AIR CANADA

Third Quarter 2010

Management's Discussion and Analysis
of Results and Financial Condition

November 4, 2010

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1. Highlights

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

	Third Quarter			First Nine Months		
	2010	**2009**	**Change $**	**2010**	**2009**	**Change $**
Financial						
Operating revenues	3,026	2,670	356	8,170	7,391	779
Operating income (loss)	327	68	259	276	(233)	509
Non-operating expense	(75)	(83)	8	(297)	(272)	(25)
Income (loss) before non-controlling interest, foreign exchange and income taxes	252	(15)	267	(21)	(505)	484
Income (loss) for the period	261	277	(16)	(27)	32	(59)
Operating margin %	10.8%	2.5%	8.3 pp	3.4%	(3.2)%	6.6 pp
EBITDAR (1)	581	320	261	1,052	512	540
EBITDAR margin % (1)	19.2%	12.0%	7.2 pp	12.9%	6.9%	6.0 pp
Cash, cash equivalents and short-term investments	2,173	1,209	964	2,173	1,209	964
Free cash flow (2)	112	(268)	380	624	(347)	971
Adjusted debt to debt plus equity ratio % (3)	77.1%	84.7%	(7.6) pp	77.1%	84.7%	(7.6) pp
Earnings (loss) per share - Basic	$0.94	$2.77	($1.83)	($0.10)	$0.32	($0.42)
Earnings (loss) per share - Diluted	$0.91	$2.44	($1.53)	($0.10)	$0.30	($0.40)
Operating Statistics			**Change %**			**Change %**
Revenue passenger miles (millions) (RPM)	15,531	14,153	9.7	40,119	36,999	8.4
Available seat miles (millions) (ASM)	18,328	16,946	8.2	48,578	45,502	6.8
Passenger load factor %	84.7%	83.5%	1.2 pp	82.6%	81.3%	1.3 pp
Passenger revenue per RPM (cents)	17.4	16.9	3.2	17.7	17.4	1.6
Passenger revenue per ASM (cents)	14.8	14.1	4.7	14.6	14.2	3.2
Operating revenue per ASM (cents)	16.5	15.8	4.7	16.8	16.2	3.5
Operating expense per ASM ("CASM") (cents)	14.7	15.4	(4.1)	16.2	16.8	(3.0)
CASM, excluding fuel expense (cents)	10.7	11.3	(5.3)	12.1	12.7	(4.6)
Average number of full-time equivalent (FTE) employees (thousands) (4)	23.5	23.2	1.3	23.2	23.1	0.5
Aircraft in operating fleet at period end (5)	326	335	(2.7)	326	335	(2.7)
Average fleet utilization (hours per day) (6)	10.7	9.9	8.6	10.0	9.4	5.7
Revenue frequencies (thousands)	145	140	3.6	406	399	1.8
Average aircraft flight length (miles) (6)	909	883	2.9	874	854	2.3
Fuel price per litre (cents) (7)	66.9	68.6	(2.5)	69.4	68.4	1.5
Fuel litres (millions)	1,089	988	10.2	2,885	2,685	7.4

(1) EBITDAR (earnings before interest, taxes, depreciation and amortization, and aircraft rent) is a non-GAAP financial measure. See section 15 "Non-GAAP Financial Measures" of this MD&A for a reconciliation of EBITDAR to operating income (loss).

(2) Free cash flow (cash flows from (used for) operating activities plus additions to capital assets) is a non-GAAP financial measure. See section 7.5 of this MD&A for additional information.

(3) Adjusted net debt (total debt less cash, cash equivalents and short-term investments plus capitalized operating leases) is a non-GAAP financial measure. See section 7.2 of this MD&A for additional information.

(4) Reflects FTE employees at Air Canada. Excludes FTE employees at Jazz and other third party carriers operating under capacity purchase agreements with Air Canada.

(5) Includes Jazz aircraft covered under the Jazz CPA.

(6) Excludes charter operations. Also excludes third party carriers operating under capacity purchase arrangements, other than Jazz aircraft covered under the Jazz CPA.

(7) Includes fuel handling and is net of fuel hedging results.

2. Introduction

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers, as the context may require, to Air Canada and/or one or more of Air Canada's subsidiaries.

Air Canada's third quarter 2010 MD&A provides the reader with a view and analysis, from the perspective of management, of Air Canada's financial results for the third quarter of 2010 and for the first nine months of 2010. This MD&A should be read in conjunction with Air Canada's interim unaudited consolidated financial statements and notes for the third quarter of 2010 and its annual audited consolidated financial statements and notes and its annual MD&A for 2009. All financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), unless indicated otherwise. Air Canada's unaudited consolidated financial statements for the third quarter of 2010 are based on accounting policies consistent with those disclosed in Note 2 to Air Canada's annual audited consolidated financial statements for 2009. Except as otherwise noted, all monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 16 "Glossary" of this MD&A. Except as otherwise noted, this MD&A is current as of November 3, 2010.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of the risks relating to Air Canada, refer to section 13 "Risk Factors" of this MD&A and section 19 "Risk Factors" of Air Canada's 2009 MD&A which can be found on Air Canada's website at **aircanada.com** or on SEDAR at **www.sedar.com**.

Air Canada issued a news release dated November 4, 2010, reporting on its results for the third quarter of 2010. This news release is available on Air Canada's website at **aircanada.com** or on SEDAR at **www.sedar.com**. For further information on Air Canada's public disclosure file, including Air Canada's Annual Information Form, consult Air Canada's website at **aircanada.com** or SEDAR at **www.sedar.com**.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

Air Canada's public communications may include written or oral forward-looking statements within the meaning of applicable securities laws. Such statements are included in this MD&A and may be included in other communications, including filings with regulatory authorities and securities regulators. Forward-looking statements 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. Forward-looking statements are identified by the use of terms and phrases such as "anticipate", "believe", "could", "estimate", "expect", "intend", "may", "plan", "predict", "project", "will", "would", and similar terms and phrases, including references to assumptions.

Forward-looking statements, by their nature, are based on assumptions, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, industry, market, credit and economic conditions, the ability to reduce operating costs and secure financing, pension issues, energy prices, currency exchange and interest rates, employee and labour relations, competition, war, terrorist acts, epidemic diseases, environmental factors (including weather systems and other natural phenomena, such as volcanic eruptions, and factors arising from man-made sources), insurance issues and costs, changes in demand due to the seasonal nature of the business, supply issues, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties as well as the factors identified throughout Air Canada's 2009 MD&A and third quarter 2010 MD&A and, in particular, those identified in section 13 "Risk Factors" of this MD&A and section 19 "Risk Factors" of Air Canada's 2009 MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of November 3, 2010 (or as of the date they are otherwise stated to be made), and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

Assumptions were made by Air Canada in preparing and making forward-looking statements. Air Canada assumes that the North American economy will continue to slowly recover in 2010. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C$1.03 per U.S. dollar in the fourth quarter of 2010 and C$1.04 per U.S. dollar for the full year 2010 and that the price of fuel will average 70 cents per litre for the fourth quarter of 2010 and for the full year 2010 (both net of fuel hedging positions).

3. Overview

Air Canada's results of operations for the third quarter of 2010 are discussed in section 4 of this MD&A.

The following is an overview of Air Canada's results of operations for the third quarter of 2010 compared to the third quarter of 2009.

Air Canada recorded net income of $261 million or $0.91 per diluted share in the third quarter of 2010 compared to net income of $277 million or $2.44 per diluted share in the third quarter of 2009. Air Canada's net income in the third quarter of 2010 included foreign exchange gains of $90 million which were primarily attributable to a stronger Canadian dollar at September 30, 2010, versus June 30, 2010. The September 30, 2010 noon day exchange rate was US$1 = C$1.0298 while the June 30, 2010 noon day exchange rate was US$1 = C$1.0606. Net income in the third quarter of 2009 included foreign exchange gains of $295 million.

In the third quarter of 2010, Air Canada recorded operating income of $327 million, an improvement of $259 million from the operating income of $68 million recorded in the third quarter of 2009. EBITDAR amounted to $581 million in the third quarter of 2010 compared to EBITDAR of $320 million in the third quarter of 2009, an increase of $261 million. See section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.

In the third quarter of 2010, Air Canada recorded operating revenues of $3,026 million, an increase of $356 million or 13.4% from the operating revenues of $2,670 million recorded in the third quarter of 2009. The increase in operating revenues was due to passenger and cargo revenue increase of $353 million or 14.2% from the third quarter of 2009. The year-over-year system passenger revenue growth of $322 million or 13.4% was due to a 9.7% increase in system passenger traffic and a 3.2% improvement in system yield. The passenger traffic growth in the third quarter of 2010 was greater than the capacity increase of 8.2% which resulted in a 1.2 percentage point improvement in system passenger load factor from the third quarter of 2009. The system yield improvement of 3.2% in the third quarter of 2010 was achieved despite a negative impact of $98 million relating to the stronger Canadian dollar on foreign currency denominated passenger revenues, which are approximately 35% of total third quarter 2010 passenger revenues. System RASM in the third quarter of 2010 increased 4.7% year-over-year due to both the yield growth and the passenger load factor improvement. The stronger Canadian dollar as compared to the third quarter of 2009 reduced the RASM improvement by 3.8 percentage points in the third quarter of 2010. Excluding the unfavourable impact of foreign exchange, RASM would have reflected a year-over-year increase of 8.5% in the third quarter of 2010. Cargo revenue growth of $31 million or 34% from the third quarter of 2009 was due to an increase in cargo traffic and, to a lesser extent, a growth in cargo yield per revenue ton mile.

In the third quarter of 2010, Air Canada recorded operating expenses of $2,699 million, an increase of $97 million or 3.7% from the operating expenses of $2,602 million recorded in the third quarter of 2009. The increase in operating expenses in the third quarter of 2010 was largely driven by the capacity growth of 8.2%, higher base fuel prices year-over-year, as well as increases in pension and commission expenses from the third quarter of 2009. Operating expense increases were partially offset by the impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars) compared to the third quarter of 2009, which reduced operating expenses by approximately $70 million from the same period in 2009, and a reduction in aircraft maintenance expense, which was largely due to a deferral of airframe maintenance activities. To date, initiatives relating to the Cost Transformation Program ("CTP") have had a favourable impact on various operating expense categories, including wages and salaries, airport user fees, capacity purchase fees with Jazz, food, beverage and supplies, information technology, terminal handling and "other" operating expenses.

In mid-2009, Air Canada launched the CTP, identifying and implementing initiatives with a goal of generating annualized revenue gains and cost savings, including through contract and operating process improvements and productivity gains. As of the date of this MD&A, Air Canada has achieved, on a run-rate basis, its $300 million CTP target for 2010 and $350 million of its overall CTP target for the end of 2011. Air Canada views the CTP as one of its most important priorities.

CASM decreased 4.1% from the third quarter of 2009. Excluding fuel expense, CASM decreased 5.3% from the third quarter of 2009. The 5.3% decrease in CASM (excluding fuel expense) for the third quarter of 2010 was in line with the 4.5% to 5.5% CASM (excluding fuel expense) decrease projected in Air Canada's news release dated August 5, 2010.

4. Results of Operations – Third Quarter of 2010 versus Third Quarter of 2009

The following table and discussion compares the results of Air Canada for the third quarter of 2010 versus the third quarter of 2009.

	Third Quarter		Change	
(Canadian dollars in millions, except per share figures)	**2010**	**2009**	**$**	**%**
Operating revenues				
Passenger	$ 2,722	$ 2,400	$ 322	13
Cargo	123	92	31	34
Other	181	178	3	2
	3,026	**2,670**	**356**	**13**
Operating expenses				
Aircraft fuel	733	682	51	7
Wages, salaries, and benefits	471	437	34	8
Airport and navigation fees	270	272	(2)	(1)
Capacity purchase with Jazz	247	246	1	-
Depreciation and amortization	166	171	(5)	(3)
Aircraft maintenance	158	183	(25)	(14)
Food, beverages and supplies	77	82	(5)	(6)
Communications and information technology	76	70	6	9
Aircraft rent	88	81	7	9
Commissions	72	51	21	41
Other	341	327	14	4
	2,699	**2,602**	**97**	**4**
Operating income	**327**	**68**	**259**	
Non-operating income (expense)				
Interest income	4	2	2	
Interest expense	(86)	(87)	1	
Interest capitalized	-	1	(1)	
Gain on assets	2	1	1	
Gain on financial instruments recorded at fair value	5	4	1	
Other	-	(4)	4	
	(75)	(83)	8	
Income (loss) before the following items	**252**	**(15)**	**267**	
Non-controlling interest	(1)	(3)	2	
Foreign exchange gain	90	295	(205)	
Provision for income taxes	(80)	-	(80)	
Income for the period	**$ 261**	**$ 277**	**$ (16)**	
EBITDAR (1)	**$ 581**	**$ 320**	**$ 261**	
Earnings (loss) per share - Basic	**$ 0.94**	**$ 2.77**	**$ (1.83)**	
Earnings (loss) per share - Diluted	**$ 0.91**	**$ 2.44**	**$ (1.53)**	

(1) See section 15 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).

System passenger revenues increased 13.4% from the third quarter of 2009

Compared to the third quarter of 2009, system passenger revenues increased $322 million or 13.4% to $2,722 million in the third quarter of 2010 due to traffic growth and yield improvements.

In the third quarter of 2010, premium cabin revenues increased almost 26% and accounted for approximately 33% of the total increase in system passenger revenues. This year-over-year growth in system premium cabin revenues was driven by a 14.1% increase in premium cabin traffic and a 10.0% improvement in premium cabin yield. In the third quarter of 2010, premium cabin revenues increased 6.0% from the third quarter of 2008 on 20.0% higher traffic.

In the third quarter of 2010, Air Canada's overall capacity was 8.2% higher than the third quarter of 2009, with capacity growth reflected in all markets. Domestic capacity increased 0.8% while the overall capacity in the international markets, including the U.S. transborder market, increased 12.0% from the third quarter of 2009. This capacity growth is consistent with one of Air Canada's 2010 key priorities to expand its international operations and to leverage its Toronto hub at Pearson International Airport as a global transfer point for travellers en route to domestic, U.S. transborder and international destinations. Components of the year-over-year change in third quarter system passenger revenues included:

- A system traffic increase of 9.7% on capacity growth of 8.2%, which resulted in a system passenger load factor improvement of 1.2 percentage points from the third quarter of 2009. The system capacity growth of 8.2% in the third quarter of 2010 compared to the third quarter of 2009 was slightly above the 7.0% to 8.0% ASM capacity increase projected in Air Canada's news release dated August 5, 2010. The slightly greater than forecasted capacity growth was attributable to a higher flight completion rate. The flight completion rate in the third quarter of 2010 was approximately 99%.

- A system yield improvement of 3.2% from the third quarter of 2009, which reflected an improvement in the economic environment as well as the impact of Air Canada's renewed focus on improving the quality of its revenues and promoting its business class services. The year-over-year third quarter yield improvement was achieved in spite of an unfavourable impact relating to the stronger Canadian dollar on foreign currency denominated passenger revenues. The stronger Canadian dollar in the third quarter of 2010 versus the third quarter of 2009 decreased the Canadian dollar value of sales in foreign countries and had a negative impact of $98 million on system passenger revenues.

- A system RASM increase of 4.7% from the third quarter of 2009, which was due to both the yield growth and the passenger load factor improvement. RASM in the premium cabin increased 18.8% year-over-year while RASM in the economy cabin improved 2.0% from the third quarter of 2009. When compared to the third quarter of 2008, RASM in the premium cabin improved 7.7% due to a 13.1 percentage point increase in passenger load factor as premium cabin yield remained below the third quarter of 2008 level. Excluding the unfavourable impact of foreign exchange, system RASM would have reflected a year-over-year increase of 8.5% in the third quarter of 2010.

