2006
Management's Discussion and Analysis of Results of Operations and Financial Condition

February 14, 2007

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1. PREFACE

The following management's discussion and analysis of results of operations and financial condition ("MD&A") should be read in conjunction with Air Canada's combined consolidated financial statements and notes which have been prepared in accordance with GAAP in Canada and are based on accounting policies consistent with those disclosed in Note 2 to Air Canada's combined consolidated financial statements. Except where the context otherwise requires, all monetary amounts are stated in millions of Canadian dollars. Except as otherwise noted, this MD&A is current as of February 14, 2007.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward Looking Statements" in this MD&A for a discussion of risks, uncertainties and assumptions relating to these statements. For a detailed description of the risks affecting the business of Air Canada and its subsidiaries, see the "Risk Factors" section in this MD&A.

Air Canada's combined consolidated financial statements include the financial position, results of operations and cash flows of the various entities as described in Note 1 to Air Canada's combined consolidated financial statements. In this MD&A, the term "Corporation" refers to, as the context may require, Air Canada and/or Jazz LP ("Jazz") and/or one or more of Air Canada's subsidiaries. Air Canada has two business segments: Air Canada Services and Jazz. Air Canada Services is the passenger and cargo transportation services business operated by Air Canada and related ancillary services. Jazz operates under the capacity purchase agreement between Air Canada and Jazz that came into effect September 30, 2004 (the "initial Jazz CPA") and was amended and restated effective January 1, 2006 (the "Jazz CPA"). Due to the terms of the Jazz CPA, Air Canada has a variable interest in Jazz, as defined under Accounting Guideline15 - Consolidation of Variable Interest Entities (AcG-15). It has been determined that Air Canada is most closely associated with Jazz and, as a result, Air Canada is the entity that consolidates Jazz. Notwithstanding the consolidation of Jazz by Air Canada, Air Canada does not hold any of the limited partnership units of Jazz Air LP or any of the shares of its general partner, Jazz Air Holding GP Inc.

Basis of Presentation

On November 24, 2006 Air Canada completed its initial public offering of class A variable voting shares and class B voting shares of Air Canada (the "Air Canada IPO"). Refer to Note 1 to Air Canada's combined consolidated financial statements for additional information. For periods prior to the Air Canada IPO, ACE Aviation Holdings Inc. ("ACE") was the direct or indirect parent holding company of Air Canada, ACGHS Limited Partnership ("Air Canada Ground Handling"), Touram Limited Partnership ("Air Canada Vacations") and AC Cargo Limited Partnership ("Air Canada Cargo"). Immediately prior to the closing of the Air Canada IPO, the partnership interests, as well as the interests in the general partners of Air Canada Cargo and Air Canada Ground Handling not held by Air Canada, were transferred to Air Canada and ACE transferred a 51 percent ownership interest in Air Canada Vacations and Air Canada Vacations' general partner to Air Canada. As at December 31, 2006, ACE directly holds 75 percent of Air Canada's outstanding shares.

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

For further information on Air Canada's public disclosure file, including Air Canada's Annual Information Form which will be filed by March 31, 2007, consult SEDAR at www.sedar.com.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

This MD&A includes forward-looking statements within the meaning of applicable securities laws. These statements relate to analyses and other information that are 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.

These forward-looking statements are identified by the use of terms and phrases such as "anticipate", "believe", "could", "estimate", "expect", "intend", "may", "plan", "predict", "project", "will", "would", and similar terms and phrases, including references to assumptions.

Forward-looking statements, by their nature, are based on assumptions and are subject to important risks and uncertainties. Any forecasts or forward-looking predictions or statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Results indicated in forward-looking statements may differ materially from actual results for a number of factors, including without limitation, energy prices, general industry, market and economic conditions, war, terrorist attacks, changes in demand due to the seasonal nature of the business, the ability to reduce operating costs and employee counts, employee relations, labour negotiations or disputes, pension issues, currency exchange and interest rates, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties as well as the factors identified throughout this MD&A and, in particular, those identified in the "Risk Factors" section. The forward-looking statements contained in this MD&A represent the Corporation's expectations as of the date of this MD&A and are subject to change after such date. However, the Corporation disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

2. GLOSSARY

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

CASM — Operating expense per ASM;

EBITDAR — EBITDAR is earnings before interest taxes, depreciation, amortization and obsolescence and aircraft rent and is a non-GAAP financial measure commonly used in the airline industry to view operating results before aircraft rent and depreciation, amortization and obsolescence as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets;

Initial Jazz CPA — The capacity purchase agreement between Air Canada and Jazz Air Limited Partnership which was in effect from October 1, 2004 until December 31, 2005;

Jazz CPA — The amended and restated capacity purchase agreement, effective January 1, 2006, between Air Canada and Jazz;

Passenger Load Factor — A measure of passenger capacity utilization derived by expressing Revenue Passenger miles as a percentage of Available Seat Miles;

Passenger Revenue per Available Seat Mile or RASM — Average passenger revenue per ASM;

Revenue Passenger Miles or RPMs — A measure of passenger traffic calculated by multiplying the total number of revenue passengers carried by the miles they are carried;

Subsidiary or subsidiaries — refers to, in relation to Air Canada, to any entity, including a corporation or a limited partnership, which is controlled, directly or indirectly, by Air Canada.

Yield — Average passenger revenue per RPM.

3. OVERVIEW AND GENERAL BUSINESS SUMMARY

The Air Canada Business

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

In 2006, Air Canada, together with Jazz, operated an average of approximately 1,300 scheduled flights each day and carried over 32 million passengers. Air Canada, together with Jazz, provided direct passenger service to 161 destinations and, through commercial agreements with other unaffiliated regional airlines, to an additional 15 destinations, for a total of 176 direct destinations on five continents.

Air Canada enhances its network through a capacity purchase agreement with Jazz pursuant to which Air Canada purchases substantially all of Jazz's fleet capacity based on predetermined rates and determines the routes and schedule operated by Jazz. Jazz operates with smaller jet and turboprop aircraft that have lower trip costs than conventional large jet aircraft, allowing Jazz to provide service to Air Canada's customers in lower density markets and also in higher density markets at off-peak times throughout Canada and the United States.

Air Canada is a founding member of the Star Alliance® network, the world's largest airline alliance group. The Star Alliance® network currently includes 17 member airlines and three regional member airlines. Through its membership in the Star Alliance® network, Air Canada is able to offer its customers access to over 855 destinations in 155 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges.

Through its long-term relationship with Aeroplan, Air Canada's frequent flyer program, Air Canada is able to build customer loyalty by offering those customers who are Aeroplan members the opportunity to earn Aeroplan miles when they fly with Air Canada. Aeroplan is also Air Canada's single largest customer. The relationship with Aeroplan provides a long-term stable and growing source of revenue from the purchase by Aeroplan of Air Canada seats to be provided to Aeroplan members who choose to redeem their Aeroplan miles for air travel rewards.

The Corporation also generates revenues from cargo services provided by Air Canada and Air Canada Cargo, tour operator services provided by Air Canada Vacations and ground handling services provided by Air Canada Ground Handling.

Air Canada's Business Strategy

Air Canada's business model allows it to compete more effectively on multiple levels against the low-pricing structures offered by low-cost carriers and the extensive services and networks of leading international full service carriers. Air Canada's strategy is based on the following components:

Leverage its Innovative Customer Driven Revenue Model

The cornerstone of Air Canada's strategy is to leverage its innovative revenue model. Since its introduction, the revenue model has contributed to higher passenger load factors, higher yields, improved RASM and increased cost efficiency for Air Canada.

Air Canada is an industry leader in offering transparent pricing and simplified branded fares in an industry which has been characterized by multi-tiered fare structures with complex rules and restrictions. Air Canada believes this strategy has contributed to its achieving both record load factors and yield improvements. During 2006, Air Canada enjoyed record loads in all months except August and September, ending a record 27 consecutive months of record loads. Air Canada believes that these two months fell to levels of the previous year primarily as a result of the August 10, 2006 terrorist threat in the United Kingdom and resultant additional security measures. Air Canada's transparent and simplified branded fare structure has given its customers the ability to pay for higher branded fares and enjoy the attributes which come with it or purchase a lower branded fare and then purchase selected attributes which typically are attached only to higher branded fares. This has allowed Air Canada to match the lowest fare in the markets in which it operates and maintain revenue premiums from customers who are willingly purchasing higher fares. For 2006, 46 percent of Air Canada's domestic consumers picked a branded fare higher than Air Canada's most competitive Tango product, a 30.6 percent improvement over 2005. The simplified pricing concept has been in place in the North American market since

2003 and certain features of the simplified pricing concept have been phased into most European markets during 2006.

New Developments in Its Innovative Strategy

In the drive to provide new and unique products that customers can only find at Air Canada, work continues to expand the offering of "passes", "subscriptions" and "à la carte" pricing options tailored to different segments of the marketplace. "Passes" provide Air Canada customers with the ability to lock-in their cost of travel through advance purchase of multiple segments within a defined geographic area. This product is gaining popularity with large corporations as well as with small business and families who value the set price and more importantly the flexibility and ease of use. "Subscriptions" to travel are another Air Canada innovation, which allows unlimited travel within a geographic area and certain conditions, for a set flat fee. "Subscriptions" provide flexibility and ease of use. Both the pass and subscription products have also provided cost savings to Air Canada through reduced sales and servicing costs while providing a product that has been readily accepted by the market. Pass sales increased 148 percent in 2006. "À la carte" options provide customers with the ability to customize their purchase by selecting the items for which they would like to pay, or not. Examples of "à la carte" options include, checked baggage, advance seat assignment, Aeroplan miles, Maple Leaf lounge access, among others. Air Canada is the only major international carrier that allows this degree of customization and Air Canada will continue to introduce new and innovative attributes on its "à la carte" menu. Since its inception on October 28, 2006, 13 percent of customers purchasing through the Air Canada website took advantage of the "à la carte" offerings. While passes generate significant cost savings for Air Canada, the "à la carte" options generate higher incidental revenues and higher customer satisfaction resulting in brand preference. All are unique products that customers can only find at Air Canada.

High Degree of Web-Penetration

All three offerings, "passes", "subscription" and "à la carte" options, are available on Air Canada websites. This strategy has generated a higher level of web-penetration. During 2006 Air Canada enjoyed an average system-wide web-penetration of 26 percent while web penetration in Canada reached 52 percent. Domestic web penetration for the fourth quarter 2006 was 57 percent and the year was capped with a 61 percent domestic web penetration figure for the month of December. Air Canada domestic direct sales (aircanada.com and call centres) for the fourth quarter 2006 was 69 percent. Transborder web penetration for the fourth quarter 2006 was 30 percent, an increase of 6 points from the previous year's quarter. Air Canada believes that the growth in direct sales is due in part to the fact that these new and unique products that Air Canada's customers desire can only be found through Air Canada's websites and call centres. Air Canada maintains two websites, one for consumers and the other for travel agencies. Both websites offer the same unique products. The growth in web penetration continues to allow Air Canada to reduce its cost of distribution.

In addition, Air Canada's customers continue to benefit from the ability to check into Air Canada flights departing from any Canadian city and from select U.S. and select international cities to Canada 24 hours prior to departure by using the web check-in facility provided on the Air Canada website. Air Canada believes this additional feature results in improved customer satisfaction and generates cost savings for Air Canada.

Potential for International Route Expansion

Air Canada believes that Canada's multi-ethnic demography provides Air Canada with growing demand for international travel. Coupled with the large number of unused route authorities, Air Canada believes it is well poised for growth in the Canada-international market. Air Canada expects to expand its existing services to international destinations, including leveraging capacity growth using the Star Alliance® network, and serve new international destinations in order to benefit from the higher margins available in international markets.

Multi-hub Strategy and Seamless Transfers at Toronto

Air Canada uses three main hubs (Toronto, Montreal and Vancouver) across Canada for its domestic, transborder and international routes. Being geographically well positioned, Air Canada believes that all three hubs provide natural advantages to serve customers traveling to or from the U.S to Asia and Europe. Since the implementation of the latest development at Pearson International Airport, Toronto, through which, started on January 29, 2007, Air Canada operates all U.S. flights from Terminal 1. This provides Air Canada with the ability to more seamlessly transfer passengers to and from the U.S. to Europe and Asia. This is a dramatic improvement from the prior challenges of checking out of Terminal 2 and checking into Terminal 1 or vice-versa. Air Canada's Toronto's operation is now consolidated in one terminal, in one of North America's newest and most convenient facilities from which to travel internationally.

Enhance its Product Offering through a Redesigned Network and a Renewed Fleet

Within North America, Air Canada adopted a demand-based network strategy. This resulted in offering improved frequencies on key routes, maintaining competitive frequencies on other routes and introducing new non-stop routes thus serving its customers to destinations where such demand was expected. Air Canada is achieving its network redesign in the North American market through the increased use of large regional jet aircraft which have lower trip costs than conventional narrow-body aircraft. In order to support the expansion of its international operations and deliver a superior aircraft product in the international market to and from Canada, Air Canada expects to introduce 19 Boeing 777 aircraft, beginning in March 2007, and 14 Boeing 787 aircraft, beginning in 2010. The new aircraft will be used to modernize and re-size the fleet, improve passenger load factors and yields, reduce operating costs through fuel efficiencies and are expected to provide Air Canada with the ability to serve new markets that could not be previously served in an efficient manner.

Air Canada recognizes the need for staying competitive by offering customers an enhanced flight experience. In addition to acquiring new aircraft, Air Canada commenced a major refurbishment of the interior of its existing aircraft in 2006. All existing aircraft, except for the Airbus A340 aircraft, will have refurbished interiors, including new seats and personal in-flight entertainment systems and in-seat power outlets at every seat in Economy Class and Executive Class. For aircraft that will be flying international routes, seats in the Executive Class cabin will also convert into lie-flat beds. Air Canada has completed the refurbishment of its 16th Airbus A320 and its fourth Boeing 767-300 aircraft. The refurbishment for the Airbus A319, A321 and A330 aircraft is expected to begin in early 2007. The new Embraer and Boeing 777 aircraft are being delivered with the new seats and entertainment systems already installed. The aircraft refurbishment program is scheduled to be completed by mid-2008.

Leveraging Technology for Enhanced Customer Service and Cost Containment

In order to support the rapid and efficient implementation of Air Canada's revenue model and to reduce transaction and distribution costs, Air Canada is developing a new web-enabled computer system to replace Air Canada's legacy systems for passenger reservation and airport customer service. Named POLARIS, this state-of-the-art new system is expected to be deployed in a phased manner commencing from late 2007 and running through a major part of 2008. The new technology is expected to be innovative, flexible and cost effective and will allow Air Canada to facilitate and streamline the reservation and travel processes for both its customers and employees. Air Canada's objective is to allow all travel transactions to be completed via Air Canada's websites, kiosks, personal handheld devices or other web-enabled platforms. The principal design focus is to create a platform that allows customers to complete any transaction required at any moment of their travel experience.

Continue to Improve its Cost Structure

Air Canada's business strategy is focused on continuously evaluating and improving its cost structure to remain highly competitive. Air Canada's fleet renewal program will provide cost efficiencies; the Embraer 190 aircraft generates 18 percent lower trip costs as compared to the Airbus 321 aircraft. Improved technology used by Boeing in its 777 and 787 aircraft bodies is expected to generate lower fuel-burn rates for airlines. Air Canada expects the Boeing 777-300 to be 26 percent more efficient on a unit cost basis as compared to the Airbus 340-500 while the Boeing 787-8 is expected to be 30 percent more efficient on a unit cost basis for fuel and maintenance. At the same time, POLARIS is expected to generate productivity improvements in call centers, airport check-in and revenue accounting.

Maintaining Positive Employee and Labour Relations

As part of its focus on employee relations, Air Canada is committed to communicating with its employees in an open and transparent manner and to providing them with the tools they need to do their jobs. Air Canada is acting on this commitment by training managers to help them create and promote meaningful and positive employee relations and by providing its employees with increased opportunities for dialogue and feedback. As part of this commitment, in January 2007, Air Canada launched a leadership and employee relationship training initiative for all management employees entitled "Relationship Matters".

Air Canada is focused on maintaining a cooperative relationship with its unions. Air Canada and some of its unions have also introduced new grievance procedures that provide for expedited resolution of grievances and are designed to facilitate the labour-management relationship and increase accountability on both sides.

4. FUEL RISK MANAGEMENT

Aircraft fuel is a major expense in the airline industry. During the period from January 1, 2006 to December 31, 2006, the price of Western Texas Intermediate ("WTI") crude oil ranged from a low of US$55.86 to a high of US$76.95. Fuel prices continue to be susceptible to factors such as political unrest in various parts of the world, Organization of Petroleum Exporting Countries (OPEC) policy, the level of demand from emerging economies such as China, the level of inventory carried by the industry, the level of fuel reserves maintained by governments, disruptions to production and refining facilities, alternative fuels and the weather. Based on 2006 volumes and US exchange rates, Management estimated that a US$1 per barrel movement in the price of WTI crude oil or in the refining spread between WTI and jet fuel impacted 2006 fuel expense by approximately C$27 million or US$24 million (excluding the impact of fuel surcharges and fuel hedging).

In order to manage the airline's exposure to the volatility of jet fuel prices, the Corporation has hedged a portion of its 2007 anticipated jet fuel requirements using mostly swap and collar option structures. The swap structure allows the Corporation to fix jet fuel price at a specific level, whereas the collar option structure creates a ceiling and a floor price, allowing the Corporation to protect itself against prices above the ceiling but exposing the Corporation to the floor if the price falls below the floor. As at December 31, 2006, the Corporation had 39 percent of its fuel requirement for 2007 hedged at prices that can fluctuate between an average of US$74 to US$85 per barrel for its heating oil-based contracts, an average of US$58 to US$69 per barrel for its WTI crude oil-based contracts and an average of US$81 to US$85 for jet-fuel based contracts. Since December 31, 2006, the Corporation has entered into new hedging positions, using collar option structures, which have added 5 percent coverage to 2007 increasing the total hedged volume for 2007 to 44 percent, as well as an additional 1 percent coverage to 2008. As at February 14, 2007, for 2007, the Corporation has hedged its projected fuel requirements as follows: 57 percent for Quarter 1, 44 percent for Quarter 2, 36 percent for Quarter 3 and 39 percent for Quarter 4.

For information on fuel hedging gains and losses recognized in fuel expense in 2006 and gains and losses recognized in "other" non-operating expense for derivative instruments that do not qualify for fuel hedging accounting, refer to section 12 of this MD&A.

5. EMPLOYEES AND LABOUR RELATIONS

As at December 31, 2006, the Corporation had 27,384 full-time equivalent ("FTE") employees (Air Canada Services – 23,101; Jazz – 4,283). The following table provides a breakdown of the Corporation's average FTE employees for the fourth quarter of 2006 and 2005 and for the full year 2006 and 2005 together with the unions that represent them.

