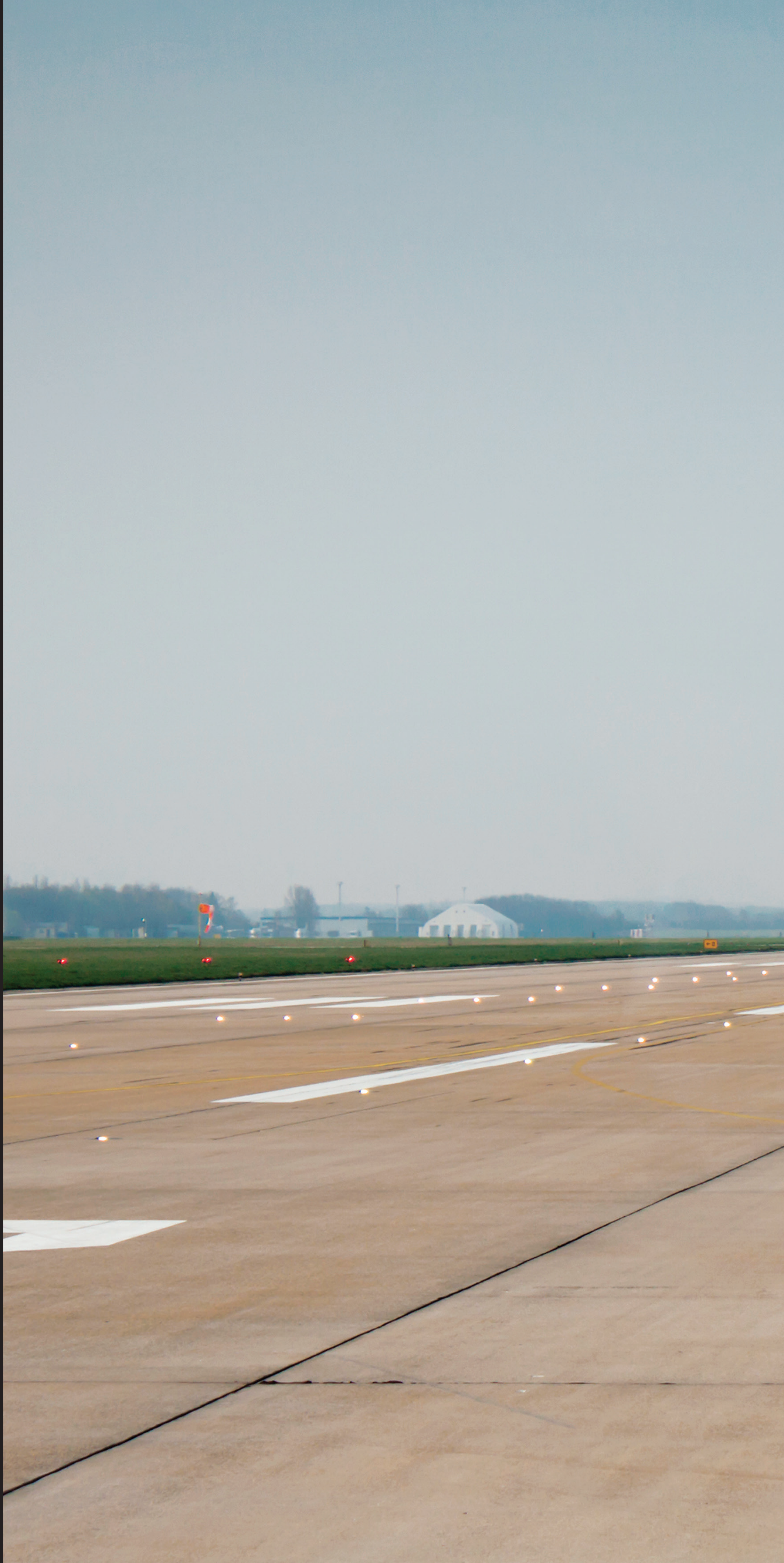
Weighted average cost of capital or WACC – Refers to management's estimate of its cost of capital, in which each category of capital is proportionately weighted.

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).

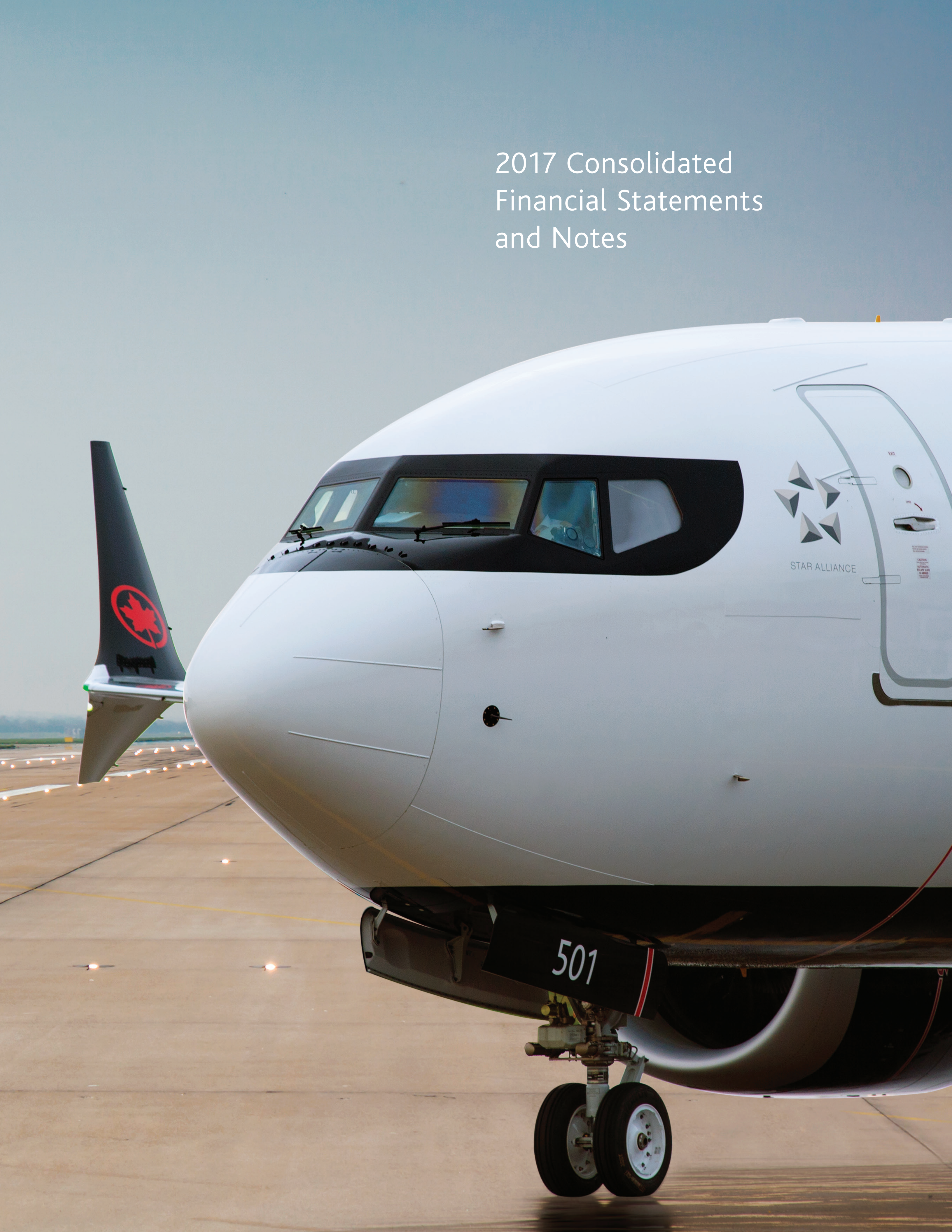


We pioneered 2d barcode scanning (2006), then introduced e-boarding passes, a first for North America (September 2007). Mobile flight notifications for delays and cancellations followed (August 2009). In 2011, we added mobile booking through our Apple App.

80th Anniversary



2017 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 15, 2018

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, 2017 and December 31, 2016 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, 2017 and December 31, 2016 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 15, 2018

1 CPA auditor, Public accountancy permit NO. A113048
"PwC" refers to PricewaterhouseCoopers LLP, an Ontario limited liability partnership.

Consolidated Statement of Financial Position

(Canadian dollars in millions)		December 31, 2017	December 31, 2016
ASSETS			
Current			
Cash and cash equivalents		$ 642	$ 787
Short-term investments		3,162	2,192
Total cash, cash equivalents and short-term investments		**3,804**	**2,979**
Restricted cash	Note 2P	148	126
Accounts receivable		814	707
Aircraft fuel inventory		91	79
Spare parts and supplies inventory	Note 2Q	115	107
Prepaid expenses and other current assets		325	349
Total current assets		5,297	4,347
Deposits and other assets		465	468
Property and equipment	Note 4	9,252	8,520
Pension assets	Note 8	1,583	1,153
Deferred income tax	Note 10	472	-
Intangible assets	Note 5	318	315
Goodwill	Note 6	311	311
Total assets		**$ 17,698**	**$ 15,114**
LIABILITIES			
Current			
Accounts payable and accrued liabilities		$ 1,961	$ 1,644
Advance ticket sales		2,428	2,073
Current portion of long-term debt and finance leases	Note 7	671	707
Total current liabilities		5,060	4,424
Long-term debt and finance leases	Note 7	5,448	5,911
Pension and other benefit liabilities	Note 8	2,592	2,436
Maintenance provisions	Note 9	1,003	922
Other long-term liabilities		216	202
Total liabilities		**$ 14,319**	**$ 13,895**
SHAREHOLDERS' EQUITY			
Share capital	Note 11	799	797
Contributed surplus		69	83
Hedging reserve		-	3
Retained earnings		2,511	336
Total shareholders' equity		3,379	1,219
Total liabilities and shareholders' equity		**$ 17,698**	**$ 15,114**

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

On behalf of the Board of Directors:

Vagn Sørensen
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)		2017	2016
Operating revenues			
Passenger	Note 18	$ 14,471	$ 13,148
Cargo	Note 18	650	512
Other		1,131	1,017
Total revenues		**16,252**	**14,677**
Operating expenses			
Aircraft fuel		2,927	2,279
Regional airlines expense	Note 19	2,617	2,408
Wages, salaries and benefits		2,671	2,510
Airport and navigation fees		905	859
Aircraft maintenance		938	894
Depreciation, amortization and impairment		956	816
Sales and distribution costs		777	703
Ground package costs		538	489
Aircraft rent		503	462
Food, beverages and supplies		383	349
Communications and information technology		254	242
Special items	Note 20	30	91
Other		1,389	1,230
Total operating expenses		**14,888**	**13,332**
Operating income		**1,364**	**1,345**
Non-operating income (expense)			
Foreign exchange gain (loss)		120	(38)
Interest income		60	48
Interest expense		(311)	(374)
Interest capitalized		36	58
Net financing expense relating to employee benefits	Note 8	(65)	(76)
Gain on financial instruments recorded at fair value	Note 15	23	4
Gain on sale and leaseback of assets	Note 21	52	19
Gain (loss) on debt settlements and modifications	Note 7	21	(89)
Other		(21)	(20)
Total non-operating expense		**(85)**	**(468)**
Income before income taxes		**1,279**	**877**
Recovery of (provision for) income taxes	Note 10	759	(1)
Net income		**$ 2,038**	**$ 876**
Net income per share	Note 13		
Basic earnings per share		$ 7.48	$ 3.16
Diluted earnings per share		$ 7.34	$ 3.10