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

Third quarter 2010 Versus Third quarter 2009	**Passenger Revenue % Change**	**Capacity (ASMs) % Change**	**Traffic (RPMs) % Change**	**Passenger Load Factor pp Change**	**Yield % Change**	**RASM % Change**
Canada	5.9	0.8	1.7	0.7	4.1	5.0
U.S. transborder	10.4	13.3	12.8	(0.3)	(2.3)	(2.7)
Atlantic	16.3	12.3	12.3	-	3.5	3.4
Pacific	37.7	10.9	17.1	4.8	17.5	24.1
Other	18.2	10.7	13.8	2.3	3.7	6.7
System	**13.4**	**8.2**	**9.7**	**1.2**	**3.2**	**4.7**

The table below provides year-over-year percentage changes in system passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the third quarter 2010 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
System	Q3'09	Q4'09	Q1'10	Q2'10	Q3'10
Passenger Revenues	(13.2)	(7.0)	4.2	12.4	13.4
Capacity (ASMs)	(3.3)	2.0	6.6	5.3	8.2
Traffic (RPMs)	(2.1)	0.4	6.4	8.7	9.7
Passenger Load Factor (pp Change)	1.0	(1.3)	(0.1)	2.6	1.2
Yield	(11.2)	(7.3)	(2.2)	3.3	3.2
RASM	(10.2)	(8.8)	(2.3)	6.6	4.7

Domestic passenger revenues increased 5.9% from the third quarter of 2009

Domestic passenger revenues of $1,057 million in the third quarter of 2010 increased $59 million or 5.9% from the third quarter of 2009 due to a yield improvement and traffic growth. Components of the year-over-year change in third quarter domestic passenger revenues included:

- A traffic increase of 1.7% on capacity growth of 0.8%, which resulted in a 0.7 percentage point improvement in passenger load factor.

- A yield increase of 4.1% from the third quarter of 2009, reflecting yield improvements in both the economy cabin and the premium cabin. Yield improvements were recorded on all major domestic services with the largest improvement reflected on routes to and from western Canada (short and long haul). The yield improvement was mainly due to a return in business traffic resulting from more favourable economic conditions, assisted by targeted Executive cabin fare products which improved both traffic and average fare performance. The year-over-year third quarter domestic yield improvement was achieved in spite of a $15 million unfavourable impact of a stronger Canadian dollar on domestic passenger revenues.

- Domestic RASM increased 5.0% from the third quarter of 2009, which was mainly due to the yield growth but also to the passenger load factor improvement.

The table below provides year-over-year percentage changes in domestic passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the third quarter 2010 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
Canada	Q3'09	Q4'09	Q1'10	Q2'10	Q3'10
Passenger Revenues	(13.3)	(7.9)	1.5	6.8	5.9
Capacity (ASMs)	(1.5)	(0.6)	2.6	(0.2)	0.8
Traffic (RPMs)	0.7	(1.3)	0.8	2.9	1.7
Passenger Load Factor (pp Change)	1.8	(0.5)	(1.4)	2.5	0.7
Yield	(13.6)	(6.7)	0.6	3.7	4.1
RASM	(11.7)	(7.3)	(1.1)	7.0	5.0

U.S. transborder passenger revenues increased 10.4% from the third quarter of 2009

U.S. transborder passenger revenues of $448 million in the third quarter of 2010 increased $42 million or 10.4% from the third quarter of 2009 due to traffic growth. In the third quarter of 2010, U.S. transborder capacity was increased by 13.3% from the third quarter of 2009, largely driven by growth in connecting traffic from the U.S. in support of Air Canada's international expansion initiatives. Components of the year-over-year change in third quarter U.S. transborder passenger revenues included:

- A traffic increase of 12.8% on the capacity growth of 13.3%, which resulted in a passenger load factor decline of 0.3 percentage points from the third quarter of 2009. The capacity growth reflected the introduction of new daily services from Toronto to seven American cities in the third quarter of 2010, including: Orange County (Santa Ana) and San Diego, California; Portland, Oregon; Memphis, Tennessee; Cincinnati, Ohio; Portland, Maine; and Syracuse, New York. In addition, Air Canada introduced service from Montreal to Houston and increased its capacity on routes to Florida with more frequencies between Toronto and Fort Lauderdale and with the use of larger aircraft between Toronto and Miami. Capacity was also significantly increased in the eastern seaboard market (New York and Boston). The suspension of Air Canada's services on Toronto-Austin and Halifax-New York in the second half of 2009, as well as the suspension of Edmonton-Los Angeles, Edmonton-Las Vegas and Calgary-San Diego in May 2010 partly offset these increases.

- A yield decrease of 2.3% from the third quarter of 2009, which was due to the impact of more aggressive competitive pricing in the U.S. transborder market and a higher proportion of international traffic flowing to and from the U.S. producing lower yields on the U.S. transborder segments, thereby impacting the overall U.S. transborder yield while increasing revenues in the international market. Yield improvements were achieved on routes from Canada to Hawaii, Las Vegas, Western Canada, Western U.S. and other long-haul markets, while incremental and new competitive flying on key transborder routes such as Boston, New York (LaGuardia) and Newark, and on routes to Florida and California challenged yields. The unfavourable impact of a stronger Canadian dollar on U.S. transborder passenger revenues was also a factor in the year-over-year yield decline, accounting for a decrease of $19 million to third quarter 2010 U.S. transborder passenger revenues.

- U.S. transborder RASM decreased 2.7% from the third quarter of 2009, which was due to the decline in yield and, to a much lesser extent, to the lower passenger load factor.

In October 2010, Air Canada announced that it had concluded a memorandum of understanding with United Air Lines, Inc. and Continental Airlines, Inc. setting out the principles for a comprehensive revenue-sharing joint venture on transborder flights. The joint venture is expected to come into effect in early 2011, subject to the parties obtaining regulatory approvals, making the necessary filings, and finalizing documentation.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the third quarter 2010 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
U.S. transborder	**Q3'09**	**Q4'09**	**Q1'10**	**Q2'10**	**Q3'10**
Passenger Revenues	(13.1)	(3.7)	6.0	11.3	10.4
Capacity (ASMs)	(8.8)	(1.8)	2.8	7.3	13.3
Traffic (RPMs)	(8.0)	(5.0)	3.4	10.3	12.8
Passenger Load Factor (pp Change)	0.7	(2.5)	0.5	2.0	(0.3)
Yield	(5.4)	1.4	2.5	0.8	(2.3)
RASM	(4.6)	(1.9)	3.1	3.6	(2.7)

Atlantic passenger revenues increased 16.3% from the third quarter of 2009

Atlantic passenger revenues of $685 million in the third quarter of 2010 increased $97 million or 16.3% from the third quarter of 2009 due to traffic and yield growth. In the third quarter of 2010, Atlantic capacity was increased by 12.3% from the third quarter of 2009, with capacity increases reflected on all major Atlantic services with the exception of routes to Italy and Switzerland. Air Canada expects to finalize the transatlantic joint venture with United Continental Holdings, Inc. ("United Airlines") and Lufthansa, referred to as A++, by the end of this year, at which point, the revenue share structure would also be implemented with retroactive effect as of January 1, 2010. Once finalized, future adjustments tied to the Corporation's performance in this joint venture will be recorded in passenger revenues. This joint venture is expected to further strengthen Air Canada's market presence between North America and Europe. Components of the year-over-year change in third quarter Atlantic passenger revenues included:

- A traffic increase of 12.3% on the capacity growth of 12.3%, which resulted in passenger load factor being unchanged from the third quarter of 2009. Traffic growth was driven by an increase in Canadian and U.S. originating traffic to Europe, Africa and Tel Aviv, as well as an increase in European originating traffic traveling both to Canada and the U.S., a result of Air Canada's international growth strategy and the airline's participation in the A++ transatlantic joint venture.

- The capacity growth in the third quarter of 2010 reflected the addition of new routes including the following year-round services which started in June 2010: Toronto-Montreal-Brussels and Toronto-Copenhagen and the following summer seasonal services: Montreal-Barcelona, Toronto-Barcelona, Toronto-Athens, Montreal-Athens and St. John's, Newfoundland-London, U.K., as well as additional frequencies on Toronto-Tel Aviv.

- A yield improvement of 3.5% from the third quarter of 2009, which reflected a greater proportion of higher-yield traffic, a notable return in business travel demand and the airline's strong focus on promoting premium services. The year-over-year third quarter Atlantic yield improvement was achieved in spite of a $45 million unfavourable impact of a stronger Canadian dollar on Atlantic passenger revenues.

- Atlantic RASM increased 3.4% from the third quarter of 2009, which was due to the yield growth. Excluding the foreign exchange impact, Atlantic RASM would have reflected a RASM improvement of approximately 10%.

The table below provides year-over-year percentage changes in Atlantic passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the third quarter 2010 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
Atlantic	**Q3'09**	**Q4'09**	**Q1'10**	**Q2'10**	**Q3'10**
Passenger Revenues	(6.7)	(4.8)	6.5	12.8	16.3
Capacity (ASMs)	6.8	6.7	6.2	2.4	12.3
Traffic (RPMs)	5.9	2.4	5.8	3.2	12.3
Passenger Load Factor (pp Change)	(0.8)	(3.3)	(0.3)	0.7	-
Yield	(11.8)	(7.0)	0.5	9.2	3.5
RASM	(12.6)	(10.8)	0.1	10.0	3.4

Pacific passenger revenues increased 37.7% from the third quarter of 2009

Pacific passenger revenues of $353 million in the third quarter of 2010 increased $97 million or 37.7% from the third quarter of 2009 due to yield and traffic growth. In the third quarter of 2010, capacity was increased by 10.9% from the third quarter of 2009 with growth reflected on all major Pacific services with the exception of routes to Korea where capacity decreased slightly from the third quarter of 2009. Components of the year-over-year change in third quarter Pacific passenger revenues included:

- A traffic increase of 17.1% on the capacity growth of 10.9%, which resulted in a passenger load factor improvement of 4.8 percentage points from the third quarter of 2009. Air Canada increased its capacity on the Pacific with the introduction of a Calgary-Narita non-stop service in March 2010, and additional frequencies from Vancouver to Beijing and Shanghai, China. The strong year-over-year traffic gains were driven by attracting passengers originating from Air Canada's international points of sale as well as from Canada and the U.S.

- A yield increase of 17.5% from the third quarter of 2009, which reflected yield improvements on all major Pacific services. The year-over-year third quarter Pacific yield improvement was achieved despite a $14 million unfavourable impact of a stronger Canadian dollar on Pacific passenger revenues.

- Pacific RASM increased 24.1% from the third quarter of 2009, which was largely due to the yield growth but also to the passenger load factor improvement. Excluding the foreign exchange impact, Pacific RASM would have reflected an improvement of approximately 29%.

The table below provides year-over-year percentage changes in Pacific passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the third quarter 2010 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
Pacific	**Q3'09**	**Q4'09**	**Q1'10**	**Q2'10**	**Q3'10**
Passenger Revenues	(21.9)	(9.7)	14.5	37.3	37.7
Capacity (ASMs)	(14.8)	6.5	25.6	17.5	10.9
Traffic (RPMs)	(12.6)	4.2	23.6	27.0	17.1
Passenger Load Factor (pp Change)	2.1	(1.8)	(1.4)	6.7	4.8
Yield	(10.6)	(13.4)	(7.4)	8.1	17.5
RASM	(8.4)	(15.2)	(8.8)	16.9	24.1

Other passenger revenues increased 18.2% from the third quarter of 2009

Other passenger revenues (comprised of Australia, Caribbean, Mexico and South America) of $179 million in the third quarter of 2010 increased $27 million or 18.2% from the third quarter of 2009, mainly due to traffic growth but also to a higher yield. The year-over-year capacity growth in the third quarter of 2010 was largely driven by increased frequencies to the Caribbean and Mexico and, starting in June 2010, increased frequencies to Caracas and Bogotá. In the third quarter of 2009, capacity to and from Mexico was significantly reduced as a result of reduced flying relating to concerns over the H1N1 influenza virus. Components of the year-over-year change in third quarter Other passenger revenues included:

- A traffic increase of 13.8% on capacity growth of 10.7%, which resulted in a passenger load factor improvement of 2.3 percentage points versus the same quarter of 2009.

- A yield increase of 3.7% from the third quarter of 2009, which reflected yield improvements on routes to Australia and South America. Yields on routes to traditional leisure destinations, such as the Caribbean and Mexico, were negatively impacted by aggressive competitive pricing activities. The year-over-year third quarter Other yield improvement was achieved despite a $5 million unfavourable impact of a stronger Canadian dollar on Other passenger revenues.

- RASM in the Other markets increased 6.7% from the third quarter of 2009, which was due to both the yield growth and the passenger load factor improvement.

The table below provides year-over-year percentage changes in Other passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the third quarter 2010 and each of the previous four quarters.

	Year-over-Year by Quarter (% Change)				
Other	**Q3'09**	**Q4'09**	**Q1'10**	**Q2'10**	**Q3'10**
Passenger Revenues	(20.1)	(10.8)	(0.5)	15.3	18.2
Capacity (ASMs)	(7.2)	(0.1)	4.3	10.1	10.7
Traffic (RPMs)	(7.6)	3.3	6.6	12.7	13.8
Passenger Load Factor (pp Change)	(0.4)	2.6	1.7	1.8	2.3
Yield	(13.5)	(13.7)	(6.6)	2.2	3.7
RASM	(13.9)	(10.7)	(4.6)	4.5	6.7

Cargo revenues increased 34% from the third quarter of 2009

Cargo revenues of $123 million in the third quarter of 2010 increased $31 million or 34% from the third quarter of 2009 due to a 29% increase in cargo traffic and, to a lesser extent, a 3% growth in cargo yield per revenue ton mile (RTM). Traffic growth was reflected in all markets. The system cargo yield per RTM improvement was mainly driven by an 11% yield increase in the Pacific market. Excluding the unfavourable impact of foreign exchange of $8 million relating to the stronger Canadian dollar on foreign currency denominated cargo revenues, yield per RTM would have reflected a 10% increase from the third quarter of 2009.

The table below provides the dollar change in cargo revenues as well year-over-year percentage changes in third quarter cargo revenues, capacity as measured by effective ton miles (“ETM”), revenue per ETM, traffic as measured by revenue ton miles (“RTM”), and yield per RTM.

Third Quarter 2010 Versus Third Quarter 2009	**Cargo Revenue $ million**	**Cargo Revenue % Change**	**Capacity (ETMs) % Change**	**Rev / ETM % Change**	**Traffic (RTMs) % Change**	**Yield / RTM % Change**
Canada	1	8.1	(6.1)	15.2	10.4	(2.1)
US transborder	1	29.4	20.1	7.7	35.0	(4.1)
Atlantic	14	44.6	10.2	31.2	40.7	2.7
Pacific	14	43.1	10.4	29.5	28.8	11.0
Other	1	9.8	1.0	8.7	5.5	4.0
System	**31**	**33.2**	**7.4**	**24.0**	**29.4**	**3.0**

Other revenues increased 2% from the third quarter of 2009

Other revenues consists primarily of revenues from the sale of the ground portion of vacation packages, ground handling services, and other airline-related services, as well as revenues related to the lease or sublease of aircraft to third parties.

Other revenues of $181 million in the third quarter of 2010 increased $3 million or 2% from the third quarter of 2009 due to an increase of $6 million or 13% in third party revenues at Air Canada Vacations and growth in cancellation fees. Partly offsetting these increases was a decrease in aircraft sublease revenues from the same quarter in 2009. The growth in both third party revenues at Air Canada Vacations and in cancellation fees were largely driven by an increase in passenger volumes reflecting increased capacity year-over-year. The decrease in aircraft sublease revenues was due to both the unfavourable impact of a stronger Canadian dollar on U.S. denominated lease and sublease revenues, as well as the impact of a fewer number of aircraft subleased to third parties compared to the third quarter of 2009. During the quarter, Mexicana filed for bankruptcy protection and four Air Canada aircraft under sublease to Mexicana were returned to or repossessed by Air Canada and the related subleases were terminated. As a result, Air Canada is no longer receiving US$1.1 million per month for the sublease of these aircraft. Air Canada continues to explore its options for these four aircraft.