Employee Group	Union[1]	Fourth quarter 2006	Fourth quarter 2005	2006	2005
Management and Administrative Support[3]	N/A[2]	3,017	3,504	3,191	3,410
Pilots	ACPA	2,708	2,541	2,625	2,546
Flight Attendants	CUPE	5,985	6,011	6,062	6,167
Customer Sales and Service Agents[3]	CAW/IBT	3,650	3,975	3,767	3,962
Technical Services, Ramp and Cargo[3]	IAMAW	6,812	6,924	6,812	6,766
United Kingdom Unionized Employees	Amicus/TGWU	697	682	691	704
Other Unionized		478	479	482	488
Air Canada Services		23,347	24,116	23,630	24,043
Jazz		4,272	3,801	4,144	3,582
Consolidated		27,619	27,917	27,774	27,625

(1) *ACPA: Air Canada Pilots Association; CUPE: Canadian Union of Public Employees; CAW: National Automobile, Aerospace, Transportation and General Workers Union of Canada; IBT: International Brotherhood of Teamsters; IAMAW: International Association of Machinists and Aerospace Workers; and TGWU: Transport and General Workers Union.*

(2) *Certain administrative support employees are represented by IAMAW.*

(3) *Not included in the numbers presented in the table above, pursuant to the Aeroplan General Services Agreement ("Aeroplan GSA"), Aeroplan has agreed to reimburse Air Canada on a fully-allocated basis for all costs, including salary and benefits, related to a group of call centre employees who are represented by the CAW and are currently working for Aeroplan's benefit. Such group represented 853 FTE employees as at December 31, 2006 and 852 FTE employees as at December 31, 2005. In addition to the numbers presented in the above table, pursuant to the ACTS General Services Agreements ("ACTS GSAs"), ACTS has agreed to reimburse Air Canada on a fully-allocated basis for all costs, including salary and benefits, related to a group of unionized and a group of non-unionized employees currently working for the benefit of ACTS. Such groups represented 3,923 FTE employees as at December 31, 2006 and 4,063 FTE employees as at December 31, 2005.*

Air Canada has long-term collective bargaining agreements with its pilots, flight attendants, maintenance personnel, certain clerical and finance personnel, customer service agents, ramp and cargo employees, dispatchers and crew schedulers which were concluded in 2003 and 2004 and which expire in 2009. No strikes or lock-outs may lawfully occur during the term of the collective agreements. In 2006, Air Canada concluded wage re-opener agreements, mediations or arbitrations under the collective agreements with all its union groups. It is still awaiting the arbitrator's decision in respect of its flight attendants, who are represented by CUPE. The wage increases awarded or agreed upon range from 0 to 2.5 percent per year until 2009. The CUPE arbitration award decision is expected during the first quarter of 2007.

Jazz has completed negotiation, mediation and arbitration with all of its unions with the exception of the Canadian Air Lines Dispatchers ("CALDA"), the union representing Jazz's dispatchers. The wage increases awarded range from 1 to 1.75 percent per year until 2009. The wage re-opener negotiations with CALDA are continuing.

Profit Sharing Plan

In 2005, the Corporation introduced incentive programs and Profit Sharing Plans in order to engage employees in their valuable role to ensure the Corporation's success. The Sharing Our Success Plan at Air Canada and Jazz's Ensemble Plan emphasize the relationship between performance and personal rewards. These Plans provide employees with financial rewards on a monthly basis when operational performance levels are achieved. The Air Canada Plans also permit employees to share in the fiscal year-end pre-tax profits and Jazz's Plans provide annual rewards where corporate, financial and operational targets are achieved. In each case, employees receive the greater of the amounts payable under either the Sharing Our Success or Jazz Emsemble Plan and the annual profit sharing plan.

Air Canada employees will receive a total of $29.2 million in respect of 2006 under the Profit Sharing Plan, of which $25.5 million has already been paid out during 2006 under the Sharing Our Success monthly incentive program. Employees at Jazz will receive a total of $10.1 million, of which $4.7 million has already been paid out during 2006 under the Jazz Ensemble Plan.

6. FLEET

The Corporation's operating fleet at December 31, 2006 was as follows:

	Total seats	Number of operating aircraft[1]	Average age	Owned [2]	Capital Lease [2]	Consolidated under AcG-15 [2]	Operating Lease
Air Canada Services							
Widebody Aircraft							
Airbus A340-500	267	2	2.5	2	-	-	-
Airbus A340-300	285-286	10	9.8	-	8	-	2
Airbus A330-300	274	8	6.2	-	8	-	-
Boeing 767-300	203-222	33	13.5	1	4	6	22
Boeing 767-200	207	11	20.1	11	-	-	-
Narrowbody Aircraft							
Airbus A321	166	10	4.8	-	-	5	5
Airbus A320	140	47	13.8	-	-	-	47
Airbus A319	120	45	8.2	-	17	17	11
Embraer 190	93	18	0.6	18	-	-	-
Embraer 175	73	15	1.3	15	-	-	-
Total Operating Aircraft		**199**	**9.6**	**47**	**37**	**28**	**87**
Jazz							
Bombardier CRJ-705	75	15	1.5	-	-	-	15
Bombardier CRJ-200	50	33	4.7	-	-	-	33
Bombardier CRJ-100	50	25	11.3	-	-	23	2
Dash-8-300	50	26	16.8	19	-	-	7
Dash-8-100	37	36	18.8	29	-	-	7
Total Operating Aircraft		**135**	**11.7**	**48**	**-**	**23**	**64**
Consolidated							
Total Operating Aircraft		**334**	**10.4**	**95**	**37**	**51**	**151**

(1) Excludes aircraft which have been permanently removed from service.

(2) Owned aircraft as well as capital leases and leases consolidated under AcG-15 are carried on the combined consolidated statement of financial position. Owned aircraft include aircraft financed under conditional sales agreements.

In 2006, Air Canada took delivery of one Embraer 175 and 15 Embraer 190 aircraft. During 2006, three Airbus A319 aircraft and two Airbus A320 aircraft were returned to the lessors, one Boeing 767-200 was removed from service and two Airbus A320 aircraft were removed from service at the end of 2006 pending return to the lessors. In addition, 10 Bombardier CRJ-100 aircraft were transferred to Jazz.

In 2006, Jazz took delivery of six Bombardier CRJ-200 aircraft and 10 Bombardier CRJ-100 aircraft were transferred from Air Canada to Jazz. Also during 2006, two Dash 8-100 aircraft were returned to the lessors. All aircraft in Jazz's operating fleet as of December 31, 2006 are Covered Aircraft, as defined under the Jazz CPA, with the exception of two Dash 8-100 which are being used for charter purposes.

7. RESULTS OF OPERATIONS – FOURTH QUARTER 2006 VERSUS FOURTH QUARTER 2005

The following table reflects the results of the Corporation as defined under "Basis of Presentation", the results of its reportable segments and certain non-GAAP measures for Quarter 4 2006 and for Quarter 4 2005.

	Quarter 4 2006				Quarter 4 2005			
Operating revenues	**Air Canada Services**	**Jazz**	**Inter-segment elimination**	**Consolidated total**	**Air Canada Services**	**Jazz**	**Inter-segment elimination**	**Consolidated total**
Passenger	$2,071	-	-	$2,071	$1,949	1	-	$1,950
Cargo	166	-	-	166	177	-	-	177
Other	178	352	(372)	158	145	303	(319)	129
	2,415	**352**	**(372)**	**2,395**	**2,271**	**304**	**(319)**	**2,256**
Operating expenses								
Salaries, wages and benefits	443	82	-	525	463	75	-	538
Aircraft fuel	583	69	(69)	583	577	62	(62)	577
Aircraft rent	75	34	(2)	107	90	28	(1)	117
Airport and navigation fees	232	46	(46)	232	222	37	(37)	222
Aircraft maintenance, materials and supplies	205	27	(4)	228	180	18	(4)	194
Communications and information technology	68	2	(1)	69	72	2	(1)	73
Food, beverages and supplies	76	4	-	80	78	3	-	81
Depreciation, amortization and obsolescence	135	5	-	140	106	4	-	110
Commissions	49	-	-	49	47	-	-	47
Capacity purchase fees paid to Jazz	224	-	(224)	-	194	-	(194)	-
Special charge for labour restructuring	(8)	-	-	(8)	-	-	-	-
Other	338	50	(27)	361	333	41	(20)	354
	2,420	**319**	**(373)**	**2,366**	**2,362**	**270**	**(319)**	**2,313**
Operating income (loss)	**(5)**	**33**	**1**	**29**	**(91)**	**34**	**-**	**(57)**
Non-operating income (expense)								
Interest income	24	2	(1)	25	14	-	1	15
Interest expense	(88)	(2)	(1)	(91)	(74)	(3)	(1)	(78)
Interest capitalized	22	-	-	22	6	-	-	6
Gain (loss) on sale of and provisions on assets	(10)	-	-	(10)	(30)	1	-	(29)
Other	-	(1)	1	-	(2)	-	-	(2)
	(52)	**(1)**	**(1)**	**(54)**	**(86)**	**(2)**	**-**	**(88)**
Income (loss) before the following items:	**(57)**	**32**	**-**	**(25)**	**(177)**	**32**	**-**	**(145)**
Non-controlling interest	(3)	-	(32)	(35)	(2)	-	(32)	(34)
Foreign exchange loss	(107)	-	-	(107)	(11)	-	-	(11)
Recovery of income taxes	23	-	-	23	55	-	-	55
Income (loss) for the period	**(144)**	**$32**	**(32)**	**($144)**	**($135)**	**$32**	**($32)**	**($135)**
EBITDAR(1)	**205**	**72**	**(1)**	**276**	**105**	**66**	**(1)**	**170**
EBITDAR(1) excluding special charges	**197**	**72**	**(1)**	**268**	**105**	**66**	**(1)**	**170**

(1) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).

The following table compares the results of the Corporation's reportable segments for Quarter 4 2006 to Quarter 4 2005. The amounts in the table below include inter-segment revenues and expenses.

	Air Canada Services				Jazz			
	Quarter 4		Change		Quarter 4		Change	
($ millions, except per share figures)	2006	2005	$	%	2006	2005	$	%
Operating revenues								
Passenger	$ 2,071	$ 1,949	$ 122	6	$ -	$ 1	$ (1)	(100)
Cargo	166	177	(11)	(6)	-	-	-	n/a
Other	178	145	33	23	352	303	49	16
	2,415	**2,271**	**144**	**6**	**352**	**304**	**48**	**16**
Operating expenses								
Salaries, wages and benefits	443	463	(20)	(4)	82	75	7	9
Aircraft fuel	583	577	6	1	69	62	7	11
Aircraft rent	75	90	(15)	(17)	34	28	6	21
Airport and navigation fees	232	222	10	5	46	37	9	24
Aircraft maintenance, materials and supplies	205	180	25	14	27	18	9	50
Communications and information technology	68	72	(4)	(6)	2	2	-	-
Food, beverages and supplies	76	78	(2)	(3)	4	3	1	33
Depreciation, amortization and obsolescence	135	106	29	27	5	4	1	25
Commissions	49	47	2	4	-	-	-	n/a
Capacity purchase fees paid to Jazz	224	194	30	15	-	-	-	n/a
Special charge for labour restructuring	(8)	-	(8)	n/a	-	-	-	n/a
Other	338	333	5	2	50	41	9	22
	2,420	**2,362**	**58**	**2**	**319**	**270**	**49**	**18**
Operating income (loss)	**(5)**	**(91)**	**86**		**33**	**34**	**(1)**	
Non-operating income (expense)								
Interest income	24	14	10		2	-	2	
Interest expense	(88)	(74)	(14)		(2)	(3)	1	
Interest capitalized	22	6	16		-	-	-	
Gain (loss) on sale of and provisions on assets	(10)	(30)	20		-	1	(1)	
Other	-	(2)	2		(1)	-	(1)	
	(52)	**(86)**	**34**		**(1)**	**(2)**	**1**	
Income (loss) before the following items:	**(57)**	**(177)**	**120**		**32**	**32**	**-**	
Non-controlling interest	(3)	(2)	(1)		-	-	-	
Foreign exchange loss	(107)	(11)	(96)		-	-	-	
Recovery of income taxes	23	55	(32)		-	-	-	
Segment income (loss)	**$ (144)**	**$ (135)**	**$ (9)**		**$ 32**	**$ 32**	**$ -**	
EBITDAR[(1)]	**205**	**105**	**100**		**72**	**66**	**6**	
EBITDAR excluding special charges [(1)]	**197**	**105**	**92**		**72**	**66**	**6**	

(1) *See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).*

7.1 Summary of Air Canada Services Segment Results

The Air Canada Services segment reported an operating loss of $5 million in Quarter 4 2006, an improvement of $86 million from the operating loss of $91 million recorded in Quarter 4 2005. EBITDAR increased $100 million over Quarter 4 2005.

Passenger Revenues

System passenger revenues in Quarter 4 2006 increased $122 million or 6 percent over Quarter 4 2005, reflecting system traffic and yield improvements due to stronger market demand. The system yield improvement of 1 percent in Quarter 4 2006 over the same period in 2005 was principally due to fuel-related fare increases and increased fuel surcharges to offset higher fuel costs and, to a lesser extent, a higher average business class fare. The yield increase was partly offset by the negative effect of a stronger Canadian dollar on international, US transborder and domestic revenues. In Quarter 4 2006, traffic grew 5 percent on a capacity increase of 4 percent over Quarter 4 2005, resulting in a passenger load factor increase of 1.1 percentage points. RASM increased 2 percent compared to Quarter 4 2005 due to both the improvement in system passenger load factor and the growth in yield.

The table below describes quarter-over quarter percentage changes in passenger revenues, capacity, traffic, passenger load factor, yield and RASM.

Quarter 4 2006 versus Quarter 4 2005	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	6	4	6	1.7	-	2
US transborder	10	11	15	2.0	(4)	(1)
Atlantic	4	2	2	-	2	2
Pacific	1	-	-	0.1	1	1
Other	6	1	5	3.0	1	5
System	**6**	**4**	**5**	**1.1**	**1**	**2**

Domestic passenger revenues increased $54 million or 6 percent in Quarter 4 2006 compared to Quarter 4 2005 due to traffic growth. Yield was essentially unchanged from the same period in 2005. Traffic grew 6 percent on a capacity increase of 4 percent resulting in a passenger load factor improvement of 1.7 percentage points. Capacity increases were largely on transcontinental services. The suspension of Canjet's scheduled domestic operations in September 2006 also had a favourable impact on traffic in Quarter 4 2006. Domestic RASM increased 2 percent compared to Quarter 4 2005 due to the improvement in domestic passenger load factor.

US transborder passenger revenues rose $41 million or 10 percent in Quarter 4 2006 compared to the corresponding period in 2005 due to an increase in traffic, the result of more capacity, a stronger market demand and additional fuel-related fare increases to offset higher fuel costs. Yield decreased 4 percent in Quarter 4 2006, reflecting a growth over 2005 in longer-haul flying to key leisure destinations. Long-haul flights generally have a lower yield per revenue passenger mile than short-haul flights. When measured on a per mile basis, the average fare paid on long-haul flights is relatively lower than on short-haul flights. At the same time, since the costs of ground handling, take-off and landing are similar for both short and long-haul flights, unit costs per ASM are normally lower for long-haul flights due to distance flown. The growth in passenger traffic of 15 percent in Quarter 4 2006 was largely a result of increased capacity on routes to Las Vegas, San Francisco and Los Angeles and the addition of the Toronto-San Diego route in June 2006. US transborder RASM decreased 1 percent over Quarter 4 2005 as a 2.0 percentage point improvement in passenger load factor was more than offset by the decline in yield.

Atlantic passenger revenues increased $15 million or 4 percent in Quarter 4 2006 compared to the corresponding period in 2005 due equally to yield improvement and traffic growth. Yield improved 2 percent over the corresponding period in 2005 largely due to increased fuel surcharges to offset higher fuel costs. Traffic growth was essentially in line with capacity growth resulting in a passenger load factor unchanged from the same period in 2005. Atlantic RASM increased 2 percent due to the yield improvement.

Pacific passenger revenues increased $3 million or 1 percent in Quarter 4 2006 compared to the same period in 2005 mainly due to a yield improvement. Yield improved 1 percent largely due to increased fuel surcharges to offset higher fuel costs. A higher average business class fare was also a factor in the yield increase. Pacific RASM increased 1 percent due to yield growth as the passenger load factor was essentially unchanged.

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) increased $9 million or 6 percent in Quarter 4 2006 compared to Quarter 4 2005 due to traffic growth and a yield improvement. Traffic grew 5 percent on a capacity increase of 1 percent resulting in a passenger load factor improvement of 3.0 percentage points. Traffic growth occurred primarily in the South America and Mexico markets. Yield rose 1 percent as a result of increased fuel surcharges to offset higher fuel costs. A higher average business class fare was also a factor in the yield increase. For Quarter 4 2006, RASM increased 5 percent due primarily to the improvement in passenger load factor and partly to the yield increase.

Cargo Revenues

Cargo revenues for Quarter 4 2006 decreased $11 million or 6 percent from Quarter 4 2005. System traffic declined 4 percent and cargo yield per revenue ton mile was down 2 percent. Freighter operations were reduced from three to two chartered MD-11 aircraft effective November 2006 as compared to three MD-11 aircraft operated in Quarter 4 2005. As a result, freighter revenues declined $4 million or 9 per cent from 2005 on a 15 percent reduction to freighter capacity. Cargo revenues from non-freighter operations were down $7 million or 5 percent from the same period in 2005, mainly as a result of a 4 percent reduction to traffic and a 1 percent decline in yield per revenue ton mile. Lower cargo capacity in certain markets and adverse currency movements impacted Cargo revenues in the quarter.

Other Revenues

For Quarter 4 2006, other revenues increased $33 million or 23 percent over the same period in 2005. Higher revenues from Air Canada Vacations, mainly due to increased passenger volumes, accounted for approximately $18 million of the increase. Other increases included flight cancellation and change fees, buy-on-board revenues and other miscellaneous revenues.

Operating Expenses

Operating expenses in Quarter 4 2006 rose $58 million or 2 percent over the corresponding period in 2005. This increase in operating expenses over Quarter 4 2005 was largely connected to a 4 percent growth in capacity as well as higher aircraft maintenance, materials and supplies expense.

Unit cost, as measured by operating expense per ASM, decreased 1 percent over Quarter 4 2005. The following table compares Air Canada Services' operating expenses per ASM for Quarter 4 2006 to Air Canada Services' operating expenses per ASM to the corresponding period in 2005.

($ cents per ASM)	**Quarter 4**		**Change**	
	2006	**2005**	**$**	**%**
Salary and wages	2.60	2.63	(0.03)	(1)
Benefits	0.49	0.72	(0.23)	(32)
Ownership (DAR) [1]	1.46	1.42	0.04	3
Airport and navigation fees	1.62	1.61	0.01	1
Aircraft maintenance, materials and supplies	1.43	1.31	0.12	9
Food, beverages and supplies	0.53	0.56	(0.03)	(5)
Commissions	0.34	0.34	-	-
Capacity purchase fees paid to Jazz	1.56	1.40	0.16	11
Other	2.83	2.94	(0.11)	(4)
Operating expense, excluding fuel expense and the special charge for labour restructuring [2]	**12.86**	**12.93**	**(0.07)**	**(1)**
Aircraft fuel	4.06	4.18	(0.12)	(3)
Special charge for labour restructuring	(0.05)	-	(0.05)	n/a
Total operating expense	**16.87**	**17.11**	**(0.24)**	**(1)**

(1) DAR refers to the combination of Aircraft rent and Depreciation, amortization and obsolescence.
(2) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for additional information.

Salaries and wages expense totaled $373 million in Quarter 4 2006, an increase of $10 million or 3 percent from Quarter 4 2005 in part due to higher average salaries partly offset by a decrease of 3 percent or an average of 769 FTE employees.

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

Employee benefits expense amounted to $70 million in Quarter 4 2006, a decrease of $30 million or 30 percent over Quarter 4 2005. Included in Quarter 4 2006 were favourable adjustments of $6 million pertaining to pension expense for the full year 2006 as a result of a revised pension expense estimate and $8 million related to an updated evaluation of workers' compensation liability. Included in Quarter 4 2005 was an unfavourable adjustment of $5 million relating to an updated actuarial evaluation of workers' compensation liability. Excluding these adjustments, the remaining $11 million decrease in employee benefits expenses was mainly due to a decline in post-employment benefits partly offset by higher pension expense which reflected a lower discount rate applied to pension obligations.

Fuel expense increased $6 million or 1 percent in Quarter 4 2006 due to a volume-related increase of $23 million bringing the total year 2006 fuel expense increase to $347 million or 16 percent. In Quarter 4 2006, a stronger Canadian dollar versus the US dollar reduced fuel expense by $24 million compared with Quarter 4 2005 and a lower average base fuel price decreased it by a further $22 million. These decreases were partly offset by an increased realized hedging loss of $29 million. The unit cost of fuel in Quarter 4 2006 was reduced by 3 percent when compared to Quarter 4 2005. Fuel expense for MD-11 freighter operations declined $6 million mainly on reduced flying.

Ownership costs, comprised of aircraft rent, depreciation, amortization and obsolescence expenses, increased $14 million in Quarter 4 2006. Increases in ownership costs included a change in assumptions relating to the residual value of certain aircraft and the addition of 16 Embraer aircraft to Air Canada's operating fleet. Decreases in ownership costs included the impact of aircraft returns and lease terminations, the transfer of 10 CRJ-100 aircraft to Jazz which shifts the ownership cost to the capacity purchase expense category, the reduction of one MD-11 freighter aircraft and the impact of a stronger Canadian dollar on aircraft rent.