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)		2017	2016
Comprehensive income			
Net income		$ 2,038	$ 876
Other comprehensive income, net of tax expense:	Note 10		
Items that will not be reclassified to net income			
Remeasurements on employee benefit liabilities	Note 8	189	412
Items that will be reclassified to net income			
Fuel derivatives designated as cash flow hedges, net	Note 15	(3)	14
Total comprehensive income		**$ 2,224**	**$ 1,302**

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, 2016	$ 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
Net income	-	-	-	2,038	2,038	-	2,038
Remeasurements on employee benefit liabilities	-	-	-	189	189	-	189
Fuel derivatives designated as cash flow hedges, net	-	-	(3)	-	(3)	-	(3)
Total comprehensive income	-	-	(3)	2,227	2,224	-	2,224
Share-based compensation	-	-	-	9	9	-	9
Shares issued (Note 11)	14	(5)	-	-	9	-	9
Shares purchased and cancelled under issuer bid (Note 11)	(12)	-	-	(59)	(71)	-	(71)
Reclassification of equity settled award to cash settled award (Note 21)	-	(9)	-	(2)	(11)	-	(11)
December 31, 2017	$ 799	$ 69	$ -	$ 2,511	$ 3,379	$ -	$ 3,379

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)		2017	2016
Cash flows from (used for):			
Operating			
Net income		$ 2,038	$ 876
Adjustments to reconcile to net cash from operations			
Deferred income tax	Note 10	(775)	-
Depreciation, amortization and impairment		984	839
Foreign exchange gain	Note 15	(183)	(34)
Gain on sale and leaseback of assets	Note 21	(52)	(19)
Loss (gain) on debt settlements and modifications	Note 7	(21)	89
Employee benefit funding less than expense	Note 8	237	299
Financial instruments recorded at fair value	Note 15	(14)	10
Change in maintenance provisions		125	148
Changes in non-cash working capital balances		349	194
Other		50	19
Net cash flows from operating activities		**2,738**	**2,421**
Financing			
Proceeds from borrowings	Note 7	733	2,538
Reduction of long-term debt and finance lease obligations	Note 7	(814)	(2,275)
Shares purchased for cancellation	Note 11	(71)	(94)
Distributions related to aircraft special purpose leasing entities		-	(32)
Issue of shares		9	2
Financing fees	Note 7	(26)	(2)
Net cash flows from (used in) financing activities		**(169)**	**137**
Investing			
Short-term investments		(998)	(99)
Additions to property, equipment and intangible assets		(2,422)	(2,921)
Proceeds from sale of assets		5	352
Proceeds from sale and leaseback of assets	Note 21	740	351
Other		(16)	(9)
Net cash flows used in investing activities		**(2,691)**	**(2,326)**
Effect of exchange rate changes on cash and cash equivalents		**(23)**	**(17)**
Increase (decrease) in cash and cash equivalents		**(145)**	**215**
Cash and cash equivalents, beginning of year		787	572
Cash and cash equivalents, end of year		**$ 642**	**$ 787**

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

For the years ended December 31, 2017 and 2016 (Canadian dollars in millions – except per share amounts)

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 15, 2018.

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.

STRUCTURED ENTITIES

The Corporation had aircraft leasing and other agreements with a number of structured entities. Under IFRS 10 Consolidated Financial Statements, the Corporation controlled and consolidated leasing entities covering nine aircraft as at December 31, 2016. The Corporation concluded that it controlled these entities because the lease or other agreements with these structured entities gave 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. During 2017, all nine aircraft were purchased by the Corporation and the structured entities were collapsed.

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 Aeroplan customers can redeem for air travel or other rewards offered by Aeroplan pursuant to its program.

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 Retained earnings 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 Retained earnings 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.

A prospective change in accounting for PSUs and RSUs was made in 2017 from equity settled instruments to cash settled instruments based on settlement experience. In accounting for cash settled instruments, compensation expense is adjusted for subsequent changes in the fair value of the PSUs and RSUs taking into account forfeiture estimates. The liability related to cash settled PSUs and RSUs is recorded in Other long-term liabilities. 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 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 applies hedge accounting for designated fuel derivatives. 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 Gain on financial instruments recorded at fair value. Refer to Note 15 for the results from fuel hedge accounting.

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 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 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 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 $54 related to spare parts and supplies consumed during the year (2016 – $62).

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 residual values initially estimated at 10%. 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 lesser of eight years or 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 5 years. Ground and other equipment is depreciated over 3 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. Borrowings made specifically for the purpose of obtaining a qualifying asset are excluded from this calculation until substantially all the activities necessary to prepare the asset for its intended use are complete.

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, 2017
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 Ronald 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 narrow-body and wide-body 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. 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 is applying 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 anticipated impact on the consolidated statement of financial position as at January 1, 2017 is an increase to Prepaid expenses and other current assets of $58 and an equivalent increase to opening Retained earnings. In addition, deferred commission costs in the amount of $40 as at December 31, 2016, currently recorded net against the Advance ticket sales liability, will be reclassified to Prepaid expenses and other current assets. The amount of deferred contract cost asset will fluctuate on a quarterly basis in line with changes in the Advance ticket sales liability. The anticipated impact on the consolidated statement of financial position as at December 31, 2017 is an increase to Prepaid expenses and other current assets of $64 and an equivalent increase to opening Retained earnings.

In addition, certain passenger and cargo related fees and surcharges will be reclassified from Other to Passenger revenue and to Cargo revenue on the consolidated statement of operations. Based on the Corporation's full year 2017 results, the amount expected to be reclassified on the adopting of IFRS15 is $122 to Passenger revenue and $58 to Cargo revenue. This reclassification will not have an impact on total operating revenues.

No other material impacts on the Corporation's financial statements were identified from the adoption of IFRS 15.

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 an improved 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 has the option of adopting a full retrospective approach or a modified retrospective approach on transition to IFRS 16.

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 has identified that, under IFRS 16, Air Canada has a lease in respect of aircraft used by CPA carriers providing services under the respective capacity purchase agreements, and Air Canada expects to record such aircraft as right of use assets and lease liabilities of Air Canada in accordance with the requirements of the new standard.

The Corporation will apply the standard effective January 1, 2019 and has not yet determined which method of transition to apply.

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 Note 8 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 and future fair values 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 $13 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. Fair value less costs to dispose may be calculated based upon a discounted cash flow analysis, which requires management to make a number of significant market participant 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, including, among other aspects, historical financial results, and expectations relating to future taxable income, the overall business environment and industry-wide trends. During 2017, Air Canada determined that it was probable that substantially all of the unrecorded deferred income tax assets, which include non-capital losses, would be realized. Refer to Note 10 Income taxes for additional information.

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, 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
Year ended December 31, 2017					
At January 1, 2017	$ 7,030	$ 409	$ 184	$ 897	$ 8,520
Additions	1,769	8	29	573	2,379
Reclassifications	309	62	36	(407)	-
Disposals	(713)	-	-	-	(713)
Depreciation	(852)	(41)	(41)	-	(934)
At December 31, 2017	$ 7,543	$ 438	$ 208	$ 1,063	$ 9,252
At December 31, 2017					
Cost	$ 11,320	$ 899	$ 545	$ 1,063	$ 13,827
Accumulated depreciation	(3,777)	(461)	(337)	-	(4,575)
	$ 7,543	**$ 438**	**$ 208**	**$ 1,063**	**$ 9,252**

As at December 31, 2017, property and equipment included finance leased assets including nine aircraft (2016 – 9) with a net book value of $104 (2016 – $130) and facilities with a net book value of $34 (2016 – $37).

Included in aircraft and flight equipment are 21 aircraft and 14 spare engines (2016 – 21 aircraft and five spare engines) which are leased to CPA carriers with a cost of $387 (2016 – $349) less accumulated depreciation of $142 (2016 – $115) for a net book value of $245 (2016 – $234). Depreciation expense for 2017 for these aircraft and flight equipment amounted to $21 (2016 – $18).

Certain property and equipment are pledged as collateral as further described under the applicable debt instrument in Note 7. There are no impairment values recorded as at December 31, 2017.

5. Intangible Assets

	International Route Rights and Slots	Marketing Based Trade Names	Technology Based (Internally Developed)	Total
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
Year ended December 31, 2017				
At January 1, 2017	$ 97	$ 88	$ 130	$ 315
Additions	-	-	41	41
Amortization	-	-	(38)	(38)
At December 31, 2017	$ 97	$ 88	$ 133	$ 318
At December 31, 2017				
Cost	$ 97	$ 88	$ 458	$ 643
Accumulated amortization	-	-	(325)	(325)
	$ 97	**$ 88**	**$ 133**	**$ 318**

In 2017, technology-based assets with cost of $38 and accumulated amortization of $38 were retired. There were no technology based asset retirements in 2016.

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 cash-generating unit level. On this basis, an impairment review was performed at the narrow-body and wide-body 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 $138 to wide-body and $47 to narrow-body.

The recoverable amount of the cash-generating units has been measured based on the fair value less cost to dispose, using a discounted cash flow model. The discounted cash flow model would represent a level 3 fair value measurement within the IFRS 13 fair value hierarchy. 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 five-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 five-year period are projected to increase consistent with the long-term growth assumption of the airline industry 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 market participant assumptions regarding the Corporation's weighted average cost of capital adjusted for taxes and specific risks associated with the cash-generating unit being tested.

Key assumptions used for the fair value less costs to dispose calculations in fiscal 2017 were as follows:

	2017
Discount rate	12.6%
Long-term growth rate	2.5%
Jet fuel price range per barrel	US$66 – US$79

The recoverable amount of both cash-generating units based on value in use exceeded their respective carrying values by approximately $7,400. Reasonably possible changes in key assumptions would not cause the recoverable amount of each CGU to be less than the carrying value.

