



**First Quarter 2011**  
Management's Discussion and Analysis  
of Results of Operations and Financial Condition



**May 5, 2011**

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## 1. Highlights

Effective January 1, 2011, Air Canada began reporting its financial results in accordance with IFRS, including comparative figures for 2010 – refer to section 10 of this MD&A for further information. The financial and operating highlights for Air Canada for the periods indicated are as follows.

(Canadian dollars in millions, except where indicated)	First Quarter		
	2011	2010	Change \$
<b>Financial Performance Metrics</b>			
Operating revenues	2,753	2,519	234
Operating loss	(66)	(136)	70
Non-operating income	47	23	24
Loss before income taxes	(19)	(113)	94
Loss for the period	(19)	(112)	93
Operating margin %	(2.4%)	(5.4%)	3.0 pp
EBITDAR <sup>(1)</sup>	207	150	57
EBITDAR margin % <sup>(1)</sup>	7.5%	6.0%	1.5 pp
Cash, cash equivalents and short-term investments	2,114	1,621	493
Free cash flow <sup>(2)</sup>	190	215	(25)
Adjusted net debt <sup>(3)</sup>	4,643	5,254	(611)
Loss per share – Diluted	(\$0.07)	(\$0.41)	\$0.34
<b>Operating Statistics</b>			
			<b>Change %</b>
Revenue passenger miles (millions) (RPM)	12,355	11,692	5.7
Available seat miles (millions) (ASM)	15,859	14,727	7.7
Passenger load factor %	77.9%	79.4%	(1.5) pp
Passenger revenue per RPM ("Yield") (cents)	18.6	17.9	4.2
Passenger revenue per ASM ("RASM") (cents)	14.5	14.2	2.2
Operating revenue per ASM (cents)	17.4	17.1	1.5
Operating expense per ASM ("CASM") (cents)	17.8	18.0	(1.4)
CASM, excluding fuel expense (cents)	13.1	13.8	(5.3)
Average number of full-time equivalent (FTE) employees (thousands) <sup>(4)</sup>	23.6	22.9	3.2
Aircraft in operating fleet at period end <sup>(5)</sup>	328	327	0.3
Average fleet utilization (hours per day) <sup>(6)</sup>	10.1	9.4	7.3
Revenue frequencies (thousands)	132	127	4.2
Average aircraft flight length (miles) <sup>(6)</sup>	890	856	4.0
Economic fuel price per litre (cents) <sup>(7)</sup>	78.2	66.2	18.1
Fuel litres (millions)	938	872	7.6

- (1) EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent) is a non-GAAP financial measure. Refer to 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 operating activities less additions to property, equipment and intangible assets) is a non-GAAP financial measure. Refer to section 6.4 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. Refer to section 6.2 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. Economic fuel price per litre is a non-GAAP financial measure. Refer to section 4 of this MD&A for additional information.

## 2. Introduction

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers to, as the context may require, Air Canada and/or one or more of Air Canada's subsidiaries. This MD&A provides the reader with a view and analysis, from the perspective of management, of Air Canada's financial results for the first quarter of 2011. This MD&A should be read in conjunction with Air Canada's interim unaudited condensed consolidated financial statements and notes for the first quarter of 2011 and Air Canada's Canadian GAAP – Part V annual audited consolidated financial statements and notes and its annual MD&A for the year ended December 31, 2010. All financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP") as set out in the Handbook of the Canadian Institute of Chartered Accountants – Part 1 ("CICA Handbook"). The CICA Handbook was revised to incorporate International Financial Reporting Standards ("IFRS"), as issued by the International Accounting Standards Board, and requires publicly accountable enterprises to apply IFRS effective for years beginning on or after January 1, 2011, and to provide comparative figures for 2010. Accordingly, Air Canada commenced reporting on this basis in its unaudited interim condensed consolidated financial statements for the first quarter of 2011. In this MD&A, the term "Canadian GAAP" refers to Canadian GAAP before the adoption of IFRS, and the term "GAAP" refers to generally accepted accounting principles in Canada after the adoption of IFRS.

As a result of the adoption of IFRS, certain trends in operating results previously experienced under Canadian GAAP may no longer be applicable under IFRS. In particular, the accounting for pension and other employee benefits, depreciation, amortization and impairment expense and aircraft maintenance expense, are significantly impacted by the changeover to IFRS – refer to section 10 "Accounting Policies" of this MD&A for additional information.

Air Canada has revised the presentation of certain operating expenses on the statement of operations. These revisions include a new expense line category within operating expenses referred to as "Sales and distribution costs" which includes sales commissions, credit card fees and other distribution costs, including fees paid to global distribution system ("GDS") providers. The expense line category related to capacity purchase fees has been expanded to include fees paid under all capacity purchase arrangements, including those paid to Jazz Aviation LP ("Jazz") pursuant to the Capacity Purchase Agreement between Air Canada and Jazz (the "Jazz CPA") and those paid to other carriers operating flights on behalf of Air Canada under commercial agreements.

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 May 4, 2011.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of Air Canada's annual MD&A for 2010 dated February 10, 2011 and section 13 of this MD&A.