CASM decreased 4.1% from the third quarter of 2009. Excluding fuel expense, CASM decreased 5.3% from the third quarter of 2009

In the third quarter of 2010, operating expenses of $2,699 million increased $97 million or 4% from the third quarter of 2009. The increase in operating expenses in the third quarter of 2010 was largely driven by the capacity growth of 8.2%, higher base fuel prices year-over-year, as well as increases in pension and commission expenses from the third quarter of 2009. Operating expense increases were partly offset by several factors, including the impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars) compared to the third quarter of 2009 which reduced operating expenses by approximately $70 million from the same period in 2009, and a reduction in aircraft maintenance expense, which was largely due to a deferral of airframe maintenance activities.

Unit cost in the third quarter of 2010, as measured by operating expense per available seat mile (CASM), decreased 4.1% from the third quarter of 2009. Excluding fuel expense, CASM decreased 5.3% year-over-year.

The favourable impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), the capacity growth, which results in the airline’s fixed costs being allocated over a greater number of ASMs, the impact of CTP initiatives, as well as increases in aircraft utilization and average stage length from the third quarter of 2009 were all contributing factors to the CASM decrease year-over-year.

The following table compares Air Canada's operating expenses per ASM for the third quarter of 2010 to Air Canada's operating expenses per ASM for the corresponding period in 2009.

	Third Quarter		Change	
(cents per ASM)	**2010**	**2009**	**cents**	**%**
Wages and salaries	2.07	2.23	(0.16)	(7.2)
Benefits	0.49	0.35	0.14	40.0
Ownership (DAR) (1)	1.39	1.48	(0.09)	(6.1)
Airport user fees	1.48	1.60	(0.12)	(7.5)
Capacity purchase with Jazz	1.35	1.45	(0.10)	(6.9)
Aircraft maintenance	0.86	1.08	(0.22)	(20.4)
Food, beverages and supplies	0.42	0.48	(0.06)	(12.5)
Communications and information technology	0.41	0.41	-	-
Commissions	0.39	0.30	0.09	30.0
Other	1.86	1.95	(0.09)	(4.6)
Operating expense, excluding fuel expense (2)	**10.72**	**11.33**	**(0.61)**	**(5.3)**
Aircraft fuel	4.00	4.02	(0.02)	(0.5)
Total operating expense	**14.72**	**15.35**	**(0.63)**	**(4.1)**

(1) DAR refers to the combination of Depreciation and amortization and Aircraft rent expenses.

(2) Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.

Fuel expense increased 7% from the third quarter of 2009

Fuel expense amounted to $733 million in the third quarter of 2010, an increase of $51 million or 7% from the third quarter of 2009. Factors contributing to the year-over-year change in third quarter fuel expense included:

- A higher base fuel price, which accounted for a fuel expense increase of $85 million.
- A higher volume of fuel litres consumed, which accounted for a fuel expense increase of $59 million.

The above-noted increases were partially offset by the following:

- The favourable impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for a decrease of $41 million to fuel expense.
- In the third quarter of 2010, fuel hedging losses amounting to $42 million were reclassified from Accumulated Other Comprehensive Loss ("AOCL") into fuel expense. In the third quarter of 2009, fuel hedging losses amounting to $94 million were reclassified from AOCL into fuel expense.

The table below provides Air Canada's fuel cost per litre, excluding and including hedging, for the periods indicated.

		Third Quarter		Change	
(Canadian dollars in millions, except where indicated)		**2010**	**2009**	**$**	**%**
Aircraft fuel expense - GAAP [1]		$ 729	$ 678	$ 51	8
Remove:	*Fuel hedging gains (losses) reclassified from AOCL into fuel expense*	(42)	(94)	52	55
Add:	*Net cash payments on fuel derivatives* [2]	17	14	3	21
Economic cost of fuel - Non-GAAP [3]		**$ 704**	**$ 598**	**$ 106**	**18**
Fuel consumption (thousands of litres)		1,088,222	988,015	100,207	10
Fuel costs per litre (cents) - GAAP		67.0	68.6	(2)	(2)
Fuel costs per litre (cents) - excluding fuel hedging gains (losses)		63.1	59.1	4	7
Economic fuel costs per litre (cents) - Non-GAAP		64.7	60.5	4	7

(1) Excludes fuel related to third party carriers, other than Jazz, operating under capacity purchase agreements.

(2) Includes net cash settlements on maturing fuel derivatives and premiums paid to enter into option contracts.

(3) The economic cost of fuel is a non-GAAP measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada uses this measure to calculate its cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period and premium costs associated with those derivatives. It excludes non-cash accounting gains and losses from fuel derivative instruments.

Wages, salaries and benefits expense amounted to $471 million in the third quarter of 2010, an increase of $34 million or 8% from the third quarter of 2009

Wages and salaries expense amounted to $381 million in the third quarter of 2010, an increase of $4 million or 1% from the third quarter of 2009. Employee benefits expense amounted to $90 million in the third quarter of 2010, an increase of $30 million or 50% from the third quarter of 2009. The increase in employee benefits expense was mainly due to higher pension expense as a result of changes in actuarial assumptions. The actuarial assumptions used for recording pension expense under GAAP differ from those used in determining the solvency deficit. For information on Air Canada's pension funding obligations, refer to section 7.8 of this MD&A.

Capacity purchase costs with Jazz increased $1 million from the third quarter of 2009

Capacity purchase costs with Jazz, pursuant to the Jazz CPA, amounted to $247 million in the third quarter of 2010 compared to $246 million in the third quarter of 2009, an increase of $1 million or less than 1%. This year-over-year increase in capacity purchase costs was mainly due to an increase in Jazz CPA rates of $5 million, including $2 million related to additional maintenance costs due to the aging of Jazz's fleet. In addition, the impact of the CTP-related amendment to the Jazz CPA effective August 1, 2009, accounted for a net increase of $2 million, comprised of a decrease of $5 million related to the reduction to the mark-up on Jazz CPA rates and an increase of $7 million related to charges arising from aircraft returns. Partly offsetting these increases was the favourable impact of foreign exchange on U.S. denominated Jazz CPA charges paid by Air Canada, which accounted for a decrease of $5 million, and the impact of reduced flying, which accounted for a decrease of $1 million.

Ownership costs increased 1% from the third quarter of 2009

Ownership costs, comprised of depreciation and amortization, and aircraft rent expense, of $254 million in the third quarter of 2010 increased $2 million or 1% from the third quarter of 2009. Factors contributing to the year-over-year change in the third quarter ownership costs included:

- Decreases in aircraft residual values, which accounted for an increase of $12 million to depreciation expense.

- The impact of the sale and leaseback of three Boeing 777 aircraft, which accounted for an increase of $8 million.

The above-noted increases were partially offset by the following:

- The impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for a decrease of $5 million to aircraft rent expense.

- A decrease in depreciation expense of $4 million relating to rotable inventory.

Aircraft maintenance expense decreased 14% from the third quarter of 2009

In the third quarter of 2010, aircraft maintenance expense of $158 million decreased $25 million or 14% from the third quarter of 2009. Factors contributing to the year-over-year change in third quarter aircraft maintenance expense included:

- A decrease of $26 million in airframe maintenance, which was mainly due to a deferral of heavy maintenance events on Airbus A319 and A320 aircraft, as well as to a decline in Boeing 767 maintenance activity due to maintenance cycle timing.

- A decrease of $8 million in engine maintenance, which was mainly due to maintenance cycle timing, particularly on Airbus A320 aircraft.

- Fewer aircraft returns in the third quarter of 2010 compared to the corresponding quarter in 2009, which accounted for a decrease of $4 million to aircraft maintenance expense.

- The impact of a stronger Canadian dollar versus the U.S. dollar on U.S. denominated maintenance expenses, mainly engine and component maintenance, which accounted for a decrease of $7 million to aircraft maintenance expense compared to the third quarter of 2009.

The above-noted increases were partially offset by the following:

- An increase in component maintenance of $17 million, which was largely due to the year-over-year growth in flying.

Commission expense increased 41% from the third quarter of 2009

In the third quarter of 2010, commission expense of $72 million increased $21 million or 41% from the third quarter of 2009, due to passenger and cargo revenue growth of 14%. Higher agency penetration and a higher proportion of premium traffic, which generally generates higher commission expense, were factors in the increase in passenger commission expense in the third quarter of 2010. Although overall revenue initiatives have resulted in additional commission expense year-over-year, based on management analysis, the benefits of these initiatives have outweighed the costs by enabling Air Canada to generate increased passenger revenues and to remain competitive in the marketplace.

Other operating expenses increased 4% from the third quarter of 2009

Other operating expenses amounted to $341 million in the third quarter of 2010, an increase of $14 million or 4% from the third quarter of 2009. The increase in other operating expenses included the impact of the capacity growth, an increase in expenses related to a greater volume of ground packages at Air Canada Vacations, as well as an increase in credit card fees, the result of higher passenger volumes. Other operating expenses increases were partly offset by the favourable impact of CTP initiatives.

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

	Third Quarter		Change	
(Canadian dollars in millions)	2010	2009	$	%
Air Canada Vacations' land costs	$ 38	$ 31	$ 7	23
Credit card fees	50	42	8	19
Terminal handling	50	50	-	-
Building rent and maintenance	30	33	(3)	(9)
Crew cycle	32	31	1	3
Miscellaneous fees and services	27	30	(3)	(10)
Remaining other expenses	114	110	4	4
	$ 341	**$ 327**	**$ 14**	**4**

Non-operating expense amounted to $75 million in the third quarter of 2010

Non-operating expense amounted to $75 million in the third quarter of 2010 compared to non-operating expense of $83 million in the third quarter of 2009. Factors contributing to the year-over-year change in third quarter non-operating expense included:

- In the third quarter of 2010, net interest expense decreased $2 million from the third quarter of 2009. The net impact of higher debt balances in the last twelve months was more than offset by a year-over-year increase in interest income, largely the result of higher cash balances, coupled with the favourable impact of a stronger Canadian dollar on U.S. denominated interest expense.

- Gains related to fair value adjustments on derivative instruments amounted to $5 million in the third quarter of 2010 versus gains of $4 million in the third quarter of 2009. The mark-to-market gains on financial instruments recorded in the third quarter of 2010 were mainly related to the change in the fair value of fuel derivatives.

Gains on foreign exchange amounted to $90 million in the third quarter of 2010

Gains on foreign exchange, which were mainly related to U.S. denominated long-term debt, amounted to $90 million in the third quarter of 2010 compared to gains of $295 million in the third quarter of 2009. The gains in the third quarter of 2010 were mainly attributable to a stronger Canadian dollar at September 30, 2010, compared to June 30, 2010. The September 30, 2010, noon day exchange rate was US$1 = C$1.0298 while the June 30, 2010, noon day exchange rate was US$1 = C$1.0606.

Provision for income taxes of $80 million in the third quarter of 2010

Air Canada recorded a provision for income taxes of $80 million on pre-tax income of $341 million in the third quarter of 2010, representing an effective income tax rate of 23%. The effective income tax rate is affected by the reversal of valuation allowance on future income tax assets arising after fresh start reporting.

5. Results of Operations – First Nine Months of 2010 versus First Nine Months of 2009

The following table and discussion compares the results of Air Canada for the first nine months of 2010 versus the first nine months of 2009.

	First Nine Months		Change	
(Canadian dollars in millions, except per share figures)	**2010**	**2009**	**$**	**%**
Operating revenues				
Passenger	$ 7,131	$ 6,469	$ 662	10
Cargo	342	248	94	38
Other	697	674	23	3
	8,170	**7,391**	**779**	**11**
Operating expenses				
Aircraft fuel	2,012	1,847	165	9
Wages, salaries, and benefits	1,415	1,333	82	6
Airport and navigation fees	732	743	(11)	(1)
Capacity purchase with Jazz	703	746	(43)	(6)
Depreciation and amortization	514	495	19	4
Aircraft maintenance	504	557	(53)	(10)
Food, beverages and supplies	226	222	4	2
Communications and information technology	235	229	6	3
Aircraft rent	262	250	12	5
Commissions	194	140	54	39
Other	1,097	1,062	35	3
	7,894	**7,624**	**270**	**4**
Operating income (loss)	**276**	**(233)**	**509**	
Non-operating income (expense)				
Interest income	10	12	(2)	
Interest expense	(297)	(286)	(11)	
Interest capitalized	-	4	(4)	
Gain (loss) on assets	1	(70)	71	
Gain (loss) on financial instruments recorded at fair value	(11)	73	(84)	
Other	-	(5)	5	
	(297)	(272)	(25)	
Loss before the following items	**(21)**	**(505)**	**484**	
Non-controlling interest	(7)	(11)	4	
Foreign exchange gain	34	549	(515)	
Provision for income taxes	(33)	(1)	(32)	
Income (loss) for the period	**$ (27)**	**$ 32**	**$ (59)**	
EBITDAR (1)	**$ 1,052**	**$ 512**	**$ 540**	
Earnings (loss) per share - Basic	**$ (0.10)**	**$ 0.32**	**$ (0.42)**	
Earnings (loss) per share - Diluted	**$ (0.10)**	**$ 0.30**	**$ (0.40)**	

(1) See section 15 "Non-GAAP Financial Measures" in this MD&A for a reconciliation of EBITDAR to operating income (loss).

System passenger revenues increased 10.2% from the first nine months of 2009

Compared to the first nine months of 2009, passenger revenues increased $662 million or 10.2% to $7,131 million in the first nine months of 2010 due to higher traffic and, to a lesser extent, a system yield improvement. An increase in passenger revenues from the premium cabin accounted for $283 million or approximately 43% of the total increase in system passenger revenues.

In the first nine months of 2010, Air Canada increased its overall capacity by 6.8% from the first nine months of 2009, comprised of a year-over-year capacity increase of 6.6% in the first quarter of 2010, a year-over-year capacity increase of 5.3% in the second quarter of 2010 and year-over-year increase of 8.2% in the third quarter of 2010. Components of the year-over-year change in first nine months system passenger revenues included:

- A capacity increase of 6.8% was below the traffic increase of 8.4%, which resulted in a higher passenger load factor of 1.3 percentage points from the first nine months of 2009, comprised of year-over-year passenger load factor decrease of 0.1 percentage points in the first quarter of 2010, a year-over-year passenger load factor increase of 2.6 percentage points in the second quarter of 2010 and a 1.2 percentage point increase in the third quarter of 2010.
- A system yield increase of 1.6% from the first nine months of 2009, which was comprised of a year-over-year yield decrease of 2.2% in the first quarter of 2010, a year-over-year yield increase of 3.3% in the second quarter of 2010 and a year-over-year increase of 3.2% in the third quarter of 2010.
- A stronger Canadian dollar in the first nine months of 2010 versus the first nine months of 2009, which had a negative impact on foreign currency denominated revenues of $261 million in the first nine months of 2010.
- A RASM increase of 3.2% from the first nine months of 2009, which was comprised of a year-over-year RASM decrease of 2.3% in the first quarter of 2010, a year-over-year RASM increase of 6.6% in the second quarter of 2010 and a year-over-year RASM increase of 4.7% in the third quarter of 2010. The RASM increase in the first nine months of 2010 was due to both the yield improvement and the increase in passenger load factor.

The table below provides year-over-year percentage changes in first nine months passenger revenues, capacity, traffic, passenger load factor, yield and RASM**.**

First Nine Months 2010 Versus First Nine Months 2009	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	4.9	1.0	1.8	0.7	2.9	3.8
U.S. transborder	9.1	7.5	8.5	0.7	0.4	1.4
Atlantic	12.8	7.5	7.8	0.2	4.6	4.8
Pacific	31.0	16.9	22.1	3.8	7.2	12.0
Other	8.9	7.7	10.3	1.9	(1.3)	1.0
System	**10.2**	**6.8**	**8.4**	**1.3**	**1.6**	**3.2**

Refer to section 4 of this MD&A for year-over-year percentage changes in passenger revenues, capacity, traffic, passenger load factor, yield and RASM by quarter for the third quarter 2010 and each of the previous four quarters.