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, 2017 and 2016. 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 (%)	2017	2016
Aircraft financing [(a)]				
Fixed rate U.S. dollar financing	2018 – 2027	4.23	$ 2,828	$ 3,598
Floating rate U.S. dollar financing	2018 – 2027	3.25	871	457
Floating rate CDN dollar financing	2026 – 2027	2.08	332	366
Fixed rate Japanese yen financing	2027	1.85	131	-
Floating rate Japanese yen financing	2020 – 2027	0.74	61	70
Senior secured notes – CDN dollar [(b)]	2023	4.75	200	200
Senior unsecured notes – U.S. dollar [(c)]	2021	7.75	503	537
Other secured financing – U.S. dollar [(b)] and [(d)]	2018 – 2023	4.06	1,073	1,175
Other secured financing – CDN dollar	-	8.15	-	44
Long-term debt		**4.16**	**5,999**	**6,447**
Finance lease obligations [(e)]	2018 - 2033	9.46	223	275
Total debt and finance leases		**4.35**	**6,222**	**6,722**
Unamortized debt issuance costs			(103)	(104)
Current portion			(671)	(707)
Long-term debt and finance leases			**$ 5,448**	**$ 5,911**

(a) Aircraft financing (US$2,943, CDN $332 and JPY ¥17,208) (2016 – US$3,021, CDN $366 and JPY ¥6,079) is secured primarily by specific aircraft with a carrying value of $5,230 (2016 – $5,523). 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$303, CDN $332 and JPY ¥4,281 of the financing is supported by a loan guarantee by the Export-Import Bank of the United States ("EXIM").

In December 2017, in connection with the financing of four new Boeing 787-9 and nine new Boeing 737 MAX-8 aircraft scheduled for delivery in 2018, Air Canada completed the closing of a private offering of three tranches of enhanced equipment trust certificates ("EETC") with a combined aggregate face amount of US$719. The private offering was comprised of Class AA certificates, Class A certificates and Class B certificates with final expected maturity dates between 2026 and 2030. The three tranches of certificates have a combined weighted average interest rate of 3.422%. Proceeds from the offering relating to each aircraft are held in escrow until the delivery of the respective aircraft. Financing fees paid in conjunction with the offering in 2017 were $10 and are reported in Financing on the consolidated statement of cash flow, and recorded in Deposits and other assets until delivery of the aircraft.

In 2017, in connection with the acquisition of four Boeing 787-9 aircraft, the Corporation completed a financing, maturing in 2027 and comprised of a principal of US$439 subject to a floating rate, JPY ¥11,743 subject to a fixed rate and JPY ¥1,247 subject to a floating rate. These financings were secured using Japanese Operating Leases with a Call Option ("JOLCO") structures with the transactions recorded as loans and the aircraft as owned for accounting purposes in the Corporation's consolidated financial statements. Financing fees paid in connection with the JOLCO structures were $13 and are reported in Financing on the consolidated statement of cash flow.

During 2017, principal of US$27 was prepaid relating to the financing of one A330 aircraft and principal of US$25 relating to the financing of four Embraer 190 aircraft. A loss of $5 is included in Gain (loss) on debt settlements and modifications related to the prepayment of such fixed rate debt (2016 – principal of US$49 prepaid relating to the financing of six Embraer 190 aircraft with a loss of $7 included in Gain (loss) on debt settlements and modifications).

During 2016, the delivery of seven Boeing 787 aircraft and two Boeing 777 were financed from the proceeds of the EETCs issued through two private offerings in 2015. An amount of US$1,004 was drawn from the proceeds and is included in fixed rate U.S dollar financing in the table above.

(b) In October 2016, as part of a 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 had an initial interest rate of 275 basis points over LIBOR (subject to a LIBOR floor of 75 basis points).

In June 2017, Air Canada completed the repricing of its US$1.1 billion senior secured credit facility, reducing the interest rate by 50 basis points, to an interest rate of 225 basis points over LIBOR (subject to a LIBOR floor of 75 basis points). The Corporation recorded a $27 Gain on debt settlements and modifications related to this transaction.

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 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, 2017, the Corporation had not drawn on the revolving credit facility and the outstanding term loan principal was US$798 (2016 – US$800 principal).

(e) Finance leases, related to facilities and aircraft, total $223 ($64 and US$126) (2016 – $275 ($68 and US$154)). During 2017, the Corporation recorded interest expense on finance lease obligations of $23 (2016 – $27). The carrying value of aircraft and facilities under finance leases amounted to $104 and $34, respectively (2016 – $130 and $37).

Cash interest paid on Long-term debt and finance leases in 2017 by the Corporation was $287 (2016 – $331).

Maturity analysis

Principal and interest repayment requirements as at December 31, 2017 on Long-term debt and finance lease obligations are as follows. U.S. dollar amounts are converted using the December 31, 2017 closing rate of CDN$1.2571.

Principal	2018	2019	2020	2021	2022	Thereafter	Total
Long-term debt obligations	$ 624	$ 487	$ 523	$ 853	$ 243	$ 3,269	**$ 5,999**
Finance lease obligations	47	44	47	16	14	55	**223**
	$ 671	**$ 531**	**$ 570**	**$ 869**	**$ 257**	**$ 3,324**	**$ 6,222**

Interest	2018	2019	2020	2021	2022	Thereafter	Total
Long-term debt obligations	$ 230	$ 210	$ 191	$ 148	$ 127	$ 277	**$ 1,183**
Finance lease obligations	18	14	9	6	5	14	**66**
	$ 248	**$ 224**	**$ 200**	**$ 154**	**$ 132**	**$ 291**	**$ 1,249**

Principal repayments in the table above exclude transaction costs of $103 which are offset against Long-term debt and finance leases in the consolidated statement of financial position.

Cash flows from financing activities

Information on the change in liabilities for which cash flows have been classified as financing activities in the statement of cash flows is presented below.

		Cash Flows			Non-Cash Changes			
	Dec. 31, 2016	Borrowings	Repayments	Financing Fees	Foreign Exchange Adjustments	Amortization of Financing Fees	Other Non-Cash Adjustments	Dec. 31, 2017
Long term debt	$ 6,447	$ 733	$ (766)	$ -	$ (392)	$ -	$ (23)	$ 5,999
Lease liabilities	275	-	(42)	-	(10)	-	-	223
Unamortized debt issuance costs	(104)	-	-	(16)	-	17	-	(103)
Total liabilities from financing activities	**$ 6,618**	**$ 733**	**$ (808)**	**$ (16)**	**$ (402)**	**$ 17**	**$ (23)**	**$ 6,119**

Financing fees of $10 paid in conjunction with the EETC offering in 2017 are reported in Financing on the consolidated statement of cash flow but excluded from this table. These fees are recorded in Deposits and other assets until delivery of the aircraft and related recognition of long-term debt. Loss on debt settlements of $6 is included in Reduction of long-term debt and finance lease obligations on the consolidated statement of cash flow, but excluded from this table.

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.

As at January 1, 2017, the aggregate solvency surplus in the domestic registered pension plans was $1.9 billion. The next required valuation to be made as at January 1, 2018 will be completed in the first half of 2018. With the Corporation's domestic registered pension plans in a solvency surplus position as at January 1, 2017, past service cost payments were not required in 2017. 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 2017 amounted to $81 ($90 employer contribution net of $9 used to fund employer contribution in defined contribution components of the same plans). Pension funding obligations for 2018 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 made in conjunction with the 2014 ACPA collective agreement (related to maximum annual pension per year of service) were or 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 represented 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 are recorded as actuarial gains (losses).

During the year ended December 31, 2017, actuarial losses of $35 (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.

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	
	2017	2016	2017	2016	2017	2016
Non-current assets						
Pension assets	$ 1,583	$ 1,153	$ -	$ -	$ 1,583	$ 1,153
Current liabilities						
Accounts payable and accrued liabilities	-	-	61	62	61	62
Non-current liabilities						
Pension and other benefit liabilities	1,311	1,197	1,281	1,239	2,592	2,436
Net benefit obligation (asset)	**$ (272)**	**$ 44**	**$ 1,342**	**$ 1,301**	**$ 1,070**	**$ 1,345**

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 2018.

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	
	2017	2016	2017	2016
Change in benefit obligation				
Benefit obligation at beginning of year	$ 19,135	$ 18,286	$ 1,301	$ 1,288
Current service cost	265	255	30	32
Past service cost	-	3	-	(8)
Past service cost – special item	-	91	-	-
Interest cost	739	750	51	52
Employees' contributions	81	82	-	-
Benefits paid	(845)	(845)	(47)	(49)
Remeasurements:				
Experience loss (gain)	34	(54)	(45)	(45)
Loss (gain) from change in demographic assumptions	-	8	-	(4)
Loss (gain) from change in financial assumptions	855	668	64	41
Plan settlements	-	(1)	-	-
Foreign exchange loss (gain)	(4)	(108)	(12)	(6)
Total benefit obligation	20,260	19,135	1,342	1,301
Change in plan assets				
Fair value of plan assets at beginning of year	19,438	18,438	-	-
Return on plan assets, excluding amounts included in Net financing expense	1,708	1,049	-	-
Interest income	739	739	-	-
Employer contributions	81	97	47	49
Employees' contributions	81	82	-	-
Benefits paid	(845)	(845)	(47)	(49)
Administrative expenses paid from plan assets	(12)	(11)	-	-
Foreign exchange gain (loss)	1	(111)	-	-
Total plan assets	21,191	19,438	-	-
(Surplus) deficit at end of year	**(931)**	**(303)**	**1,342**	**1,301**
Asset ceiling / additional minimum funding liability	659	347	-	-
Net benefit obligation (asset)	**$ (272)**	**$ 44**	**$ 1,342**	**$ 1,301**

The actual return on plan assets was $2,447 (2016 – $1,788).