Air Canada issued a news release dated May 5, 2011, reporting on its results for the first quarter of 2011. This news release is available on Air Canada's website at [aircanada.com](http://aircanada.com) and on SEDAR at [www.sedar.com](http://www.sedar.com). For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult Air Canada's website at [aircanada.com](http://aircanada.com) or SEDAR at [www.sedar.com](http://www.sedar.com).

## **CAUTION REGARDING FORWARD-LOOKING INFORMATION**

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

Forward-looking statements, by their nature, are based on assumptions, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, 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 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 this MD&A and, in particular, those identified in section 18 "Risk Factors" of Air Canada's annual MD&A for 2010 and section 13 of this MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of May 4, 2011 (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 recover in 2011. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C\$0.97 per U.S. dollar in the second quarter of 2011 and C\$0.98 per U.S. dollar for the full year 2011 and that the price of fuel will average 90 cents per litre for the second quarter of 2011 and 88 cents per litre for the full year 2011.

### 3. Overview

Air Canada's results of operations for the first quarter of 2011 are discussed in section 4 of this MD&A.

The following is an overview of Air Canada's results of operations for the first quarter of 2011 compared to the first quarter of 2010.

Air Canada recorded a net loss of \$19 million or \$0.07 per diluted share in the first quarter of 2011 compared to a net loss of \$112 million or \$0.41 per diluted share in the first quarter of 2010. Air Canada's net loss in the first quarter of 2011 included foreign exchange gains of \$104 million which were primarily attributable to a stronger Canadian dollar at March 31, 2011 compared to December 31, 2010. The March 31, 2011 closing exchange rate was US\$1 = C\$0.9696 while the December 31, 2010 closing exchange rate was US\$1 = C\$0.9946. Air Canada's net loss in the first quarter of 2010 included foreign exchange gains of \$123 million.

In the first quarter of 2011, Air Canada recorded an operating loss of \$66 million, an improvement of \$70 million from the operating loss of \$136 million recorded in the first quarter of 2010. EBITDAR amounted to \$207 million in the first quarter of 2011 compared to EBITDAR of \$150 million in the first quarter of 2010, an increase of \$57 million. See section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.

In the first quarter of 2011, Air Canada recorded operating revenues of \$2,753 million, an increase of \$234 million or 9% from the operating revenues of \$2,519 million recorded in the first quarter of 2010. The increase in operating revenues was mainly due to passenger and cargo revenue growth of \$228 million or 10.4% from the first quarter of 2010. A year-over-year system passenger revenue growth of \$216 million or 10.3% was due to a 5.7% increase in system passenger traffic and a 4.2% improvement in system yield. The growth in system yield was mainly driven by increased fares and higher fuel surcharges and was achieved despite a negative impact of \$25 million relating to the stronger Canadian dollar on foreign currency denominated passenger revenues. A capacity increase of 7.7% exceeded the passenger traffic growth in the first quarter of 2011, which resulted in a 1.5 percentage point decrease in system passenger load factor from the first quarter of 2010. This 7.7% system capacity growth was in line with the 7.5% to 8.0% first quarter 2011 ASM capacity increase projected in Air Canada's news release dated March 16, 2011. System RASM increased 2.2% year-over-year on the yield improvement. The stronger Canadian dollar in the first quarter of 2011 compared to the first quarter of 2010 reduced the RASM improvement by 1.1 percentage points. Excluding the unfavourable impact of foreign exchange, RASM increased 3.3% in the first quarter of 2011. Cargo revenue growth of \$12 million or 12% from the first quarter of 2010 was due to a 5.8% increase in cargo traffic and a 4.9% improvement in cargo yield per revenue ton mile ("RTM").

In the first quarter of 2011, Air Canada recorded operating expenses of \$2,819 million, an increase of \$164 million or 6% from the operating expenses of \$2,655 million recorded in the first quarter of 2010. The increase in operating expenses in the first quarter of 2011 was mainly due to the system capacity growth of 7.7 per cent, higher base fuel prices and an increase in employee benefits expense, mainly pension, as well as sales and distribution costs. Partially offsetting these increases were the impact of a stronger Canadian dollar on foreign currency denominated expenses (which reduced operating expenses by approximately \$63 million when compared to the first quarter of 2010) and a reduction in aircraft maintenance expense and ownership costs. Cost Transformation Program ("CTP") initiatives also reduced various operating expense categories, including those discussed below.

Initiatives relating to the CTP had a favourable impact on various operating expense categories, including wages and salaries, airport user fees, capacity purchase fees, 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. In 2010, Air Canada achieved annual benefits of \$330 million. To date, Air Canada has achieved \$440 million of its overall CTP target of \$530 million for the end of 2011, on a run-rate basis. Air Canada views the CTP as one of its most important priorities.

Unit cost, as measured by operating expense per ASM ("CASM") decreased 1.4% from the first quarter of 2010. Excluding fuel expense, CASM decreased 5.3% from the first quarter of 2010. The 5.3% decrease in CASM (excluding fuel expense) for the first quarter of 2011 was slightly above the 4.0% to 5.0% CASM (excluding fuel expense) decrease projected in Air Canada's news release dated March 16, 2011. The improvement was mainly due to the impact of a stronger Canadian dollar on U.S. currency denominated expenses than what Air Canada had previously projected.