Cargo revenues increased 38% from the first nine months of 2009

Cargo revenues in the first nine months of 2010 amounted to $342 million and were $94 million or 38% higher than the first nine months of 2009 on higher traffic. Cargo traffic increased 45% compared to the same period last year on strong traffic growth in all markets. System cargo yield per revenue ton mile (RTM) declined 4.6% versus the same nine-month period in 2009, mainly due to increased competitive pressure on rates and the unfavourable impact of a stronger Canadian dollar on foreign denominated currencies. Excluding the unfavourable impact of foreign exchange of $29 million relating to the stronger Canadian dollar on foreign currency denominated cargo revenues, yield per RTM would have reflected a 4% increase from the first nine months of 2009.

The table below provides the dollar change in cargo revenues as well as year-over-year percentage changes in nine months cargo revenues, capacity as measured by effective ton miles (“ETM”), revenue per ETM, traffic as measured by revenue ton miles (“RTM”), and yield per RTM.

First Nine Months 2010 Versus First Nine Months 2009	**Cargo Revenue $ million**	**Cargo Revenue % Change**	**Capacity (ETMs) % Change**	**Rev / ETM % Change**	**Traffic (RTMs) % Change**	**Yield / RTM % Change**
Canada	5	13.6	(1.8)	15.7	23.5	(8.0)
US transborder	2	19.1	9.8	8.4	28.8	(7.6)
Atlantic	30	33.4	5.9	26.0	44.9	(8.0)
Pacific	48	65.1	16.2	42.1	52.1	8.6
Other	9	28.2	4.5	22.7	39.9	(8.4)
System	**94**	**37.9**	**7.4**	**28.4**	**44.7**	**(4.6)**

Other revenues increased 3% from the first nine months of 2009

Other revenues of $697 million in the first nine months of 2010 increased $23 million or 3% from the first nine months of 2009 due to a $54 million or 20% increase in third party revenues at Air Canada Vacations, driven by an increase in passenger volumes reflecting increased capacity year-over-year and, to a lesser extent, a higher selling price of tour packages. This increase was partly offset by a decrease in aircraft sublease revenues which was mainly due to the impact of a fewer number of aircraft subleased to third parties compared to the first nine months of 2009, as well as the unfavourable impact of a stronger Canadian dollar on U.S. denominated aircraft lease and sublease revenues. During the quarter, Mexicana filed for bankruptcy protection and four Air Canada aircraft under sublease to Mexicana were returned to or repossessed by Air Canada and the related subleases were terminated. As a result, Air Canada is no longer receiving US$1.1 million per month for the sublease of these aircraft. Air Canada continues to explore its options for these four aircraft.

CASM decreased 3.0% from the first nine months of 2009. Excluding fuel expense, CASM decreased 4.6% from the first nine months of 2009

In the first nine months of 2010, operating expenses of $7,894 million increased $270 million or 4% from the first nine months of 2009. The increase in operating expenses in the first nine months of 2010 was largely driven by the capacity growth of 6.8%, higher base fuel prices year-over-year, as well as increases in pension, commission and ownership expenses from the first nine months of 2009. Operating expense increases were partly offset by several factors, including the impact of a stronger Canadian dollar on foreign currency denominated expenses which reduced operating expenses by approximately $383 million from the same period in 2009, and notable reductions in aircraft maintenance and capacity purchase fees paid to Jazz.

Unit cost in the first nine months of 2010, as measured by operating expense per available seat mile (CASM), decreased 3.0% over the first nine months of 2009. Excluding fuel expense, CASM decreased 4.6% year-over-year.

The favourable impact of a stronger Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars) was the largest contributing factor to the CASM decrease year-over-year. The capacity growth, which results in the airline’s fixed costs being allocated over a greater number of ASMs, the impact of CTP initiatives, including cost reduction initiatives relating to the Jazz CPA, as well as increases in aircraft utilization and average stage length from the first nine months of 2009 were also contributing factors to the CASM decrease year-over-year. Partly offsetting these decreases were increases in pension and commission expenses.

The following table compares Air Canada's operating expenses per ASM for the first nine months of 2010 to Air Canada's operating expenses per ASM for the corresponding period in 2009.

	First Nine Months		Change	
(cents per ASM)	**2010**	**2009**	**cents**	**%**
Wages and salaries	2.30	2.48	(0.18)	(7.3)
Benefits	0.61	0.45	0.16	35.6
Ownership (DAR) (1)	1.60	1.64	(0.04)	(2.4)
Airport user fees	1.51	1.63	(0.12)	(7.4)
Capacity purchase with Jazz	1.45	1.64	(0.19)	(11.6)
Aircraft maintenance	1.04	1.22	(0.18)	(14.8)
Food, beverages and supplies	0.46	0.49	(0.03)	(6.1)
Communications and information technology	0.48	0.50	(0.02)	(4.0)
Commissions	0.40	0.31	0.09	29.0
Other	2.26	2.34	(0.08)	(3.4)
Operating expense, excluding fuel expense (2)	**12.11**	**12.70**	**(0.59)**	**(4.6)**
Aircraft fuel	4.14	4.06	0.08	2.0
Total operating expense	**16.25**	**16.76**	**(0.51)**	**(3.0)**

(1) DAR refers to the combination of Depreciation and amortization and Aircraft rent expenses.

(2) Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.

Fuel expense increased 9% from the first nine months of 2009

Fuel expense amounted to $2,012 million in the first nine months of 2010, an increase of $165 million or 9% from the first nine months of 2009. Factors contributing to the year-over-year change in fuel expense in the first nine months included:

- A higher base fuel price, which accounted for a fuel expense increase of $446 million.
- A higher volume of fuel litres consumed, which accounted for a fuel expense increase of $111 million.

The above-noted increases were partially offset by the following:

- The favourable impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for a fuel expense decrease of $210 million.
- In the first nine months of 2010, fuel hedging losses amounting to $152 million were reclassified from Accumulated Other Comprehensive Loss ("AOCL") into fuel expense. In the first nine months of 2009, fuel hedging losses amounting to $334 million were reclassified from AOCL into fuel expense.

The table below provides Air Canada's fuel cost per litre, excluding and including hedging, for the periods indicated.

(Canadian dollars in millions, except where indicated)		First Nine Months 2010	2009	Change $	%
Aircraft fuel expense - GAAP [1]		$ 2,002	$ 1,838	$ 164	9
Remove:	*Fuel hedging gains (losses) reclassified from AOCL into fuel expense*	(152)	(334)	182	54
Add:	*Net cash payments on fuel derivatives* [2]	48	76	(28)	(37)
Economic cost of fuel - Non-GAAP [3]		**$ 1,898**	**$ 1,580**	**$ 318**	**20**
Fuel consumption (thousands of litres)		2,884,253	2,685,032	199,221	7
Fuel costs per litre (cents) - GAAP		69.4	68.4	1	1
Fuel costs per litre (cents) - excluding fuel hedging gains (losses)		64.2	56.0	8	15
Economic fuel costs per litre (cents) - Non-GAAP		65.8	58.8	7	12

(1) Excludes fuel related to third party carriers, other than Jazz, operating under capacity purchase agreements.

(2) Includes net cash settlements on maturing fuel derivatives and premiums costs associated with those derivatives. Excludes early terminated hedging contracts of $172 million in the first quarter of 2009 covering 2009 and 2010 fuel consumption and $5 million in the second quarter of 2010 covering 2010 fuel consumption.

(3) The economic cost of fuel is a non-GAAP measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada uses this measure to calculate its cash cost of fuel. It includes the actual net cash settlements from maturing fuel derivative contracts during the period and premium costs associated with those derivatives. It excludes non-cash accounting gains and losses from fuel derivative instruments.

Wages, salaries and benefits expense amounted to $1,415 million in the first nine months of 2010, an increase of $82 million or 6% from the first nine months of 2009

Wages and salaries expense totaled $1,120 million in the first nine months of 2010, a decrease of $10 million or 1% from the first nine months of 2009, mainly due to a decrease in expenses related to employee reduction programs from the same period in 2009.

Employee benefits expense amounted to $295 million in the first nine months of 2010, an increase of $92 million or 45% from the first nine months of 2009. The increase in employee benefits expense was mainly due to higher pension expense as a result of changes in actuarial assumptions.

Capacity purchase costs with Jazz decreased 6% from the first nine months of 2009

Capacity purchase costs with Jazz, pursuant to the Jazz CPA, amounted to $703 million in the first nine months of 2010 compared to $746 million in the first nine months of 2009, a decrease of $43 million or 6%. This year-over-year decrease in capacity purchase costs was mainly due to the favourable impact of foreign exchange on U.S. denominated Jazz CPA charges paid by Air Canada, which accounted for a decrease of $30 million. In addition, the impact of the CTP-related amendment to the Jazz CPA effective August 1, 2009, accounted for a net decrease of $17 million, comprised of a decrease related to the reduction to the mark-up on Jazz CPA rates and an increase related to charges arising from the return of aircraft. Furthermore, the impact of reduced flying, accounted for a decrease of $15 million. Partly offsetting these decreases was a year-over-year increase in Jazz CPA rates of $19 million, including $3 million due to one-time maintenance credits in 2009 and $7 million related to additional maintenance costs for Jazz's fleet.

Ownership costs increased 4% from the first nine months of 2009

Ownership costs, comprised of depreciation and amortization, and aircraft rent expense, of $776 million in the first nine months of 2010 increased $31 million or 4% from the first nine months of 2009. Factors contributing to the year-over-year change in ownership costs in the first nine months included:

- Decreases in aircraft residual values, which accounted for an increase of $41 million to depreciation expense.

- The impact of the sale and leaseback of three Boeing 777 aircraft and the addition of one Boeing 777 aircraft in July 2009 to Air Canada's operating fleet, which together accounted for an increase of $33 million.

The above-noted increases were partially offset by the following:

- The impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for a decrease of $30 million to aircraft rent expense.

Aircraft maintenance expense decreased 10% from the first nine months of 2009

In the first nine months of 2010, aircraft maintenance expense of $504 million decreased $53 million or 10% from the first nine months of 2009. Factors contributing to the year-over-year change in aircraft maintenance expense in the first nine months included:

- The favourable impact of a stronger Canadian dollar versus the U.S. dollar on U.S. denominated maintenance expenses, mainly engine and component maintenance, which accounted for a decrease of $43 million to aircraft maintenance expense compared to the first nine months of 2009.

- A decrease of $36 million in airframe maintenance, which was mainly due to the deferral of heavy maintenance events on Airbus A319 and A320 aircraft, as well as to a decline in maintenance activity on Boeing 767 aircraft due to maintenance cycle timing.

- Fewer aircraft lease returns in the first nine months of 2010 compared to the first nine months of 2009, which accounted for a decrease of $13 million to aircraft maintenance expense.

The above-noted decreases were partially offset by the following:

- An increase in component maintenance of $37 million, which was largely due to the year-over-year growth in flying.

Commission expense increased 39% from the first nine months of 2009

In the first nine months of 2010, commission expense of $194 million increased $54 million or 39% from the first nine months of 2009, due to passenger and cargo revenue growth of 11% and the introduction of a 7% commission for Canadian travel agents to sell Tango fares for flights within Canada. Higher agency penetration and a higher proportion of premium traffic, which generally generates higher commission expense, were factors in the increase in passenger commission expense in the first nine months of 2010. An increase in commission expense of $7 million at Air Canada Vacations in the first nine months of 2010 was also a factor in the increase in passenger commission expense year-over-year. The increase in commission expense at Air Canada Vacations was mainly driven by an increase in passenger volumes and higher yields, and a change in the commission structure versus the same nine-month period in 2009. Although overall revenue initiatives have resulted in additional commission expense year-over-year, based on management analysis, the benefits of these initiatives have outweighed the costs by enabling Air Canada to generate increased passenger revenues and to remain competitive in the marketplace.

Other operating expenses increased 3% from the first nine months of 2009

Other operating expenses amounted to $1,097 million in the first nine months of 2010, an increase of $35 million or 3% from the first nine months of 2009. The year-over-year increase in other operating expenses from the first nine months of 2009 was primarily related to the capacity growth, an increase in expenses at Air Canada Vacations, which was largely due to higher passenger volumes, and an increase in credit card fees, which was also related to larger passenger volumes.

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

(Canadian dollars in millions)	First Nine Months 2010	First Nine Months 2009	Change $	Change %
Air Canada Vacations' land costs	$ 223	$ 203	$ 20	10
Credit card fees	151	130	21	16
Terminal handling	142	143	(1)	(1)
Building rent and maintenance	95	96	(1)	(1)
Crew cycle	89	89	-	-
Miscellaneous fees and services	77	84	(7)	(8)
Remaining other expenses	320	317	3	1
	$ 1,097	**$ 1,062**	**$ 35**	**3**

Non-operating expense amounted to $297 million in the first nine months of 2010

Non-operating expense amounted to $297 million in the first nine months of 2010 compared to non-operating expense of $272 million in the first nine months of 2009. Factors contributing to the year-over-year increase in non-operating expense in the first nine months included:

- In the first nine months of 2010, interest expense increased $11 million from the first nine months of 2009. Factors contributing to the year-over-year change in interest expense in the first nine months included:
  - A charge of $54 million in interest expense related to its secured term credit facility, including early payment fees of $29 million and $25 million for adjustments related to the unamortized portion of transaction costs and debt discounts. Refer to section 7.3 of this MD&A for additional information relating to this transaction.
  - The net impact of financing transactions completed in the last twelve months.

  These increases were largely offset by the following:

  - A charge of $17 million in the first nine months of 2009 related to a sale and leaseback transaction. There was no such charge recorded in the first nine months of 2010.
  - A charge of $9 million in the first nine months of 2009 related to the termination of the capital leases of two Airbus A340 aircraft and the subsequent sale of these aircraft. There was no such charge recorded in the first nine months of 2010.
  - The favourable impact of a stronger Canadian dollar on U.S. denominated interest expense.
  - The impact of sale and leaseback transactions of Boeing 777 aircraft substantially completed in the fourth quarter of 2009.
  - Lower average interest rates year-over-year.
- In the first nine months of 2009, Air Canada recorded an impairment charge of $67 million related to previously capitalized costs incurred in the development of a new reservation system and a loss on sale of $2 million related to the sale of the two Airbus A340 aircraft referred to above. There were no significant disposals or provisions during the first nine months of 2010.
- Losses related to fair value adjustments on derivative instruments amounted to $11 million in the first nine months of 2010 versus gains of $73 million in the first nine months of 2009. The mark-to-market losses on financial instruments recorded in the first nine months of 2010 were mainly related to the change in the fair value of fuel derivatives.

Gains on foreign exchange amounted to $34 million in the first nine months of 2010

Gains on foreign exchange, which were mainly related to U.S. denominated long-term debt, amounted to $34 million in the first nine months of 2010 compared to gains of $549 million in the first nine months of 2009. The gains in the first nine months of 2010 were mainly attributable to a stronger Canadian dollar at September 30, 2010, compared to December 31, 2009. The September 30, 2010, noon day exchange rate was US$1 = C$1.0298 while the December 31, 2009, noon day exchange rate was US$1 = C$1.0466.

Provision for income taxes of $33 million in the first nine months of 2010

Air Canada recorded a provision for income tax of $33 million on pre-tax income of $6 million in the first nine months of 2010. The effective income tax rate is affected by the reclassification of losses on fuel derivatives from Accumulated Other Comprehensive Loss ("AOCL") to income of $152 million, which do not attract any net tax recovery due to the reversal of valuation allowance from prior years. It is also impacted by certain non-deductible expenses, as well as the reversal of valuation allowance on future income tax assets arising from fresh start reporting.