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

	2017	2016
Domestic registered plans	$ 3	$ 1
International plans	78	92
Supplementary plans	1,230	1,104
	$ 1,311	**$ 1,197**

The weighted average duration of the defined benefit obligation is 14.3 years (2016 – 14.2 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	
	2017	2016	2017	2016
Consolidated Statement of Operations				
Components of cost				
Current service cost	$ 265	$ 255	$ 30	$ 32
Past service cost	-	3	-	(8)
Past service cost – special item	-	91	-	-
Plan settlements	-	(1)	-	-
Administrative and other expenses	12	11	-	-
Actuarial gains, including foreign exchange	-	-	(7)	(14)
Total cost recognized in Wages, salaries and benefits	**$ 277**	**$ 359**	**$ 23**	**$ 10**
Net financing expense relating to employee benefits	**$ 14**	**$ 24**	**$ 51**	**$ 52**
Total cost recognized in statement of operations	**$ 291**	**$ 383**	**$ 74**	**$ 62**
Consolidated Other Comprehensive (Income) Loss				
Remeasurements:				
Experience loss (gain), including foreign exchange	29	(51)	(50)	(37)
Loss (gain) from change in demographic assumptions	-	8	-	(4)
Loss (gain) from change in financial assumptions	855	668	64	41
Return on plan assets	(1,708)	(1,049)	-	-
Minimum funding liability	299	12	-	-
Total cost (income) recognized in OCI	**$ (525)**	**$ (412)**	**$ 14**	**$ -**

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

	2017	2016
Net defined pension and other future employee benefits expense recorded in the consolidated statement of operations		
Wages, salaries and benefits	$ 300	$ 369
Net financing expense relating to employee benefit liabilities	65	76
	$ 365	**$ 445**
Employee benefit funding by Air Canada		
Pension benefits	$ 81	$ 97
Other employee benefits	47	49
	$ 128	$ 146
Employee benefit funding less than expense	**$ 237**	**$ 299**

Composition of Defined Benefit Pension Plan assets

DOMESTIC REGISTERED PLANS

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

	2017	2016	Target Allocation
Bonds	70%	60%	60%
Canadian equities	3%	7%	7%
Foreign equities	7%	13%	13%
Alternative investments	20%	20%	20%
	100%	100%	100%

For the Domestic Registered Plan assets, approximately 80% of assets as of December 31, 2017 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 17,646,765 (2016 – 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 $457 at December 31, 2017 (2016 – $241), 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. As permitted under the investment policy, the actual asset mix may deviate from the target allocation from time to time. The deviations at December 31, 2017 are within the limits established in the investment policy. 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, 2017, 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, 2017, 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	
	2017	2016	2017	2016
Discount rate used to determine:				
Net interest on the net benefit obligation for the year ended December 31	3.9%	4.1%	3.9%	4.1%
Service cost for the year end December 31	4.1%	4.3%	4.1%	4.3%
Accrued benefit obligation as at December 31	3.6%	3.9%	3.6%	3.9%
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 for calculating the liability recognized in the consolidated statement of financial position.

Sensitivity analysis on 2017 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	23	(17)
	$ 42	**$ (35)**
Increase (decrease) in pension obligation	**$ 723**	**$ (699)**

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, 2017, 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 $492.

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 2017 (2016 – 5.8%). The rate is assumed to decrease gradually to 5% by 2020 (2016 – assumed to decrease gradually to 5% by 2020). A one percentage point increase in assumed health care trend rates would have increased the total of current service and interest costs by $5 and the obligation by $64. 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 $65.

A 0.25 percentage point decrease in discount rate for other employee future benefits 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 $44.

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, $9 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 2017 (2016 – $4).

The Corporation's expense for these pension plans amounted to $21 for the year ended December 31, 2017 (2016 – $15). 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 2018 are $16.

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, 2016				
Current	$ 93	$ -	$ 18	$ 111
Non-current	922	25	-	947
	$ 1,015	**$ 25**	**$ 18**	**$ 1,058**
Provisions arising during the year	$ 159	$ -	$ -	$ 159
Amounts disbursed	(8)	-	-	(8)
Changes in estimated costs	(46)	4	(1)	(43)
Accretion expense	19	1	-	20
Foreign exchange gain	(68)	-	-	(68)
At December 31, 2017	**$ 1,071**	**$ 30**	**$ 17**	**$ 1,118**
Current	$ 68	$ -	$ 17	$ 85
Non-current	1,003	30	-	1,033
	$ 1,071	**$ 30**	**$ 17**	**$ 1,118**

(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 2018 to 2029 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 $52 at December 31, 2017 and an increase to maintenance expense in 2018 of approximately $7. Expected future cash flows to settle the obligation are discounted. 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 $16 at December 31, 2017. An equivalent but opposite movement in the discount rate would result in a similar impact in the opposite direction.

(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 2018 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

Income tax recorded in the consolidated statement of operations is presented below.

	2017	2016
Current income tax	$ 16	$ 1
Deferred income tax	(775)	-
Income tax expense (recovery)	**$ (759)**	**$ 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:

	2017	2016
Income before income taxes	$ 1,279	$ 877
Statutory income tax rate based on combined federal and provincial rates	26.60%	27.03%
Income tax expense based on statutory tax rates	**340**	**237**
Effects of:		
Non-taxable portion of capital gains	(52)	(17)
Non-deductible expenses	24	15
Income not subject to tax	-	(3)
Tax rate changes on deferred income taxes	9	(3)
Recognition of previously unrecognized deferred income tax assets	(1,076)	(228)
Other	(4)	-
Income tax expense (recovery)	**$ (759)**	**$ 1**

The applicable statutory tax rate is 26.60% (2016 – 27.03%). The Corporation's applicable tax rate is the Canadian combined rates applicable in the jurisdictions in which the Corporation operates. The decrease is mainly due to corporate income tax decreases in Quebec, Saskatchewan and the Yukon, as well as changes in the level of activity by province.

Income tax recorded in the consolidated statement of comprehensive income is presented below.

	2017	2016
Remeasurements on employee benefit liabilities - deferred income tax	$ 322	$ -
Income tax expense	**$ 322**	**$ -**

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

	2017	2016
Other comprehensive income before income taxes	$ 508	$ 426
Statutory income tax rate based on combined federal and provincial rates	26.60%	27.03%
Income tax expense based on statutory tax rates	**135**	**115**
Effects of:		
Recognition of previously unrecognized deferred income tax liability	184	-
Unrecognized deferred income tax liability	-	(115)
Other	3	-
Income tax expense in other comprehensive income	**$ 322**	**$ -**

Income tax recorded in shareholders' equity is presented below.

	2017	2016
Share-based compensation	$ (19)	$ -
Income tax recovery	**$ (19)**	**$ -**

Deferred income tax

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, including historical financial results and expectations relating to future taxable income, the overall business environment and industry-wide trends.

During 2017, Air Canada determined that it was probable that substantially all of the deferred income tax assets, which include non-capital losses, would be realized.

Deferred tax assets and liabilities of $472 are recorded net as a noncurrent deferred income tax asset on the consolidated statement of financial position. 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 (2016 – $49) is not expected to reverse until the assets are disposed of, become impaired or amortizable. As a result, this recognized net deferred income tax liability of $49 is included in Other long-term liabilities.

The significant components of deferred income tax assets and liabilities were as follows:

	2017	2016
Deferred income tax assets		
Non-capital losses	$ 649	$ 540
Post-employment obligations	286	-
Accounting provisions not currently deductible for tax	61	-
Investment tax credits and recoverable taxes	31	-
Other	34	-
	1,061	540
Deferred income tax liabilities		
Property and equipment book basis over tax basis	(554)	(500)
Intangible assets	(49)	(49)
Other	(35)	(40)
	(638)	(589)
Net recognized deferred income tax assets (liabilities)	**423**	**(49)**
Balance sheet presentation		
Deferred income tax assets	472	-
Deferred income tax liabilities included in Other long-term liabilities	(49)	(49)
Net recognized deferred income tax assets (liabilities)	**423**	**(49)**

The following table presents the variation of the components of deferred income tax balances:

	January 1, 2017	2017 Income Statement Movement	2017 OCI Movement	2017 Equity Movement	December 31, 2017
Non-capital losses	$ 540	$ 91	$ -	$ 18	$ 649
Post-employment obligations	-	608	(322)	-	286
Accounting provisions not currently deductible for tax	-	60	-	1	61
Investment tax credits and recoverable taxes	-	31	-	-	31
Other deferred tax assets	-	34	-	-	34
Property and equipment book basis over tax basis	(500)	(54)	-	-	(554)
Intangible assets	(49)	-	-	-	(49)
Other deferred tax liabilities	(40)	5	-	-	(35)
Total recognized deferred income tax assets (liabilities)	**$ (49)**	**$ 775**	**$ (322)**	**$ 19**	**$ 423**

At December 31, 2017, the Corporation has deductible temporary differences of a capital nature for which no deferred income tax asset has been recognized at this time as the ability to utilize these tax attributes is limited to future taxable capital gains. Net capital losses do not have an expiry date.

The following are the temporary differences and tax loss carryforwards for which no deferred income tax assets could be recognized:

	2017	2016
Total non-capital losses carryforwards	$ -	$ 3,061
Less: Recognized property and equipment book basis over tax basis	-	(1,853)
Less: Recognized other taxable temporary differences	-	(148)
Unrecognized non-capital losses carryforwards	-	1,060
Post-employment obligations	-	1,334
Accounting provisions not currently deductible for tax	-	271
Unrealized foreign exchange losses	62	266
Unrecognized net capital losses carryforwards	40	171
Other	-	304
Total unrecognized net temporary differences	**$ 102**	**$ 3,406**
Deferred income tax rate based on combined federal and provincial rates	26.79%	26.97%
Total unrecognized net deferred income tax assets	**27**	**919**

The following are the Federal non-capital tax losses expiry dates:

	Tax Losses
2029	$ 257
2030	39
2031	865
2032	523
2033	403
2034	3
2035	244
2036	3
2037	1
Non-capital losses carryforwards	**$ 2,338**

Cash income taxes paid in 2017 by the Corporation were $1 (2016 – nil).

11. Share Capital

	Number of Shares	Value
At January 1, 2016	**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**
Shares issued on the exercise of stock options	3,906,662	14
Shares purchased and cancelled under issuer bid	(4,042,818)	(12)
At December 31, 2017	**273,076,646**	**$ 799**

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

		2017	2016
Issued and outstanding			
Class A variable voting shares		115,986,084	86,657,994
Class B voting shares		157,090,562	186,554,808
Total issued and outstanding		**273,076,646**	**273,212,802**
Potential shares			
Stock options	Note 12	6,121,252	8,985,958
Total outstanding and potentially issuable shares		**279,197,898**	**282,198,760**

Shares

As at December 31, 2017, 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 2020 annual meeting of shareholders, one right (a "Right") is issued with respect to each Share of Air Canada issued and outstanding. 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 105 days (or such shorter minimum period determined in accordance with National Instrument 62-104 – Take-Over Bids and Issuer Bids ("NI 62-104")), (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 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

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 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. The excess of the cost over the average book value of $63 was charged to Retained earnings.

In May 2017, Air Canada received approval from the Toronto Stock Exchange ("TSX") for the renewal of its normal course issuer bid, authorizing, between May 31, 2017 and May 30, 2018, the purchase of up to 22,364,183 Shares, representing 10% of the public float as at May 17, 2017. The renewal followed the conclusion of the 2016 normal course issuer bid which expired on May 29, 2017.