Airport and navigation fees increased $10 million or 5 percent in Quarter 4 2006, mainly due to an increase of 7 percent in aircraft departures and increased rates for landing and general terminal fees, primarily at Toronto's Pearson International Airport. At Pearson, general terminal charges rose 9 percent per seat for domestic and international arrivals. These increases were partly offset by a rate reduction for navigation fees in Canada and favourable foreign exchange for international navigation fees.

Aircraft maintenance, materials and supplies increased $25 million or 14 percent in Quarter 4 2006 largely due to increased airframe maintenance activity for Boeing 767 aircraft and, to a lesser extent, Airbus A320 aircraft, due to cycle timing. Other increases included increased engine maintenance activity for Airbus A320 and A340 aircraft and expenses related to satisfying minimum return conditions on short-term leases and future return to lessor expenses. These increases were partly offset by an overall reduction in volume of aircraft components.

Food, beverage and supplies expense decreased $2 million or 3 percent versus Quarter 4 2005 on a passenger traffic increase of 5 percent. The volume-related increase was more than offset by cost reduction initiatives and the impact of new catering programs, including the buy-on-board program.

For Quarter 4 2006, capacity fees paid to Jazz, pursuant to the Jazz CPA, amounted to $224 million compared to capacity fees paid to Jazz of $194 million in Quarter 4 2005, pursuant to the Initial Jazz CPA. The increase of 15 percent in Quarter 4 2006 was mainly driven by a growth of 12 covered aircraft in Jazz's operating fleet, resulting in a 21 percent increase in block hours over Quarter 4 2005. ASM capacity for flights operated by Jazz increased 26 percent over Quarter 4 2005.

Non-operating expense amounted to $52 million in Quarter 4 2006 compared to non-operating expense of $86 million for Quarter 4 2005. For Quarter 4 2006, net interest expense decreased $12 million. The increase in interest expense, largely driven by the financing of additional aircraft, was more than offset by a higher amount of capitalized interest relating to the acquisition of the Boeing 777 and 787 aircraft and growth in interest income

due to higher cash balances and higher average interest rates. Capitalized interest includes interest on funds used to finance the acquisition of new flight equipment and other property and equipment for periods preceding the dates that the assets are available for service. Refer to Note 2 to Air Canada's combined consolidated financial statements for additional information on interest capitalized. In Quarter 4 2006, the Air Canada Services segment recorded an impairment provision of $7 million relating to one property. In Quarter 4 2005, loss on sale and provisions on assets amounted to $30 million of which approximately $15 million related to the write-down of inactive Boeing 747 inventory.

Losses from the revaluation of foreign currency monetary items amounted to $107 million in Quarter 4 2006, attributable to a weaker Canadian dollar at December 31, 2006 compared to September 30, 2006. This compared to losses of $11 million in Quarter 4 2005.

A segment loss of $144 million was recorded in Quarter 4, 2006 compared to a segment loss of $135 million in Quarter 4 2005.

7.2 Summary of Jazz Segment Results

Jazz recorded operating income of $33 million in Quarter 4 2006, pursuant to the Jazz CPA, compared to operating income of $34 million in Quarter 4 2005, pursuant to the Initial Jazz CPA. EBITDAR for Quarter 4 2006 improved $6 million over the corresponding period in 2005. The increase in EBITDAR was mainly due to a growth in fleet size consistent with Jazz's plan to increase its relative share of the North American ASM capacity, an increase in hours of contract flying under the Jazz CPA, as well as cost control.

The Jazz CPA came into effect on January 1, 2006. The major changes from the Initial Jazz CPA include: a longer term, a larger number of Covered Aircraft with a guaranteed minimum of 133 aircraft throughout the term, and Jazz expenses now reimbursed by Air Canada at a higher mark-up for controllable costs, and on an at-cost basis by Air Canada for other expenses.

Operating revenues for Quarter 4 2006 increased $48 million or 16 percent compared to the corresponding period in 2005. The significant increase in revenues was due to a net addition of 14 aircraft operated by Jazz resulting in a 21 percent increase in block hours flown over Quarter 4 2005 as well as higher pass-though costs charged to Air Canada under the Jazz CPA.

Operating expenses increased $49 million or 18 percent compared to Quarter 4 2005 and included an increase in pass-through costs of $18 million or 17 percent in Quarter 4 2006, driven largely by a capacity increase of 26 percent over the corresponding period in 2005. Unit cost for Quarter 4 2006 decreased 8 percent over the same period in 2005, in part due to an increase in longer-haul flying which generally results in lower unit costs per ASM. Excluding fuel expense, unit cost for Quarter 4 2006 was down 5 percent over the corresponding period in 2005. The unit aircraft rental cost increase mainly reflected six CRJ-200 aircraft deliveries and the transfer of 10 CRJ-100 aircraft from Air Canada partly offset by a termination of two Dash 8 aircraft operating leases.

Segment income of $32 million was recorded in Quarter 4, 2006, unchanged from Quarter 4 2005.

7.3 Summary of Consolidated Results

The Corporation, as defined under "Basis of Presentation", recorded operating income of $29 million for Quarter 4 2006, an improvement of $86 million from the operating loss of $57 million recorded in the same period in 2005.

Losses from the revaluation of foreign currency monetary items amounted to $107 million in Quarter 4 2006 attributable to a weaker Canadian dollar at December 31, 2006 compared to September 30, 2006. This compared to losses of $11 million in Quarter 4 2005.

Net loss for Quarter 4 2006 amounted to $144 million or $1.55 per diluted share compared to a net loss of $135 million or $1.53 per diluted share for Quarter 4 2005.

Unit cost, as measured by operating expense per ASM, decreased 2 percent over Quarter 4 2005.

8. RESULTS OF OPERATIONS – 2006 VERSUS 2005

The following table reflects the results of the Corporation as defined under "Basis of Presentation", the results of its reportable segments and certain non-GAAP measures for the year ended December 31, 2006 and for the year ended December 31, 2005.

	Year ended December 31, 2006				Year ended December 31, 2005			
Operating revenues	**Air Canada Services**	**Jazz**	**Inter-segment elimination**	**Consolidated total**	**Air Canada Services**	**Jazz**	**Inter-segment elimination**	**Consolidated total**
Passenger	$8,887	-	-	$8,887	$8,197	2	-	$8,199
Cargo	629	-	-	629	625	-	-	625
Other	723	1,381	(1,453)	651	687	1,021	(1,074)	634
	10,239	**1,381**	**(1,453)**	**10,167**	**9,509**	**1,023**	**(1,074)**	**9,458**
Special charge for Aeroplan miles	(102)	-	-	(102)	-	-	-	-
	10,137	**1,381**	**(1,453)**	**10,065**	**9,509**	**1,023**	**(1,074)**	**9,458**
Operating expenses								
Salaries, wages and benefits	1,816	311	-	2,127	1,857	265	-	2,122
Aircraft fuel	2,544	285	(284)	2,545	2,197	177	(177)	2,197
Aircraft rent	314	134	(7)	441	341	80	(4)	417
Airport and navigation fees	982	178	(178)	982	924	124	(124)	924
Aircraft maintenance, materials and supplies	768	98	(11)	855	693	68	(10)	751
Communications and information technology	273	8	(3)	278	294	5	(2)	297
Food, beverages and supplies	322	15	(2)	335	326	8	-	334
Depreciation, amortization and obsolescence	493	21	-	514	404	18	-	422
Commissions	237	-	-	237	253	-	-	253
Capacity purchase fees paid to Jazz	871	-	(871)	-	693	-	(693)	-
Special charge for labour restructuring	20	-	-	20	-	-	-	-
Other	1,383	187	(98)	1,472	1,336	149	(62)	1,423
	10,023	**1,237**	**(1,454)**	**9,806**	**9,318**	**894**	**(1,072)**	**9,140**
Operating income	**114**	**144**	**1**	**259**	**191**	**129**	**(2)**	**318**
Non-operating income (expense)								
Interest income	82	6	(1)	87	48	1	(1)	48
Interest expense	(313)	(8)	-	(321)	(270)	(16)	2	(284)
Interest capitalized	62	(1)	-	61	14	-	-	14
Gain (loss) on sale of and provisions on assets	(6)	-	-	(6)	(31)	4	-	(27)
Other	(16)	(1)	-	(17)	15	-	1	16
	(191)	**(4)**	**(1)**	**(196)**	**(224)**	**(11)**	**2**	**(233)**
Income (loss) before the following items:	**(77)**	**140**	**-**	**63**	**(33)**	**118**	**-**	**85**
Non-controlling interest	(12)	-	(140)	(152)	(13)	-	(118)	(131)
Foreign exchange gain	12	-	-	12	47	-	-	47
Provision for (recovery of) income taxes	3	-	-	3	(21)	-	-	(21)
Income (loss) for the period	**(74)**	**$140**	**(140)**	**($74)**	**($20)**	**$118**	**($118)**	**($20)**
EBITDAR[(1)]	**921**	**299**	**(6)**	**1,214**	**936**	**227**	**(6)**	**1,157**
EBITDAR[(1)] excluding special charges	**1,043**	**299**	**(6)**	**1,336**	**936**	**227**	**(6)**	**1,157**

(1) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss) and EBITDAR excluding special charges for Aeroplan miles and labour restructuring to operating income (loss).

Special Charge for Aeroplan Miles

In 2001, Air Canada established Aeroplan Limited Partnership as a limited partnership wholly-owned by Air Canada. The Aeroplan loyalty program was previously a division of Air Canada. Under the Commercial Participation Services Agreement ("CPSA") between Air Canada and Aeroplan, Air Canada retained responsibility for the miles to be redeemed from accumulations of miles up to December 31, 2001. Aeroplan assumed responsibility for all miles issued beginning January 1, 2002. On December 31, 2001, there were 171 billion miles outstanding of which, after considering breakage, Management estimated that 103 billion miles would be redeemed.

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

Special Charge for Labour Restructuring

A workforce reduction plan was announced in February 2006 to reduce the number of non-unionized employees by 20 percent. As at February 14, 2007, approximately 75 percent of the planned reductions had been completed. A special charge of $28 million was recorded in the Air Canada Services segment in Quarter 1 2006 relating to this program. During Quarter 4 2006, the estimated cost of this plan was revised due to the favourable impact of attrition and other factors which reduced the cost of achieving the target. As a result, the Air Canada Services segment recorded a reduction of $8 million in Quarter 4 2006 to the special charge for labour restructuring.

The following table compares the results of the Corporation's reportable segments for the year ended December 31, 2006 to the year ended December 31, 2005. The amounts in the table below include inter-segment revenues and expenses.

	Air Canada Services				Jazz			
			Change				Change	
($ millions, except per share figures)	**2006**	**2005**	**$**	**%**	**2006**	**2005**	**$**	**%**
Operating revenues								
Passenger	$ 8,887	$ 8,197	$ 690	8	$ -	$ 2	$ (2)	(100)
Cargo	629	625	4	1	-	-	-	n/a
Other	723	687	36	5	1,381	1,021	360	35
	10,239	**9,509**	**730**	**8**	**1,381**	**1,023**	**358**	**35**
Special charge for Aeroplan miles	(102)	-	(102)	n/a	-	-	-	n/a
	10,137	**9,509**	**628**	**7**	**1,381**	**1,023**	**358**	**35**
Operating expenses								
Salaries, wages and benefits	1,816	1,857	(41)	(2)	311	265	46	17
Aircraft fuel	2,544	2,197	347	16	285	177	108	61
Aircraft rent	314	341	(27)	(8)	134	80	54	68
Airport and navigation fees	982	924	58	6	178	124	54	44
Aircraft maintenance, materials and supplies	768	693	75	11	98	68	30	44
Communications and information technology	273	294	(21)	(7)	8	5	3	60
Food, beverages and supplies	322	326	(4)	(1)	15	8	7	88
Depreciation, amortization and obsolescence	493	404	89	22	21	18	3	17
Commissions	237	253	(16)	(6)	-	-	-	n/a
Capacity purchase fees paid to Jazz	871	693	178	26	-	-	-	n/a
Special charge for labour restructuring	20	-	20	n/a	-	-	-	n/a
Other	1,383	1,336	47	4	187	149	38	26
	10,023	**9,318**	**705**	**8**	**1,237**	**894**	**343**	**38**
Operating income	**114**	**191**	**(77)**		**144**	**129**	**15**	
Non-operating income (expense)								
Interest income	82	48	34		6	1	5	
Interest expense	(313)	(270)	(43)		(8)	(16)	8	
Interest capitalized	62	14	48		(1)	-	(1)	
Gain (loss) on sale of and provisions on assets	(6)	(31)	25		-	4	(4)	
Other	(16)	15	(31)		(1)	-	(1)	
	(191)	**(224)**	**33**		**(4)**	**(11)**	**7**	
Income (loss) before the following items:	**(77)**	**(33)**	**(44)**		**140**	**118**	**22**	
Non-controlling interest	(12)	(13)	1		-	-	-	
Foreign exchange gain	12	47	(35)		-	-	-	
Recovery of (provision for) income taxes	3	(21)	24		-	-	-	
Segment income (loss)	**$ (74)**	**$ (20)**	**$ (54)**		**$ 140**	**$ 118**	**$ 22**	
EBITDAR[(1)]	**921**	**936**	**(15)**		**299**	**227**	**72**	
EBITDAR excluding special charges [(1)]	**1,043**	**936**	**107**		**299**	**227**	**72**	

(1) See section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss) and EBITDAR excluding special charges for Aeroplan miles and labour restructuring to operating income (loss).

8.1 Summary of Air Canada Services Segment Results

For the full year 2006, the Air Canada Services segment reported operating income of $114 million, a decrease of $77 million from the operating income of $191 million recorded in 2005. Excluding the special charges of $122 million for Aeroplan miles and labour restructuring, operating income increased $45 million over 2005. EBITDAR decreased $15 million from 2005. Excluding the special charge for Aeroplan miles and the special charge for labour restructuring, EBITDAR improved $107 million over 2005.

Passenger Revenues

System passenger revenues for 2006 increased $690 million or 8 percent, reflecting yield and traffic improvements due to stronger market demand. The system yield improvement of 3 percent in 2006 was principally due to fuel-related fare increases and increased fuel surcharges to offset higher fuel costs. A higher average business class fare was also a factor in the yield increase. The impact of the fuel-related fare increases, increased fuel surcharges and a higher business class fare was partially offset by the negative effect of a stronger Canadian dollar on international, US transborder and domestic revenues, which accounted for approximately $200 million in 2006. The August 10, 2006 terrorist threat in the United Kingdom and resultant additional security measures also had an adverse impact in 2006. For 2006, traffic grew 5 percent on a capacity increase of 4 percent over 2005 resulting in a passenger load factor improvement of 0.7 percentage points over 2005. RASM increased 4 percent compared to 2005 due primarily to the growth in system yield and partly to the improvement in passenger load factor.

The table below describes percentage changes in passenger revenues, capacity, traffic, passenger load factor, yield and RASM for 2006 to 2005.

2006 versus 2005	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	8	4	4	(0.5)	4	3
US transborder	17	12	16	2.5	1	4
Atlantic	5	2	2	0.5	2	3
Pacific	2	-	1	1.4	1	3
Other	9	1	3	1.8	6	8
System	**8**	**4**	**5**	**0.7**	**3**	**4**

Domestic passenger revenues increased $262 million or 8 percent in 2006 compared to 2005 due to traffic growth reflecting increased capacity and a 4 percent yield improvement. The suspension of Canjet's scheduled domestic operations in September 2006 also had a favourable impact on traffic. Yield increased 4 percent due to fuel-related fare increases to offset higher fuel costs. Increased demand for the higher-priced Tango Plus product was also a factor in the passenger yield growth over 2005. For 2006, domestic RASM rose 3 percent as a result of the yield improvement partly offset by a decrease of 0.5 percentage points in passenger load factor.

US transborder passenger revenues increased $268 million or 17 percent in 2006 compared to 2005 due to increased capacity, much stronger market demand and a yield improvement of 1 percent over 2005. Traffic increased 16 percent on a capacity increase of 12 percent resulting in a passenger load factor improvement of 2.5 percentage points. The growth in passenger traffic for 2006 was largely the result of increased capacity on routes to Las Vegas, San Francisco and Los Angeles and the addition of the Toronto-San Diego route in June 2006. The yield improvement over 2005 reflected fuel-related fare increases partly offset by the adverse impact of a stronger Canadian dollar and the impact of additional longer-haul flying to more key leisure destinations attracting traffic with lower average yields. For 2006, US transborder RASM increased 4 percent over 2005 as a result of the higher passenger load factor and, to a lesser extent, the yield growth.

Atlantic passenger revenues increased $83 million or 5 percent in 2006 compared to 2005 due to traffic growth and increased fuel surcharges to offset higher fuel costs. In 2006, Atlantic yield improved 2 percent over 2005. The favourable impact of increased fuel surcharges was partly offset by the adverse effect of a stronger Canadian dollar. A higher average business class fare was also a factor in the yield increase. Traffic grew 2 percent on a 2 percent capacity growth resulting in a half percentage point improvement in passenger load factor. Atlantic RASM increased 3 percent due to both the yield improvement and the higher passenger load factor. Changes to Air Canada's Atlantic network included the conversion of its service to Rome from summer

to year-round service in the latter part of 2005. In addition, in September 2006, Air Canada modified its Halifax-St. John's-London route to operate non-stop between Halifax and London. In November 2006, Air Canada introduced new non-stop service between Edmonton and London. Air Canada's Atlantic service was impacted by the August 10, 2006 terrorist threat in the United Kingdom and the new security measures introduced subsequently across the entire network.

Pacific passenger revenues increased $22 million or 2 percent in 2006 compared to 2005 due to traffic growth and increased fuel surcharges to offset higher fuel costs. Yield improved 1 percent over 2005. The impact of increased fuel surcharges was largely offset by the negative effect of a stronger Canadian dollar on foreign currency denominated revenues. A higher average business class fare was also a factor in the yield increase. The traffic growth in 2006 was largely offset by the change in the India service in November 2005 from Toronto-Delhi to Toronto-Zurich-Delhi. In 2005, all revenues from the India services were reflected in the Pacific route grouping whereas in 2006 only Zurich-Delhi revenue was reflected in the Pacific route grouping. Excluding the change in the India services, traffic increased approximately 6 percent while all countries in the Pacific route grouping, with the exception of Japan, were strong. For 2006, Pacific RASM increased 3 percent over 2005 due to both the 1.4 percentage point improvement in passenger load factor and the growth in yield.

Other passenger revenues (comprised of South Pacific, Caribbean, Mexico and South America) increased $55 million or 9 percent in 2006 compared to 2005 due to a yield improvement of 6 percent, as a result of increased fuel surcharges to offset higher fuel costs, and to an increase in traffic. Traffic grew 3 percent on a capacity increase of 1 percent resulting in a passenger load factor improvement of 1.8 percentage points over 2005. Traffic growth was primarily reflected in the Mexico and South America markets due to increased capacity and stronger market demand. For 2006, RASM increased 8 percent due to both the improvement in passenger load factor and the yield increase.

Cargo Revenues

For the year 2006, cargo revenues increased $4 million or 1 percent due to a growth in cargo traffic of 4 percent partly offset by a 3 percent decline in yield per revenue ton mile. Freighter revenues increased $28 million over 2005 mostly in the Pacific market during the first six months of 2006 where additional MD-11 freighter capacity was deployed. Effective November 2006, Air Canada reduced its freighter aircraft from three to two chartered MD-11 freighter aircraft. Shanghai operations have been reduced from five times a week to three times a week and freighter operations to Europe remain essentially unchanged.

Cargo revenues from non-freighter operations declined $24 million or 5 percent from 2005 mainly as a result of a 3 percent reduction in traffic and a 2 percent decline in yield per revenue ton mile. Of this, revenues from North American non-freighter services were down $10 million or 6 percent on reduced traffic partly offset by higher yield per revenue ton mile. International non-freighter revenues were down $14 million or 4 percent mainly as a result of lower yields. Adverse currency movements were an important factor in the yield decline.