#### 4. Results of Operations – First Quarter 2011 versus First Quarter 2010

The following table and discussion compares the results of Air Canada for the first quarter of 2011 versus the first quarter of 2010.

(Canadian dollars in millions, except per share figures)	First Quarter		Change	
	2011	2010	\$	%
<b>Operating revenues</b>				
Passenger	\$ 2,311	\$ 2,095	\$ 216	10
Cargo	116	104	12	12
Other	326	320	6	2
	<b>2,753</b>	<b>2,519</b>	<b>234</b>	<b>9</b>
<b>Operating expenses</b>				
Aircraft fuel	742	619	123	20
Wages, salaries, and benefits	506	474	32	7
Airport and navigation fees	234	226	8	4
Capacity purchase costs	242	235	7	3
Depreciation, amortization and impairment	185	196	(11)	(6)
Aircraft maintenance	166	186	(20)	(11)
Sales and distribution costs	166	142	24	17
Food, beverages and supplies	68	74	(6)	(8)
Communications and information technology	50	49	1	2
Aircraft rent	88	90	(2)	(2)
Other	372	364	8	2
	<b>2,819</b>	<b>2,655</b>	<b>164</b>	<b>6</b>
<b>Operating loss</b>	<b>(66)</b>	<b>(136)</b>	<b>70</b>	
<b>Non-operating income (expense)</b>				
Foreign exchange gain	104	123	(19)	
Interest income	9	2	7	
Interest expense	(84)	(83)	(1)	
Net financing expense relating to employee benefit liabilities	(4)	(19)	15	
Gain on financial instruments recorded at fair value	27	2	25	
Other	(5)	(2)	(3)	
	47	23	24	
<b>Loss before incomes taxes</b>	<b>(19)</b>	<b>(113)</b>	<b>94</b>	
Recovery of income taxes	-	1	(1)	
<b>Loss for the period</b>	<b>\$ (19)</b>	<b>\$ (112)</b>	<b>\$ 93</b>	
<b>EBITDAR <sup>(1)</sup></b>	<b>\$ 207</b>	<b>\$ 150</b>	<b>\$ 57</b>	
<b>Loss per share - Diluted</b>	<b>\$ (0.07)</b>	<b>\$ (0.41)</b>	<b>\$ 0.34</b>	

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



### System passenger revenues increased 10.3% from the first quarter of 2010

System passenger revenues of \$2,311 million in the first quarter of 2011 increased \$216 million or 10.3% from the first quarter of 2010 due to traffic growth and a yield improvement. Premium cabin revenues increased \$57 million or almost 13% from the first quarter in 2010, mainly due to traffic growth of 12%.

In the first quarter of 2011, Air Canada's overall capacity was 7.7% higher than the first quarter of 2010, with capacity growth reflected in all markets with the exception of Canada. Overall capacity in the international markets, including the U.S. transborder market, increased 11.3% from the first quarter of 2010.

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

First Quarter 2011 Versus First Quarter 2010	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	RASM % Change
Canada	8.4	(0.9)	(0.5)	0.4	8.7	9.2
U.S. transborder	14.5	10.8	11.5	0.4	2.5	3.1
Atlantic	0.8	6.2	(0.8)	(5.0)	1.3	(5.4)
Pacific	17.0	21.5	16.0	(4.0)	0.7	(3.9)
Other	16.4	9.1	7.7	(1.1)	8.1	6.7
<b>System</b>	<b>10.3</b>	<b>7.7</b>	<b>5.7</b>	<b>(1.5)</b>	<b>4.2</b>	<b>2.2</b>

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 first quarter 2011 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q1'10	Q2'10	Q3'10	Q4'10	Q1'11
Passenger Revenues	4.2	12.4	13.4	11.2	10.3
Capacity (ASMs)	6.6	5.3	8.2	7.8	7.7
Traffic (RPMs)	6.4	8.7	9.7	8.0	5.7
Passenger Load Factor (pp Change)	(0.1)	2.6	1.2	0.2	(1.5)
Yield	(2.2)	3.3	3.2	2.8	4.2
RASM	(2.3)	6.6	4.7	3.0	2.2

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

- A system traffic increase of 5.7% on the capacity growth of 7.7%, which resulted in a system passenger load factor decrease of 1.5 percentage points from the first quarter of 2010. This system capacity growth was in line with the 7.5% to 8.0% first quarter 2011 ASM capacity increase projected in Air Canada's news release dated March 16, 2011.
- A system yield improvement of 4.2% from the first quarter of 2010, which reflected yield growth in all markets. The system yield improvement was mainly due to increased fares and higher fuel surcharges to partly offset higher fuel prices. A more favourable fare mix, mainly in the economy cabin, as well as a higher proportion of premium cabin traffic also contributed to the yield improvement year-over-year.
- The year-over-year first 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 first quarter of 2011 versus the first quarter of 2010 decreased the Canadian dollar value of sales in foreign countries and had a negative impact of \$25 million on system passenger revenues.
- A system RASM increase of 2.2% from the first quarter of 2010, which was due to the yield growth. RASM in the premium cabin increased 5.4% year-over-year while RASM in the economy cabin improved 1.5% from the first quarter of 2010.

### Domestic passenger revenues increased 8.4% from the first quarter of 2010

Domestic passenger revenues of \$898 million in the first quarter of 2011 increased \$69 million or 8.4% from the first quarter of 2010 due to a yield 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 first quarter 2011 and each of the previous four quarters.