In 2017, the Corporation purchased, for cancellation, 4,042,818 Shares at an average cost of $17.49 per Share for aggregate consideration of $71. The excess of the cost over the average book value of $59 was charged to Retained earnings. At December 31, 2017, a total of 20,718,565 Shares remain available for repurchase under the existing 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 stock options, performance share units and restricted share units to senior management and officers of Air Canada. 19,381,792 Shares are authorized for issuance under the Long-term Incentive Plan of which 9,607,273 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 Long-term Incentive Plan specifies 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:

	2017	2016
Compensation expense ($ millions)	$ 6	$ 5
Number of stock options granted to Air Canada employees	1,219,976	1,570,720
Weighted average fair value per option granted ($)	$ 6.14	$ 3.71
Aggregated fair value of options granted ($ millions)	$ 7	$ 6
Weighted average assumptions:		
Share price	$ 14.85	$ 9.12
Risk-free interest rate	0.86%-1.89%	0.42%-0.98%
Expected volatility	39.6%-49.3%	50.0%-52.0%
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:

	2017		2016	
	Options	Weighted Average Exercise Price/ Share	Options	Weighted Average Exercise Price/ Share
Beginning of year	8,985,958	$ 4.92	8,735,634	$ 3.69
Granted	1,219,976	14.73	1,570,720	9.27
Exercised	(3,906,662)	2.30	(1,169,436)	1.84
Expired or cancelled	(35,148)	4.89	(65,441)	1.35
Forfeited	(142,872)	8.36	(85,519)	4.25
Outstanding options, end of year	**6,121,252**	**$ 8.46**	**8,985,958**	**$ 4.92**
Options exercisable, end of year	**2,348,815**	**$ 4.29**	**3,737,782**	**$ 2.42**

The weighted average Share price on the date of exercise for options exercised in 2017 was $19.77 (2016 – $12.04).

		2017 Outstanding Options			2017 Exercisable Options	
Range of Exercise Prices	Expiry Dates	Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/ Share	Number of Exercisable Options	Weighted Average Exercise Price/ Share
$2.34	2018	-	1	$ -	-	$ -
$0.96	2019	40,604	2	0.96	40,604	0.96
$2.49 – $5.69	2020	1,711,049	3	2.89	1,711,049	2.89
$5.35 – $8.27	2021	818,126	4	5.43	257,165	5.44
$12.27 – $12.64	2022	852,965	5	12.56	157,649	12.64
$9.23 – $9.61	2023	1,481,246	6	9.27	182,348	9.27
$12.83 – $26.40	2024	1,217,262	7	14.74	-	-
		6,121,252		**$ 8.46**	**2,348,815**	**$ 4.29**

		2016 Outstanding Options			2016 Exercisable Options	
Range of Exercise Prices	Expiry Dates	Number of Options Outstanding	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price/ Share	Number of Exercisable Options	Weighted Average Exercise Price/ Share
$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**

Performance and restricted share units

The Long-term Incentive Plan also includes performance share units ("PSUs") and restricted share units ("RSUs"). 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 2017 was $33 (2016 – $9). The increase in compensation expense related to the PSUs and RSUs is mainly related to the increase in the Share price during 2017 and the change in accounting from equity settled instruments to cash settled instruments as described in Note 2I).

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

	2017	2016
Beginning of year	3,052,028	3,930,051
Granted	922,716	1,198,745
Settled	(1,098,067)	(2,021,095)
Forfeited	(170,416)	(55,673)
Outstanding share units, end of year	**2,706,261**	**3,052,028**

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 2017 contributions, Air Canada will match 33.33% of the contributions made by employees. During 2017, the Corporation recorded compensation expense of $8 (2016 – $10) related to the Employee Share Purchase Plan.

13. Earnings Per Share

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

(in millions, except per share amounts)	2017	2016
Numerator:		
Numerator for basic and diluted earnings per share:		
Net income	$ 2,038	$ 876
Denominator:		
Weighted-average shares	273	277
Effect of potential dilutive securities:		
Stock options	5	5
Total potential dilutive securities	5	5
Adjusted denominator for diluted earnings per share	**278**	**282**
Basic earnings per share	**$ 7.48**	**$ 3.16**
Diluted earnings per share	**$ 7.34**	**$ 3.10**

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

Excluded from the 2017 calculation of diluted earnings per Share were 101,000 (2016 – 1,352,000) 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, 2017. The Corporation has various operating lease agreements for aircraft, equipment and other property. U.S. dollar amounts are converted using the December 31, 2017 closing rate of CDN$1.2571. Minimum future commitments under these contractual arrangements are shown below.

	2018	2019	2020	2021	2022	Thereafter	Total
Capital commitments	$ 1,821	$ 1,353	$ 1,334	$ 1,016	$ 565	$ -	**$ 6,089**
Operating leases							
Aircraft	509	443	329	242	182	643	**2,348**
Other property	97	77	68	46	28	239	**555**
Total	**$ 2,427**	**$ 1,873**	**$ 1,731**	**$ 1,304**	**$ 775**	**$ 882**	**$ 8,992**

The Corporation leases and subleases certain aircraft and spare engines to Jazz, Sky Regional and Air Georgian, which are charged back to Air Canada through their respective CPAs. These are reported net on the consolidated statement of operations. The leases and subleases relate to five Bombardier Q400 aircraft, 12 CRJ-200 aircraft, 25 Embraer 175 aircraft, and 14 spare engines. The lease and sublease revenue and expense related to these aircraft and engines each amount to $92 in 2017 (2016 – $77).

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. The subleases with Jazz have the same terms and maturity as the Corporation's corresponding lease commitments to the lessors. These subleases relate to five Bombardier Q400 aircraft, 10 Bombardier CRJ-200 aircraft, and 15 Bombardier CRJ-705 aircraft which have final maturities ranging from 2021 to 2025. The sublease revenue and lease expense related to these aircraft each amounted to $81 in 2017 (2016 – $81). 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, 2017 closing rate of CDN$1.2571, as follows:

	2018	2019	2020	2021	2022	Thereafter	Total
Jazz flow – through leases	$ 75	$ 75	$ 75	$ 66	$ 51	$ 64	**$ 406**

Other contractual commitments

The CPSA between the Corporation and Aimia Inc. imposes a requirement for the Corporation to purchase a minimum number of Aeroplan Miles® from Aimia. The estimated minimum requirement for 2018 is $214. 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 2017, the Corporation purchased $263 of Aeroplan Miles® from Aimia.

The future minimum non-cancellable commitment for the next 12 months under the Jazz CPA is approximately $1,196 and under the capacity purchase agreements with other regional carriers is $270.

15. Financial Instruments and Risk Management

Summary of financial instruments

	Carrying Amounts				
	December 31, 2017				
	Financial Instruments Classification				
	Fair Value Through Profit and Loss	Assets at Amortized Cost	Liabilities at Amortized Cost	Total	December 31, 2016
Financial Assets					
Cash and cash equivalents	$ 642	$ -	$ -	$ 642	$ 787
Short–term investments	3,162	-	-	3,162	2,192
Restricted cash	148	-	-	148	126
Accounts receivable	-	814	-	814	707
Prepaid expenses and other current assets					
Collateral on aircraft financing	-	24	-	24	-
Deposits and other assets					
Restricted cash	186	-	-	186	188
Aircraft related and other deposits	-	128	-	128	145
Derivative instruments					
Fuel derivatives	-	-	-	-	14
Share forward contracts	54	-	-	54	40
Foreign exchange derivatives	-	-	-	-	26
	$ 4,192	**$ 966**	**$ -**	**$ 5,158**	**$ 4,225**
Financial Liabilities					
Accounts payable	$ -	$ -	$ 1,668	$ 1,668	$ 1,545
Foreign exchange derivatives	215	-	-	215	21
Current portion of long–term debt and finance leases	-	-	671	671	707
Long–term debt and finance leases	-	-	5,448	5,448	5,911
	$ 215	**$ -**	**$ 7,787**	**$ 8,002**	**$ 8,184**

Summary of gain on financial instruments recorded at fair value

	2017	2016
Share forward contracts	$ 26	$ 9
Fuel derivatives	(3)	-
Prepayment option on senior secured notes	-	(5)
Gain on financial instruments recorded at fair value	**$ 23**	**$ 4**

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 an economic hedge and offset by changes in cash flows of the relevant risk being hedged.

The fair values of derivative 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 such as discounted cash flow analysis are applied. 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 2017:

- Hedging gains on the settlement of fuel derivatives of $26 and the associated premium costs of $28, for a net hedging loss of $2 were reclassified from other comprehensive income to Aircraft fuel expense (net fuel hedging loss of $23 was reclassified from other comprehensive income to Aircraft fuel expense in 2016). No hedge ineffectiveness was recorded.
- The Corporation purchased crude-oil call options covering a portion of 2017 fuel exposure. The cash premium related to these contracts was $18 ($34 in 2016 for 2016 and 2017 exposures).
- Fuel derivative contracts cash settled with a fair value of $26 in favour of the Corporation ($23 in favour of the Corporation in 2016).

As at December 31, 2017, there are no outstanding fuel derivatives. The fair value of the fuel derivatives portfolio was $14 in favour of the Corporation as at December 31, 2016 and 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 2017, these net operating cash inflows totaled approximately US$3.6 billion. Also in 2017, U.S. denominated operating costs amounted to approximately US$5.4 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$1.6 billion. For 2017, this resulted in a U.S. dollar net cash flow exposure of approximately US$3.4 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, 2017 amounted to $686 (US$542) ($560 (US$416) as at December 31, 2016). 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 2017, a loss of $58 (loss of $25 in 2016) 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, 2017, as further described below, approximately 74% of net U.S. cash outflows are hedged for 2018 and 38% for 2019, resulting in derivative coverage of 64% over the next 18 months. Operational U.S. dollar cash and investment reserves combined with derivative coverage results in 69% coverage.

As at December 31, 2017, the Corporation had outstanding foreign currency options and swap agreements, settling in 2018 and 2019, to purchase at maturity $3,400 (US$2,704) of U.S. dollars at a weighted average rate of $1.2703 per US$1.00 (2016 – $2,612 (US$1,946) with settlements in 2017 and 2018 at a weighted average rate of $1.2898 per $1.00 U.S. dollar). The Corporation also has protection in place to sell a portion of its excess Euros, Sterling, YEN, YUAN and AUD (EUR €101, GBP £105, JPY ¥8,623, CNY ¥41 and AUD $32) which settle in 2018 at weighted average rates of €1.1664, £1.3259, ¥0.0090, ¥0.1468 and $0.7576 per $1.00 U.S. dollar, respectively (as at December 31, 2016 - EUR €82, GBP £69, JPY ¥2,334, CNY ¥53 and AUD $33 with settlement in 2017 at weighted average rates of €1.1059, £1.2589, ¥0.0096, ¥0.1522 and $0.7500, respectively per $1.00 U.S. dollar).

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, 2017 was $215 in favour of the counterparties (2016 – $5 in favour of the Corporation). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. During 2017, a loss of $274 was recorded in Foreign exchange gain (loss) related to these derivatives (2016 – $136 loss). In 2017, foreign exchange derivative contracts cash settled with a net fair value of $55 in favour of the counterparties ($51 in 2016 in favour of the counterparties). The total combined loss, related to U.S. cash, investments and foreign exchange derivatives recorded by the Corporation in 2017 was $332 ($160 loss in 2016).