Other Revenues

For 2006, other revenues increased $36 million or 5 percent over 2005. Increases included flight cancellation and change fees, buy-on-board revenues and other miscellaneous revenues.

Operating Expenses

Operating expenses increased $705 million or 8 percent in 2006 largely reflecting a 4 percent growth in capacity in addition to a $347 million or 16 percent increase in fuel expense.

For 2006, unit cost increased 4 percent over 2005. Excluding fuel expense and the special charge for labour restructuring, unit cost increased 1 percent over 2005.

The following table compares Air Canada Services' operating expenses per ASM for 2006 to Air Canada Services' operating expenses per ASM in 2005.

($ cents per ASM)			**Change**	
	2006	**2005**	**$**	**%**
Salary and wages	2.35	2.45	(0.10)	(4)
Benefits	0.62	0.70	(0.08)	(11)
Ownership (DAR) [1]	1.32	1.27	0.05	4
Airport and navigation fees	1.61	1.57	0.04	3
Aircraft maintenance, materials and supplies	1.26	1.18	0.08	7
Food, beverages and supplies	0.53	0.55	(0.02)	(4)
Commissions	0.39	0.43	(0.04)	(9)
Capacity purchase fees paid to Jazz	1.43	1.18	0.25	21
Other	2.70	2.78	(0.08)	(3)
Operating expense, excluding fuel expense and the special charge for labour restructuring [2]	**12.21**	**12.11**	**0.10**	**1**
Aircraft fuel	4.17	3.73	0.44	12
Special charge for labour restructuring	0.03	-	0.03	n/a
Total operating expense	**16.41**	**15.84**	**0.57**	**4**

(1) DAR refers to the combination of Aircraft rent and Depreciation, amortization and obsolescence.
(2) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for additional information.

Salaries and wages expense totaled $1,437 million in 2006, a decrease of $6 million from 2005, mainly reflecting a reduction of 2 percent or an average of 413 FTE employees.

Employee benefits expense amounted to $379 million in 2006, a decrease of $35 million or 8 percent over 2005. This decrease was largely due to a decline in post-employment benefits partly offset by higher pension expense which reflected a lower discount rate applied to pension obligations. Included in Quarter 4 2006 was a favourable adjustment of $8 million related to an updated evaluation of workers' compensation liability. Included in Quarter 4 2005 was an unfavourable adjustment of $5 million relating to an updated actuarial evaluation of workers' compensation liability.

Fuel expense increased $347 million or 16 percent in 2006, driven by high fuel prices. In 2006, an average base fuel price increase of $384 million, a volume-related increase of $100 million and an increased fuel hedging loss of $40 million were partially offset by a reduction of $177 million due to the favourable impact of a stronger Canadian dollar.

Ownership costs, comprised of aircraft rent, depreciation, amortization and obsolescence expenses, increased $62 million in 2006. Increases in ownership costs included a change in assumptions relating to the residual value of certain aircraft, the addition of 16 Embraer aircraft to Air Canada's operating fleet and increased MD-11 freighter aircraft flying in the first half of 2006. Decreases in ownership costs included the transfer of 10 CRJ-100 aircraft to Jazz, the impact of a stronger Canadian dollar on aircraft rent and the impact of aircraft returns and terminations.

Airport and navigation fees increased $58 million or 6 percent in 2006, mainly due to a 6 percent increase in aircraft departures and increased rates for landing and general terminal fees primarily at Toronto's Pearson International Airport. At Pearson, general terminal charges rose 9 percent per seat for domestic and international arrivals. These increases were partly offset by a rate reduction for navigation fees in Canada and Europe and favourable foreign exchange for international navigation fees.

Aircraft maintenance, materials and supplies increased $75 million or 11 percent in 2006 primarily due to growth in Airbus A320 aircraft maintenance costs and, to a lesser extent, in Boeing 767 aircraft maintenance costs. The Airbus A320 engines are in a work cycle that requires replacement of life limited parts as well as major inspections. Other engine maintenance increases were due to an increase in maintenance activity for Airbus A340 aircraft and overall engine price increases. These increases were partially offset by reduced Boeing 767 engine maintenance activity. An addition to maintenance reserves required to satisfy minimum return

conditions on short-term leases and future return to lessor expenses were also factors in the increase over 2005.

Food, beverage and supplies expense decreased $4 million or 1 per cent versus 2005 on a passenger traffic increase of 5 per cent. The volume-related increase was more than offset by cost reduction initiatives and the impact of new catering programs, including the buy-on-board program.

Commission expense decreased $16 million or 6 percent in 2006 on combined passenger and cargo revenue growth in 2006 of 8 percent. The decrease in commission expense was largely due to the impact of a change in the base commission structure together with other commercial initiatives to reduce commission expense which more than offset the volume-related increase. Commissions, as a percent of passenger and cargo revenues, declined from 2.9 percent in 2005 to 2.5 percent in 2006. Approximately 61 percent of domestic bookings were via the web in December 2006, up approximately 11 percentage points from the same month last year.

For 2006, capacity fees paid to Jazz, pursuant to the Jazz CPA, amounted to $871 million compared to $693 million in 2005, pursuant to the Initial Jazz CPA. The increase of 26 percent was mainly driven by a growth of 12 covered aircraft in Jazz's operating fleet, resulting in a 27 percent increase in block hours over 2005. ASM capacity for flights operated by Jazz increased 51 percent over 2005.

For 2006, other expenses increased $47 million over 2005. Increases included credit card fees, consulting and advisory fees, advertising and promotion expenses, building rent and crew cycle expenses.

Non-operating expense amounted to $191 million for 2006 compared to non-operating expense of $224 million for 2005. For 2006, net interest expense decreased $39 million from 2005. The increase in interest expense, largely driven by the financing of additional aircraft, was more than offset by capitalized interest relating to the acquisition of the Boeing 777 and 787 aircraft and growth in interest income due to higher cash balances and higher average interest rates. In 2006, loss on sale and provision on assets of $6 million was recorded. The Air Canada Services segment recorded an impairment loss of $7 million on one of its buildings in Quarter 4 2006 and a gain on sale of assets of $5 million on one of its commercial real estate properties in Quarter 3 2006. In 2005, loss on sale and provision on assets amounted to $31 million of which approximately half related to the write-down of Boeing 747 inventory.

For 2006, gains from the revaluation of foreign currency monetary items amounted to $12 million, attributable to a stronger Canadian dollar at December 31, 2006 compared to December 31, 2005. This compared to foreign exchange gains of $47 million recorded in 2005.

Segment loss of $74 million was recorded in 2006 compared to a segment loss of $20 million in 2005, a deterioration of $54 million, for the reasons disclosed above.

8.2 Summary of Jazz Segment Results

For 2006, operating income amounted to $144 million, pursuant to the Jazz CPA, compared to operating income of $129 million in 2005, pursuant to the Initial Jazz CPA. EBITDAR for 2006 improved $72 million over 2005. The increase in operating income and EBITDAR in 2006 was mainly due to a growth in fleet size consistent with Jazz's plan to increase its relative share of the North American ASM capacity, an increase in hours of contract flying under the Jazz CPA, as well as cost control.

The Jazz CPA came into effect on January 1, 2006. The major changes from the Initial Jazz CPA include: a longer term, a larger number of Covered Aircraft with a guaranteed minimum of 133 aircraft throughout the term, and Jazz expenses now reimbursed by Air Canada at a higher mark-up for controllable costs, and on an at-cost basis by Air Canada for other expenses.

Operating revenues for 2006 increased $358 million or 35 percent over 2005. The significant increase in revenues was due to a net addition of 14 aircraft operated by Jazz resulting in a 27 percent increase in block hours flown over 2005 as well as higher pass-though costs charged to Air Canada under the Jazz CPA.

Operating expenses increased $343 million or 38 percent over 2005 and included an increase in pass-through costs of $177 million or 55 percent, driven largely by a capacity increase of 51 percent. Unit cost for 2006 decreased 12 percent compared to 2005, in part due to an increase in long-haul flying which generally results in lower unit costs per ASM. Excluding fuel expense, unit cost for 2006 was down 10 percent. Unit cost reductions were achieved in all expense categories with the exception of fuel expense and aircraft rent. The

unit aircraft rental cost increase mainly reflected six CRJ-200 aircraft deliveries and the transfer of 10 CRJ-100 aircraft from Air Canada partly offset by a termination of two Dash 8 aircraft operating leases.

Segment income of $140 million was recorded in 2006 compared to segment income of $118 million in 2005.

8.3 Summary of Consolidated Results

The Corporation, as defined under "Basis of Presentation", recorded operating income of $259 million, a decrease of $59 million from the operating income of $318 million recorded in 2005. Excluding special charges of $122 million for Aeroplan miles and labour restructuring, operating income increased $63 million over 2005.

Gains from the revaluation of foreign currency monetary items amounted to $12 million in 2006 attributable to a stronger Canadian dollar at December 31, 2006 compared to December 31, 2005. This compared to gains of $47 million in 2005.

Net loss in 2006 amounted to $74 million or $0.83 per diluted share compared to a net loss of $20 million or $0.25 per diluted share in 2005. The 2006 net loss included special charges of $122 million ($83 million after tax).

Unit cost, as measured by operating expense per ASM, increased 3 percent in 2006 compared to 2005. For 2006, excluding fuel expense and the special charge for labour restructuring, unit cost was essentially unchanged from 2005.

9. FINANCIAL AND CAPITAL MANAGEMENT

9.1 Financial Position

The Corporation's combined consolidated statement of financial position includes the accounts of certain entities which are not legally controlled by Air Canada, including Jazz and certain aircraft and engine leasing entities and fuel facility corporations. While the assets and liabilities of these entities are included in Air Canada's combined consolidated financial statements, there is no recourse to Air Canada for the liabilities of the separate legal entities except to the extent of any existing obligations under agreements such as the Jazz CPA or guarantees. The information in the discussion of financial position has been presented on a consolidated basis. Creditors of Jazz have no recourse to Air Canada with respect to Jazz's recognized liabilities.

Consolidated Summary

As at December 31, 2006, current assets have increased $1,811 million since December 31, 2005, largely due to an increase in cash, cash equivalents and short-term investments of $909 million, reflecting in part the net proceeds from the Air Canada IPO of $187 million and the proceeds of $1,156 million from the transfer of investments to ACE as further described in Note 1 to Air Canada's combined consolidated financial statements. Current assets also include a future income tax asset of $345 million arising from a tax loss utilization strategy, offset by a tax payable of $345 million, and a prepaid maintenance asset of $535 million with ACTS LP ("ACTS"), both of which were related to the Air Canada IPO. Property and equipment increased $495 million mainly due to additions, primarily aircraft, offset by depreciation. Intangible assets decreased $617 million mainly due to the reversal by ACE of future income tax valuation allowance which results in a pro-rata reduction to Air Canada's intangible asset. Refer to Note 8 to Air Canada's combined consolidated financial statements for additional information.

As at December 31, 2006, current liabilities have increased $1,187 million, largely reflecting an increase in current portion of long-term debt and current taxes payable of $345 million relating to the Air Canada IPO.

Long-term debt and capital lease obligations increased $200 million and included the impact of certain financing activities, as described under "Financial and Capital Management — Liquidity and Working Capital" in this MD&A, as well as the favourable impact of a stronger Canadian dollar on US dollar debt and capital leases.

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

Refer to section 9.6 of this MD&A for the Corporation's projected planned and committed capital expenditures and for the impact these expenditures will have on property and equipment and long-term debt in the future.

The following provides an overview of the financial position of the Corporation as defined under "Basis of Presentation" and its two reportable segments for the periods indicated.

($ millions)	December 31, 2006				December 31, 2005			
	Air Canada Services	Jazz	Inter-segment elimination	Consolidated total	Air Canada Services	Jazz	Inter-segment elimination	Consolidated total
ASSETS								
Current								
Cash and cash equivalents	$ 1,312	$ 135	$ -	$ 1,447	$ 1,000	$ 34	$ -	$ 1,034
Short-term investments	798	-	-	798	302	-	-	302
	2,110	**135**	**-**	**2,245**	**1,302**	**34**	**-**	**1,336**
Restricted cash	109	-	-	109	86	-	-	86
Accounts receivable	739	71	(122)	688	699	198	(237)	660
Spare parts, materials and supplies	119	29	-	148	154	25	-	179
Prepaid expenses and other current assets	115	9	-	124	115	7	-	122
Prepaid maintenance to ACTS	535	-	-	535	-	-	-	-
Future income tax	345	-	-	345	-	-	-	-
	4,072	**244**	**(122)**	**4,194**	**2,356**	**264**	**(237)**	**2,383**
Property and equipment	5,747	199	-	5,946	5,257	194	-	5,451
Deferred charges	73	30	-	103	94	33	-	127
Intangible assets	1,185	9	-	1,194	1,799	10	2	1,811
Deposits and other assets	311	1	-	312	489	3	(2)	490
	11,388	**483**	**(122)**	**11,749**	**9,995**	**504**	**(237)**	**10,262**
LIABILITIES								
Current								
Accounts payable and accrued liabilities	1,430	213	(122)	1,521	1,476	172	(237)	1,411
Advance ticket sales	1,019	-	-	1,019	893	-	-	893
Aeroplan Miles obligation	58	-	-	58	89	-	-	89
Current portion of long-term debt and capital leases	367	-	-	367	262	3	-	265
Note payable to ACTS	535	-	-	535	-	-	-	-
Current taxes payable	345	-	-	345	-	-	-	-
	3,754	**213**	**(122)**	**3,845**	**2,720**	**175**	**(237)**	**2,658**
Long-term debt and capital leases	3,081	115	-	3,196	2,786	210	-	2,996
Notes payable to ACE subsidiary	-	-	-	-	340	-	-	340
Future income taxes	134	-	-	134	217	-	-	217
Pension and other benefit liabilities	1,867	9	-	1,876	2,147	7	-	2,154
Other long-term liabilities	410	62	-	472	437	59	-	496
Preferred shares	-	-	-	-	50	-	-	50
	9,246	**399**	**(122)**	**9,523**	**8,697**	**451**	**(237)**	**8,911**
NON-CONTROLLING INTEREST	**212**	**-**	**162**	**374**	**203**	**-**	**130**	**333**
SEGMENT EQUITY	**1,930**	**84**	**(162)**	**1,852**	**1,095**	**53**	**(130)**	**1,018**
	$ 11,388	**$ 483**	**$ (122)**	**$ 11,749**	**$ 9,995**	**$ 504**	**$ (237)**	**$ 10,262**

9.2 Liquidity and Working Capital

Air Canada Services

At December 31, 2006, Air Canada Services had cash, cash equivalents and short-term investments of $2,110 million and positive working capital of $318 million. Compared to December 31, 2005, cash, cash equivalents and short-term investments have increased $808 million mainly due net proceeds of $187 million and a transfer of Air Canada's investment to ACE of $1,156 million ($673 million related to the transfer of ACTS to ACE and $483 million related to the transfer of Jazz to ACE).

The introduction of Air Canada's innovative customer driven revenue model in conjunction with a redesigned network and a renewed fleet is expected to generate increased revenue and improved cost efficiencies going forward. This, in turn, is expected to improve cash generated from operations which will in part be used to fund capital expenditures as well as to pay down debt incurred to finance a large portion of the capital expenditures. The Corporation continues to closely monitor its liquidity requirements and is assessing various financing transactions and initiatives with the objective of ensuring its future liquidity needs are addressed. At December 31, 2006, Air Canada Services had an unused secured syndicated revolving credit facility of $400 million on which no amounts have been drawn.

Jazz

At December 31, 2006, Jazz had cash and cash equivalents of $135 million and positive working capital of $31 million. Compared to December 31, 2005, cash and cash equivalents have increased $101 million while working capital has decreased $58 million.

Consolidated Summary

At December 31, 2006, the Corporation had cash, cash equivalents and short-term investments of $2,245 million and positive working capital of $349 million. Compared to December 31, 2005, cash, cash equivalents and short-term investments have increased $909 million and working capital has improved $624 million.

9.3 Cash flows for Quarter 4 2006 and Quarter 4 2005

The following table provides an overview of the cash flows of the Corporation as defined under "Basis of Presentation" and its two reportable segments for the periods indicated:

($ millions)	Three months ended December 31, 2006				Three months ended December 31, 2005			
	Air Canada Services	Jazz	Inter-segment elimination	Consolidated total	Air Canada Services	Jazz	Inter-segment elimination	Consolidated total
Cash from (used for) operating activities								
Income (loss) for the period	$ (144)	$ 32	$ (32)	**$ (144)**	$ (136)	$ 32	$ (32)	**$ (136)**
Adjustments to reconcile to net cash provided by operations								
Depreciation, amortization and obsolescence	135	6	-	**141**	106	4	-	**110**
(Gain) loss on sale of assets	10	-	-	**10**	30	(1)	-	**29**
Foreign exchange (gain) loss	134	-	-	**134**	11	-	-	**11**
Future income taxes	(23)	-	-	**(23)**	(57)	-	-	**(57)**
Employee future benefit funding more than expense	(98)	-	-	**(98)**	(26)	-	-	**(26)**
Decrease (increase) in accounts receivable	93	7	3	**103**	271	(32)	23	**262**
Decrease (increase) in spare parts, materials and supplies	(27)	(3)	-	**(30)**	(70)	(2)	-	**(72)**
Increase (decrease) in accounts payable and accrued liabilities	(131)	(12)	(3)	**(146)**	74	39	(24)	**89**
Increase (decrease) in advance ticket sales, net of restricted cash	(32)	-	-	**(32)**	(164)	-	-	**(164)**
Increase (decrease) in Aeroplan miles obligation	(25)	-	-	**(25)**	(40)	-	-	**(40)**
Non-controlling Interest	-	-	36	**36**	-	-	35	**35**
Allocation of corporate expenses	2	-	-	**2**	2	-	-	**2**
Aircraft lease payments (in excess of) less than rent expense	(3)	-	-	**(3)**	9	30	-	**39**
Other	(50)	3	(4)	**(51)**	(58)	3	(2)	**(57)**
Cash flows from operating activities	**(159)**	**33**	**-**	**(126)**	**(48)**	**73**	**-**	**25**
Cash from (used for) financing activities								
Issue by Air Canada of share capital	187	-	-	**187**	-	-	-	**-**
Transfer of ACTS investments to ACE	673	-	-	**673**	20	-	-	**20**
Transfer of Jazz investments to ACE	83	-	-	**83**				
Aircraft-related borrowings	76	-	-	**76**	191	-	-	**191**
Cash management with related parties	-	-	-	**-**	(50)	-	-	**(50)**
Distributions paid to non-controlling interest	-	(15)	-	**(15)**	-	-	-	**-**
Settlement of notes payable to ACE	(140)	-	-	**(140)**	-	-	-	**-**
Reduction of long-term debt and capital lease obligations	(71)	-	-	**(71)**	(60)	-	-	**(60)**
Other	-	-	-	**-**	-	(1)	-	**(1)**
	808	**(15)**	**-**	**793**	**101**	**(1)**	**-**	**100**
Cash from (used for) investing activities								
Short-term investments	(383)	-	-	**(383)**	921	-	-	**921**
Additions to capital assets	(206)	(7)	-	**(213)**	(465)	(2)	-	**(467)**
Reduction of note receivable from ACE	186	-	-	**186**	-	-	-	**-**
Proceeds from sale of assets	-	-	-	**-**	-	1	-	**1**
Decrease (increase) in amount receivable from Air Canada	-	-	-	**-**	42	(42)	-	**-**
Cash management with related parties	40	-	-	**40**	(43)	-	-	**(43)**
Cash collateralization of letters of credit	18	-	-	**18**	-	-	-	**-**
Other	2	-	-	**2**	5	(5)	-	**-**
	(343)	**(7)**	**-**	**(350)**	**460**	**(48)**	**-**	**412**
Increase (decrease) in cash and cash equivalents	306	11	-	317	513	24	-	537
Cash and cash equivalents, end of period	**$ 1,312**	**$ 135**	**-**	**$ 1,447**	**$ 1,000**	**$ 34**		**$ 1,034**

As described in Note 1 to Air Canada's combined consolidated financial statements, inter-company accounts between ACE and Air Canada were settled at the time of the Air Canada IPO which resulted in an increase to cash and cash equivalents of $170 million, a reduction to deposits and other assets of $269 million (consisting of an advance of $186 million and a note receivable on the transfer of the Jazz investment of $83 million), a reduction to accounts receivable of $41 million and a reduction of long-term debt of $140 million. These cash flows are included in the applicable section of the cash flows, as described further below.