6. Fleet

The following table provides the number of aircraft in Air Canada's current operating fleet and planned changes to its operating fleet (excluding aircraft operated by Jazz under the Jazz CPA):

	Actual						Planned			
	December 31, 2009	**March 31, 2010**	**Second Quarter 2010 Fleet Changes**	**June 30, 2010**	**Third Quarter 2010 Fleet Changes**	**September 30, 2010**	**Remainder of 2010 Fleet Changes**	**December 31, 2010**	**2011 Fleet Changes**	**December 31, 2011**
Boeing 777-300	12	12	-	12	-	12	-	12	-	12
Boeing 777-200	6	6	-	6	-	6	-	6	-	6
Boeing 767-300	30	30	-	30	-	30	-	30	-	30
Airbus A330-300	8	8	-	8	-	8	-	8	-	8
Airbus A321	10	10	-	10	-	10	-	10	-	10
Airbus A320	41	41	-	41	-	41	-	41	-	41
Airbus A319	35	35	1	36	-	36	2	38	2	40
EMBRAER 190	45	45	-	45	-	45	-	45	-	45
EMBRAER 175	15	15	-	15	-	15	-	15	-	15
Total	202	202	1	203	-	203	2	205	2	207
Average age (years)	9.7	10.0		10.2		10.5		10.7		11.6

At September 30, 2010, pursuant to the Jazz CPA, Jazz's operating fleet was comprised of 123 aircraft, a decrease of 7 aircraft from December 31, 2009. Jazz's covered fleet had an average age of 15.5 years at September 30, 2010, comprised of the following aircraft:

- 22 Bombardier CRJ-100 aircraft;
- 25 Bombardier CRJ-200 aircraft;
- 16 Bombardier CRJ-705 aircraft;
- 34 Dash 8-100 aircraft; and
- 26 Dash 8-300 aircraft

In August 2010, Mexicana filed for bankruptcy protection. Further to their filing, four Air Canada aircraft under sublease to Mexicana were returned or repossessed. Air Canada continues to explore its options for these four aircraft.

On October 4, 2010, Air Canada announced that it settled the terms of a long term commercial carrier operating agreement with the Toronto Port Authority, the operator of Billy Bishop Toronto City Airport. The conclusion of that agreement is subject to certain conditions, including entering into an agreement with the operator of the terminal, City Centre Terminal Corp., for lease of terminal space at the airport, which is in the process of being negotiated. On October 4, 2010, Air Canada also announced that it entered into a capacity purchase agreement with Sky Regional Airlines Inc., an associated company of Skyservice Business Aviation, to operate flights to and from Billy Bishop Toronto City Airport beginning February 2011. Air Canada announced as well that it had signed a letter of intent with a lessor for five Bombardier Dash 8-Q400 aircraft, subject to finalization of formal terms and conditions of the lease agreements which have since been completed. The regional carrier will sublease and operate these Dash 8-Q400 aircraft on behalf of Air Canada.

7. Financial and Capital Management

7.1 Financial Position

The following table provides a condensed statement of financial position of Air Canada as at September 30, 2010, and as at December 31, 2009.

(Canadian dollars in millions)	September 30, 2010	December 31, 2009
Assets		
Cash, cash equivalents and short-term investments	$ 2,173	$ 1,407
Other current assets	1,236	1,244
Current assets	3,409	2,651
Property and equipment	5,892	6,369
Intangible assets	901	916
Deposits and other assets	484	470
	$ 10,686	**$ 10,406**
Liabilities		
Current liabilities	$ 3,110	$ 3,002
Long-term debt and capital leases	4,183	4,054
Pension and other benefit liabilities	1,078	1,163
Other long-term liabilities	577	540
	8,948	**8,759**
Non-controlling interest	**166**	**201**
Shareholders' equity	**1,572**	**1,446**
	$ 10,686	**$ 10,406**

Movements in current assets and liabilities are described below under "Working Capital".

Property and equipment amounted to $5,892 million at September 30, 2010, a reduction of $477 million from December 31, 2009. The reduction was mainly due to the impact of depreciation expense of $471 million in the first nine months of 2010 and the impact of the remaining part of a sale and leaseback transaction completed in the first quarter of 2010 partly offset by additions to capital assets of $74 million.

Long-term debt and capital leases, including the current portion, amounted to $4,694 million at September 30, 2010, an increase of $172 million from December 31, 2009. The increase in long-term debt and capital leases from December 31, 2009 was mainly due to borrowings of $1,175 million. Largely offsetting this increase was long-term debt and capital lease repayments of $1,035 million and the favourable impact of a stronger Canadian dollar on Air Canada's foreign denominated dollar debt (mainly U.S. dollars) and capital leases which accounted for a decrease of $26 million.

7.2 Adjusted Net Debt

The table reflects Air Canada's adjusted net debt balances and net debt to net debt plus equity ratio as at September 30, 2010, and as at December 31, 2009.

(Canadian dollars in millions)	September 30, 2010	December 31, 2009	Change $
Total long-term debt and capital leases	$ 4,183	$ 4,054	$ 129
Current portion of long-term debt and capital leases	511	468	43
Total long-term debt and capital leases, including current portion	4,694	4,522	172
Less cash, cash equivalents and short-term investments	(2,173)	(1,407)	(766)
Net debt	**$ 2,521**	**$ 3,115**	**$ (594)**
Capitalized operating leases [(1)]	2,618	2,513	105
Adjusted net debt	**5,139**	**5,628**	**(489)**
Non-controlling interest	166	201	(35)
Adjusted net debt and non-controlling interest	**$ 5,305**	**$ 5,829**	**$ (524)**
Shareholders' equity	**$ 1,572**	**$ 1,446**	**$ 126**
Adjusted net debt and non-controlling interest to adjusted net debt and non-controlling interest plus equity ratio	**77.1%**	**80.1%**	**(3.0) pp**

(1) *Adjusted net debt is a non-GAAP measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7.5. This definition of capital is used by Air Canada and may not be comparable to similar measures presented by other public companies. Aircraft rent was $349 million for the twelve months ended September 30, 2010, and $335 million for the twelve months ended December 31, 2009. Aircraft rent expense includes aircraft rent associated with aircraft subleased to third parties. The sublease revenue associated with these aircraft subleases is included in Other revenues on Air Canada's Consolidated Statement of Operations.*

At September 30, 2010, adjusted net debt and non-controlling interest decreased $524 million from December 31, 2009, mainly due to positive free cash flow of $624 million recorded in the first nine months of 2010, as described in section 7.5 of this MD&A. The adjusted net debt and non-controlling interest to adjusted net debt and non-controlling interest plus equity ratio for Air Canada at September 30, 2010 was 77.1%, an improvement of 3.0 percentage points from December 31, 2009.

7.3 Liquidity

At October 31, 2010, cash, cash equivalents and short-term investments amounted to approximately $2.3 billion. At September 30, 2010, Air Canada's cash balances amounted to $2,173 million, or almost 21% of 12-month trailing operating revenues, exceeding Air Canada's minimum target liquidity level of 15% of 12-month trailing operating revenues. For additional information on Air Canada's liquidity risks, refer to section 10.3 of Air Canada's 2009 MD&A dated February 10, 2010.

Loan Facility

On August 20, 2010, Air Canada concluded a credit agreement with GE Japan Corporation, PK Airfinance Japan ("GE Japan") for a senior secured term loan facility in the amount of up to approximately US$171 million to refinance amounts related to sixteen aircraft currently operated by Air Canada and leased from special purpose leasing entities which are consolidated by Air Canada. On a consolidated basis, the draws on this loan facility will be accounted for as a settlement of the special purpose leasing entities' debt related to these aircraft. Draw-downs under the facility are subject to customary terms and conditions.

This loan facility will be available in 2011 to refinance up to US$129 million of the amount related to eight Airbus A319 aircraft and four Boeing 767-300ER aircraft, with terms of seven and four years respectively. This loan facility will also be available in 2012 to refinance up to US$42 million of the amount related to four Airbus A319 aircraft, with a term of five years. As a result of this agreement, the amounts due under the existing debt maturities within the next 12 months that will be refinanced by the commitment on a long-term basis have been classified as long-term at September 30, 2010.

Term Credit Facility

In the first quarter of 2010, Air Canada entered into arrangements with a new lender, comprised of a group of entities that are related to each other, to obtain a $100 million increase to its $600 million secured term credit facility concluded in July 2009. The addition to the facility increased, on a pro-rata basis, the scheduled repayments, including the final payment. Air Canada received net financing proceeds of $98 million in February 2010.

On August 3, 2010, Air Canada completed private note offerings which are described below. Air Canada used approximately $729 million of the net proceeds of the offerings to repay all of the outstanding debt under the secured term credit facility. Air Canada recorded a charge of $54 million in interest expense during the second quarter of 2010, including early payment fees of $29 million and $25 million for the adjustment related to the unamortized portion of transaction costs and debt discounts.

Private Note Offerings

On August 3, 2010, Air Canada completed a private offering of two series of senior secured notes, consisting of US$600 million senior secured first lien notes due 2015 (the "U.S. Dollar First Lien Notes") and $300 million senior secured first lien notes due 2015 (the "Canadian Dollar First Lien Notes" and, collectively with the U.S. Dollar First Lien Notes, the “First Lien Notes”). On August 3, 2010, Air Canada also completed a private offering of US$200 million senior secured second lien notes due 2016 (the "Second Lien Notes" and, together with the First Lien Notes, the "Notes"). Air Canada received net proceeds of $1,075 million after deduction of fees, expenses and discounts. Air Canada used approximately $729 million of the net proceeds of the offerings to repay all of the outstanding debt under the secured term credit facility, including $29 million for early payment fees.

The U.S. Dollar First Lien Notes bear interest at a rate of 9.250% per annum, the Canadian Dollar First Lien Notes bear interest at a rate of 10.125% per annum, and the Second Lien Notes bear interest at a rate of 12.000% per annum, in each case payable February 1 and August 1 of each year, beginning on February 1, 2011. Air Canada is required to pay additional special interest of 2% per annum on the Notes if (i) the priority lien debt value ratio (appraised value of collateral / priority lien debt) is less than 1.7:1.0, or (ii) the total appraised value ratio (total appraised value of collateral / secured debt) is less than 1.25:1.0.

Air Canada may redeem some or all of the First Lien Notes at any time on or after August 1, 2012 at certain established redemption prices, plus accrued and unpaid interest. At any time prior to August 1, 2012, Air Canada may redeem some or all of the First Lien Notes at a price equal to 100% of their principal amount plus a “make-whole” premium and accrued and unpaid interest. At any time prior to August 1, 2012, Air Canada may redeem up to 35% of the aggregate principal amount of each issue of First Lien Notes with the proceeds of certain equity offerings, at established redemption prices, plus accrued and unpaid interest. In addition, at any time and from time to time prior to August 1, 2014, Air Canada may redeem, during any 12-month period, up to 10% of the original aggregate principal amount of each issue of First Lien Notes at a redemption price of 103% of the principal amount, plus accrued and unpaid interest.

Air Canada may redeem some or all of the Second Lien Notes at any time on or after February 1, 2013 at certain established redemption prices, plus accrued and unpaid interest. At any time prior to February 1, 2013, Air Canada may redeem some or all of the Second Lien Notes at a price equal to 100% of their principal amount plus a “make-whole” premium and accrued and unpaid interest. At any time prior to February 1, 2013, Air Canada may redeem up to 35% of the aggregate principal amount of the Second Lien Notes, with the proceeds of certain equity offerings and by paying a redemption price equal to 112% of the principal amount of the Second Lien Notes being redeemed, plus accrued and unpaid interest thereon.

The prepayment options within the First Lien Notes and Second Lien Notes are considered embedded derivatives. The value of these embedded derivatives at September 30, 2010 is nominal. Upon specified change of control events or upon certain sales of assets, Air Canada must offer to repurchase the Notes.

The Notes are senior secured obligations of Air Canada, (i) secured on a first-lien basis (in the case of the First Lien Notes) or on a junior lien basis (in the case of the Second Lien Notes), subject to certain permitted liens, by accounts receivable, certain real estate interests, certain spare engines, ground equipment, certain airport slots and gate leaseholds, and Air Canada's licenses to operate its Pacific routes and the airport slots and gate leaseholds utilized in connection with these Pacific routes and (ii) guaranteed on a senior secured basis by certain subsidiaries of Air Canada, subject to certain thresholds and exclusions.

As a result of the notes offering discussed above, both Standard & Poor's Rating Services ("S&P") and Moody's Investor Service ("Moody's") took rating actions. S&P raised its long-term corporate credit rating on Air Canada to B- with a stable outlook from CCC+. Moody's initiated coverage of Air Canada providing a corporate family rating of B3 with a stable outlook.

Refer to section 9 of this MD&A for a description of the impact to market risk related to the private note offerings.

7.4 Working capital

The following table provides information on Air Canada's working capital balances at September 30, 2010 and at December 31, 2009.

(Canadian dollars in millions)	September 30, 2010	December 31, 2009	Change $
Cash and short-term investments	$ 2,173	$ 1,407	$ 766
Accounts receivable	774	701	73
Other current assets	462	543	(81)
Accounts payable and accrued liabilities	(1,279)	(1,246)	(33)
Advance ticket sales	(1,320)	(1,288)	(32)
Current portion of long-term debt and capital leases	(511)	(468)	(43)
Net working capital (deficiency)	$ **299**	**$ (351)**	**$ 650**

The net positive working capital of $299 million at September 30, 2010 represented an improvement of $650 million from December 31, 2009, mainly due to net proceeds of $1,075 million related to Air Canada's private notes offerings as described above and positive net cash from operating activities. This improvement was largely offset by scheduled repayments of long-term debt and capital lease obligations of $1,035 million, including the repayment of Air Canada's term credit facility as described above, the impact of capital expenditures of $92 million and pension funding payments amounting to $180 million in the first nine months of 2010.

Collateral deposits for fuel derivatives

Air Canada currently holds, within its derivative portfolio, swaps and put option contracts within collar structures which could expose Air Canada to the potential of posting cash collateral deposits. Once the fair value in favour of the counterparties of certain fuel derivatives exceeds certain agreed credit thresholds with those counterparties, Air Canada could be required to extend collateral to the counterparties to cover their exposure.

As at October 31, 2010, there were no cash collateral deposits held by counterparties ($2 million at September 30, 2010 and $43 million at December 31, 2009).

7.5 Consolidated Cash Flow Movements

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

	Third Quarter			First Nine Months		
(Canadian dollars in millions)	**2010**	**2009**	**Change $**	**2010**	**2009**	**Change $**
Net cash from operating activities, before the under noted items	$ 488	$ 240	$ 248	$ 706	$ 388	$ 318
Cash used for fuel hedge settlements, terminations and premiums	(16)	(13)	(3)	(62)	(257)	195
Fuel hedge collateral deposits, net	11	(3)	14	41	206	(165)
Excess of employee future benefit funding over expense	(43)	(103)	60	(83)	(315)	232
Changes in non-cash working capital	(303)	(355)	52	114	(179)	293
Cash flows from (used for) operating activities	137	(234)	371	716	(157)	873
Additions to capital assets	(25)	(34)	9	(92)	(190)	98
Free cash flow (1)	**112**	**(268)**	**380**	**624**	**(347)**	**971**
Proceeds from sale and leaseback transactions	-	-	-	20	172	(152)
Proceeds from contractual commitments	-	230	(230)	-	230	(230)
Reduction to Aveos letter of credit	-	-	-	23	-	23
Short-term investments	48	252	(204)	(370)	339	(709)
Other	(21)	9	(30)	(6)	75	(81)
Cash flows from (used for) investing activities (excluding additions to capital assets)	**27**	**491**	**(464)**	**(333)**	**816**	**(1,149)**
Borrowings	1,075	587	488	1,175	930	245
Reduction of long-term debt and capital lease obligations	(808)	(256)	(552)	(1,035)	(856)	(179)
Other	-	-	-	(35)	-	(35)
Cash flows from financing activities	**267**	**331**	**(64)**	**105**	**74**	**31**
Net increase in cash and cash equivalents	406	554	(148)	396	543	(147)
Net increase (decrease) in short-term investments	(48)	(252)	204	370	(339)	709
Net increase in cash, cash equivalents and short-term investments	**$ 358**	**$ 302**	**$ 56**	**$ 766**	**$ 204**	**$ 562**

(1) *Free cash flow is a non-GAAP measure used by Air Canada and may not be comparable to measures presented by other public companies. Air Canada considers free cash flow to be an indicator of the financial strength and performance of its business because it shows how much cash is available, including repaying debt, meeting ongoing financial obligations and reinvesting in Air Canada.*

An increase in free cash flow in the third quarter of 2010 of $380 million was largely due to an improvement in Air Canada's cash operating results year-over-year of $248 million. The impact of not making past service pension cost contributions in the third quarter of 2010 as a result of the adoption of the Air Canada 2009 Pension Plan Funding Regulations in July 2009, and an improvement in non-cash working capital were also factors in the free cash flow improvement. Similar factors supported the improvement in free cash flow in the first nine months of 2010 of $971 million versus the first nine months of 2009.