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, 2017 is 73% fixed and 27% floating (76% and 24%, respectively as at December 31, 2016).

SHARE-BASED COMPENSATION RISK

The Corporation issues RSUs and PSUs to certain of its employees, as described in Note 12, which 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.

To hedge the Share price exposure, the Corporation entered into share forward contracts to hedge PSUs and RSUs that may vest between 2018 and 2020, subject to the terms of vesting including realization of performance vesting criteria. The forward dates for the share forward contracts coincide with the vesting terms and planned settlement dates of 2,073,433 PSUs and RSUs from 2018 to 2020. These contracts were not designated as hedging instruments for accounting purposes. Accordingly, changes in the fair value of these contracts are recorded in Gain on financial instruments recorded at fair value in the period in which they arise. During 2017, a gain of $26 was recorded (2016 – gain of $9). Share forward contracts cash settled with a fair value of $12 in favour of the Corporation in 2017 (2016 – $10). As at December 31, 2017, the fair value of the share forward contracts is $54 in favour of the Corporation (2016 – $40 in favour of the Corporation), with those contracts maturing in 2018 valued at $17 recorded in Prepaid expenses and other current assets and the remainder of $37 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, 2017, unrestricted liquidity was $4,181 comprised of Cash and cash equivalents and Short-term investments of $3,804 and undrawn lines of credit of $377. 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 $30 pertaining to investments with original maturities of three months or less at December 31, 2017 ($110 as at December 31, 2016).

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, 2017, 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 government in Canada, and major corporations. Accounts receivable are generally the result of sales of passenger tickets to individuals, often through the use of major credit cards, through geographically dispersed travel agents, corporate outlets, or other airlines. Similarly, accounts receivable related to cargo revenues relate to accounts from a large number of geographically dispersed customers. 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, 2017. 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, 2017 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		Foreign Exchange Rate Risk (1)		Other Price Risk (2)	
	Income		Income		Income	
	1% Increase	1% Decrease	5% Increase	5% Decrease	10% Increase	10% Decrease
Cash and cash equivalents	$ 6	$ (6)	$ (13)	$ 13	$ -	$ -
Short–term investments	$ 32	$ (32)	$ (21)	$ 21	$ -	$ -
Aircraft related deposits	$ -	$ -	$ (5)	$ 5	$ -	$ -
Long-term debt and finance leases	$ (23)	$ 23	$ 282	$ (282)	$ -	$ -
Share forward contracts	$ -	$ -	$ -	$ -	$ 5	$ (5)
Foreign exchange derivatives	$ -	$ -	$ (167)	$ 372	$ -	$ -

(1) 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 $10 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.

(2) 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 2017, the Corporation made no cash deposits under these agreements (nil in 2016).

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 $6,233 compared to its carrying value of $6,119.

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.

		Fair Value Measurements at Reporting Date Using:		
Recurring measurements	**December 31, 2017**	**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	$ 30	$ -	$ 30	$ -
Short–term investments	3,162	-	3,162	-
Derivative instruments				
Share forward contracts	54	-	54	-
Total	**$ 3,246**	**$ -**	**$ 3,246**	**$ -**
Financial Liabilities				
Derivative instruments				
Foreign exchange derivatives	215	-	215	-
Total	**$ 215**	**$ -**	**$ 215**	**$ -**

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 2017.

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 $75 as at December 31, 2017 ($81 as at December 31, 2016). 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, 2017 and 2016, 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	
Financial assets	**Gross Assets**	**Gross Liabilities Offset**	**Net Amounts Presented**	**Financial Instruments**	**Net**
December 31, 2017					
Derivative assets	$ -	$ -	$ -	$ 54	$ 54
Accounts receivable	114	(48)	66	-	66
	$ 114	**$ (48)**	**$ 66**	**$ 54**	**$ 120**
December 31, 2016					
Derivative assets	$ 58	$ (32)	$ 26	$ 52	$ 78
Accounts receivable	103	(47)	56	-	56
	$ 161	**$ (79)**	**$ 82**	**$ 52**	**$ 134**

	Amounts Offset			Amounts Not Offset	
Financial liabilities	**Gross Assets**	**Gross Liabilities Offset**	**Net Amounts Presented**	**Financial Instruments**	**Net**
December 31, 2017					
Derivative liabilities	$ 286	$ (71)	$ 215	$ -	$ 215
	$ 286	**$ (71)**	**$ 215**	**$ -**	**$ 215**
December 31, 2016					
Derivative liabilities	$ 32	$ (11)	$ 21	$ (2)	$ 19
	$ 32	**$ (11)**	**$ 21**	**$ (2)**	**$ 19**

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 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 Euros (approximately $29) was imposed on Air Canada in 2010. Air Canada appealed the decision and the European General Court granted Air Canada's appeal in 2015 and annulled the decision of the European Union with regard to Air Canada and certain other airlines, following which the European Commission refunded 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.

In March 2017, the Commission issued a new decision, based on the same allegations and imposed the same fine (21 Euros; approximately $30) on Air Canada as it had in 2010. Air Canada recorded the charge as a Special item in the first quarter of 2017, and paid the fine, as required, in the second quarter of 2017, pending the outcome of an appeal it made in 2017 to the European General Court. While Air Canada cannot predict with certainty the outcome of its appeal or any related proceedings, Air Canada believes it has reasonable grounds to challenge the European Commission's ruling.

As at December 31, 2017, Air Canada has a provision of $17 ($17 as at December 31, 2016) 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-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 three 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 $529 as at December 31, 2017 (December 31, 2016 – $487), 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, 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 targeted leverage ratios determined by management to be prudent;
- To ensure capital allocation decisions generate sufficient returns and to assess the efficiency with which the Corporation allocates its capital to generate returns.
- 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 or amount of capital utilized, including purchase versus debt financing 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:

	2017	2016
Long-term debt and finance leases	$ 5,448	$ 5,911
Current portion of long-term debt and finance leases	671	707
	6,119	6,618
Capitalized operating leases	3,801	3,451
Adjusted debt	9,920	10,069
Market capitalization	7,067	3,735
Total Capital	**$ 16,987**	**$ 13,804**
Adjusted debt	$ 9,920	$ 10,069
Less Cash and cash equivalents and Short-term investments	(3,804)	(2,979)
Adjusted net debt	**$ 6,116**	**$ 7,090**

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:

Passenger Revenue	2017	2016
Canada	$ 4,582	$ 4,426
U.S. transborder	3,164	2,879
Atlantic	3,517	3,026
Pacific	2,192	1,985
Other	1,016	832
	$ 14,471	**$ 13,148**

Cargo Revenue	2017	2016
Canada	$ 75	$ 63
U.S. transborder	35	29
Atlantic	213	187
Pacific	271	193
Other	56	40
	$ 650	**$ 512**

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, India, the Middle East and North Africa. 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 Central and South America and the Caribbean and Mexico.

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:

	2017	2016
Capacity purchase fees	$ 1,267	$ 1,199
Aircraft fuel	412	327
Airport and navigation fees	293	290
Sales and distribution costs	146	142
Other operating expenses	499	450
Regional airlines expense	**$ 2,617**	**$ 2,408**

20. Special Items

Special items recorded within operating expenses consist of the following:

	2017	2016
Labour agreements	$ -	$ 91
Litigation	30	-
Special items	**$ 30**	**$ 91**

In 2017, the Corporation recorded $30 related to cargo investigations, as described in Note 16, and paid the fine to the European Commission as required, pending the outcome of its appeal.

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.

21. Sale-Leaseback

During 2017, the Corporation took delivery of four 787 aircraft that were financed under sale-leaseback transactions with proceeds of $740. The sales were at fair value and accordingly the resulting gain on sale of $52 was recognized in non-operating income. The leases are accounted for as operating leases with 12 year terms, paid monthly.

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.

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 Financial Officer, President, Passenger Airlines, and Executive Vice-President and Chief Commercial Officer. Amounts reported are based upon the expense as reported in the consolidated financial statements. Compensation to key management is summarized as follows:

	2017	2016
Salaries and other benefits	$ 11	$ 11
Pension and post-employment benefits	5	3
Share-based compensation [a]	18	10
	$ 34	**$ 24**

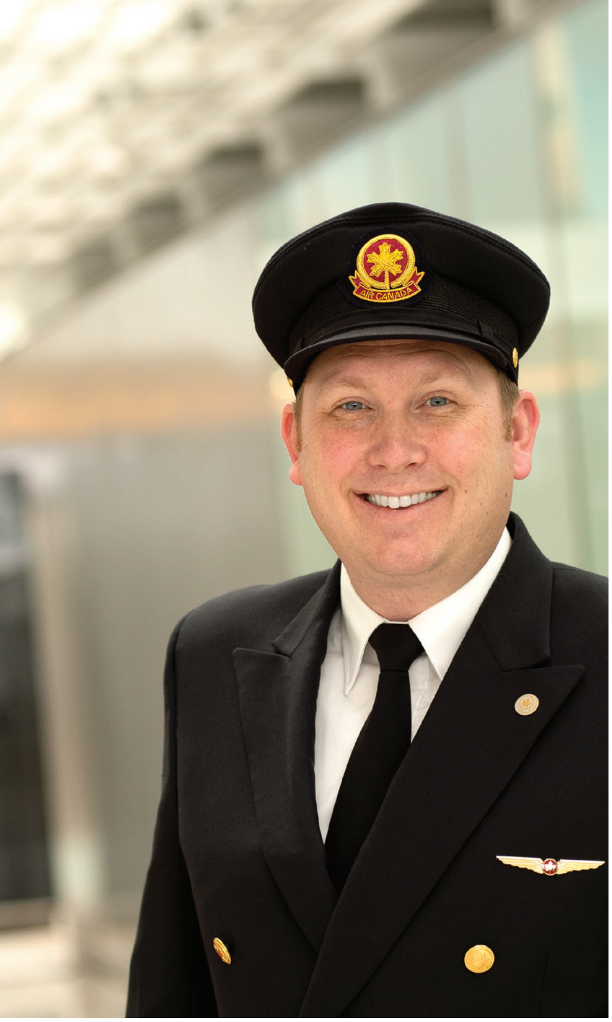
(a) The increase in share-based compensation expense is mainly related to the change to the cash settled method of accounting for PSUs and RSUs as described in Note 2I, the increase in the Air Canada Share price during 2017 and its impact on the share unit compensation plans.