Cash Flows from Operating Activities

In Quarter 4, cash flows used from operations were $159 million, a deterioration of $111 million over Quarter 4 2005, primarily as a result of unfavourable variances in working capital items affecting cash, as well as an increase in pension plan funding of $72 million over Quarter 4 2005. The variances in working capital items relate mainly to timing differences in the settlement of amounts related to normal operating activities.

The Jazz segment delivered cash flows from operations of $33 million in Quarter 4 2006, which was generated in large part by Jazz's positive operating results under the Jazz CPA with Air Canada offset by cash costs incurred.

Cash Flows from Financing Activities

Cash flows from financing activities included net proceeds of $187 million, a transfer of Air Canada's investment to ACE of $756 million ($673 million related to the transfer of ACTS to ACE and $83 million relating to the settlement of a note receivable from ACE on the transfer of Air Canada's investment in Jazz) and a settlement of notes payable to ACE of $140 million, all of which were in conjunction with the Air Canada IPO.

Aircraft-related borrowings for the Air Canada Services segment amounted to $76 million in Quarter 4 2006 and related mainly to the delivery of three Embraer aircraft in Quarter 4 2006. Scheduled and other debt and capital lease payments in Quarter 4 2006 amounted to $71 million.

Cash used for financing activities for the Jazz segment amounted to $15 million in Quarter 4 2006 and related to distributions paid to non-controlling interest.

Cash Flows used for Investing Activities

For Quarter 4 2006, additions to capital assets totaled $206 million for the Air Canada Services segment. These additions included $89 million related to three Embraer aircraft and $50 million to the aircraft interior refurbishment program and to the installation of an in-flight entertainment system on Jazz Bombardier CRJ-705 aircraft. Other additions to capital assets related to inventory and spare engines, systems development projects as well as ground equipment and facilities. In addition, Air Canada Services received $186 million from ACE related to the settlement of notes receivable in connection with the Air Canada IPO.

Cash used for investing activities for the Jazz segment amounted to $7 million in Quarter 4 2006, primarily related to aircraft improvements and to the purchase of two Dash 8-300 aircraft.

9.4 Cash flows for 2006 and 2005

The following table provides an overview of the cash flows of the Corporation as defined under "Basis of Presentation" and its two reportable segments for the periods indicated:

($ millions)	Year ended December 31, 2006				Year ended December 31, 2005			
	Air Canada Services	Jazz	Inter-segment elimination	Consolidated total	Air Canada Services	Jazz	Inter-segment elimination	Consolidated total
Cash from (used for) operating activities								
Income (loss) for the period	$ (74)	$ 140	$ (140)	**$ (74)**	$ (20)	$ 117	$ (117)	**$ (20)**
Adjustments to reconcile to net cash provided by operations								
Depreciation, amortization and obsolescence	493	21	-	**514**	404	18	-	**422**
(Gain) loss on sale of assets	6	-	-	**6**	31	(4)	-	**27**
Foreign exchange (gain) loss	6	-	-	**6**	(83)	-	-	**(83)**
Future income taxes	(3)	-	-	**(3)**	11	-	-	**11**
Employee future benefit funding more than expense	(228)	-	-	**(228)**	(74)	-	-	**(74)**
Decrease (increase) in accounts receivable	(81)	124	(115)	**(72)**	176	(146)	157	**187**
Decrease (increase) in spare parts, materials and supplies	35	(4)	-	**31**	(51)	(13)	-	**(64)**
Increase (decrease) in accounts payable and accrued liabilities	30	(125)	115	**20**	(218)	215	(157)	**(160)**
Increase (decrease) in advance ticket sales, net of restricted cash	103	-	-	**103**	183	-	-	**183**
Increase (decrease) in Aeroplan miles obligation	(108)	-	-	**(108)**	(146)	-	-	**(146)**
Non-controlling Interest	-	-	152	**152**	-	-	131	**131**
Special charge for Aeroplan miles	102	-	-	**102**	-	-	-	**-**
Allocation of corporate expenses	11	-	-	**11**	21	-	-	**21**
Aircraft lease payments (in excess of) less than rent expense	(16)	-	-	**(16)**	21	12	-	**33**
Other	(65)	26	(12)	**(51)**	(59)	(7)	(14)	**(80)**
Cash flows from operating activities	**211**	**182**	**-**	**393**	**196**	**192**	**-**	**388**
Cash from (used for) financing activities								
Issue by Air Canada of share capital	187	-	-	**187**	-	-	-	-
Issue of Jazz units	-	218	-	**218**	-	-	-	**-**
Transfer of ACTS investments to ACE	673	-	-	**673**	-	-	-	**-**
Transfer of Jazz investments to ACE	483		-	**483**	-	-	-	**-**
Transfer of Aeroplan investments to ACE	-	-	-	**-**	1,070			**1,070**
Acquisition promissory note paid by Jazz to ACE	-	(424)	-	**(424)**	-	-	-	**-**
Jazz credit facility borrowings	-	113	-	**113**	-	-	-	**-**
Aircraft-related borrowings	397	-	-	**397**	404	-	-	**404**
Cash management with related parties	-	-	-	**-**	(4)	-	-	**(4)**
Distributions paid to non-controlling interest	-	(86)	-	**(86)**	-	-	-	**-**
Settlement of notes payable to ACE	(140)	-	-	**(140)**	-	-	-	**-**
Reduction of long-term debt and capital lease obligations	(264)	(14)	-	**(278)**	(351)	(3)	-	**(354)**
Increase (decrease) in Air Canada indebtedness	-	-	-	**-**	5	(5)	-	**-**
Other	(1)	-	-	**(1)**	(5)	(1)	-	**(6)**
	1,335	**(193)**	**-**	**1,142**	**1,119**	**(9)**	**-**	**1,110**
Cash from (used for) investing activities								
Short-term investments	(496)	-	-	**(496)**	(250)	-	-	**(250)**
Additions to capital assets	(863)	(25)	-	**(888)**	(852)	(16)	-	**(868)**
Reduction of note receivable from ACE	186	-	-	**186**	-	-	-	**-**
Proceeds from sale of assets	40	-	-	**40**	37	4	-	**41**
Decrease (increase) in amount receivable from Air Canada	(137)	137	-	**-**	137	(137)	-	**-**
Cash management with related parties	32	-	-	**32**	(59)	-	-	**(59)**
Cash collateralization of letters of credit	4	-	-	**4**	(35)	-	-	**(35)**
	(1,234)	**112**	**-**	**(1,122)**	**(1,022)**	**(149)**	**-**	**(1,171)**
Increase (decrease) in cash and cash equivalents	312	101	-	413	293	34	-	327
Cash and cash equivalents, end of period	**$ 1,312**	**$ 135**	**-**	**$ 1,447**	**$ 1,000**	**$ 34**	**-**	**$ 1,034**

Cash Flows from Operating Activities

For 2006, cash flows from operations for the Air Canada Services segment were $211 million, an increase of $15 million over 2005, primarily due to improved operating results partly offset by increased pension plan funding. Pension funding amounted to $447 million in 2006 versus $278 million in 2005.

The Jazz segment delivered positive cash flows from operations of $182 million in 2006, which was generated in large part by Jazz's positive operating results under the Jazz CPA with Air Canada offset by cash costs incurred.

Cash Flows from Financing Activities

Cash flows from financing activities included net proceeds of $187 million related to the issue of Air Canada shares, a transfer of Air Canada's investments to ACE of $1,156 million ($673 million related to the transfer of ACTS to ACE, $483 million related to the transfer of Air Canada's investment in Jazz) and a settlement of notes payable to ACE of $140 million.

Aircraft-related borrowings for the Air Canada Services segment amounted to $397 million in 2006 and related mainly to the delivery of 16 Embraer aircraft in 2006. Scheduled and other debt and capital lease payments in 2006 amounted to $264 million.

Cash used for financing activities for the Jazz segment amounted to $193 million in 2006. Net proceeds to Jazz from the issuance of Jazz units were $218 million. Also in connection with the offering, Jazz arranged for senior secured syndicated credit facility in the amount of $150 million. Jazz received proceeds of $115 million ($113 million, net of fees of $2 million), representing the drawing under this new credit facility. In connection with the initial public offering, Jazz Air Limited Partnership transferred substantially all of its assets and liabilities to the new Jazz Air LP that was wholly-owned by ACE. In consideration, ACE received 99,365,143 units of the partnership and an acquisition promissory note of $424 million. The acquisition promissory note was repaid to ACE from proceeds received from the offering, from the new term credit facility and from working capital.

Other cash used for financing activities for the Jazz segment mainly related to distributions paid to non-controlling interests which amounted to $86 million in 2006.

Cash Flows used for Investing Activities

For 2006, Air Canada Services additions to capital assets totaled $863 million. These additions included $481 million related to 16 Embraer aircraft and $148 million related to the aircraft interior refurbishment program and to the installation of an in-flight entertainment system on Jazz Bombardier CRJ-705 aircraft. In addition, pre-delivery payments made on Boeing aircraft amounted to $44 million. Other additions to capital assets related to inventory and spare engines, systems development projects as well as ground equipment and facilities. In addition, Air Canada Services received $186 million from ACE related to the settlement of notes receivable in connection with the Air Canada IPO.

In 2006, additions to capital assets for the Jazz segment amounted to $25 million and were primarily related to aircraft improvements and to the purchase of two Dash 8-300 aircraft.

9.5 Debt and Lease Obligations

The debt and lease obligations reported in Air Canada's combined consolidated statement of financial position includes debt incurred by Air Canada, its subsidiaries, including those consolidated under Accounting Guideline of the CICA Handbook, Consolidation of Variable Interest Entities ("AcG-15:), and other entities which have been combined in Air Canada's combined consolidated financial statements. Entities consolidated under AcG-15 include Jazz and certain engine leasing entities and fuel facilities corporations.

Summary of Principal Repayment and Future Minimum Lease Payment Requirements as at December 31, 2006

The table below summarizes the principal repayment requirements as at December 31, 2006 for the years 2007 through to 2011 and thereafter on long-term debt and capital lease obligations.

	2007	2008	2009	2010	2011	Thereafter
($ millions)						
Long-term debt principal obligations	67	85	70	55	70	710
Debt consolidated under AcG-15[(1)]	120	117	60	118	248	447
Capital lease principal obligations	180	179	92	90	87	653
Air Canada Services	367	381	222	263	405	1,810
Jazz — Long-term debt obligations	-	-	115	-	-	-
Consolidated total	367	381	337	263	405	1,810

(1) Includes end of lease debt principal payments due on aircraft and engine leasing entities consolidated under AcG-15 before taking into account the anticipated fair value of the aircraft and engines at the time of lease expiry. In 2007, amounts due of approximately US$39 million relate to end of lease obligations. In 2008, amounts due of approximately US$51 million relate to end of lease obligations. In 2010, amounts due of approximately US$54 million relate to end of lease obligations. In 2011, amounts due of approximately US$183 million relate to end of lease obligations. In these leasing transactions, Air Canada has the option to either refinance the aircraft on lease expiry or to return the aircraft to the lessor.

The table below summarizes the future minimum lease payments for the years 2007 through to 2011 and thereafter under existing operating leases as at December 31, 2006.

($ millions)	2007	2008	2009	2010	2011	Thereafter
Air Canada Services						
Aircraft operating leases[(1)]	403	334	304	269	200	1,072
Other property	53	46	32	27	24	140
Total Air Canada Services	456	380	336	296	224	1,212
Jazz						
Aircraft operating leases	3	1	1	1	-	-
Other property	13	12	11	7	1	3
Total Jazz	16	13	12	8	1	3
Consolidated total	472	393	348	304	225	1,215

(1) Includes aircraft leased and subleased to Jazz.

9.6 Capital Expenditures

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

Embraer

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

Deliveries of the 15 Embraer 175 series aircraft commenced in July 2005 and the last aircraft was delivered in January 2006. All Embraer ERJ-175 deliveries were 80 percent financed by a third party as described in Note 7 to Air Canada's combined consolidated financial statements.

The Embraer 190 series deliveries commenced in December 2005. As at December 31, 2006, 18 of the Embraer 190 series firm aircraft orders have been completed and the remaining 27 deliveries were planned to be completed by November 2007 in accordance with the purchase agreement. Certain aircraft deliveries, which were planned to be completed by November 2007, have been delayed with the last delivery expected by January 2008. The impact of these delays has been reflected in the projected planned and committed capital expenditures table below. These projections are based on estimates using information currently available and are subject to change.

For the first 18 firm Embraer 190 deliveries, all of which have been delivered, Air Canada received loans from a syndicate of banks and the manufacturer covering 80 percent of the capital expenditure as described in Note 7 to Air Canada's combined consolidated financial statements.

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

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

Boeing

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

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

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

Air Canada has received financing commitments from Boeing and the engine manufacturer for all firm aircraft orders covering up to 90 percent of the capital expenditure. This available financing would be at an interest rate of 9.86 percent, based on interest rates as at December 31, 2006. The term to maturity would be 15 years with principal payments made on a mortgage style basis resulting in equal installment payments of principal and interest over the term to maturity. On November 3, 2006, Air Canada made an application for loan guarantee support from the Export-Import Bank of the United States for the first seven Boeing 777 aircraft deliveries in 2007. The loan guarantee, if provided, would cover a 12-year loan term for 85 percent of the capital expenditure at an interest rate of approximately 5.36 percent, based on interest rates as at December 31, 2006.

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

Refurbishment of Existing Aircraft

In addition to acquiring new aircraft, Air Canada commenced a major refurbishment of the interior of its existing aircraft in April 2006. Air Canada has completed the refurbishment of its 16th Airbus A320 and its fourth Boeing 767-300 aircraft. The refurbishment for the Airbus A319, A321 and A330 aircraft is expected to begin in early 2007. The Embraer and Boeing 777 aircraft are being delivered with the new seats and entertainment systems already installed. The aircraft refurbishment program is scheduled to be completed by mid-2008. The capital expenditure associated with this program will be amortized over a five-year period.

Projected Planned and Committed Capital Expenditures

The table below provides projections for aircraft expenditures for firm aircraft orders, net of aircraft financing, combined with planned and committed expenditures for aircraft engines, inventory, property and equipment, net of related financing, if applicable, for the years 2007 through to 2011.

In addition to the firm aircraft orders, Air Canada's purchase agreements include options, cancelable orders and purchase rights, all of which are not included in these projections.

Air Canada Services Projected planned and committed capital expenditures (1)(2)(3)	**2007**	**2008**	**2009**	**2010**	**2011**
Projected committed expenditures	2,144	1,458	448	933	868
Projected planned but uncommitted expenditures	246	293	158	148	154
Total projected expenditures	2,390	1,751	606	1,081	1,022
Projected financing on committed expenditures	(1,533)	(1,293)	(302)	(834)	(732)
Total projected expenditures, net of financing	857	458	304	247	290

Jazz Projected planned and committed capital expenditures (1)(2)	**2007**	**2008**	**2009**	**2010**	**2011**
Projected committed expenditures	7	-	-	-	-
Projected planned but uncommitted expenditures	20	28	23	23	23
Total projected expenditures	27	28	23	23	23

(1) US dollar amounts are converted using the December 31, 2006 noon day rate of $1.1653. Final aircraft delivery prices include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day USD LIBOR rate at December 31, 2006.
(2) The dollar amounts reflected above do not include obligations pertaining to day-to-day operations.
(3) The projected financing amounts include loan commitments obtained as at December 31, 2006.

Projected Cash Payments for Committed Aircraft Deliveries

The following table provides Air Canada Services' cash principal payments for the future firm aircraft deliveries for the years 2007 through to 2011. Jazz has no projected principal repayments relating to new deliveries in these years.

The projected principal repayments disclosed below are based on the assumption that all aircraft acquisitions will be financed under debt. Air Canada has not yet decided whether certain aircraft acquisitions will be financed under debt or operating lease arrangements.

($ millions)	2007	2008	2009	2010	2011
Principal repayment on aircraft-related long-term debt(1)(2)	25	94	132	156	201

(1) US dollar amounts are converted using the December 31, 2006 noon day rate of $1.1653. Final aircraft delivery prices include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day USD LIBOR rate at December 31, 2006.

(2) The projected principal repayment amounts reflect certain loan commitments received and Management's best estimate as to market terms available.

9.7 Pension Plan Cash Funding Obligations

As at December 31, 2006 and based on the January 1, 2006 solvency valuations, the table below provides projections for the Corporation's cash pension plan funding obligations for the years 2007 through to 2011. The final funding obligation for 2007 will be determined based on the January 1, 2007 valuation.

($ millions)	2007	2008	2009	2010	2011
Past service costs for domestic registered plans	248	242	245	246	246
Current service costs for domestic registered plans	155	160	165	170	175
Other pension arrangements(1)	86	86	65	69	74
Air Canada Services	489	488	475	485	495
Jazz	9	9	9	9	7
Consolidated total	498	497	484	494	502

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

The above pension funding requirements are in respect of all the Corporation's pension arrangements. The most recent actuarial valuation is as at January 1, 2006 and the effective date of the next required actuarial valuation is January 1, 2007. For domestic registered pension plans, the funding requirements are based on the minimum past service contributions disclosed in the January 1, 2006 valuations plus a projection of the current service contributions based upon the January 1, 2006 actuarial valuation. The required contributions disclosed above do not reflect actual experience of 2006 and assume no future gains or losses on plan assets and liabilities over the projection period. The changes in the economic conditions, mainly the return on assets generated by the fund and the change in interest rates, will impact projected required contributions.

The Corporation maintains several benefit and defined contribution plans providing pension, other retirement and post-employee benefits to its employees, including those employees of the Corporation who are contractually assigned to ACTS and Aeroplan. Air Canada's combined consolidated financial statements include all of the assets and liabilities of all the Corporation sponsored plans. Employee benefits expense reflects a cost recovery which is charged to the related parties for those employees currently performing work for their benefit.

The deficit, on an accounting basis, at December 31, 2006 for pension benefits was $1.4 billion compared to $2.5 billion at December 31, 2005. The decrease in the accounting deficit was mainly the result of a return on plan assets of approximately 13.8 percent during 2006 and funding of past service contributions of $261 million. The solvency deficit on the registered pension plans at January 1, 2007 is also expected to decrease significantly compared to January 1, 2006 and, as a result, employer contributions determined in accordance with regulations are expected to decline by $90 million in 2007 and $120 million each year thereafter.

9.8 Share Information

An aggregate of 100 million Class A variable voting shares and Class B voting shares in the capital of Air Canada are issued and outstanding. On November 24, 2006, Air Canada sold an aggregate of 9,523,810 Class A variable voting shares and Class B voting shares at $21 per share for net proceeds of $187 million. The transaction was part of Air Canada's IPO which included a secondary offering whereby ACE sold an aggregate of 15,476,190 Class A variable voting shares and Class B voting shares also at $21 per share for gross proceeds of $325 million.

The authorized share capital of Air Canada consists of an unlimited number of Class A variable voting shares and an unlimited number of Class B voting shares. The Class A variable voting shares may only be held, beneficially owned or controlled, directly or indirectly, by persons who are not Canadians, as such term is defined in the Canada Transportation Act ("Qualified Canadians"). The Class B voting shares may only be held, beneficially owned and controlled, directly or indirectly, by Qualified Canadians. The two classes of shares have equivalent rights except for voting rights. Holders of Class A variable voting shares are entitled to one vote per share unless (i) the aggregate number of Class A variable voting shares outstanding, as a percentage of the total number of votes attaching to all issued and outstanding voting shares of Air Canada exceeds 25 percent, or (ii) the total number of votes cast by or on behalf of holders of Class A variable voting shares at any meeting exceeds 25 percent of the total number of votes that may be cast at such meeting. If the 25 percent threshold would be surpassed at any time, the votes attaching to the Class A variable voting shares would be proportionately reduced. Class A variable voting shares will be automatically converted, without any further act of Air Canada or the holder, to Class B voting shares if the shares become held, beneficially owned and controlled, directly or indirectly, by a Qualified Canadian. Class B Voting shares will be automatically converted, without any further act of Air Canada or the holder, to Class A variable voting shares if the shares become held, beneficially owned or controlled, directly or indirectly, by a party that is not a Qualified Canadian.