7.6 Capital Expenditures and Related Financing Arrangements

Information on Air Canada's capital expenditures and related financing agreements is described in section 10.4 of Air Canada's 2009 MD&A dated February 10, 2010. There have been no material changes to Air Canada's capital expenditures and related financing agreements from what was disclosed at that time.

Certain maintenance events will be capitalized under International Financial Reporting Standards ("IFRS") beginning on January 1, 2011 as opposed to being recorded in maintenance expense under existing Canadian GAAP. As this reflects a change in accounting practice only, this will not change the underlying cash flows. Refer to section 10.1 of this MD&A for additional information on the expected impact of IFRS reporting on Air Canada's statement of financial position as at January 1, 2010.

7.7 Contractual Obligations

Information on Air Canada's contractual obligations is described in section 10.5 of Air Canada's 2009 MD&A dated February 10, 2010.

The table below provides updated information on Air Canada's long-term debt and capital lease obligations, including interest and principal repayment obligations as at September 30, 2010. The table also includes the impact of the loan facility from GE Japan assuming the full commitment will be drawn upon. Refer to section 7.3 of this MD&A for additional information. There have been no material changes to other contractual obligation amounts from what was disclosed in Air Canada's 2009 MD&A dated February 10, 2010.

(Canadian dollars in millions)	**Remainder of 2010**	**2011**	**2012**	**2013**	**2014**	**Thereafter**	**Total**
Principal	$ 95	$ 634	$ 405	$ 472	$ 297	$ 2,868	$ 4,771
Interest	80	295	270	244	217	354	1,460
Total	**175**	**929**	**675**	**716**	**514**	**3,222**	**6,231**
Add							
Net impact of GE Japan loan facility	-	(104)	(9)	35	35	85	42
Total	**$ 175**	**$ 825**	**$ 666**	**$ 751**	**$ 549**	**$ 3,307**	**$ 6,273**

Principal and interest repayments are based on interest rates and applicable foreign exchange rates effective at September 30, 2010.

Principal repayments in the table above exclude transaction costs of $77 million which are offset against long-term debt and capital leases in Air Canada's Consolidated Statement of Financial Position.

7.8 Pension Funding Obligations

Air Canada maintains several pension plans including defined benefit and defined contribution pension plans and plans providing other retirement and post-employment benefits to its employees. As at December 31, 2009, Air Canada reported that, based on preliminary actuarial valuations as at January 1, 2010, the preliminary estimate of the aggregate solvency deficit in the registered pension plans was estimated to be between $2,500 million and $2,700 million. As a result of final actuarial valuations, including a decrease in the annuity rate applied in discounting the pension obligations, the solvency deficit as at January 1, 2010 is $2,728 million. The reduction of $107 million in the aggregate solvency deficit versus the aggregate deficit of $2,835 million as at

January 1, 2009, includes the impact of the actual return on plan assets partially offset by a decrease in the discount rate used to value the benefit obligation, which has the effect of increasing the benefit obligation. As described below, the January 1, 2010, valuations will not impact the 2010 pension funding obligations.

Air Canada's pension funding obligations, on a cash basis, for 2010 and its projected estimate of those obligations for the next three years are provided in the table below. Actual funding obligations are dependent on a number of factors, including the Air Canada 2009 Pension Plan Funding Regulations described in Air Canada's 2009 MD&A dated February 10, 2010, the assumptions used in the most recently filed actuarial valuation reports for current service (including the applicable discount rate), the plan demographics at the valuation date, the existing plan provisions, existing pension legislation and changes in economic conditions, mainly the return on fund assets and changes in interest rates. Actual contributions that are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition to changes in plan demographics and experience, actuarial assumptions and methods may be changed from one valuation to the next, including by reason of changes in plan experience, financial markets, future expectations, and changes in legislation and other factors. As of 2014, the Air Canada Pension Plan Funding Regulations, 2009 will cease to have effect and Air Canada's pension funding obligations may vary significantly based on a wide variety of factors, including regulatory developments, assumptions and methods used and changes in the economic conditions, mainly the return on fund assets and changes in interest rates.

(Canadian dollars in millions)	**Remainder of 2010**	**Full Year 2010**	**2011**	**2012**	**2013**
Past service domestic registered plans	$ -	$ -	$ 138	$ 173	$ 221
Current service domestic registered plans	49	174	180	186	191
Other pension arrangements(1)	32	87	79	81	83
Projected pension funding obligations	**$ 81**	**$ 261**	**$ 397**	**$ 440**	**$ 495**

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

7.9 Share Information

An aggregate of 278,148,934 Class A variable voting shares and Class B voting shares in the capital of Air Canada are issued and outstanding. The issued and outstanding shares of Air Canada, along with shares potentially issuable, are as follows:

	Number of Shares at	
	October 31, 2010	**December 31, 2009**
Issued and outstanding shares		
Class A variable voting shares	58,123,709	56,586,112
Class B voting shares	220,025,225	221,560,947
Total issued and outstanding shares	**278,148,934**	**278,147,059**
Class A variable voting and Class B voting shares potentially issuable		
Warrants	90,250,000	90,250,000
Stock options	3,997,271	3,963,474
Performance share units	206,416	561,846
Total shares potentially issuable	**94,453,687**	**94,775,320**
Total outstanding and potentially issuable shares	**372,602,621**	**372,922,379**

Additional information on Air Canada's issued and outstanding shares and its potentially issuable shares, is disclosed in section 10.7 of Air Canada's 2009 MD&A dated February 10, 2010.

8. Quarterly Financial Data

The following table summarizes quarterly financial results and major operating statistics for Air Canada for the last eight quarters.

(Canadian dollars in millions, except per share figures)

	Q4 2008	Q1 2009	Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010	Q3 2010
Operating revenues	**$ 2,498**	**$ 2,391**	**$ 2,330**	**$ 2,670**	**$ 2,348**	**$ 2,519**	**$ 2,625**	**$ 3,026**
Aircraft fuel	792	593	572	682	601	619	660	733
Ownership (DAR)(1)	254	245	248	252	250	264	258	254
Other operating expenses	1,598	1,741	1,623	1,668	1,580	1,762	1,632	1,712
Operating expenses	**2,644**	**2,579**	**2,443**	**2,602**	**2,431**	**2,645**	**2,550**	**2,699**
Operating income (loss)	**(146)**	**(188)**	**(113)**	**68**	**(83)**	**(126)**	**75**	**327**
Total non-operating income (expense), non-controlling interest, foreign exchange gain (loss) and tax	(581)	(212)	268	209	27	41	(278)	(66)
Net income (loss)	**$ (727)**	**$ (400)**	**$ 155**	**$ 277**	**$ (56)**	**$ (85)**	**$ (203)**	**$ 261**
Revenue passenger miles (millions)	10,845	10,984	11,862	14,153	10,885	11,692	12,896	15,531
Available seat miles (millions)	13,571	13,821	14,735	16,946	13,841	14,727	15,523	18,328
Passenger load factor (%)	79.9	79.5	80.5	83.5	78.6	79.4	83.1	84.7
RASM (cents)	16.0	14.5	13.9	14.1	14.6	14.2	14.8	14.8
CASM (cents)	19.5	18.7	16.6	15.4	17.6	18.0	16.4	14.7
CASM, excluding fuel expense (cents)	13.6	14.4	12.7	11.3	13.2	13.8	12.2	10.7
Fuel price per litres (cents)(2)	95.8	71.4	65.4	68.6	72.6	70.7	71.1	66.9
EBITDAR(3)	**$ 108**	**$ 57**	**$ 135**	**$ 320**	**$ 167**	**$ 138**	**$ 333**	**$ 581**
Earnings (loss) per share								
- Basic	**$ (7.27)**	**$ (4.00)**	**$ 1.55**	**$ 2.77**	**$ (0.25)**	**$ (0.31)**	**$ (0.72)**	**$ 0.94**
- Diluted	**$ (7.27)**	**$ (4.00)**	**$ 1.55**	**$ 2.44**	**$ (0.25)**	**$ (0.31)**	**$ (0.72)**	**$ 0.91**

(1) DAR refers to the combination of Depreciation and amortization, and Aircraft rent expenses.

(2) Includes fuel handling and is net of fuel hedging results.

(3) See section 15 "Non-GAAP Financial Measures" in this MD&A for additional information.

9. Financial Instruments and Risk Management

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

The following is a summary of gain (loss) on financial instruments recorded at fair value included in non-operating income (expense) on Air Canada's Consolidated Statement of Operations for the periods indicated:

	Third Quarter		First Nine Months	
(Canadian dollars in millions)	2010	2009	2010	2009
Fuel derivatives not under hedge accounting	$ (1)	$ 2	$ (22)	$ 78
Other	6	2	11	(5)
Gain (loss) on financial instruments recorded at fair value	**$ 5**	**$ 4**	**$ (11)**	**$ 73**

Risk Management

Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: foreign exchange risk; interest rate risk; and other price risk.

Air Canada's foreign exchange rate risk related to long-term debt has been impacted with the issuance of the U.S. Dollar First Lien and Second Lien Notes. In relation to this increase in foreign currency denominated debt, a 5% strengthening or weakening in rates of the Canadian dollar versus the U.S. dollar would result in an additional $41 million increase or decrease to pre-tax income, respectively. The sensitivity to total US dollar debt exposure is partially offset by US$593 million held in cash and cash equivalents, Short-term investments and deposits and other assets for operational activities as at September 30, 2010 for which a 5% strengthening or weakening in rates of the Canadian dollar would impact pre-tax income by approximately $31 million.

The First Lien Notes and Second Lien Notes have fixed interest rates and there is no significant impact to interest rate risk. Refer to sections 13 and 19 of Air Canada's 2009 MD&A dated February 10, 2010 for additional information on interest rate risk and foreign exchange risk.

Fuel price risk

In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, Air Canada enters into derivative contracts with financial intermediaries. Air Canada uses derivative contracts on jet fuel and other crude oil-based commodities, heating oil and crude oil. Heating oil and crude oil commodities are used due to the relative limited liquidity of jet fuel derivative instruments on a medium to long-term horizon since jet fuel is not traded on an organized futures exchange. Air Canada's policy permits hedging of up to 75% of the projected jet fuel purchases for the next 12 months, 50% for the next 13 to 24 months and 25% for the next 25 to 36 months. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. Air Canada performs regular reviews and, if necessary, adjusts the strategy in light of market conditions. Air Canada does not purchase or hold any derivative financial instrument for speculative purposes.

As of October 31, 2010, approximately 35% of Air Canada's anticipated purchases of jet fuel for the remainder of 2010 are hedged at an average West Texas Intermediate ("WTI") capped price of US$88 per barrel and approximately 7% is subject to an average floor price of US$90 per barrel. Air Canada's contracts to hedge anticipated jet fuel purchases over the 2010 period are comprised of crude-oil based contracts. Air Canada has also hedged approximately 13% of its 2011 anticipated jet fuel purchases in crude-oil based contracts hedged at an average capped price of US$91 per barrel.

The following table outlines the notional volumes per barrel along with the WTI weighted average floor and capped price for each year currently hedged by type of derivative instruments as at October 31, 2010.

Derivative Instruments	**Term**	**Volume (bbls)**	**WTI Weighted Average Floor Price (US$/bbl)**	**WTI Weighted Average Capped Price (US$/bbl)**
Call options	2010	1,030,000	$ n/a	$ 86
Call options	2011	3,240,000	$ n/a	$ 91
Swaps	2010	130,000	$ 100	$ 100
Collars	2010	130,000	$ 80	$ 88

Air Canada is expected to generate fuel hedging gains if oil prices increase above the average capped price and is exposed to fuel hedging losses if oil prices decrease below the average floor price.

The fuel derivative contracts are not designated under hedge accounting as at September 30, 2010. As at September 30, 2010, the fair market value of the fuel derivatives in favour of Air Canada was $8 million and was recorded within prepaid expenses and other current assets on Air Canada's Consolidated Statement of Financial Position ($31 million in favour of the counterparties as at December 31, 2009 and was recorded within accounts payable and accrued liabilities on Air Canada's Consolidated Statement of Financial Position).

During the third quarter of 2010:

- Air Canada recorded a loss of $1 million in gain (loss) on financial instruments recorded at fair value related to fuel derivatives (a loss of $22 million in the first nine months of 2010) (a gain of $2 million in the third quarter of 2009 and a gain of $78 million in the first nine months of 2009).

- Air Canada purchased crude-oil call options. The premium related to these contracts was $9 million in the third quarter of 2010 ($30 million in the first nine months of 2010).

- Fuel derivative contracts cash settled with a fair value of $7 million in favour of the counterparties ($26 million in the first nine months of 2010) ($14 million in favour of the counterparties in the third quarter of 2009 and $76 million in favour of the counterparties in the first nine months of 2009).

From time to time, Air Canada may choose to adjust or restructure its hedging portfolio in light of market conditions. During the second quarter of 2010, Air Canada modified its fuel hedge portfolio with the termination of swap and collar contracts for $5 million, in favour of the counterparty. The collateral held by the counterparty was in excess of the settlement amount, and such excess was returned, resulting in a cash inflow for Air Canada.

Air Canada discontinued applying hedge accounting effective the third quarter of 2009. Amounts that were deferred to AOCL for derivatives previously designated under hedge accounting will be taken into fuel expense in the period where the derivative was scheduled to mature. During the third quarter of 2010, $42 million was reclassified from AOCL to aircraft fuel expense ($152 million in the first nine months of 2010). As at September 30, 2010, the net amount of existing losses reported in AOCL that are expected to be reclassified to net income during the following three months is $31 million before tax. The AOCL balance related to fuel hedging contracts will be completely depleted as of December 31, 2010.

Below is a table summarizing the impact of fuel derivatives on Air Canada's Consolidated Statement of Operations, Consolidated Statement of Comprehensive Loss and Consolidated Statement of Financial Position.

(Canadian dollars in millions)		Third Quarter 2010	Third Quarter 2009	First Nine Months 2010	First Nine Months 2009
Consolidated Statement of Operations					
Operating expense					
Aircraft fuel	Realized effective loss on derivatives designated under hedge accounting	$ (42)	$ (94)	$ (152)	$ (334)
Non-operating income (expense)					
Gain (loss) on financial instruments recorded at fair value	Ineffective gain (loss) on derivatives designated under hedge accounting	n/a	n/a	n/a	$ -
	Fair market value gain (loss) on economic hedges	$ (1)	$ 2	$ (22)	$ 78
Consolidated Statement of Comprehensive Income (Loss)					
	Effective loss on derivatives designated under hedge accounting	n/a	n/a	n/a	$ (1)
	Tax expense on effective gain	n/a	n/a	n/a	$ -
	Reclassification of net realized loss on fuel derivatives designed under hedge accounting to aircraft fuel expense	$ 42	$ 94	$ 152	$ 334
	Tax on reclassification	$ -	$ -	$ -	$ 4

(Canadian dollars in millions)		September 30, 2010	December 31, 2009
Consolidated Statement of Financial Position			
Prepaid expenses and other current assets	Collateral deposits for fuel derivatives	$ 2	$ 43
	Fair market value of fuel derivatives	$ 8	$ -
Accounts payable and accrued liabilities	Fair market value of fuel derivatives	$ -	$ (31)
Shareholders' equity (AOCL)	Net loss from fuel derivatives designated under hedge accounting (net of tax 2010 - $1 million and 2009 - $1 million)	$ (32)	$ (184)

Liquidity Risk

Liquidity risk is the risk that Air Canada will encounter difficulty in meeting obligations associated with its financial liabilities, contractual and other obligations. Refer to section 13 of Air Canada's 2009 MD&A dated February 10, 2010 for additional information on Air Canada's liquidity risk.