Canada	Year-over-Year by Quarter (% Change)				
	Q1'10	Q2'10	Q3'10	Q4'10	Q1'11
Passenger Revenues	1.5	6.8	5.9	7.5	8.4
Capacity (ASMs)	2.6	(0.2)	0.8	0.2	(0.9)
Traffic (RPMs)	0.8	2.9	1.7	2.0	(0.5)
Passenger Load Factor (pp Change)	(1.4)	2.5	0.7	1.4	0.4
Yield	0.6	3.7	4.1	5.3	8.7
RASM	(1.1)	7.0	5.0	7.1	9.2

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

- A traffic decrease of 0.5% on a capacity reduction of 0.9%, which resulted in a 0.4 percentage point improvement in passenger load factor from the first quarter of 2010.
- A yield increase of 8.7% from the first quarter of 2010, reflecting yield improvements on all major domestic services. The yield improvement was mainly due to increased fares to offset higher fuel prices. A more favourable fare mix in the economy cabin and, to a lesser extent, the premium cabin was also a factor in the yield improvement year-over-year. In addition, a higher proportion of premium traffic resulted in an overall yield improvement year-over-year.
- The stronger Canadian dollar in the first quarter of 2011 had a negative impact of \$4 million on foreign denominated domestic passenger revenues.
- A domestic RASM increase of 9.2% from the first quarter of 2010, which was primarily due to the yield growth.

### U.S. transborder passenger revenues increased 14.5% from the first quarter of 2010

U.S. transborder passenger revenues of \$533 million in the first quarter of 2011 increased \$68 million or 14.5% from the first quarter of 2010 due to traffic growth and, to a lesser extent, a yield improvement. In the first quarter of 2011, U.S. transborder capacity increased 10.8% from the first quarter of 2010, largely driven by growth in sixth freedom traffic flows from the U.S. (meaning U.S. originating traffic carried through points in Canada to other destinations) in support of Air Canada's international expansion initiatives.

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 first quarter 2011 and each of the previous four quarters.

U.S. transborder	Year-over-Year by Quarter (% Change)				
	Q1'10	Q2'10	Q3'10	Q4'10	Q1'11
Passenger Revenues	6.0	11.3	10.4	10.7	14.5
Capacity (ASMs)	2.8	7.3	13.3	11.7	10.8
Traffic (RPMs)	3.4	10.3	12.8	12.0	11.5
Passenger Load Factor (pp Change)	0.5	2.0	(0.3)	0.2	0.4
Yield	2.5	0.8	(2.3)	(1.3)	2.5
RASM	3.1	3.6	(2.7)	(1.0)	3.1

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

- A traffic increase of 11.5% on the capacity growth of 10.8%, which resulted in a passenger load factor improvement of 0.4 percentage points from the first quarter of 2010.
- The year-over-year change in capacity was mainly driven by capacity increases implemented after the first quarter of 2010. These included:
  - The introduction of new daily services from Toronto to San Diego, Memphis, New Orleans, Cincinnati, Portland (Maine), Portland (Oregon) and Syracuse, as well as new weekend service from Montreal to Phoenix and West Palm Beach;
  - An increase in capacity on routes to California between Toronto and Los Angeles through the use of larger aircraft and between Toronto and San Francisco through an increase in frequencies;
  - An increase in frequencies on routes to Florida between Toronto and Fort Lauderdale, and Toronto and Fort Myer's, and between Montreal and Orlando;
  - An increase in capacity in the eastern seaboard market (New York, Boston, Washington, Pittsburgh and Philadelphia) through the combination of an increase in frequencies and the use of larger aircraft.

The suspension of the following services partly offset this capacity growth: Edmonton-Los Angeles, Edmonton-Las Vegas, Calgary-San Diego, Calgary-Seattle and Calgary-Portland, Oregon.

- A yield improvement of 2.5% from the first quarter of 2010, which reflected yield improvements on all major U.S. transborder services. The overall U.S. transborder yield improvement was mainly due to increased fares to partly offset higher fuel prices.
- The year-over-year first quarter U.S. transborder yield improvement was achieved in spite of a \$7 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated U.S. transborder passenger revenues.
- A U.S. transborder RASM growth of 3.1% from the first quarter of 2010, which was primarily due to the yield growth.

**Atlantic passenger revenues increased 0.8% from the first quarter of 2010**

Atlantic passenger revenues of \$347 million in the first quarter of 2011 increased \$3 million or 0.8% from the first quarter of 2010 due to yield growth.

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 first quarter 2011 and each of the previous four quarters.