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

	Number of shares (000)
	At January 31, 2007
Issued and outstanding shares	
Class A variable voting shares	17,572,543
Class B voting shares	82,427,457
Total issued and outstanding shares	**100,000,000**

	Number of shares (000)
	At January 31, 2007
Class A variable voting and Class B voting shares potentially issuable	
Stock options	1,695,035
Total shares potentially issuable	**1,695,035**

	Number of shares (000)
	At January 31, 2007
Total outstanding and potentially issuable shares	**101,695,035**

10. QUARTERLY FINANCIAL DATA

The table below describes quarterly financial results and major operating statistics for the Corporation and its two reportable segments since the first quarter of 2005. The amounts in the tables below include inter-segment revenues and expenses.

Consolidated total	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Operating revenues	$2,097	$2,363	$2,742	$2,256	$2,376	$2,559	$2,837	$2,395
Special charge for Aeroplan miles [1]	-	-	-	-	-	-	(102)	-
Operating revenues	**$2,097**	**$2,363**	**$2,742**	**$2,256**	**$2,376**	**$2,559**	**$2,735**	**$2,395**
Operating expenses [2]	(2,150)	(2,244)	(2,433)	(2,313)	(2,464)	(2,410)	(2,566)	(2,366)
Operating income (loss)	**(53)**	**119**	**309**	**(57)**	**(88)**	**149**	**169**	**29**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(63)	(129)	(68)	(78)	(38)	3	(125)	(173)
Net income (loss)	**($116)**	**($10)**	**$241**	**($135)**	**($126)**	**$152**	**$44**	**($144)**
Earning (loss) per share								
- Basic	**$ (1.85)**	**$ (0.12)**	**$ 2.73**	**$ (1.53)**	**$ (1.43)**	**$ 1.72**	**$ 0.50**	**$ (1.55)**
- Diluted	**$ (1.85)**	**$ (0.12)**	**$ 2.73**	**$ (1.53)**	**$ (1.43)**	**$ 1.72**	**$ 0.50**	**$ (1.55)**
Revenue passenger miles (millions)	10,586	11,613	13,981	10,584	11,240	12,248	14,346	11,160
Available seat miles (millions)	13,566	14,487	16,961	13,808	14,287	14,926	17,529	14,343
Passenger load factor (%)	78.0	80.2	82.4	76.7	78.7	82.1	81.8	77.8

Air Canada Services	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Operating revenues	$2,108	$2,373	$2,757	$2,271	$2,394	$2,576	$2,854	$2,415
Special charge for Aeroplan miles [1]	-	-	-	-	-	-	(102)	-
Operating revenues	**$2,108**	**$2,373**	**$2,757**	**$2,271**	**$2,394**	**$2,576**	**$2,752**	**$2,415**
Operating expenses [2]	(2,190)	(2,281)	(2,485)	(2,362)	(2,518)	(2,463)	(2,622)	(2,420)
Operating income (loss)	**(82)**	**92**	**272**	**(91)**	**(124)**	**113**	**130**	**(5)**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(34)	(101)	(32)	(44)	(2)	39	(86)	(139)
Net income (loss)	**($116)**	**($9)**	**$240**	**($135)**	**($126)**	**$152**	**$44**	**($144)**
Revenue passenger miles (millions)	10,586	11,612	13,980	10,584	11,240	12,248	14,345	11,160
Available seat miles (millions)	13,565	14,486	16,960	13,807	14,287	14,925	17,528	14,343
Passenger load factor (%)	78.0	80.2	82.4	76.7	78.7	82.1	81.8	77.8
Operating expense per available seat mile (CASM) (cents)	16.2	15.8	14.7	17.1	17.6	16.5	15.0	16.9
CASM, excluding fuel expense (cents) [3]	13.1	12.1	10.7	12.9	13.7	12.3	10.6	12.8
CASM, excluding fuel expense and the special charge for labour restructuring (cents) [3]	13.1	12.1	10.7	12.9	13.5	12.3	10.6	12.9

(1) Quarter 3 2006 includes a special charge of $102 million in connection with Air Canada's obligation for the redemption of pre-2002 Aeroplan miles.
(2) Quarter 1 2006 includes a special charge for labour restructuring of $28 million. In Quarter 4, 2006, this charge was reduced by $8 million to $20 million.
(3) See section 20 "Non-GAAP Financial Measures" in this MD&A for additional information.

Jazz	Q1 2005	Q2 2005	Q3 2005	Q4 2005	Q1 2006	Q2 2006	Q3 2006	Q4 2006
Passenger revenue	$-	$1	$-	$1	$-	$-	$-	$-
Other revenue	213	231	274	303	320	340	369	352
Operating revenues	**$213**	**$232**	**$274**	**$304**	**$320**	**$340**	**$369**	**$352**
Operating expenses	(183)	(205)	(236)	(270)	(285)	(303)	(330)	(319)
Operating income	**30**	**27**	**38**	**34**	**35**	**37**	**39**	**33**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(4)	(4)	(1)	(2)	(2)	(1)	-	(1)
Segment income	**$26**	**$23**	**$37**	**$32**	**$33**	**$36**	**$39**	**$32**

Seasonality

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

11. SELECTED ANNUAL INFORMATION

The following table provides selected annual information for the Corporation, as defined under "Basis of Presentation", for the years 2006 and 2005 and for the three-month period ended December 31, 2004. The table also provides selected information for the nine-month period ended September 30, 2004 for the "Predecessor Company". "Predecessor Company" refers to Air Canada prior to September 30, 2004 and included the operations of the various entities included in the Air Canada Services segment, as well as those of Jazz, Aeroplan and ACTS and, as such, prior results may not be comparable.

	Air Canada			Predecessor Company
Consolidated total	**Year ended December 31, 2006**	**Year ended December 31, 2005**	**Three months ended December 31, 2004**	**Nine months ended September 30, 2004**
Operating revenues	$10,167	$9,458	$1,959	$6,838
Special charge for Aeroplan miles [(1)]	(102)	-	-	-
Operating revenues	**10,065**	**9,458**	**1,959**	**6,838**
Operating expenses [(2)]	(9,806)	(9,140)	(2,018)	(6,718)
Operating income (loss), before reorganization and restructuring items	**259**	**318**	**(59)**	**120**
Reorganization and restructuring items	-	-	-	(871)
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and income tax	(333)	(338)	44	(144)
Net income (loss)	**(74)**	**(20)**	**(15)**	**(895)**
EBITDAR [(3)]	**1,214**	**1,157**		
EBITDAR excluding special charges [(3)]	**1,336**	**1,157**		
Earning (loss) per share				
- Basic	**($0.83)**	**($0.25)**	**($0.27)**	**($7.45)**
- Diluted	**($0.83)**	**($0.25)**	**($0.27)**	**($7.45)**
Cash, cash equivalents and short-term investments	**2,245**	**1,336**	**759**	
Total assets	**11,749**	**10,262**	**9,417**	
Total long-term liabilities [(4)]	**3,668**	**3,882**	**3,917**	

(1) 2006 includes a special charge of $102 million in connection with Air Canada's obligation for the redemption of pre-2002 Aeroplan miles.

(2) 2006 includes a special charge for labour restructuring of $20 million.

(3) Refer to section 20 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).

(4) Total long-term liabilities include long-term debt and capital leases and other long-term liabilities.

12. OFF-BALANCE SHEET ARRANGEMENTS

Refer to Notes 16 and 17 to Air Canada's combined consolidated financial statements for additional information regarding derivative financial instruments and guarantees of the Corporation. The following is summary of the more significant off-balance sheet arrangements.

Guarantees

Performance Obligations Relating to Aircraft Leasing Agreements

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

Derivative Instruments

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

Interest Rate Risk Management

The Corporation from time to time enters into interest rate swaps to manage the risks associated with interest rate movement on US dollar. and Canadian dollar floating rate debt and investments, including anticipated debt transactions.

During 2006, the Corporation entered into 19 interest rate swaps with a notional value of US$414 million to receive floating rates and pay a weighted average fixed rate of 5.81 percent for the debt to be arranged in relation to the financing of Embraer 190 aircraft between June 2006 and November 2007. The swaps have 15-year terms from the expected delivery date of the aircraft and their maturities range from June 2021 to December 2022. The Corporation intends on settling the interest rate swaps upon delivery of the related aircraft. Before December 31, 2006, seven of these swaps were settled at a net loss of $4 million. As at December 31, 2006, the fair value of the remaining 12 swaps was $13 million in favour of the counterparty and is recorded in "other long-term liabilities" on Air Canada's combined consolidated statement of financial position. The Corporation has recognized a net loss of $17 million in "other" non-operating expense on Air Canada's consolidated statement of operations since inception of these swaps in the second quarter of 2006.

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

The Corporation has interest rate swaps with a term to January 2024 and convert-lease payments related to two Boeing 767 aircraft leases consolidated under AcG-15, from fixed to floating rates. As at December 31, 2006, these two swaps have a fair value of $4 million in favour of the Corporation ($7 million in favour of the Corporation as at December 31, 2005).

Foreign Exchange Risk Management

Foreign exchange risk exposure is common to an international business such as Air Canada. To manage this risk exposure, Air Canada enters into various foreign currency hedging structures. These hedging structures provide protection to Air Canada in the form of reduced risk and volatility with respect to movements in the foreign exchange markets. At December 31, 2006, the Corporation had entered into foreign currency forward contracts and option agreements on US$503 million or approximately 31 percent of its projected net 2007 US dollar shortfall with the majority of hedges occurring in the first half of 2007. Based on foreign currency prices at December 31, 2006, the average price of the hedge portfolio is $1.1035. The fair value of the foreign currency contracts as at December 31, 2006 is $25 million in favour of the Corporation ($1 million in favour of third

parties as at December 31, 2005 on currency forward contracts and option agreements on US$521 million). These derivative instruments have not been designated as hedges for accounting purposes. The unrealized gain has been recorded in "foreign exchange gain (loss)" on Air Canada's combined consolidated statement of operations.

The Corporation has entered into currency swap agreements for 16 Bombardier regional jet operating leases until lease terminations between 2007 and 2011. Currency swaps for five Bombardier regional jet operating leases, with third parties, were put in place on the inception of the leases and have a fair value at December 31, 2006 of $10 million in favour of third parties ($13 million in favour of third parties as at December 31, 2005), taking into account foreign exchange rates in effect at that time. Currency swaps for 11 Bombardier regional jet operating leases with third parties have a fair value as at December 31, 2006 of $3 million in favour of the Corporation ($3 million in favour of the Corporation as at December 31, 2005). These swaps have not been designated as hedges for hedge accounting purposes. The unrealized changes in fair value have been recorded in "foreign exchange gain (loss)" on Air Canada's combined consolidated statement of operations.

Fuel Price Risk Management

The Corporation enters into contracts with financial intermediaries to manage its exposure to jet fuel price volatility. As at December 31, 2006, the Corporation had collar option and swap structures in place to hedge a portion of its anticipated jet fuel requirements over the 2007 and 2008 period. Since jet fuel is not traded on an organized futures exchange, liquidity for hedging this commodity is mostly limited to a shorter time horizon. Crude oil and heating oil contracts are effective commodities for hedging jet fuel and the Corporation mainly uses these commodities for medium to longer term hedges. Refer to section 4 of this MD&A for the Corporation's hedging position as at December 31, 2006 and as at February 14, 2007.

Hedge accounting was applied prospectively from October 1, 2005. Under hedge accounting, gains or losses on fuel hedging contracts are recognized in earnings as a component of aircraft fuel expense when the underlying jet fuel being hedged is consumed. Prior to the commencement of the Corporation's hedge accounting being applied, an unrealized gain of $2 million was recorded in "other" non-operating expense on Air Canada's combined consolidated statement of operations.

In 2006, the Corporation recognized a net loss of $43 million as a component of fuel expense on its combined consolidated statement of operations (net loss of $3 million in 2005) on the settlement of matured contracts and amortization of deferred costs. The fair value of the Corporation's fuel hedging contracts as at December 31, 2006 was $24 million (US$21 million) in favour of counterparties ($3 million in favour of counterparties as at December 31, 2005).

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

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

In 2006 the Corporation recognized a net loss of $3 million in "other" non-operating expense on Air Canada's consolidated statement of operations for the derivative instruments which do not qualify as hedge accounting.

Concentration of Credit Risk

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

13. RELATED PARTY TRANSACTIONS

The Corporation has various related party transactions with ACE (the principal shareholder with a 75 percent ownership interest in Air Canada at December 31, 2006 and a 79.7 percent ownership interest in Jazz, both at December 31, 2006) and with other entities under common control, including ACTS and Aeroplan. These transactions are recorded at the exchange amount.

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

Pursuant to the Jazz CPA effective January 1, 2006, Air Canada Services purchases substantially all of Jazz's fleet capacity based on predetermined rates, in addition to reimbursing Jazz, without mark-up, for certain pass-through costs as defined in the Jazz CPA. The capacity purchase fees paid to Jazz and the pass-through costs reimbursed to Jazz by Air Canada Services are eliminated within Air Canada's combined consolidated financial statements and are therefore not reflected in the table below.

Related party trade balances relate mainly to the provision of services, the allocation of employee-related costs, the allocation of corporate expenses and centralized cash management activities.

Refer to Notes 1, 6, 7 and 9 to Air Canada's combined consolidated financial statements for additional information.

Commercial Agreements – Aeroplan

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

Pursuant to the Aeroplan Commercial Participation and Services Agreement ("CPSA"), Air Canada allocates fixed seat capacity to Aeroplan on Air Canada Flights. The rates charged for such seat capacity are fixed through the end of 2007. Air Canada pays a fee to participate in the Aeroplan Program, which fee is based on the Aeroplan Miles awarded to Air Canada customers who travel on Air Canada Flights. Aeroplan is required to purchase annually a minimum number of reward travel seats on Air Canada Flights, which number is a function of Aeroplan's consumption of seats in the three preceding calendar years. Moreover, Air Canada is required to purchase a minimum number of Aeroplan miles annually (2006 — $170 million).

Pursuant to the Aeroplan Master Services Agreement ("MSA"), Air Canada has agreed to provide certain services to Aeroplan (such as infrastructure support, information technology, human resources, finance, accounting and legal services) in return for a fee based on Air Canada's fully allocated cost of providing such services to Aeroplan plus a mark-up to reflect overhead and administrative costs.

Pursuant to the Aeroplan General Services Agreement ("GSA"), Air Canada provides Aeroplan with the services of a group of call centre employees of Air Canada for which is reimbursed by Aeroplan for all costs, including salary and benefits, on a fully allocated basis.

Commercial Agreements – ACTS

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

Pursuant to various service agreements between ACTS and Air Canada effective as of October 1, 2006, ACTS provides the following services to Air Canada with respect to certain of Air Canada's aircraft, engines and other aircraft equipment: aircraft heavy maintenance services (excluding line and cabin maintenance services which are primarily provided by Air Canada), engine maintenance services, component maintenance services, supply chain and asset management services, auxiliary power unit maintenance services, aircraft paint services and related services. ACTS serves as Air Canada's exclusive repair agency in respect of aircraft heavy maintenance, engine maintenance, auxiliary power unit maintenance services as well as for maintenance services relating to certain components. ACTS serves as Air Canada's non-exclusive repair agency in respect of other services provided. Except for the services agreements relating to aircraft heavy maintenance and paint services which expire in October 2009, each of the agreements referred to above expires in October 2013.

Pursuant to a component maintenance agreement (the "ACTS-Jazz Agreement") dated August 1, 2005 between Jazz and ACTS, ACTS provides selected maintenance, repair, overhaul and related services with respect to Jazz's CRJ regional jets. According to the ACTS-Jazz Agreement, ACTS serves as Jazz's exclusive repair agency to provide component repair and overhaul work on parts which can be removed from the aircraft in respect of CRJ-100/200 and common CRJ-705 parts not performed internally by Jazz employees. The initial term of the ACTS-Jazz Agreement expires in August 2015 and it is renewable for three successive two-year periods. However, beginning in August 2008, either Jazz or ACTS may terminate the ACTS-Jazz Agreement upon 180 days' prior written notice.

Pursuant to the ACTS Master Services Agreement ("MSA"), Air Canada has agreed to provide ACTS with services including infrastructure support and services which are mostly administrative in nature, including information technology, human resources, finance and accounting, and legal services in return for fees to be paid by ACTS to Air Canada. ACTS may elect to terminate any services under the ACTS MSA or the entire ACTS MSA upon six months' prior written notice, with the exception of services relating to information technology which ACTS cannot terminate prior to the expiry of the ACTS MSA. Air Canada may elect to terminate any services under the ACTS MSA or the entire ACTS MSA upon 18 months' prior written notice.

Pursuant to General Services Agreements between Air Canada and ACTS (the "ACTS GSAs") Air Canada provides ACTS with the services of a group of unionized and non-unionized employees for which is reimbursed by ACTS for all costs, including salary and benefits, on a fully allocated basis. The ACTS GSAs may be terminated by either party at any time and without cause upon a 30 days' prior written notice.

For a summary of significant related party agreements, refer to Note 18 to Air Canada's combined consolidated financial statements.

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

	December 31 2006	December 31 2005
Accounts receivable		
ACE	-	57
Aeroplan	6	5
ACTS	97	75
	103	**137**
Accounts payable and accrued liabilities		
ACE	12	7
ACTS	111	96
	123	**103**

	Quarter 4 2006	Quarter 4 2005	2006	2005
Revenues				
Revenues from Aeroplan related to Aeroplan rewards	84	70	358	307
Revenue offset from purchase of Aeroplan miles	(62)	(54)	(243)	(204)
Property rental revenues from related parties	9	11	46	44
Revenues from information technology services	8	6	27	28
Revenues from corporate services and other	2	-	14	13
Cargo revenues from related parties	1	2	4	5
	42	**35**	**206**	**193**
Expenses				
Maintenance expense from ACTS	158	146	614	562
Call centre management and marketing fees from Aeroplan	3	5	10	13
Other expenses	10	4	39	25
Recovery of salary, wages and benefit expense for employees assigned to related parties	(106)	(99)	(413)	(374)
	65	**56**	**250**	**226**
Net interest expense from related parties	**1**	**7**	**6**	**21**

For a summary of accounting policies, refer to Note 2 to Air Canada's combined consolidated financial statements.

14. CRITICAL ACCOUNTING ESTIMATES

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

The Corporation has identified the following areas that contain critical accounting estimates utilized in the preparation of its financial statements:

Passenger and Cargo Revenues

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

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

Employee Future Benefits

The Corporation maintains several defined benefit and defined contribution plans providing pension, other retirement and post-employment benefits to its employees, including those employees of Air Canada who are contractually assigned to ACTS and Aeroplan. These employees are members of Air Canada's sponsored defined benefit pension plans and also participate in Air Canada's sponsored health, life and disability future benefit plans. Air Canada's combined consolidated financial statements include all of the assets and liabilities of all sponsored plans of the Corporation.

Management makes a number of assumptions in the calculation of both the accrued benefit obligation as well as the pension costs:

	December 31, 2006	December 31, 2005
Weighted average assumptions used to determine accrued benefit obligation		
Discount rate as at period-end	5.00%	5.00%
Rate of compensation increase [(1)]	2.50%	4.00%
Weighted average assumptions used to determine pension costs		
Discount rate as at period-end	5.00%	5.75%
Expected long-term rate of return on plan assets	7.50%	7.50%
Rate of compensation increase [(2)]	4.00%	4.00%

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

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

Discount Rate

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

Expected Return on Assets Assumption

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

Asset Allocation

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

	November 30 2005	November 30 2006	Target allocation
Equity	62.3%	59.1%	59.0%
Bonds and Mortgages	32.1%	34.7%	41.0%
Real Estate	0.1%	0.0%	0.0%
Short-term and Other	5.5%	6.2%	0.0%
Total	**100.0%**	**100.0%**	**100.0%**

Domestic Registered Plans

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

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

- Equity investments can include convertible securities and are required to be diversified among industries and economic sectors. Foreign equities can comprise 37 percent to 43 percent of the total market value of the trust. Limitations are placed on the overall allocation to any individual security at both cost and market value. Derivatives are permitted to the extent they are not used for speculative purposes or to create leverage.