Covenants in credit card agreements

Air Canada has various agreements with companies that process customer credit card transactions, as further described in section 13 of Air Canada's 2009 MD&A dated February 10, 2010. Under the terms of its credit card processing agreements with one of its principal credit card processors, the credit card processing company may withhold payment of funds to Air Canada or require Air Canada to provide the processor with deposits and security upon the occurrence of certain events ("triggering events"). During 2009, Air Canada entered into amendments with this processor to amend certain credit card processing agreements under which the triggering events were revised. In May 2010, Air Canada entered into a set of further amendments, extending these agreements to the end of November 2010 on the same terms and providing options for Air Canada, on certain terms, to further extend these agreements for a period of up to two years, on revised terms. Although Air Canada did not exercise any of the options to extend the agreements pursuant to the May 2010 amendments, in October 2010, Air Canada further extended these agreements to the end of May 2011. In addition to the extension of the term of these agreements, Air Canada entered into agreements with this processor for the provision of certain credit card processing services requirements for markets other than North America and for its cargo operations worldwide.

Air Canada has accepted a proposal from a new service provider for the provision of its principal credit card processing services requirements in North America for Visa and MasterCard, for a five year term beginning at the expiry of the current agreements being replaced. Air Canada and the credit card processor have agreed to triggering events upon which Air Canada would be required to provide the credit card processor with deposits. The obligation to provide, and the amount of, deposits required would be based upon a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio and unrestricted cash of Air Canada. Agreement between Air Canada and the credit card processor is subject to certain conditions, including conclusion of formal documentation.

Cargo investigations and proceedings

Air Canada is exposed to potential liabilities related to the investigations and proceedings of alleged anti-competitive cargo pricing activities as further described in section 19 of Air Canada's 2009 MD&A dated February 10, 2010. There are reports that a decision pursuant to the European Commission's investigation of alleged anti-competitive cargo pricing activities of airlines and cargo operators, including the Corporation, is imminent, although the Corporation has not received any such information from the European Commission.

10. Accounting Policies

10.1 Update on the Progress of the International Financial Reporting Standards Conversion Plan

The following information and the information in Section 17.2 "Future Accounting Standard Changes" of Air Canada's 2009 MD&A dated February 10, 2010 have been provided solely for the purpose of allowing investors and others to obtain a better understanding of the Corporation's IFRS changeover plan and the resulting expected effects on the Corporation's financial statements and operating performance measures. Readers are cautioned that it may not be appropriate to use such information for any other purpose. The accounting policy differences identified in this MD&A should not be considered as complete or final as further changes, or other effects and other policy differences may be identified. In addition, the information provided reflects the Corporation's current assumptions, estimates and expectations, all of which are subject to change. Circumstances may arise, including changes in IFRS, regulations or economic conditions, which could change these assumptions, estimates or expectations or the information provided.

The Canadian Accounting Standards Board has confirmed January 1, 2011 as the changeover date for Canadian publicly accountable enterprises to start using International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences in recognition, measurement and disclosures.

The Corporation has developed a plan to convert its consolidated financial statements to IFRS and has established a cross-functional IFRS team represented by managers in the areas of Accounting, Taxation, IT and Data Systems, Internal Control and Processes, Planning, Compensation, Treasury, Investor Relations and Legal. Updates regarding the progress of the conversion plan are provided to the Corporation's Audit, Finance and Risk Committee on a quarterly basis.

The plan addresses the impact of IFRS on accounting policies and implementation decisions, infrastructure, business activities and control activities. A summary status of the key elements of the changeover plan is included in section 17.2 "Future Accounting Standard Changes" of Air Canada's 2009 MD&A dated February 10, 2010. The IFRS changeover plan is progressing as outlined and no significant changes to the plan have been made from what was disclosed at that time, except as described below related to key accounting policy choices and related impacts.

First time adoption of IFRS

With regard to IFRS transition, the Corporation has largely completed its analysis on the optional exemptions available under IFRS 1 "First-time Adoption of International Financial Reporting Standards" ("IFRS 1"). IFRS 1, provides entities adopting IFRS for the first time with a number of optional exemptions and mandatory exceptions, in certain areas, to the general requirement for full retrospective application of IFRSs. The decisions about the optional exemptions available under IFRS 1 are preliminary and may be subject to change based on changes in circumstances.

The most significant IFRS 1 exemptions that are expected to apply to the Corporation upon adoption are summarized in the following table:

Optional exemption under IFRS 1	Summary of Exemption Available	Policy Selection
Business Combinations	The Corporation may elect not to apply IFRS 3 (as amended in 2008) retrospectively to past business combinations prior to the date of transition to IFRS. Such election has the effect of leaving past business combinations as previously reported.	The Corporation expects to elect not to apply IFRS 3 (as amended in 2008) retrospectively to business combinations that occurred before January 1, 2010, the date of transition to IFRS.
Fair value or revaluation as deemed cost	The Corporation may elect to use any one of the following amounts at the date of transition for any item within the scope of the exemption: a) fair value at date of transition to IFRS; or b) a revaluation under previous GAAP that meets specified criteria; or c) a deemed cost measurement recognized under previous GAAP based on fair value at the date of an event such as a privatization or an initial public offering (an 'event-driven' value).	The Corporation expects to elect to measure owned and finance leased aircraft and engines at January 1, 2010 at fair value and use that fair value as deemed cost at that date. Under existing Canadian GAAP, the Corporation applied fresh start reporting on September 30, 2004. As a result, all consolidated assets and liabilities of Air Canada were reported at fair values, except for future income taxes. As permitted under IFRS 1, the Corporation expects to elect to apply those fair values as deemed cost for IFRS as at the date of the revaluation, with the exception of owned and finance leased aircraft and engines, which are being measured at fair value as at January 1, 2010 as described above and intangible assets and goodwill, which, in such case, would be measured at historical cost without the application of the fresh start fair values. Refer to “Fresh Start Reporting” below for additional information.
Employee Benefits	The Corporation may elect to recognize in retained earnings all cumulative actuarial gains and losses at the date of transition to IFRSs.	The Corporation expects to elect to recognize all cumulative actuarial gains and losses on pension and other post-retirement benefit plans as at January 1, 2010 directly in Deficit.
Borrowing Costs	The Corporation may elect to designate any date before the date of transition to IFRSs to capitalize borrowing costs relating to all qualifying assets for which the commencement date for capitalization is on or after that date of transition to IFRS.	The Corporation expects to apply IAS 23R for annual periods beginning on or after January 1, 2010, the date of transition to IFRS. Under existing Canadian GAAP, the Corporation had an accounting policy of capitalizing interest.

Summary of significant accounting policy changes under IFRS

The Corporation has identified the following significant differences between its current accounting policies and those required or expected to apply in preparing IFRS financial statements which are summarized in the following table:

Accounting policy	Significant accounting policy changes under IFRS and expected impact
Principles of Consolidation	Under IAS 27 "Consolidated and separate financial statements", consolidation is based on a control model. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. This control model also applies to interests in special purpose entities. Non-controlling interest is initially measured at the minority's interest in the fair value of the subsidiary's net assets. At subsequent periods, it is measured at the minority's interest in the equity of the subsidiary. Non-controlling interest is presented as a component of equity separately from the equity from the owner's of the parent on the balance sheet and net income and comprehensive income attributable to the owners of the parent and to the non-controlling interests below net income and comprehensive income. **Policy choices:** Under IFRS, an entity can elect on an acquisition by acquisition basis the use of either the proportionate or full goodwill method. The Corporation expects to apply the proportionate goodwill method for all non-controlling interests. **Differences from existing Canadian GAAP:** Under existing Canadian GAAP, consolidation is based on a controlling financial interest model. For variable interest entities, consolidation is based on an analysis of the primary beneficiary. For non-variable interest entities, consolidation of an entity is based on the continuing power to govern the financial and operating policies of an entity so as to obtain benefits from its activities and be exposed to related risks. Non-controlling interest is initially measured at the minority's interest in the historical cost of the subsidiary's net assets. Non-controlling interest is presented outside of liabilities and equity on the balance sheet and as a reduction to net income on the income statement. **Expected impact to the opening balance sheet:** Non-controlling interests on the balance sheet as at January 1, 2010 amounting to $201 million is expected to be reported in Shareholders' Equity. Certain special purpose entities ("SPEs") that were not consolidated under existing Canadian GAAP, as the Corporation was determined not to be the primary beneficiary, will be consolidated under IFRS. This relates to aircraft leasing entities covering seven A319 aircraft, six A340 aircraft and eight A330 aircraft. This adjustment is expected to result in an increase to Property and equipment of $212 million (based upon the fair value of the aircraft as at January 1, 2010 and included in the IFRS 1 Property and equipment impacts further discussed below), an increase to Long-term debt of $259 million, a decrease to non-controlling interest of $53 million and a credit to the Deficit of $6 million. The additional debt consolidated in the SPEs relates to third party guarantees in the SPE leasing entities. **Expected impact subsequent to transition:** Interest expense will increase related to the non-cash accretion on the debt consolidated from the SPEs at an average effective interest rate of approximately 8% per year. Refer to Property and Equipment section below for a discussion of changes to depreciation expense.

Accounting policy	Significant accounting policy changes under IFRS and expected impact
Employee Benefits	*Actuarial gains and losses of Post Employment and Post Retirement Benefits* **Policy choices:** Under IAS 19 "Employee benefits" ("IAS19"), actuarial gains and losses may either be: • recognized in profit or loss under the corridor approach (excess amounts amortized when they exceed either 10% of the greater of the obligation and market-related value of plan assets at the beginning of the period) (the 'corridor approach'); • recognized in any systematic method that results in faster recognition of actuarial gains or losses, provided that the same basis is applied consistently from period to period; • recognized immediately in other comprehensive income without subsequent recycling to income, however with reclassifications to retained earnings. **Policy selection:** The Corporation expects to recognize actuarial gains and losses in other comprehensive income. **Differences from existing Canadian GAAP:** Under existing Canadian GAAP, the corridor approach was used and cumulative actuarial gains and losses in excess of 10% of the greater of the obligation and market-related value of plan assets at the beginning of the period is amortized in profit or loss. *Fair value of plan assets versus market-related value of plan assets* **Policy choices:** There are no policy choices available under IFRS. The expected return on plan assets is based on actual plan assets. **Differences from existing Canadian GAAP:** Under existing Canadian GAAP, a market-related value of assets was used whereby the difference between actual and expected return was gradually recognized over four years. *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* IFRIC 14 "IAS 19 - The Limit of a Defined Benefit Asset, Minimum Funding Requirements and their Interaction" ("IFRIC 14") addresses the application of paragraph 58 of IAS 19 which limits the measurement of a defined benefit asset to "the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan" plus cumulative unrecognized net losses and past service cost. IFRIC 14 provides guidance regarding (a) when refunds or reductions in future contributions should be regarded as available in accordance with paragraph 58 of IAS 19, (b) how a minimum funding requirement might affect the availability of reductions in future contributions and (c) when a minimum funding requirement might give rise to a liability. **Policy choices:** There are no policy choices available under IFRS. **Differences from existing Canadian GAAP:** There is Canadian GAAP guidance related to the limit on the carrying amount of an accrued benefit asset and recognition of a related valuation allowance. However, IFRS and Canadian GAAP had different methods of calculating the defined benefit asset limit. Furthermore, Canadian GAAP did not address accounting for an additional liability due to minimum funding requirements.

Accounting policy	Significant accounting policy changes under IFRS and expected impact
Employee Benefits	*Presentation of employee benefits expense* **Policy choices:** IAS19 does not specify the presentation of current service cost, interest cost and the expected return on plan assets as components or a single item of income or expense. Accordingly, the Corporation can elect to present the components of pension cost (current service cost, interest cost and the expected return on plan assets) either net or separately on the income statement. **Policy selection:** The Corporation expects to elect to separately present the components of pension expense on the income statement. Current service costs are expected to continue to be recorded in operating expenses. Interest cost and the expected return on plan assets are expected to be presented in non-operating expenses. **Expected impact to the opening balance sheet:** Pension and other benefit liabilities are expected to increase by $2,776 million, offset by a charge to the Deficit. This includes the impact of IFRIC 14 and the IFRS 1 employee benefits optional exemption described above. The additional minimum funding requirement liability under IFRIC 14 included in the adjustment is expected to amount to approximately $1,936 million. **Expected impact subsequent to transition:** The effect of actuarial gains and losses are no longer expected to affect net income under the Corporation's accounting policy choice; however, the pension and other employee benefit liabilities and shareholders' equity are expected to be subject to greater variability as the effects of actuarial gains and losses will be recognized immediately, rather than being deferred and amortized over a period of time. The income related to the market return on plan assets is expected to be subject to more volatility as it is based on actual plan assets as opposed to a smoothed value and based on the current value of plan assets, the income may be lower than comparable values under Canadian GAAP.

Accounting policy	Significant accounting policy changes under IFRS and expected impact
Property and Equipment	*Capitalization of major engine and airframe overhaul* IAS 16 provides guidance that would require major engine and airframe overhaul be treated as separate components of an aircraft if it meets a significant part of the asset's cost. The actual cost of the overhaul or inspection is then capitalized provided that it meets the recognition criteria, that it is probable that future economic benefits will flow to the entity and that the cost can be measured reliably. This inspection/overhaul cost is then depreciated over the period to the next inspection/overhaul. *Cost/Revaluation Model* **Policy choices:** Either a cost model or a revaluation model can be used to value classes of property, plant and equipment. **Policy selection:** The Corporation expects to utilize the cost model. **Expected impact to the opening balance sheet**: Property and equipment is expected to be reduced by $324 million, offset by a charge to the Deficit, which includes (1) the impact of the fair value adjustment to aircraft and spare engines as at January 1, 2010 as described above and (2) the impact of componentizing the aircraft and adjusting the fair values based upon the estimated remaining life of each component, including capitalized engine and airframe overhaul costs. The amount of $324 million excludes the impact of the consolidation of special purpose entities ("SPEs") as described above, which has the effect of increasing property and equipment by $212 million for a net decrease of $112 million to property and equipment. **Expected impact subsequent to transition:** Depreciation and aircraft maintenance expense will be different under IFRS on owned and finance leased aircraft. Major engine and airframe overhaul costs that were charged to aircraft maintenance expense under Canadian GAAP on owned and finance leased aircraft will be capitalized and depreciated over their estimated useful lives under IFRS. Major engine and airframe overhaul costs that were charged to aircraft maintenance expense under Canadian GAAP on operating lease aircraft will continue to be expensed as incurred, except for end of lease return obligations which will be accrued during the term of the operating lease.

Accounting policy	Significant accounting policy changes under IFRS and expected impact
Leases	Under IAS 17 "Leases" ("IAS17"), a lease is classified as either a finance lease or an operating lease. Lease classification depends on whether substantially all of the risks and rewards incidental to ownership of a leased asset have been transferred from the lessor to the lessee, and is made at inception of the lease. A number of indicators are used to assist in lease classification however, quantitative thresholds are not offered as an indicator as under current Canadian GAAP. In addition, under IAS 17, immediate gain recognition from the sale and leaseback of an asset depends on whether or not the sale takes place at fair value, and whether the leaseback is classified as an operating lease or a finance lease. Under existing Canadian GAAP, immediate gain recognition from the sale and leaseback of an asset does not occur unless the leaseback is classified as an operating lease and the seller-lessee retains the rights to use only a minor portion of the asset sold. **Policy choices:** There are no policy choices available under IFRS. **Expected impact to the opening balance sheet:** As described under Principles of consolidation, 21 capital leases are expected to be treated as owned aircraft financings upon the consolidation of the special purpose leasing entity. Other long-term liabilities are expected to decrease by $69 million offset by a decrease to the Deficit for the reversal of deferred gains on sale leasebacks. **Expected impact subsequent to transition:** Aircraft rent is expected to increase due to the elimination of the deferred gains on sale leasebacks, which were amortizing to 2018 – 2020.