Atlantic	Year-over-Year by Quarter (% Change)				
	Q1'10	Q2'10	Q3'10	Q4'10	Q1'11
Passenger Revenues	6.5	12.8	16.3	7.5	0.8
Capacity (ASMs)	6.2	2.4	12.3	5.5	6.2
Traffic (RPMs)	5.8	3.2	12.3	2.5	(0.8)
Passenger Load Factor (pp Change)	(0.3)	0.7	-	(2.2)	(5.0)
Yield	0.5	9.2	3.5	4.7	1.3
RASM	0.1	10.0	3.4	1.7	(5.4)

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

- A traffic decline of 0.8% on the capacity growth of 6.2%, which resulted in a passenger load factor decrease of 5.0 percentage points from the first quarter of 2010. In the first quarter of 2010, traffic on the Atlantic services had been favourably impacted by an increase in originating traffic from Europe, attributed to the effect of the Vancouver Olympics in the first quarter of 2010. In addition, the first quarter of 2011 witnessed increased industry capacity.
- The year-over-year change in capacity was mainly driven by capacity increases implemented after the first quarter of 2010. These included the addition of new routes; including the following year-round services which started in June 2010, namely: Toronto-Montreal-Brussels and Toronto-Copenhagen, additional frequencies on Toronto-Tel Aviv, and the use of larger aircraft on Eastern Canada to Germany, the United Kingdom and Switzerland.
- A yield improvement of 1.3% from the first quarter of 2010, which was mainly due to increased fuel surcharges to partly offset higher fuel prices, higher fares, as well as gains in premium cabin traffic. Increased competition had a negative impact on Atlantic yield in the first quarter of 2011.
- The year-over-year first quarter Atlantic yield improvement was achieved in spite of a \$10 million unfavourable impact of a stronger Canadian dollar on foreign currency denominated Atlantic passenger revenues.
- An Atlantic RASM decrease of 5.4% from the first quarter of 2010, which was due to the decline in passenger load factor.

#### **Pacific passenger revenues increased 17.0% from the first quarter of 2010**

Pacific passenger revenues of \$241 million in the first quarter of 2011 increased \$35 million or 17.0% from the first quarter of 2010, mainly due to traffic growth. In the first quarter of 2011, capacity increased 21.5% from the first quarter of 2010 with growth reflected on all major Pacific services, particularly on routes to China. Towards the end of the first quarter of 2011, traffic was negatively impacted by the March 11, 2011 earthquake in Japan and its aftermath. Management estimates that the impact on first quarter 2011 passenger revenues was \$3 million.

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 first quarter 2011 and each of the previous four quarters.

Pacific	Year-over-Year by Quarter (% Change)				
	Q1'10	Q2'10	Q3'10	Q4'10	Q1'11
Passenger Revenues	14.5	37.3	37.7	31.7	17.0
Capacity (ASMs)	25.6	17.5	10.9	23.0	21.5
Traffic (RPMs)	23.6	27.0	17.1	22.9	16.0
Passenger Load Factor (pp Change)	(1.4)	6.7	4.8	(0.1)	(4.0)
Yield	(7.4)	8.1	17.5	7.2	0.7
RASM	(8.8)	16.9	24.1	7.0	(3.9)

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

- A traffic increase of 16.0% on capacity growth of 21.5%, which resulted in a passenger load factor decline of 4.0 percentage points from the first quarter of 2010. The year-over-year change in capacity was mainly driven by capacity increases implemented after the first quarter of 2010. These included additional frequencies from Toronto and Vancouver to Beijing and Shanghai, providing daily non-stop service on both routes versus the first quarter of 2010, additional frequencies on Vancouver to Korea and the use of larger aircraft on routes to Hong Kong.
- A yield increase of 0.7% from the first quarter of 2010, which was mainly due to higher fuel surcharges to partly offset higher fuel prices and higher fares. Increased competition had a negative impact on Pacific yield in the first quarter of 2011.

- The stronger Canadian dollar in the first quarter of 2011 had a negative impact of \$2 million on foreign currency denominated Pacific passenger revenues.
- A Pacific RASM decrease of 3.9% from the first quarter of 2010, which was due to the decline in passenger load factor.

#### Other passenger revenues increased 16.4% from the first quarter of 2010

Other passenger revenues (comprised of routes to Australia, Caribbean, Mexico, Central and South America) of \$292 million in the first quarter of 2011 increased \$41 million or 16.4% from the first quarter of 2010 due to yield and traffic growth.

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 first quarter 2011 and each of the previous four quarters.

Other	Year-over-Year by Quarter (% Change)				
	Q1'10	Q2'10	Q3'10	Q4'10	Q1'11
Passenger Revenues	(0.5)	15.3	18.2	15.4	16.4
Capacity (ASMs)	4.3	10.1	10.7	7.2	9.1
Traffic (RPMs)	6.6	12.7	13.8	9.4	7.7
Passenger Load Factor (pp Change)	1.7	1.8	2.3	1.6	(1.1)
Yield	(6.6)	2.2	3.7	5.4	8.1
RASM	(4.6)	4.5	6.7	7.5	6.7

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

- A traffic increase of 7.7% on the capacity growth of 9.1%, which resulted in a passenger load factor decrease of 1.1 percentage points versus the first quarter of 2010. The year-over-year change in capacity was mainly driven by capacity increases implemented after the first quarter of 2010. These included increased frequencies to the Caribbean, Mexico, Chile and Argentina.
- A yield increase of 8.1% from the first quarter of 2010, which reflected yield improvements on all major services. The yield improvement was mainly due to higher fuel surcharges to partly offset higher fuel prices and higher fares. A more favourable fare mix in both the economy and premium cabins was also a factor in the yield improvement year-over-year.
- The stronger Canadian dollar in the first quarter of 2011 had a negative impact of \$2 million on foreign currency denominated Other passenger revenues.
- A RASM increase of 6.7% from the first quarter of 2010, which was due to the yield growth.