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

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

Best Estimate of Employer Contributions

Based upon an agreement between Air Canada and representatives of the unionized and non-unionized employees and retirees with respect to the funding of the domestic registered plans, which agreement is subject to approval of the Office of the Superintendent of Financial Institutions (Canada) ("OSFI"), the actual 2005 and 2006 contributions are as follows:

($ millions)	2006 Contributions	2005 Contributions
Past service cost for registered pension plans	224	99
Current service cost for registered pension plans	140	127
Other pension arrangements (1)	83	52
Air Canada Services(2)	**447**	**278**
Jazz	**8**	**6**
Consolidated	**455**	**284**

(1) Includes retirement compensation arrangements, supplemental plans and international plans.
(2) Includes obligations relating to employees who have been assigned to related parties.

As previously discussed, the Corporation recovers costs relating to some employees who have been contractually assigned to ACTS and Aeroplan. The cost recovery relating to Air Canada's sponsored defined pension plans amounted to $33 million for 2006 and $28 million for 2005. The cost recovery relating to Air Canada's sponsored future benefit plans amounted to $23 million for 2006 and $24 million for 2005.

Sensitivity Analysis

Sensitivity analysis on the 2006 pension expense based on different actuarial assumptions with respect to discount rate and expected return on plan assets is as follows:

Impact on 2006 pension expense in $ millions	0.25 percentage point Decrease	0.25 percentage point Increase
Discount rate on obligation assumption	29	(19)
Long-term rate of return on plan assets assumption	25	(25)

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

Income Taxes

The Corporation utilizes the liability method of accounting for income taxes under which future income tax assets and liabilities are recognized for the estimated future income tax consequences attributable to differences between the financial statement carrying value amount and the tax basis of assets and liabilities. Management uses judgment and estimates in determining the appropriate rates and amounts in recording future taxes, giving consideration to timing and probability. Actual taxes could significantly vary from these estimates as a result of future events, including changes in income tax law or the outcome of reviews by tax authorities and related appeals. The resolution of these uncertainties and the associated final taxes may result in adjustment to the Corporation's tax assets and tax liabilities.

Future income tax assets are recognized to the extent that realization is considered more likely than not. The Corporation considers past results, current trends and outlooks for future years in assessing realization of income tax assets. The benefit of future income taxes that existed at fresh start, including the benefit recognized by affiliates of the Corporation, and against which a valuation allowance is recorded, amounts to $1,169 million. For additional information refer to Note 8 to Air Canada's combined consolidated financial statements.

Cash Tax Projections

ACE and Air Canada implemented a tax loss utilization strategy prior the Air Canada IPO. Accordingly, certain tax attributes of Air Canada were transferred to ACE. Notwithstanding, as at December 31, 2006, Air Canada retains over $3 billion of tax attributes in the form of undepreciated capital cost and other tax attributes to shelter future taxable income. These tax attributes are expected to increase over the next few years due to capital expenditures related to aircraft acquisitions. Refer to section 9.6 of this MD&A for additional information on

these capital expenditures. Based on projected results, Air Canada does not forecast having any significant current taxes payable within the foreseeable future.

Impairment of Long-Lived Assets

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

Property and Equipment

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

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

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

Aircraft depreciable life is determined through economic analysis, a review of existing fleet plans and comparisons to other airlines operating similar fleet types. Residual values are estimated based on the Corporation's historical experience with regard to the sale of aircraft and spare parts, as well as forward-looking valuations prepared by independent third parties.

Intangible Assets

The identifiable intangible assets of the Corporation were recorded at their estimated fair values at September 30, 2004. Indefinite-life intangible assets are subject to impairment tests under Canadian GAAP on an annual basis or when events or circumstances indicate a potential impairment. If the carrying value of such assets exceeds the fair values, the assets are written down to fair value.

Fair value under Canadian GAAP is defined as "the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act". Assessing the fair value of intangible assets requires significant management estimates on future cash flows to be generated by the assets, including the estimated useful life of the assets.

15. FUTURE ACCOUNTING STANDARD CHANGES

The Accounting Standards Board has issued three new standards dealing with financial instruments that the Corporation will be required to adopt in future years:

(i) Financial Instruments — Recognition and Measurement;

(ii) Hedges;

(iii) Comprehensive Income.

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

16. SENSITIVITY OF RESULTS

Financial results of the Air Canada Services segment are subject to many different internal and external factors which can have a significant impact on operating results. In order to provide a general guideline, the following table describes, on an indicative basis, the financial impact that changes in operating assumptions would generally have had on the Air Canada Services segment operating results. These guidelines were derived from 2006 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 vary significantly from actual results due to factors beyond the control of the Air Canada Services segment. Conversely, an opposite change in the sensitivity factor would have had the opposite effect on operating income.

Key Variable		2006 Measure	Sensitivity factor	Estimated Operating Income Impact ($ millions)
Revenue Measures				
Passenger yield (cents)	System	18.1	1% change in yield	84
	Canada	23.7		35
Traffic (RPMs) (millions)	System	48,993	1% change in traffic	76
	Canada	15,465		31
Passenger load factor	System	80.2	1 percentage point change	95
RASM (cents)	System	14.5	1% change in RASM	80
Cost Measures				
Labour and benefits expenses ($ millions)		1,816	1% change	18
Fuel – WTI price (US$/barrel) (1)		65.8	US$1/barrel change to WTI	27
Fuel – jet fuel price (CAD cents/litre) (1)		65.0	1% change	25
Cost per ASM (cents)		16.4	1% change	100

(1) Excludes impact of fuel surcharges and fuel hedging.

Key Variable	2006 Measure	Sensitivity factor	Estimated Operating Income Impact ($ millions)	Estimated Pre-Tax Income Impact ($ millions)
Currency Exchange				
Canada to US ($)	1.13	1 cent change (e.g. $1.13 to $1.12)	16	48

17. RISK FACTORS

The risks described herein may not be the only risks faced by the Corporation. Other risks of which the Corporation is not aware or which the Corporation currently deems to be immaterial may surface and have a material adverse impact on the Corporation's business, results from operations and financial condition.

Risks Relating to the Corporation

Operating Results

In the recent past, the Corporation has sustained significant operating losses and may sustain significant losses in the future. On September 30, 2004, the Corporation and certain of its subsidiaries emerged from protection under the CCAA and implemented a plan of arrangement. For the years ended December 31, 2003, 2002 and 2001, Air Canada incurred operating losses before reorganization and restructuring items and non-recurring labour expenses of $684 million, $192 million and $731 million, respectively. For the nine-month period ended September 30, 2004, Air Canada realized operating income before reorganization and restructuring items of $120 million and, for the three-month period ended December 31, 2004, the Corporation incurred an operating loss of $59 million. For the years ended December 31, 2006 and 2005, the Corporation realized operating income of $259 million and $318 million, respectively. Prior to September 30, 2004, the operations or Air Canada included the operations of various entities included in the Air Canada Services segment, as well as those of Jazz, Aeroplan and ACTS and, as such, those prior results may not be comparable. Despite Air Canada's emergence from creditor protection under the CCAA, the resulting and ongoing business initiatives and efforts at cost reductions and its recent results, the Corporation may not be able to successfully achieve planned business initiatives and cost reductions, including those which seek to offset significant fuel and other expenses or restore positive net profitability and may sustain significant losses in the future.

Leverage and Liquidity

The Corporation has, and is expected to continue to have, a significant amount of indebtedness, including substantial fixed obligations under aircraft leases and financings. The Corporation may incur additional debt, including secured debt, in the future. The amount of indebtedness that the Corporation currently has and which it may incur in the future could have a material adverse effect on the Corporation, for example, by (i) limiting the Corporation's ability to obtain additional financing , (ii) requiring the Corporation 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 the Corporation more vulnerable to economic downturns, and (iv) limiting the Corporation's flexibility in planning for, or reacting to, competitive pressures or changes in its business environment.

The ability of the Corporation 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. Each of these factors is to a large extent subject to economic, financial, competitive, regulatory, operational and other factors, many of which are beyond the Corporation's control. In addition, as the Corporation incurs indebtedness which bears interest at fluctuating interest rates, to the extent these interest rates increase, its interest expense will increase. There can be no assurance that the Corporation will be able to generate sufficient cash from its operations to pay its debts and lease obligations.

Need for Additional Capital

The Corporation faces a number of challenges in its current business operations, including high fuel prices and increased competition from international, transborder and low-cost domestic carriers. In order to meet such challenges and to support the Corporation's business strategy, significant operating and capital expenditures are, and may in the future be, required. There can be no assurance that the Corporation will continue to be able to obtain on a timely basis sufficient funds on terms acceptable to the Corporation to provide adequate liquidity and to finance the operating and capital expenditures necessary to support its business strategy if cash flows from operations and cash on hand are insufficient.

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

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

Limitations Due to Restrictive Covenants

Some of the financing and other major agreements of the Corporation contain restrictive covenants which affect and, in some cases, significantly limit or prohibit, among other things, the manner in which the Corporation may structure or operate its business, including by limiting the Corporation's ability to incur indebtedness, create liens, sell assets, make capital expenditures and engage in acquisitions, mergers or restructurings. In addition, certain financing arrangements require the Corporation to maintain financial ratios. Any future borrowings may also be subject to similar covenants which limit Air Canada's operating and financial flexibility, which could materially and adversely affect Air Canada's profitability.

A failure by the Corporation to comply with its contractual obligations (including restrictive 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 and lessors, and such defaults could trigger additional defaults under other indebtedness or agreements. In such a situation, it is unlikely that the Corporation would be able to repay the accelerated indebtedness or fulfill its obligations under certain contracts, make required 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 the Corporation which secure the Corporation's obligations.

Fuel Costs

Fuel costs constituted the largest percentage of the total operating costs of the Corporation in 2006. Fuel prices fluctuate widely depending on many factors including international market conditions, geopolitical events and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict fuel prices. During 2004, 2005 and 2006, fuel prices increased and fluctuated near or at historically high levels. Should fuel prices continue at, or continue to increase above, such high levels, fuel costs could have a material adverse effect on the Corporation's business, results from operations and financial condition. Due to the competitive nature of the airline industry, the Corporation may not be able to pass on increases in fuel prices to its customers by increasing its fares. Based on 2006 volumes, Management estimates that a US$1 per barrel movement in the average price of West Texas Intermediate crude oil would have resulted in an approximate C$27 million change in 2006 fuel expense for the Corporation (excluding any impact of fuel surcharges and fuel hedging), assuming flying capacity remained unchanged and that refining spreads between West Texas Intermediate crude oil and jet fuel as well as foreign exchange rates remained constant.

Labour Costs and Labour Relations

Labour costs constitute one of the Corporation's largest operating cost items. There can be no assurance that the Corporation will be able to maintain such costs at levels which do not negatively affect its business, results from operations and financial condition. There can be no assurance that future agreements with employees' unions or the outcome of arbitrations will be on terms consistent with the Corporation's expectations or comparable to agreements entered into by the Corporation's competitors. Any future agreements or outcome of negotiations, mediations or arbitrations including in relation to wages or other labour costs or work rules may result in increased labour costs or other charges which could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Most of the Corporation's employees are unionized and long-term collective agreements were concluded in 2003 and 2004. No strikes or lock-outs may lawfully occur during the term of the collective agreements expiring in 2009. However, there can be no assurance that there will not be a labour conflict that could lead to an interruption or stoppage in the Corporation's service or otherwise adversely affect the ability of the Corporation to conduct its operations, all of which could have a material adverse effect on its business, results from operations and financial condition.

If there is a labour disruption or work stoppage by any of the unionized work groups of Jazz, there could also likely be a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, labour problems at the Corporation's Star Alliance® partners could result in lower demand

for connecting traffic with the Corporation and, ultimately, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Airport User Fees and Air Navigation Fees

With the privatization of airports and air navigation authorities over the last decade in Canada, new airport and air navigation authorities have imposed significant increases in their fees. If such authorities continue to increase their fees at the rate at which they have increased them in the recent past, the Corporation's business, results from operations and financial condition could be materially adversely affected.

Competition

The Corporation operates within a highly competitive industry. Over the past few years, several carriers have entered or announced their intention to enter into the domestic, the U.S. transborder and international markets in which the Corporation operates.

Canadian low-cost carriers have entered or announced their intention to compete in many of the Corporation's key domestic markets and have also entered the U.S. transborder market. U.S. carriers currently operate routes in the Corporation's transborder market. The Corporation is also facing increasing competition in international markets as carriers increase their international capacity, both by expansion and by shifting existing domestic capacity to international operations to avoid low-cost domestic competition.

If Canadian low-cost carriers are successful in entering or expanding into the Corporation's domestic and the U.S. transborder markets, if additional U.S. carriers are successful in entering the Corporation's transborder market or if carriers are successful in their expansion in international markets of the Corporation, the Corporation's business results from operations and financial condition could be materially adversely affected

The Corporation also encounters substantial price competition. The expansion of low-cost carriers in recent years has resulted in a substantial increase in discounted and promotional fares initiated by the Corporation's competitors. The decision to match competitors' fares, to maintain passenger traffic, results in reduced yields which, in turn, could have a material adverse effect on the Corporation's business, results from operations and financial condition. Furthermore, the Corporation's ability to reduce its fares in order to effectively compete with other carriers may be limited by government policies to encourage competition.

Internet travel websites have enabled consumers to more efficiently find lower fare alternatives by providing them with access to more pricing information. The increased price awareness of both business and leisure travelers as well as the growth in new distribution channels have further motivated airlines to price aggressively to gain fare and market share advantages.

In addition, consolidation in the airline industry could result in increased competition as some airlines emerging from such consolidations may be able to compete more effectively against the Corporation which could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Strategic, Business, Technology and Other Important Initiatives

In order to operate its business, achieve its goals and remain competitive, the Corporation continuously seeks to identify and devise, invest in and implement strategic, business, technology and other important initiatives, such as those relating to the aircraft fleet restructuring program, the aircraft refurbishment program, the new revenue model, the reservation and airport customer service initiative (which will also support the revenue model), the business process initiatives as well as other initiatives. 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 the Corporation's control. Such factors include the performance of third parties, including suppliers, the implementation and integration of such initiatives into the Corporation's other activities and processes as well as the adoption and acceptance of initiatives by the Corporation's customers, suppliers and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement these initiatives could adversely affect the Corporation's ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on the Corporation's business, results from operations and financial condition.

For instance, a key component of the Corporation's business plan is the restructuring of its aircraft fleet, including the elimination and replacement of older, less efficient aircraft, the introduction of new regional jet aircraft, and the modernization of its international wide-body fleet through the acquisition of new and more

efficient aircraft. A delay or failure in the completion of the Corporation's fleet restructuring, including a delay by the manufacturers in the delivery of the regional jet or wide-body aircraft, or an inability to remove, as planned, certain aircraft from the fleet in coordination with the planned entry into service of new aircraft, could adversely affect the implementation of the Corporation's business plan which may, in turn, have a material adverse effect on the Corporation's business, results from operations and financial condition.

Another important component of the Corporation's business plan is the replacement of its legacy systems for passenger reservation and airport customer service with a newly developed web-enabled system in order to support the rapid and efficient implementation of the Corporation's revenue model. The new system is expected to be deployed in phases from late 2007 to early 2008. A delay or failure in the implementation of the Corporation's new system could adversely affect the implementation of the Corporation's business plan which may, in turn, have a material adverse effect on the Corporation's business, results from operations and financial condition.

Dependence on Technology

The Corporation relies 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 the Corporation's telecommunications, websites, computerized airline reservations and airport customer services and flight operations.

These technology systems may be vulnerable to a variety of sources of failure, interruption or misuse, including by reason of natural disasters, terrorist attacks, telecommunications failures, power failures, computer viruses, hackers, unauthorized or fraudulent users, and other operational and security issues. While the Corporation continues to invest in initiatives, including security initiatives and disaster recovery plans, these measures may not be adequate or implemented properly. Any such technology systems failure could materially and adversely affect the Corporation's operations and could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Key Supplies and Suppliers

The Corporation is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services in a timely manner, including those required for the Corporation's operations such as fuel, aircraft and related parts and aircraft and engine maintenance services (including maintenance services obtained from ACTS). In certain cases, such goods and services may only be available from a limited number of suppliers. Such failure, refusal or inability may arise as a result of a wide range of causes, many of which are beyond the Corporation's control. Any failure or inability of the Corporation to successfully source goods and services, including by reason of a failure, refusal or inability of a supplier, or to source goods and services on terms and pricing and within the timeframes acceptable to the Corporation, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Aeroplan

Through its relationship with Aeroplan, the Corporation is able to offer its customers who are Aeroplan members the opportunity to earn Aeroplan miles. Based on customer surveys, Management believes that rewarding customers with Aeroplan miles is a significant factor in customers' decision to travel with Air Canada and Jazz and contributes to building customer loyalty. The failure by Aeroplan to adequately fulfill its obligations towards the Corporation under the Aeroplan CPSA and in connection with the Aeroplan program, or other unexpected interruptions of Aeroplan services which are beyond the Corporation's control could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Jazz

Under the Jazz CPA, Jazz provides the Corporation'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 the Corporation's mainline routes. The Corporation reimburses Jazz, without mark-up, for certain pass-through costs incurred directly by Jazz, such as fuel, navigation, landing and terminal fees and certain other costs. Significant increases in such pass-through costs, the failure by Jazz to adequately fulfill its obligations towards the Corporation under the Jazz CPA, or other unexpected interruptions of Jazz's services which are beyond the Corporation's control could have a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization guarantee which requires that the Corporation make certain minimum payments to Jazz regardless of the revenue generated by Jazz.

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).

The solvency liability is influenced primarily by long-term interest rates and by the investment return on plan assets. The interest rate used to calculate benefit obligations for solvency purposes is a prescribed rate derived from the interest rates on long-term Government of Canada bonds. In the current low interest rate environment, the calculation results in a higher present value of the pension obligations, leading to a larger unfunded solvency position.

In May 2004, Air Canada and the Office of the Superintendent of Financial Institutions agreed on a protocol pursuant to which the solvency funding requirements for the Corporation's registered pension plans provided for in the then existing regulations were amended retroactive to January 1, 2004. The Corporation is required to make substantial annual cash contributions, and the level of those contributions will increase in the event of poor pension fund investment performance and/or further declines in long-term Government of Canada bond rates. See "Management's Discussion and Analysis — Critical Accounting Estimates — Employee Future Benefits — Sensitivity Analysis". Underfunded pension plans or a failure or inability by the Corporation to make required cash contributions to its registered pension plans could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Equal Pay Litigation

CUPE, which represents the Corporation's flight attendants, has two complaints before the Canadian Human Rights Commission where it alleges gender-based wage discrimination. CUPE claims the predominantly female flight attendant group should be paid the same as the predominantly male pilot and mechanics groups because their work is of equal value. The complaints date from 1991 and 1992 but have not been investigated on the merits because of a legal dispute over whether the three groups work in the same "establishment" within the meaning of the Canadian Human Rights Act. On January 26, 2006, the Supreme Court of Canada ruled that they do work in the same "establishment" and sent the case back to the Canadian Human Rights Commission, which may now proceed to assess the merits of CUPE's complaints.

As part of the restructuring under the CCAA, it was agreed that any resolution of the complaints would have no retroactive financial impact prior to September 30, 2004. It is the view of Air Canada that any investigation will show that Air Canada has complied and continues to comply with the equal pay provisions of the Canadian Human Rights Act. Nonetheless, should these complaints succeed, the accrued liability and future costs could be very significant and Air Canada's business, results from operations and financial condition could be materially adversely affected.

Star Alliance®

The strategic and commercial arrangements with Star Alliance® members provide the Corporation 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, the Corporation's business, results from operations and financial condition could be materially adversely affected.