Accounting policy	Significant accounting policy changes under IFRS and expected impact
Borrowing Costs	Under IAS 23R "Borrowing costs" ("IAS 23"), borrowing costs related to "qualifying" assets are capitalized. Interest on both general borrowing and borrowings specific to the asset under construction are eligible for capitalization. The capitalization of interest commences when borrowing costs are incurred, expenditures for the asset are being incurred, and activities to prepare the asset for its intended use or sale are in progress. Capitalization ceases when the activities necessary to prepare the asset for its intended use or sale are substantially complete. Borrowing costs are capitalized at the weighted average rate of both general borrowings and borrowings specific to the asset under construction, as applicable. **Policy choices:** There are no policy choices available under IFRS. **Differences from existing Canadian GAAP:** Under existing Canadian GAAP, borrowing costs directly attributable to property and equipment may be capitalized if certain conditions are met. There is no specific standard however for the capitalization of interest and differences may arise with respect to the identification of qualifying assets, the amount of interest that can be capitalized on general or specific borrowings, the treatment of investment income on the temporary investment of specific borrowings and when the capitalization of interest should commence or be suspended. Borrowing costs were capitalized by the Corporation at the weighted average cost of all outstanding borrowings. **Expected impact to the opening balance sheet:** No expected impact. **Expected impact subsequent to transition:** It is expected that there will be an ongoing difference based on the difference in capitalization rates.

Accounting policy	Significant accounting policy changes under IFRS and expected impact
Fresh Start Reporting	Under IFRS, there are no explicit standards related to fresh start reporting or when an entity undertakes a financial reorganization. **Differences from existing Canadian GAAP:** Under Canadian GAAP, the Corporation applied fresh start reporting on September 30, 2004. As a result, all consolidated assets and liabilities of Air Canada were reported at fair values, except for future income taxes. Goodwill is not recognized upon adoption of fresh start reporting. Under fresh start reporting, retained earnings and contributed surplus were reset to zero. **Expected impact to the opening balance sheet:** Goodwill, which was reported by Air Canada prior to the application of fresh start reporting under Canadian GAAP of $311 million, is expected to be reinstated with an offsetting credit to Deficit. Adjustments to Deficit and Contributed surplus related to the impact of fresh start reporting are expected to be undone with the offset to Share capital. As outlined under IFRS 1 exemptions above, the majority of the Corporation's intangible assets under Canadian GAAP were carried in the balance sheet on the basis of valuations performed on September 30, 2004 following the application of fresh start reporting. In accordance with IFRS 1, the Corporation is expected to elect to reverse the intangible assets that were established in accordance with Section 1625 of the CICA Handbook, Comprehensive Revaluation of Assets and Liabilities ("CICA 1625"). As a result, Intangible assets are expected to decrease by $587 million, representing the derecognition of existing Canadian GAAP intangible assets that were established in accordance with fresh start reporting. The associated Future income tax liability on the intangibles with indefinite lives is expected to decrease $40 million, for a net charge to the Deficit of $547 million.
Impairment of Long-lived Assets	Under IAS 36 Impairment of Assets ("IAS 36"), impairment testing of assets is based on comparing the carrying amount of the asset or group of assets to their recoverable amount. Recoverable amount is calculated as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. Value in use is calculated based upon a discounted cash flow analysis. In addition, IAS 36 requires, under certain circumstances, the reversal of impairment losses. **Policy choices:** There are no policy choices available under IFRS. **Differences from existing Canadian GAAP:** Under Canadian GAAP, recoverable amount is initially based on undiscounted cash flows. If the recoverable amount is less than the carrying value then the asset or asset group is written down to fair value. Impairment losses cannot be reversed under current Canadian GAAP. **Expected impact to the opening balance sheet:** The opening impairment test on transition to IFRS is in the process of being finalized. **Expected impact subsequent to transition:** Impairments may be recognized more frequently under IFRS, which may be reversed in future periods.

Accounting policy	Significant accounting policy changes under IFRS and expected impact
Provisions and contingent liabilities (including Asset Retirement Obligations)	*Provisions* IAS 37 “Provisions, Contingent Liabilities and Contingent Assets”, requires a provision to be recognized when: there is a present obligation as a result of a past transaction or event; it is probable that an outflow of resources will be required to settle the obligation; and a reliable estimate can be made of the obligation. “Probable” in this context means more likely than not. Under IAS 37, there are a number of different estimation techniques to arrive at the best estimate, including the single most likely outcome, the weighted average of all possible outcomes or the midpoint where there is a range of equally possible outcomes. *Asset Retirement Obligations* Measurement of Asset Retirement Obligations under IFRS is based on management’s best estimate of future cash flows, discounted to present value using a discount rate specific to the liability. *Lease return conditions* Under IFRS, it is expected that a provision will be recorded over the term of the lease for the end of lease maintenance return condition obligations within the Corporation’s operating leases, offset by a prepaid maintenance asset to the extent of any related power by the hour maintenance service agreements or any recoveries under aircraft subleasing arrangements . The provision is recorded using a discount rate specific to the liability, which approximates the risk free rate over the remaining term of the lease. Interest accretion on the provision is recorded in other non-operating expense. For aircraft under operating leases which are subleased to third parties, the provision expense on the income statement is recorded net of the recovery under the sublease, as applicable. **Policy choices:** There are no policy choices available under IFRS. **Differences from existing Canadian GAAP:** *Provisions* Under Canadian GAAP, the criterion for recognition in the financial statements is “likely”, which is a higher threshold than “probable”. Where there is a range of equally possible outcomes, the provision is recorded at the low point of the range. *Asset Retirement Obligations* Measurement of an Asset Retirement Obligation under Canadian GAAP is based on the fair value of the obligation (which takes market assumptions into account). Cash flow estimates are discounted to present value using a credit adjusted discount rate. *Lease return conditions* Maintenance costs for lease return conditions are booked only for short term leases under the Corporation’s accounting policies under existing Canadian GAAP. **Expected impact to the opening balance sheet:** Equity is expected to be reduced by approximately $350-$400 million relating to maintenance provisions associated with lease return conditions. **Expected impact subsequent to transition:** Provisions may be recognized more frequently under IFRS. Maintenance expense will include the accrual for maintenance provisions associated with lease return conditions, while interest expense will include the accretion of the obligation over the life of the lease. Actual maintenance costs related to the end of lease return conditions will be charged against the provision, thereby reducing some of the income statement volatility relating to the timing of lease returns.

11. Off-Balance Sheet Arrangements

Information on Air Canada's off-balance sheet arrangements is disclosed in section 14 of Air Canada's 2009 MD&A dated February 10, 2010. There have been no material changes to Air Canada's off-balance sheet arrangements from what was disclosed at that time.

12. Related Party Transactions

ACE Aviation Holdings Inc. ("ACE") reported holding, as of September 30, 2010, a 27% ownership interest in Air Canada. For a summary of significant related party transactions, refer to section 15 "Related Party Transactions" of Air Canada's 2009 MD&A dated February 10, 2010. Air Canada had various related party transactions with ACE and Aveos. As a result of the Aveos Restructuring Plan, Air Canada and Aveos are no longer related parties.

Aveos Restructuring Plan

In the first quarter of 2010, Aveos reached an agreement with its lenders and equity holders on the terms of a consensual restructuring plan to recapitalize the company. As part of this recapitalization, Air Canada and Aveos entered into agreements to settle certain issues and modify the terms of certain contractual arrangements in exchange for Air Canada receiving a minority equity interest in Aveos. This restructuring modified the terms of certain commercial agreements between Air Canada and Aveos, including terms of the Pension and Benefits Agreement and the Agreement with Aveos on Revised Payment Terms as described in Air Canada's 2009 MD&A dated February 10, 2010 and below. The modified terms relating to maintenance agreements are not expected to have a material impact on maintenance expense over their terms.

As part of these agreements, Air Canada also agreed to extend repayment terms on $22 million of receivables (as further described in section 15 of Air Canada's 2009 MD&A dated February 10, 2010 under Agreement with Aveos on Revised Payment Terms), due in 2010, over six years with annual repayments on a non-interest bearing basis, with such payments subject to satisfaction of certain conditions. This agreement is now referred to as the Term Note.

The terms of the Pension and Benefits Agreement were also modified to defer the determination of pension assets and related solvency deficiencies of transferring unionized employees performing airframe maintenance services to April 2011. This has the result of Air Canada assuming changes in the solvency deficiency for those affected employees from the date of the Pension and Benefits Agreement, which was entered into as of October 16, 2007, to the date of their transfer to Aveos, scheduled for April 2011. As part of the amendment, all letters of credit issued under the Pension and Benefits Agreement were cancelled and a new letter of credit in the amount of $20 million was issued by Air Canada in favour of Aveos to secure the payment of all compensation payments owing by Air Canada to Aveos in respect of pension, disability, and retiree liabilities for which Air Canada would be liable under the Pension and Benefits Agreement. This modification resulted in a reduction to the outstanding deposit under Air Canada's letter of credit facility of $23 million during the first quarter of 2010. Until such future time as the assets and obligations under the Air Canada pension and other employee and retiree benefit arrangements pertaining to unionized employees may be transferred to Aveos, the current service pension cost and the current service and interest costs for other employee benefits in respect of Air Canada employees providing services to Aveos are charged by Air Canada to Aveos, and as such, the modifications to the Pension and Benefits Agreement have no accounting consequence in the current period. For additional information on the Pension and Benefits Agreement, refer to section 15 of Air Canada's 2009 MD&A dated February 10, 2010.

As a result of the above agreements, Air Canada's equity investment in Aveos was recorded at $49 million, based upon its estimated fair value. The Term Note of $22 million was recorded at its estimated fair value of $11 million, based on the present value of expected cash flows on a discounted basis. Other trade receivables from Aveos of $4 million were settled. For accounting purposes, $34 million for consideration of agreement amendments is deferred and will be amortized over the terms of the amended agreements with Aveos of four years, on average. The accounting treatment recorded in the first quarter of 2010 is summarized as follows:

Share consideration received	$49 million
Allocated to*:*	
Term Note	*$11 million*
Trade receivables settled	*$4 million*
Agreements and contract amendments	*$34 million*
	$49 million

The investment in Aveos common shares is recorded in deposits and other assets and will be carried at cost going forward. The Term Note is also recorded in deposits and other assets and is carried at amortized cost. As a result of the restructuring and the change in equity interests in Aveos, Aveos and Air Canada are no longer related parties.

13. Risk Factors

For a detailed description of risk factors associated with Air Canada, refer to the section 19 "Risk Factors" of Air Canada's 2009 MD&A dated February 10, 2010. Air Canada is not aware of any significant changes to Air Canada's risk factors from those disclosed at that time. However, the risk factors in Air Canada's 2009 MD&A dated February 10, 2010 related to *Interruptions or Disruptions in Service* and *Seasonal Nature of the Business and Other Factors and Prior Performance* is expanded as follows.

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

In addition, the risk factors in Air Canada's 2009 MD&A dated February 10, 2010 related to *Current Legal Proceedings* is updated to account for the fact that, on May 14, 2010, Porter filed a discontinuance of its counterclaim before the Federal Court of Canada; however, the counterclaim filed by Porter in the Ontario Superior Court remains.

The *Current Legal Proceedings* risk factors in Air Canada's 2009 MD&A dated February 10, 2010 also refer to class action lawsuits that have been filed before the United States District Court and in Canada in connection with alleged anti-competitive cargo pricing activities, where Air Canada is named defendant. Air Canada has been or may be named as a defendant or may otherwise be implicated in these or other lawsuits or proceedings in connection with these allegations.

14. Controls and Procedures

Disclosure controls and procedures and internal controls over financial reporting

Disclosure controls and procedures within Air Canada have been 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.

Internal controls over financial reporting have been designed by management, with the participation of Air Canada's President and Chief Executive Officer ("CEO") and the Executive Vice President and Chief Financial Officer ("CFO"), to provide reasonable assurance regarding the reliability of Air Canada's financial reporting and its preparation of financial statements for external purposes in accordance with GAAP.

In Air Canada's 2009 filings, Air Canada's CEO and CFO certified, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design and effectiveness of Air Canada's disclosure controls and procedures, and the design and effectiveness of internal controls over financial reporting.

In Air Canada's third quarter 2010 filings, Air Canada's CEO and CFO certify, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design of Air Canada's disclosure controls and procedures, and the design of internal controls over financial reporting.

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

Management's report on disclosure controls and procedures

Management, with the participation of Air Canada's CEO and CFO, concluded, as at September 30, 2010, that such disclosure controls and processes were designed to provide reasonable assurance that:

- material information relating to Air Canada was made known to its Disclosure Policy Committee by others; and

- information required to be disclosed by Air Canada in its annual filings, interim filings and other reports filed or submitted by Air Canada under securities legislation was recorded, processed, summarized and reported within the time periods specified in securities legislation.

Management's report on internal controls over financial reporting

Management, with the participation of Air Canada's CEO and CFO, concluded, as at September 30, 2010, that Air Canada's internal controls over financial reporting were designed to provide reasonable assurance regarding the reliability of financial reporting and its preparation of financial statements for external purposes in accordance with GAAP.

Management and the CEO and CFO use the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control - Integrated Framework to design Air Canada's control framework.

Changes in internal controls over financial reporting

There have been no changes to Air Canada's internal controls over financial reporting during the third quarter of 2010 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

15. Non-GAAP Financial Measures

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation and amortization, and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation and amortization, and aircraft rent 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 for Air Canada are reconciled to operating income (loss) as follows:

	Third Quarter			First Nine Months		
(Canadian dollars in millions)	**2010**	**2009**	**Change $**	**2010**	**2009**	**Change $**
GAAP operating income (loss)	$ 327	$ 68	$ 259	$ 276	$ (233)	$ 509
Add back:						
Aircraft rent	88	81	7	262	250	12
Depreciation and amortization	166	171	(5)	514	495	19
EBITDAR	**$ 581**	**$ 320**	**$ 261**	**$ 1,052**	**$ 512**	**$ 540**

Operating expense excluding fuel expense

Air Canada uses operating expense excluding fuel expense to assess the operating performance of its ongoing business without the effects of fuel expense as it could potentially distort the analysis of trends in business performance. Fuel expense fluctuates widely depending on many factors including international market conditions, geopolitical events and the Canada/U.S. exchange rate, and excluding this expense from GAAP results analysis allows Air Canada to compare its operating performance on a consistent basis. 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 expense, excluding fuel expense, for Air Canada is reconciled to operating expense as follows:

	Third Quarter			First Nine Months		
(Canadian dollars in millions)	**2010**	**2009**	**Change $**	**2010**	**2009**	**Change $**
GAAP operating expense	$ 2,699	$ 2,602	$ 97	$ 7,894	$ 7,624	$ 270
Remove:						
Aircraft fuel	(733)	(682)	(51)	(2,012)	(1,847)	(165)
Operating expense, excluding fuel expense	**$ 1,966**	**$ 1,920**	**$ 46**	**$ 5,882**	**$ 5,777**	**$ 105**

16. Glossary

Atlantic passenger and cargo revenues — Refers to revenues from flights that cross the Atlantic Ocean with origins and destinations principally in Europe.

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 and amortization, and aircraft rent and is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation and amortization, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. Refer to section 15 of this MD&A for additional information.

Other passenger and cargo revenues — Refers to revenues from flights with origins and destinations principally in South America, Australia, the Caribbean and Mexico.

Pacific passenger and cargo revenues — Refers to revenues from flights that cross the Pacific Ocean with origins and destinations principally in Asia.

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.

Percentage point (pp) — A measure for the arithmetic difference of two percentages.

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.

Yield — Average passenger revenue per RPM.