#### Cargo revenues increased 12% from the first quarter of 2010

Cargo revenues of \$116 million in the first quarter of 2011 increased \$12 million or 12% from the first quarter of 2010 due to a 5.8% increase in cargo traffic and a 4.9% growth in cargo yield per revenue ton mile (RTM). Traffic growth was reflected in all markets, with the exception of the domestic market. The system cargo yield per RTM improvement was primarily the result of higher fuel surcharges year-over-year and was mainly driven by growth in the Atlantic market. Excluding the unfavourable impact of foreign exchange of \$4 million relating to the stronger Canadian dollar on foreign currency denominated cargo revenues, yield per RTM increased 5% from the first quarter of 2010.

The table below provides the dollar change in cargo revenues as well as year-over-year percentage changes in 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 for the first quarter of 2011 versus the first quarter of 2010.

First Quarter 2011 Versus First Quarter 2010	Cargo	Cargo	Capacity	Rev / ETM	Traffic	Yield / RTM
	Revenue \$ million	Revenue % Change	(ETMs) % Change	% Change	(RTMs) % Change	% Change
Canada	(2)	(11.2)	(12.5)	1.5	(7.9)	(4.6)
US transborder	-	5.8	16.4	(9.1)	8.9	(2.8)
Atlantic	10	25.9	6.0	18.8	13.6	10.8
Pacific	2	4.9	21.0	(13.3)	-	4.9
Other	2	11.5	3.4	7.8	3.9	7.4
<b>System</b>	<b>12</b>	<b>12.0</b>	<b>7.4</b>	<b>3.3</b>	<b>5.8</b>	<b>4.9</b>

#### Other revenues increased 2% from the first quarter of 2010

Other revenues consist 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 \$326 million in the first quarter of 2011 increased \$6 million or 2% from the first quarter of 2010. The increase in other revenues year-over-year was largely due to an increase in ground package revenues at Air Canada Vacations, mainly as a result of higher passenger volumes, as well as growth in flight cancellation and change fees. These increases were partly offset by a decrease in aircraft sublease revenues when compared to the same quarter in 2010.

#### CASM decreased 1.4% from the first quarter of 2010. Excluding fuel expense, CASM decreased 5.3% from the first quarter of 2010

CASM decreased 1.4% from the first quarter of 2010. 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 first quarter of 2010 were all contributing factors to the year-over-year CASM decrease.

The following table compares Air Canada’s operating expenses per ASM for the first quarter of 2011 to Air Canada’s operating expenses per ASM for the corresponding period in 2010.

(cents per ASM)	First Quarter		Change	
	2011	2010	cents	%
Wages and salaries	2.36	2.48	(0.12)	(4.8)
Benefits	0.83	0.74	0.09	12.2
Airport user fees	1.47	1.53	(0.06)	(3.9)
Capacity purchase costs	1.52	1.59	(0.07)	(4.4)
Ownership (DAR) <sup>(1)</sup>	1.72	1.93	(0.21)	(10.9)
Aircraft maintenance	1.04	1.26	(0.22)	(17.5)
Sales and distribution costs	1.04	0.96	0.08	8.3
Food, beverages and supplies	0.42	0.50	(0.08)	(16.0)
Communications and information technology	0.31	0.33	(0.02)	(6.1)
Other	2.38	2.50	(0.12)	(4.8)
<b>Operating expense, excluding fuel expense <sup>(2)</sup></b>	<b>13.09</b>	<b>13.82</b>	<b>(0.73)</b>	<b>(5.3)</b>
Aircraft fuel	4.68	4.21	0.47	11.2
<b>Total operating expense</b>	<b>17.77</b>	<b>18.03</b>	<b>(0.26)</b>	<b>(1.4)</b>

(1) DAR refers to the combination of depreciation, amortization and impairment and aircraft rent expenses.

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

### Fuel expense increased 20% from the first quarter of 2010

Fuel expense amounted to \$742 million in the first quarter of 2011, an increase of \$123 million or 20% from the first quarter of 2010. Factors contributing to the year-over-year change in first quarter fuel expense included:

- A higher base fuel price, which accounted for a fuel expense increase of \$180 million.
- A higher volume of fuel consumed, driven by the additional capacity year-over-year, which accounted for a fuel expense increase of \$42 million.

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

- Fuel hedging losses of \$58 million in the first quarter of 2010 versus no fuel hedging losses recorded in fuel expense in the first quarter of 2011.
- The favourable impact of a stronger Canadian dollar versus the U.S. dollar (the primary currency for Air Canada's fuel purchases), which accounted for a decrease of \$41 million to fuel expense.