Directors

Christie J.B. Clark	Corporate Director, Toronto, Ontario
Rob Fyfe	Corporate Director, Auckland, New Zealand
Michael M. Green	Chief Executive Officer and Managing Director, Tenex Capital Management, Radnor, Pennsylvania
Jean Marc Huot	Partner, Stikeman Elliott LLP, Montreal, Quebec
Madeleine Paquin	President and Chief Executive Officer, Logistec Corporation, Montreal, Quebec
Roy J. Romanow	Senior Fellow, Public Policy, University of Saskatchewan, Saskatoon, Saskatchewan
Calin Rovinescu	President and Chief Executive Officer, Air Canada, Montreal, Quebec
Vagn Sørensen	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

Officers

Vagn Sørensen	Chairman of the Board
Calin Rovinescu	President and Chief Executive Officer
Benjamin M. Smith	President, Passenger Airlines
Lucie Guillemette	Executive Vice President and Chief Commercial Officer
Michael Rousseau	Executive Vice President and Chief Financial Officer
Catherine Dyer	Senior Vice President and Chief Information Officer
Kevin C. Howlett	Senior Vice President, Regional Markets and Government Relations
Amos Kazzaz	Senior Vice President, Finance
Craig Landry	Senior Vice President, Revenue Optimization
Arielle Meloul-Wechsler	Senior Vice President, People, Culture and Communications
David J. Shapiro	Senior Vice President, International and Regulatory Affairs and Chief Legal Officer
Richard Steer	Senior Vice President, Operations
Duncan Bureau	Vice President, Global Sales
Samuel Elfassy	Vice President, Safety
Mark Galardo	Vice President, Network Planning
Carolyn M. Hadrovic	Vice President and Corporate Secretary
Chris Isford	Vice President and Controller
John MacLeod	Vice President, Commercial Strategy
Mark Nasr	Vice President, Loyalty and eCommerce
Kevin O'Connor	Vice President, System Operations Control
Al Read	Vice President, Airports – North America
Renee Smith-Valade	Vice President, In-Flight Service
Tim Strauss	Vice President, Cargo
Murray Strom	Vice President, Flight Operations
Jon Turner	Vice President, Maintenance
Andrew Yiu	Vice President, Product

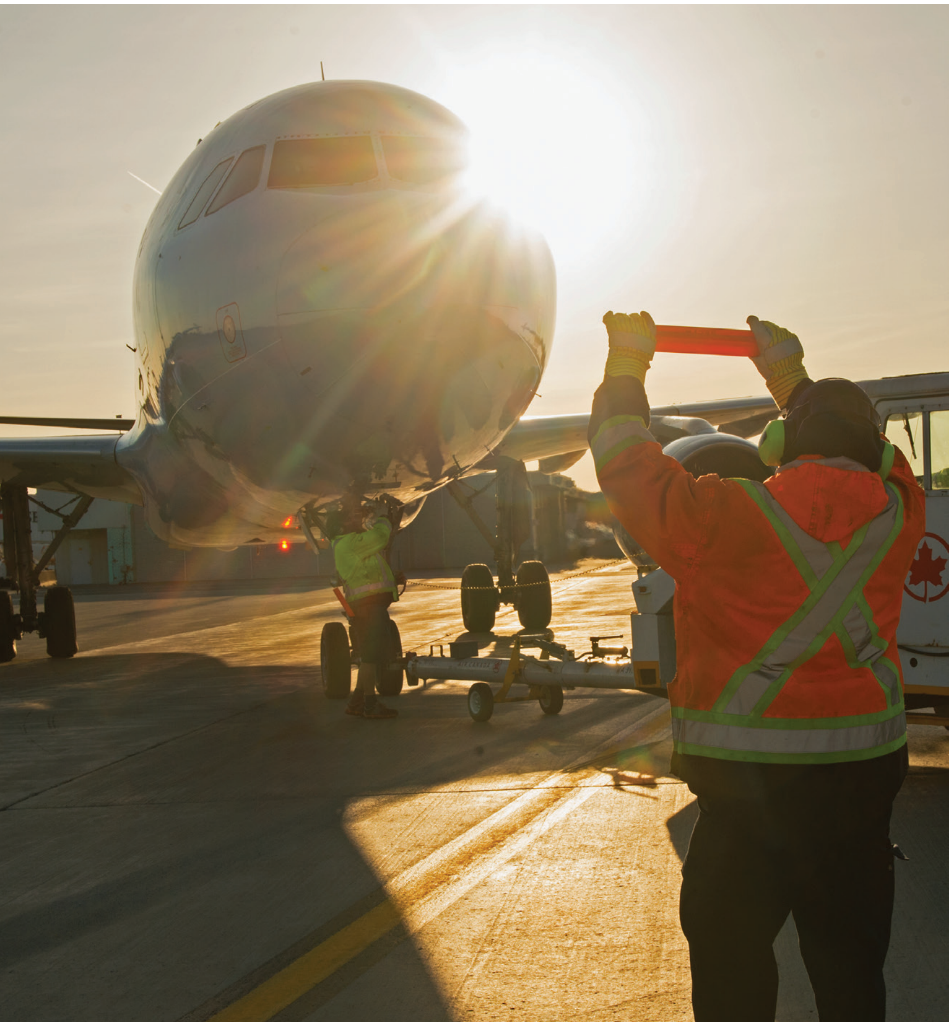


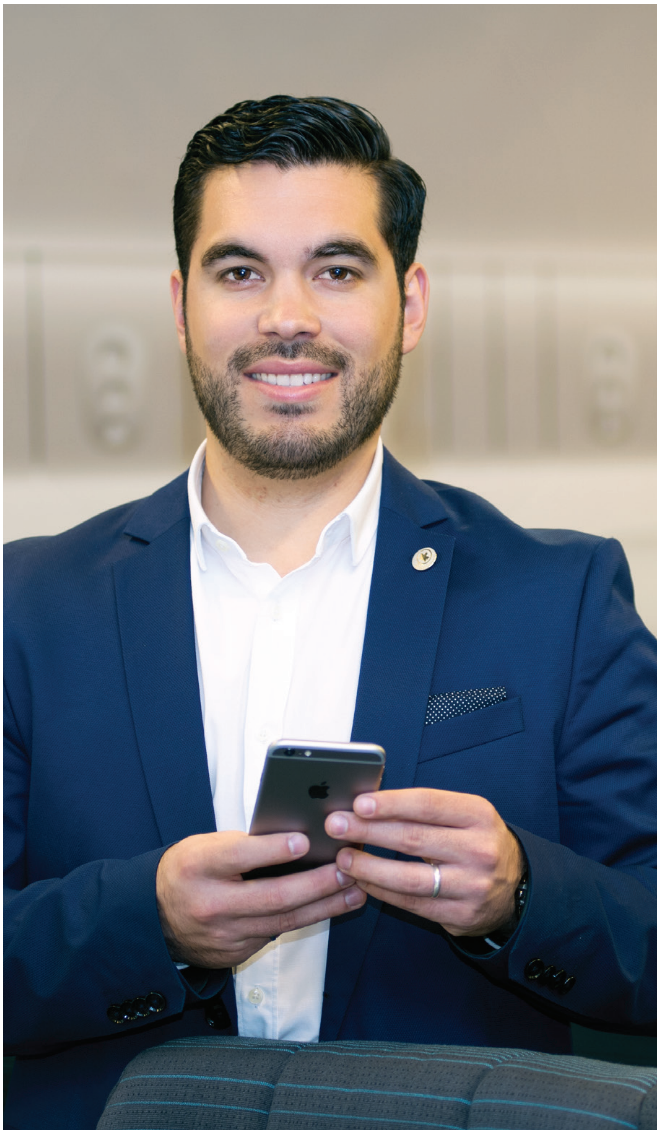
AIR CANADA

Highlights of the Corporate Sustainability Report

In 2017, Air Canada released its 2016 *Citizens of the World*, the airline's sixth corporate sustainability report (CSR), and received the 2018 award of Best Sustainability Report in the Transportation Category from The Finance and Sustainability Initiative (FSI). It is the second consecutive annual award from FSI, a non-profit organization that brings together finance professionals dedicated to promoting sustainable finance and responsible investment to financial institutions, companies and universities.

As in previous years, Air Canada's CSR evaluates the airline's performance in the areas of safety, the environment, employee relations and community involvement. A summary of Air Canada's progress in these areas is provided below:





Safety

When flying with Air Canada, customers are doing much more than counting on it for their travel plans; they are entrusting us with their personal safety and well-being. Safety is Air Canada's prime imperative for which considerable energy is expended and significant investments are made. Numerous interconnecting systems and process have been implemented to continually reduce risk and operate with maximum safety. Air Canada has a robust Safety Management System with accountability for safety ultimately lying with the President and Chief Executive Officer. The airline also maintains an extensive reporting structure to identify, track, report and remedy safety issues that arise and actively promotes safety with specialized training, education and awareness programs.

Environment

Sustainability is most often associated with the environment and an evaluation of any corporation's social responsibility performance gives significant weight to its environmental programs and activities. This is certainly the case for Air Canada, which incorporates environmental considerations into decision-making at all levels. It was one of the first airlines in North America to adopt an ISO 14001 Environmental Management System, which sets out a systematic approach for monitoring, planning, implementing and improving environmental performance. The Environment Affairs department provides reports on a periodic basis to the Audit, Finance and Risk Committee of the Board of Directors and to the senior management Corporate Environment Board. There is also a cross-functional Fuel, Energy and Emissions Reduction Program, mandated to reduce the airline's "gate-to-gate" fuel and energy consumption and emissions.

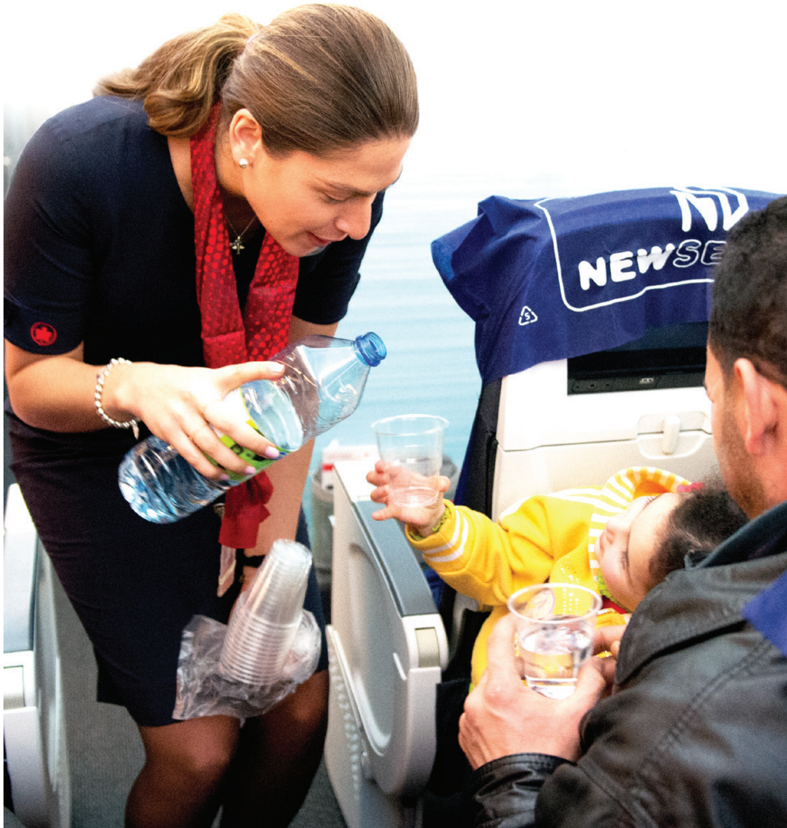
Earlier in 2018, Air Canada was named *2018 Eco-Airline of the Year by Air Transport World* (ATW) in its 44th Annual Airline Industry Achievement Awards. In recognizing Air Canada's environmental accomplishments, ATW cited the carrier's commitment to emission reductions through supporting the development of alternative fuels and its numerous green programs and partnerships, including being the first airline in the world to voluntarily join the World Bank's IMF Cabin Pricing Leadership Coalition.