Interruptions or Disruptions in Service

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

Foreign Exchange

The Corporation's financial results are sensitive to the changing value of the Canadian dollar. In particular, the Corporation has a significant annual net outflow of U.S. dollars and is affected by fluctuations in the Canada/U.S. dollar exchange rate. Management estimates that during 2006, a $0.01 increase in the Canada/U.S. dollar exchange rate (i.e., $1.13 to $1.14 per U.S. dollar) would have had an estimated $16 million unfavourable impact on operating income and an estimated $48 million unfavourable impact on pre-tax income.

Conversely, an opposite change in the exchange rate would have had the opposite effect on operating income. The Corporation incurs significant expenses in U.S. dollars for such items as fuel, aircraft rental charges, interest payments, debt servicing and computerized reservations system fees, while a substantial portion of its revenues are generated in Canadian dollars. A significant deterioration of the Canadian dollar relative to the U.S. dollar would increase the costs of the Corporation relative to its U.S. competitors and could have a material adverse effect on the Corporation's business, results from operations and financial condition. In addition, the Corporation may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

Current Legal Proceedings

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

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

In addition, see above Risk Factor entitled "Equal Pay Litigation".

Key Personnel

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

Risks Relating to the Industry

Airline Reorganizations

Since September 11, 2001, a number of U.S. air carriers have sought to reorganize under Chapter 11 of the United States Bankruptcy Code or outside the scope of formal reorganization proceedings. Successful completion of such reorganizations could present the Corporation with competitors having reduced levels of indebtedness and significantly lower operating costs derived from labour, supply and financing contracts renegotiated under the protections of the United States Bankruptcy Code or outside the scope of formal reorganization proceedings. In addition, certain air carriers, including those involved in reorganizations, may undertake substantial fare discounting in order to maintain cash flows and to enhance continued customer loyalty. Such fare discounting could result in lower yields for the Corporation which, in turn, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Economic and Geopolitical Conditions

Airline operating results are sensitive to economic and geopolitical conditions which can have a significant impact on the demand for air transportation. Airline fares and passenger demand have fluctuated significantly in the past and may fluctuate significantly in the future. The Corporation is not able to predict with certainty market conditions and the fares that the Corporation 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. A downturn in economic growth in North America, as well as geopolitical instability in various areas of the world, could have the effect of reducing demand for air travel in Canada and abroad and, together with the other factors discussed herein, could materially adversely impact the Corporation's profitability. Any prolonged or significant weakness of the Canadian or world economies could have a material adverse effect on the Corporation's business, results from operations and financial condition, especially given the Corporation's substantial fixed cost structure.

Airline Industry Characterized by Low Gross Profit Margins and High Fixed Costs

The airline industry generally and scheduled service in particular are characterized by low gross profit margins and high fixed costs. The costs of operating any particular flight do not vary significantly with the number of passengers carried and, therefore, a relatively small change in the number of passengers or in fare pricing or traffic mix could have a significant effect on the Corporation's operating and financial results. This condition has been exacerbated by aggressive pricing by low-cost carriers, which has had the effect of driving down fares in general. Accordingly, a shortfall from expected revenue levels could have a material adverse effect on the Corporation's business, results from operations and financial condition. The Corporation incurs substantial fixed costs which do not meaningfully fluctuate with overall capacity. As a result, should the Corporation be required to reduce its overall capacity or the number of flights operated, it may not be able to successfully reduce certain fixed costs in the short term and may be required to incur important termination or other restructuring costs, which could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Terrorist Attacks and Security Measures

The September 11, 2001 terrorist attacks and subsequent terrorist activity, notably in the Middle East, Southeast Asia and Europe, caused uncertainty in the minds of the traveling public. The occurrence of a major terrorist attack (whether domestic or international and whether involving the Corporation or another carrier or no carrier at all) and increasingly restrictive security measures, such as the current restrictions on the content of carry-on baggage, could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on the Corporation's flights. It could also lead to a substantial increase in insurance, airport security and other costs. Any resulting reduction in passenger revenues and/or increases in insurance, security or other costs could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Epidemic Diseases (Severe Acute Respiratory Syndrome (SARS), Influenza or Other Epidemic Diseases)

As a result of the international outbreaks of Severe Acute Respiratory Syndrome (SARS) in 2003, the World Health Organization (the "WHO") issued on April 23, 2003 a travel advisory, which was subsequently lifted on April 30, 2003, against non-essential travel to Toronto, Canada. The seven day WHO travel advisory relating to Toronto, the location of the Corporation's primary hub, and the international SARS outbreak had a significant adverse effect on passenger demand for air travel destinations served by the Corporation and Jazz, and on the number of passengers traveling on the Corporation's and Jazz's flights and resulted in a major negative impact on traffic on the entire network. The WHO warns that there is a substantial risk of an influenza pandemic within

the next few years. An outbreak of SARS or of another epidemic disease such as influenza (whether domestic or international) or a further WHO travel advisory (whether relating to Canadian cities or regions or other cities, regions or countries) could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on the Corporation's and Jazz's flights. Any resulting reduction in traffic on the Corporation's and Jazz's network could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Casualty Losses

Due to the nature of its core operating business, the Corporation may be subject to liability claims arising out of accidents or disasters involving aircraft on which the Corporation's customers are traveling or involving aircraft of other carriers maintained or repaired by the Corporation, including claims for serious personal injury or death. There can be no assurance that the Corporation's insurance coverage will be sufficient to cover one or more large claims and any shortfall may be material. Additionally, any accident or disaster involving one of the Corporation's aircraft or an aircraft of another carrier maintained or repaired by the Corporation may significantly harm the Corporation's reputation for safety, which would have a material adverse effect on the Corporation's business, results from operations and financial condition.

Seasonal Nature of the Business, Other Factors and Prior Performance

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

As described elsewhere, demand for air travel is also affected by factors such as economic conditions, war or the threat of war or terrorist attacks, fare levels and weather conditions. Due to these and other factors, operating results for an interim period are not necessarily indicative of operating results for an entire year, and operating results for a historical period are not necessarily indicative of operating results for a future period.

Regulatory Matters

The airline industry is subject to extensive Canadian and foreign government regulations relating to, among other things, security, safety, licensing, competition, noise levels and the environment and, in some measure, pricing. Additional laws and regulations may be proposed, and decisions rendered, from time to time which could impose additional requirements or restrictions on airline operations. The implementation of additional regulations or decisions by Transport Canada, the Competition Bureau and/or the Competition Tribunal, the Canadian Transportation Agency, the Treasury Board or other domestic or foreign governmental entities may have a material adverse effect on the Corporation's business, results from operations and financial condition. The Corporation cannot give any assurances that new regulations or revisions to the existing legislation, or decisions, will not be adopted or rendered. The adoption of such new laws and regulations or revisions, or the rendering of such decisions, could have a material adverse effect on the Corporation's business, results from operations and financial condition.

The availability of international routes to Canadian air carriers is regulated by agreements between Canada and foreign governments. Changes in Canadian or foreign government aviation policy could result in the alteration or termination of these agreements and could adversely affect the Corporation's international operations.

In July 2000, the Government of Canada amended the CTA, the Competition Act and the Air Canada Public Participation Act to address the competitive airline environment in Canada and ensure protection for consumers. This legislation included airline-specific provisions concerning "abuse of dominance" under the Competition Act, later supplemented by creating "administrative monetary penalties" for a breach of the abuse of dominance provisions by a dominant domestic air carrier.

In July 2003, the Competition Tribunal released its reasons and findings in a proceeding between the Commissioner of Canada and the Corporation which had considered the approach to be taken in determining whether the Corporation was operating below "avoidable costs" in violation of one of the new airline-specific abuse of dominance provisions. The Competition Tribunal applied a very broadly crafted cost test in its decision. In September 2004, the Commissioner of Competition published a letter describing the enforcement approach that would be taken in future cases involving the airline-specific abuse of dominance provisions, which included a statement that the Tribunal's approach to avoidable costs remains relevant.

In addition, on November 2, 2004, the Minister of Industry tabled amendments to the Competition Act in Bill C-19 which, if enacted, would have removed the airline-specific "abuse of dominance" provisions from the Competition Act. However, on November 29, 2005, the 38th Parliament of Canada was dissolved. As a result, the legislative process relating to the adoption of Bill C-19 was terminated. Management cannot predict if or when such proposed legislation will be re-introduced in the House of Commons.

If the Commissioner of Competition commences inquiries or brings similar applications with respect to significant competitive domestic routes and such applications are successful, it could have a material adverse effect on the Corporation's business, results from operations and financial condition.

The Corporation is subject to domestic and foreign laws regarding privacy of passenger and employee data that are not consistent in all countries in which the Corporation operates. Compliance with these regulatory regimes is expected to result in additional operating costs and could have a material adverse effect on the Corporation's business, results from operations and financial condition.

Increased Insurance Costs

Since September 11, 2001 the aviation insurance industry has been continually reevaluating the terrorism risks that it covers and this activity may adversely affect some of the Corporation's existing insurance carriers or the Corporation's ability to obtain future insurance coverage. To the extent that the Corporation'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, the Corporation's insurance costs may increase further and may result in the Corporation being in breach of regulatory requirement or contractual arrangements requiring that specific insurance be maintained, which may have a material adverse effect on the Corporation's business, results from operations and financial condition.

Third Party War Risk Insurance

There is a risk that the Government of Canada may not continue to provide an indemnity for third party war risk liability coverage, which it currently provides to the Corporation and certain other carriers in Canada. In the event that the Government of Canada does not continue to provide such indemnity or amends such indemnity, the Corporation and other industry participants would have to turn to the commercial insurance market to seek such coverage. The Corporation estimates that such coverage would cost the Corporation approximately $15 million per year. Alternative solutions, such as those envisioned by the International Civil Aviation Organization ("ICAO") and the International Air Transport Association ("IATA"), have not developed as planned, due to actions taken by other countries and the recent availability of supplemental insurance products. ICAO and IATA are continuing their efforts in this area, however the achievement of a global solution is not likely in the immediate or near future. The U.S. federal government has set up its own facility to provide war risk coverage to U.S. carriers, thus removing itself as a key component of any global plan.

Furthermore, the London aviation insurance market has introduced a new standard war and terrorism exclusion clause which is applicable to aircraft hull and spares war risk insurance, and intends to introduce similar exclusions to airline passenger and third party liability policies. Such clause excludes claims caused by the hostile use of a dirty bomb, electromagnetic pulse device, or biochemical materials. The Government of Canada indemnity program is designed to address these types of issues as they arise, but the Government of Canada has not yet decided to extend the existing indemnity to cover this exclusion. Unless and until the Government of Canada does so, the loss of coverage exposes the Corporation to this new uninsured risk and may result in the Corporation being in breach of certain regulatory requirements or contractual arrangements, which may have a material adverse effect on the Corporation's business, results from operations and financial condition.

Risks Related to the Corporation's Relationship with ACE

Control of the Corporation and Related Party Relationship

ACE owns shares of Air Canada representing 75 percent of the voting interests in Air Canada. Voting control will enable ACE to determine substantially all matters requiring security holder approval as a result of its voting interest in Air Canada. ACE will exercise control over corporate transactions submitted to Air Canada's board of directors and/or Air Canada's security holders for approval. ACE will effectively have sufficient voting power to prevent a change in control of Air Canada. This voting control may discourage transactions involving a change of control of Air Canada, including as a result, transactions in which the public shareholders of Air Canada might otherwise receive a premium for their shares over the then-current market price.

The interests of ACE may conflict with those of other shareholders.

Future Sales of Shares by or for ACE

Sales of substantial amounts of Air Canada's shares by ACE, or the possibility of those sales by ACE, could adversely affect the market price of the shares and impede Air Canada's ability to raise capital through the issuance of equity securities.

ACE has no contractual obligation to retain any of the Air Canada shares, except for a period of 90 days ending on February 22, 2007 during which ACE is restricted from selling any of the Air Canada shares without the consent of RBC Dominion Securities Inc. This 90-day lock-up period was agreed to by ACE in connection with the closing of the Offering. The registration rights agreement that Air Canada entered into with ACE grants ACE the right to require Air Canada to file a prospectus and otherwise assist with a public offering of shares that ACE holds in specified circumstances. In addition, after the expiration of this 90-day lock-up period, Air Canada could issue and sell additional shares. Any sale by ACE or Air Canada of shares in the public market, or the perception that sales could occur could adversely affect prevailing market prices of the shares.

Refer to Note 18 to Air Canada's combined consolidated financial statements for additional information on related party transactions.

18. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures
Disclosure controls and procedures within Air Canada are designed to provide reasonable assurance that all relevant information is identified to its Disclosure Policy Committee to ensure appropriate and timely decisions are made regarding public disclosure.

An evaluation of the effectiveness of Air Canada's disclosure controls and procedures, as defined under the rules of the Canadian Securities Administration (CSA) was conducted at December 31, 2006 by and under Air Canada's management, including the President and Chief Executive Officer and the Chief Financial Officer. Based on this evaluation, the President and Chief Executive Officer and the Chief Financial Officer have concluded that Air Canada's disclosure controls and procedures are effective.

Internal Controls over Financial Reporting
Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of Air Canada's financial reporting and the preparation of financial statements in compliance with Canadian generally accepted accounting principles.

An evaluation of the design effectiveness of Air Canada's internal controls over financial reporting was conducted at December 31, 2006 by Air Canada's management, including the President and Chief Executive Officer and the Chief Financial Officer. Based on this evaluation, management has concluded that the design of Air Canada's internal controls and procedures is effective except for controls related to accounting for income taxes, where process design improvements are required. Management has commenced remedial action to add additional qualified income tax professionals with the appropriate knowledge and experience which addresses this design area.

There were no changes to the Corporation's internal controls over financial reporting during the year ended December 31, 2006 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

19. OUTLOOK

A fundamental building block of the airline industry is to match capacity with demand. Air Canada has successfully pursued this strategy as evidenced by its annual record load factors over the last three years. In 2006, Air Canada Services flew 61.1 billion available seat miles, an increase of 4 percent as compared to 2005. Air Canada Services had a load factor of 80.2 percent in 2006 versus 79.5 percent in 2005, an increase of 0.7 percentage points.

As at December 31, 2006, Air Canada operated 199 aircraft and 133 aircraft were operated by Jazz as Covered Aircraft as defined under the Jazz CPA. Air Canada anticipates operating 205 to 208 aircraft by December 31, 2007.

Twenty-five Embraer 190 aircraft are expected to be delivered by December 31, 2007 of which twenty-four are expected to be in operation prior to December 31, 2007. Eight Boeing 777 aircraft, inclusive of the one leased from ILFC, are expected to be delivered and in operation prior to December 31, 2007. Air Canada is planning to remove from service approximately 23 aircraft which consist of eight wide-body aircraft and 15 narrow-body aircraft. These aircraft removals would be in the form of aircraft retirements, returns to lessors or subleases. The Jazz operated Covered Aircraft is expected to remain at 133 aircraft for 2007. Capacity for Air Canada Services is expected to grow within a range of 3 to 4 percent in 2007 as compared to 2006.

20. NON-GAAP FINANCIAL MEASURES

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization and obsolescence and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before aircraft rent and depreciation, amortization and obsolescence as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets.

EBITDAR is not a recognized measure for financial statement presentation under Canadian GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies.

EBITDAR is reconciled to operating income (loss) as follows:

($ millions)	Quarter 4		$			$
	2006	**2005**	**Change**	**2006**	**2005**	**Change**
Air Canada Services						
GAAP operating income (loss)	(5)	(91)	86	114	191	(77)
Add back:						
Aircraft rent	75	90	(15)	314	341	(27)
Depreciation, amortization and obsolescence	135	106	29	493	404	89
EBITDAR	**205**	**105**	**100**	**921**	**936**	**(15)**
Add back:						
Special charge for labour restructuring	(8)	-	(8)	20	-	20
Special charge for Aeroplan miles	-	-	-	102	-	102
EBITDAR excluding special charges	**197**	**105**	**92**	**1,043**	**936**	**107**
Jazz						
GAAP operating income	33	34	(1)	144	129	15
Add back:						
Aircraft rent	34	28	6	134	80	54
Depreciation, amortization and obsolescence	5	4	1	21	18	3
EBITDAR	**72**	**66**	**6**	**299**	**227**	**72**
Consolidated total						
GAAP operating income (loss)	29	(57)	86	259	318	(59)
Add back:						
Aircraft rent	107	117	(10)	441	417	24
Depreciation, amortization and obsolescence	140	110	30	514	422	92
EBITDAR	**276**	**170**	**106**	**1,214**	**1,157**	**57**
Add back:						
Special charge for labour restructuring	(8)	-	(8)	20	-	20
Special charge for Aeroplan miles	-	-	-	102	-	102
EBITDAR excluding special charges	**268**	**170**	**98**	**1,336**	**1,157**	**179**

Operating Income excluding the Special Charge for Aeroplan Miles and the Special Charge for Labour Restructuring

The Air Canada Services segment uses operating income excluding the special charges for Aeroplan miles and labour restructuring to assess the operating performance of its ongoing business without the effects of these special charges. These items are excluded from Air Canada Services' segment results as they could potentially distort the analysis of trends in business performance. The special charge for Aeroplan miles is the full and final settlement between the parties in connection with Air Canada's obligations for the redemption of pre-2002 miles. The special charge for labour restructuring is the total cost of the 20 percent non-unionized workforce reduction plan announced in February 2006. The special charges for Aeroplan miles and labour restructuring are not reflective of the underlying financial performance of the Air Canada Services segment from ongoing operations.

The following measure is not a recognized measure for financial statement presentation under Canadian GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies.

Operating income excluding the special charge for Aeroplan miles and the special charge for labour restructuring is reconciled to operating income as follows:

($ millions)	Q4 2006	Q4 2005	Change	2006	2005	Change
Air Canada Services						
GAAP operating income (loss)	(5)	(91)	86	114	191	(77)
Add back:						
Special charge for Aeroplan miles	-	-	-	102	-	102
Operating income (loss), excluding the special charge for Aeroplan miles	**(5)**	**(91)**	**86**	**216**	**191**	**25**
Add back:						
Special charge for labour restructuring	(8)	-	(8)	20	-	20
Operating income (loss), excluding the special charges for Aeroplan miles and labour restructuring	**(13)**	**(91)**	**78**	**236**	**191**	**45**

($ millions)	Q4 2006	Q4 2005	Change	2006	2005	Change
Consolidated total						
GAAP operating income (loss)	29	(57)	86	259	318	(59)
Add back:						
Special charge for Aeroplan miles	-	-	-	102	-	102
Operating income (loss), excluding the special charge for Aeroplan miles	**29**	**(57)**	**86**	**361**	**318**	**43**
Add back:						
Special charge for labour restructuring	(8)	-	(8)	20	-	20
Operating income (loss), excluding the special charges for Aeroplan miles and labour restructuring	**21**	**(57)**	**78**	**381**	**318**	**63**

Operating Expense excluding Fuel Expense and the Special Charge for Labour Restructuring

The Air Canada Services segment uses operating expense excluding fuel expense and the special charge for labour restructuring to assess the operating performance of its ongoing business without the effects of fuel expense and the special charge for labour restructuring. These items are excluded from Air Canada Services' results as they could potentially distort the analysis of trends in business performance. Fuel expense has increased significantly year-over-year and excluding this expense from GAAP results allows Air Canada Services to compare its operating performance on a consistent basis. The special charge for labour restructuring is not reflective of the underlying financial performance of the Air Canada Services segment from ongoing operations.

The following measure is not a recognized measure for financial statement presentation under Canadian GAAP and does not have a standardized meaning and is therefore not likely to be comparable to similar measures presented by other public companies.

($ millions)	**Q4 2006**	**Q4 2005**	**Change**	**2006**	**2005**	**Change**
Air Canada Services						
GAAP operating expense	2,420	2,362	58	10,023	9,318	705
Remove:						
Aircraft fuel	(583)	(577)	(6)	(2,544)	(2,197)	(347)
Operating expense, excluding fuel expense	**1,837**	**1,785**	**52**	**7,479**	**7,121**	**358**
Remove:						
Special charge for labour restructuring	8	-	8	(20)	-	(20)
Operating expense, excluding fuel expense and the special charge for labour restructuring	**1,845**	**1,785**	**60**	**7,459**	**7,121**	**338**