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

(Canadian dollars in millions, except where indicated)	First Quarter		Change	
	2011	2010	\$	%
Aircraft fuel expense – GAAP <sup>(1)</sup>	\$ 738	\$ 616	\$ 122	20
<b>Remove:</b> Fuel hedging gains (losses) reclassified from AOCL into fuel expense	n/a	(58)	58	100
<b>Add:</b> Net cash payments (receipts) on fuel derivatives <sup>(2)</sup>	(4)	18	(22)	(122)
<b>Economic cost of fuel – Non-GAAP <sup>(3)</sup></b>	<b>\$ 734</b>	<b>\$ 576</b>	<b>\$ 158</b>	<b>27</b>
Fuel consumption (thousands of litres)	938,206	871,542	66,664	8
Fuel price per litre (cents) – GAAP	78.7	70.7	8.0	11
Fuel price per litre (cents) – excluding fuel hedging gains (losses)	78.7	64.1	14.6	23
Economic fuel price per litre (cents) – Non-GAAP	78.2	66.2	12.0	18

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

(2) Includes net cash settlements on maturing fuel derivatives and premium costs associated with those derivatives.

(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 \$506 million in the first quarter of 2011, an increase of \$32 million or 7% from the first quarter of 2010

Wages and salaries expense amounted to \$374 million in the first quarter of 2011, an increase of \$9 million or 2% from the first quarter of 2010. On capacity growth of 7.7%, the average number of full-time equivalent ("FTE") employees, increased 3.2% year-over-year, resulting in a productivity improvement of 4.4%, as measured by ASM per FTE employee.

Employee benefits expense amounted to \$132 million in the first quarter of 2011, an increase of \$23 million or 21% from the first quarter of 2010. The increase in employee benefits expense was largely due to higher pension and post-employment benefits expenses based on actuarial estimates made as of January 1, 2011. For information on Air Canada's pension funding obligations, refer to section 6.7 of this MD&A.



**Airport and navigation fees increased 4% from the first quarter of 2010**

Airport and navigation fees amounted to \$234 million in the first quarter of 2011, an increase of \$8 million or 4% from the first quarter of 2010. The year-over-year increase in airport and navigation fees was mainly due to a 4.2% increase in aircraft departures from the first quarter of 2010, combined with changes in schedule and aircraft types being operated to certain destinations. Partially offsetting these increases was the favourable impact of a stronger Canadian dollar versus the U.S. dollar in the first quarter of 2011 compared to the first quarter of 2010 on U.S. and other foreign currency denominated airport and navigation fees.

**Capacity purchase costs increased 3% from the first quarter of 2010**

Capacity purchase costs amounted to \$242 million in the first quarter of 2011 compared to \$235 million in the first quarter of 2010, an increase of \$7 million or 3% from the first quarter of 2010. This year-over-year increase in capacity purchase costs was mainly due to increased flying by Jazz, which accounted for an increase of \$10 million to first quarter 2011 capacity purchase costs, partly offset by the favourable impact of foreign exchange on U.S. currency denominated Jazz CPA charges paid by Air Canada, which accounted for a decrease of \$4 million to first quarter 2011 capacity purchase costs.

**Ownership costs decreased 5% from the first quarter of 2010**

Ownership costs, which are comprised of depreciation, amortization and impairment and aircraft rent expenses, of \$273 million in the first quarter of 2011 decreased \$13 million or 5% from the first quarter of 2010. The decrease included the favourable impact of a stronger Canadian dollar versus the U.S. dollar, which accounted for a decrease of \$4 million to aircraft rent expense, and decreases in software amortization costs and depreciation expense on rotatable inventory.

**Aircraft maintenance expense decreased 11% from the first quarter of 2010**

In the first quarter of 2011, aircraft maintenance expense of \$166 million decreased \$20 million or 11% from the first quarter of 2010, largely driven by a reduction in airframe and components maintenance activity, mainly due to maintenance cycle timing, as well as a decrease in costs associated with engines leased to third parties. In addition, the favourable impact of a stronger Canadian dollar on U.S. currency denominated maintenance expenses, mainly engine and component maintenance, accounted for a decrease of \$6 million to aircraft maintenance expense in the first quarter of 2011.

**Sales and distribution costs increased 17% from the first quarter of 2010**

Sales and distribution costs increased \$24 million or 17% from the first quarter of 2010 on passenger and cargo revenue growth of 10%. Sales and distribution costs are comprised of commissions and incentives paid to passenger and cargo distributors, credit card settlement fees, GDS transaction fees, as well as sales and distribution costs related to Air Canada Vacations. Factors contributing to the year-over-year change in first quarter sales and distribution costs included:

- The passenger and cargo revenue growth of 10% in the first quarter of 2011;
- An increase in credit card fees which was driven by higher passenger sales, a growth in advance sales year-over-year, as well as an increase in the proportion of sales made on credit cards versus other forms of payment;
- A growth in GDS fees from the first quarter of 2010, which was mainly the result of a higher volume of transactions and rate increases;
- An increase in sales and distribution costs at Air Canada Vacations, which was largely driven by a change in Air Canada Vacations' commission structure as well as higher passenger sales versus the same period in 2010.

**Food, beverages and supplies expense decreased 8% from the first quarter of 2010**

In the first quarter of 2011, food, beverages and supplies expense of \$68 million decreased \$6 million or 8% from the first quarter of 2010. The impact of a 5.7% growth in passenger traffic growth was more than offset by the favourable impact of cost reduction initiatives, which were mainly related to contract and process improvements, and the favourable impact of a stronger Canadian dollar versus the U.S. dollar which reduced food, beverages and supplies expense in the first quarter of 2011.