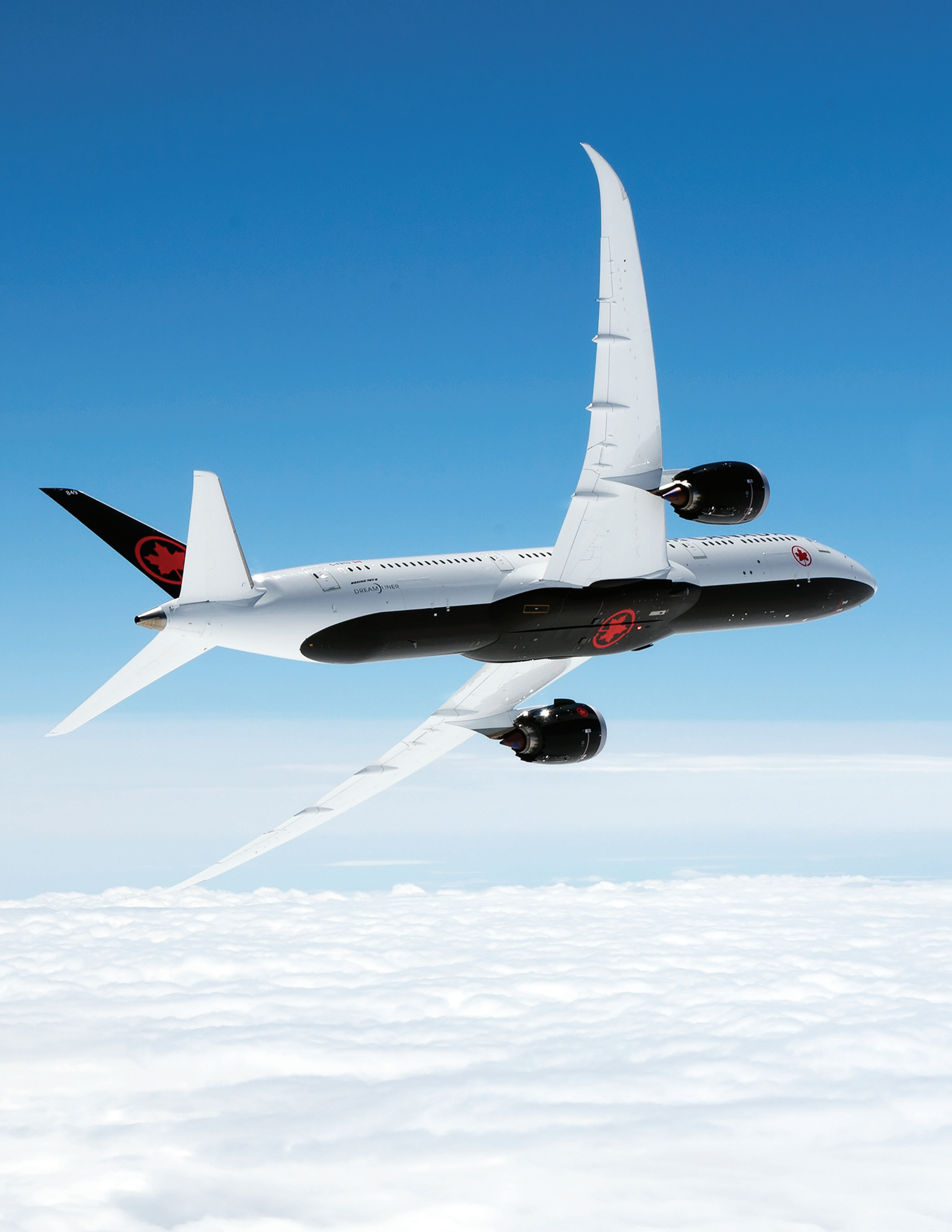
Employees

Air Canada believes employee engagement is central to the long-term sustainability of its business. To this end, it maintains a range of Human Resources programs and tools for its employees' entire career and life cycles, beginning with the pre-employment selection and extending into retirement. With 30,000 employees worldwide, Air Canada is highly focused on creating and maintaining a positive employee culture. Throughout the year, it received many awards. Air Canada's reputation as an attractive place to work makes it a popular destination for job seekers, attracting 56,000 monthly visits to its employment web pages, averaging over 390 applicants for each position posted.

Community

To succeed, Air Canada needs the communities where it operates and where its employees, customers and other stakeholders live and work to be healthy, financially strong and dynamic. Air Canada maintains three channels to engage with communities. Through the Air Canada Foundation, it directly funds or otherwise supports charitable organizations to benefit vulnerable children. Government and Community Relations maintains links with local communities, particularly with respect to economic development. Lastly, through marketing and sponsorship initiatives, Air Canada supports a wide range of cultural activities, including in the arts, sports and other areas, where achievement is celebrated.




DREAMLINER

Investor and Shareholder Information

TSX price range and trading volume of Air Canada variable voting shares and voting shares (AC)

2017	High	Low	Volume traded
1st Quarter	$ 14.43	$ 12.72	77,302,386
2nd Quarter	$ 18.10	$ 12.49	82,675,419
3rd Quarter	$ 27.68	$ 17.20	107,858,019
4th Quarter	$ 28.70	$ 21.76	102,961,918
			370,797,742

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.

In May 2017, the Minister of Transport tabled in the House of Commons Bill C-49, entitled *An Act to amend the Canada Transportation Act and other Acts respecting transportation and to make related and consequential amendments to other Acts* ("Transportation Modernization Act" or "Bill C-49"). Among other things, Bill C-49 would increase foreign ownership limits in Canadian airlines from 25% to 49%, provided that no single non-Canadian holds more than 25% of the voting interests and provided that non-Canadian air service providers do not, in the aggregate, hold more than 25% of the voting interests in a Canadian carrier. On February 8, 2018 the Transportation Modernization Act passed second reading in the Senate and was referred to the Standing Senate Committee on Transport and Communications. Management cannot predict the outcome or timing for passage of Bill C-49.

For further information

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Air Canada complies with the rules adopted by the Toronto Stock Exchange.

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Ce rapport annuel est publié dans les deux langues officielles du Canada. Pour en recevoir un exemplaire en français, veuillez communiquer avec les Relations avec les actionnaires.

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.

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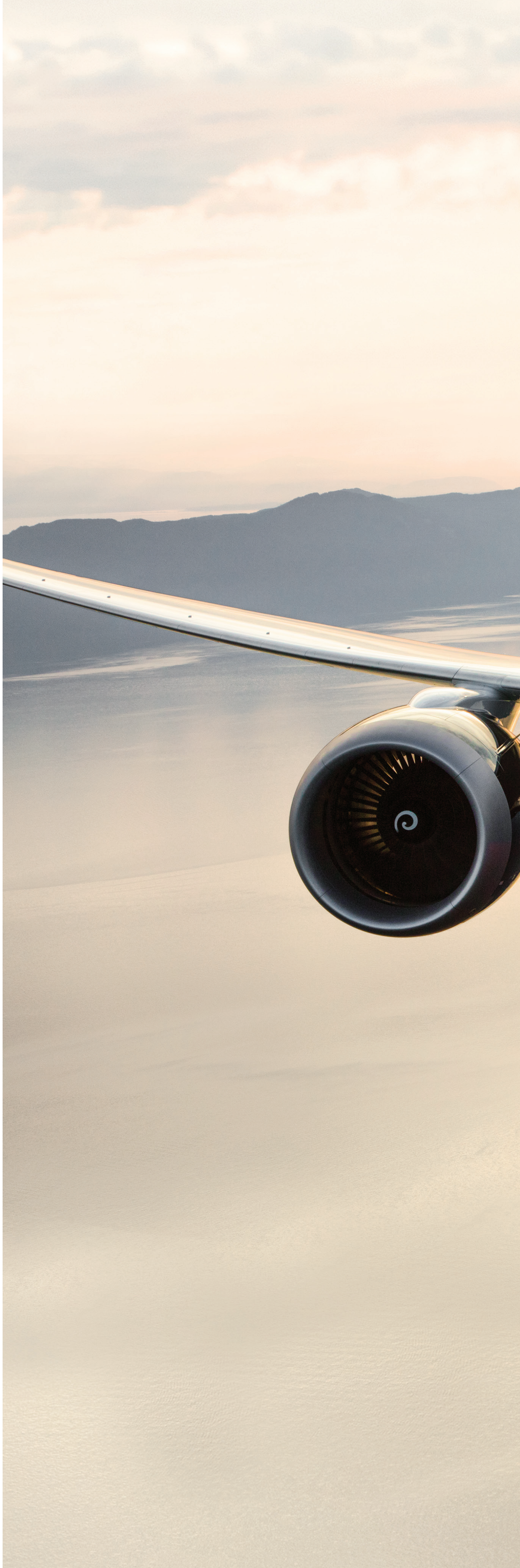

Corporate profile

Air Canada is Canada's largest domestic and international airline, serving more than 200 airports on six continents. Canada's flag carrier is among the 20 largest airlines in the world and in 2017 served approximately 48 million customers. In 2017, Air Canada, together with Jazz, Sky Regional and other regional airlines operating flights on behalf of Air Canada under capacity purchase agreements, operated, on average, 1,602 daily scheduled flights, comprised of 64 Canadian cities, 57 destinations in the United States and a total of 96 cities in Europe, Africa, the Middle East, Asia, Australia, the Caribbean, Mexico and South America.

Air Canada is a founding member of the Star Alliance® network. Through the 28-member airline network, Air Canada offers its customers access to 1,300 destinations in 191 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, which also named Air Canada the Best Airline in North America for 2017.

World Airline Skytrax Awards 2017

Canada's Top 100 Employers 2017

2017 Canada's Best Diversity Employers

aircanada.com