**Other operating expenses increased 2% from the first quarter of 2010**

Other operating expenses amounted to \$372 million in the first quarter of 2011, an increase of \$8 million or 2% from the first quarter of 2010. The increase in other operating expenses included the impact of the capacity growth, as well as an increase in costs related to ground packages at Air Canada Vacations, the result of higher passenger volumes. Other operating expense 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:

(Canadian dollars in millions)	First Quarter		Change	
	2011	2010	\$	%
Air Canada Vacations' land costs	\$ 143	\$ 135	\$ 8	6
Terminal handling	47	46	1	2
Building rent and maintenance	33	34	(1)	(3)
Crew cycle	29	29	-	-
Miscellaneous fees and services	23	23	-	-
Remaining other expenses	97	97	-	-
	<b>\$ 372</b>	<b>\$ 364</b>	<b>\$ 8</b>	<b>2</b>

**Non-operating income amounted to \$47 million in the first quarter of 2011**

Non-operating income amounted to \$47 million in the first quarter of 2011 compared to non-operating income of \$23 million in the first quarter of 2010. Factors contributing to the year-over-year change in first quarter non-operating expense included:

- Gains on foreign exchange amounted to \$104 million in the first quarter of 2011 compared to gains of \$123 million in the first quarter of 2010. The gains in the first quarter of 2011 were mainly attributable to a stronger Canadian dollar at March 31, 2011 compared to December 31, 2010. The March 31, 2011 closing exchange rate was US\$1 = C\$0.9696 while the December 31, 2010, closing exchange rate was US\$1 = C\$0.9946.
- In the first quarter of 2011, interest income increased \$7 million from the first quarter of 2010, due to higher rates of interest and, to a lesser extent, higher cash balances.
- Net financing expense related to employee benefit liabilities decreased \$15 million due to a decline in the discount rate used to measure the obligations.
- Gains related to fair value adjustments on derivative instruments amounted to \$27 million in the first quarter of 2011 versus gains of \$2 million in the first quarter of 2010. Refer to section 8 of this MD&A for additional information on Air Canada's derivative instruments.

## 5. Fleet

The following table provides the number of aircraft in Air Canada's current operating fleet as at March 31, 2011, as well as planned changes to its operating fleet (excluding aircraft operated by Jazz under the Jazz CPA and other airlines operating flights on behalf of Air Canada under commercial agreements with Air Canada):

Fleet Plan	Current			Planned			
	December 31, 2010	First Quarter 2011 Fleet Changes	March 31, 2011	Remainder of 2011 Fleet Changes	December 31, 2011	2012 Fleet Changes	December 31, 2012
Boeing 777-300	12	-	12	-	12	-	12
Boeing 777-200	6	-	6	-	6	-	6
Boeing 767-300	30	-	30	1	31	(1)	30
Airbus A330-300	8	-	8	-	8	-	8
Airbus A321	10	-	10	-	10	-	10
Airbus A320	41	-	41	-	41	-	41
Airbus A319	38	-	38	-	38	-	38
EMBRAER 190	45	-	45	-	45	-	45
EMBRAER 175	15	-	15	-	15	-	15
<b>Total</b>	<b>205</b>	<b>-</b>	<b>205</b>	<b>1</b>	<b>206</b>	<b>(1)</b>	<b>205</b>
<b>Average age (years)</b>	<b>10.7</b>		<b>11.0</b>		<b>11.6</b>		<b>12.6</b>

Air Canada and Sky Regional Airlines Inc. ("Sky Regional") are parties to a capacity purchase agreement whereby Air Canada purchases capacity from Sky Regional for the payment of certain fees by Air Canada to Sky Regional. On May 1, 2011, Sky Regional, on behalf of Air Canada, commenced service from the Toronto Island's Billy Bishop Airport to Montreal's Pierre Elliott Trudeau International Airport using five Bombardier Dash 8 Q400 aircraft which have been subleased to Sky Regional from Air Canada.

At March 31, 2011, Jazz's operating fleet was comprised of 123 aircraft operating under the Jazz CPA, unchanged from December 31, 2010. Jazz's covered fleet had an average age of 16.0 years at March 31, 2011, 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

## 6. Financial and Capital Management

### 6.1 Financial Position

The following table provides a condensed statement of financial position of Air Canada as at March 31, 2011 and as at December 31, 2010.

(Canadian dollars in millions)	March 31, 2011	December 31, 2010	Change \$
<b>Assets</b>			
Cash, cash equivalents and short-term investments	\$ 2,114	\$ 2,192	\$ (78)
Other current assets	1,200	1,155	45
<b>Current assets</b>	<b>3,314</b>	<b>3,347</b>	<b>(33)</b>
Property and equipment	5,513	5,629	(116)
Intangible assets	313	317	(4)
Goodwill	311	311	-
Deposits and other assets	555	549	6
<b>Total assets</b>	<b>\$ 10,006</b>	<b>\$ 10,153</b>	<b>\$ (147)</b>
<b>Liabilities</b>			
Current liabilities	\$ 3,224	\$ 3,124	\$ 100
Long-term debt and finance leases	3,879	4,028	(149)
Pension and other benefit liabilities	3,291	3,328	(37)
Maintenance provisions	499	493	6
Other long-term liabilities	454	468	(14)
<b>Total liabilities</b>	<b>11,347</b>	<b>11,441</b>	<b>(94)</b>
<b>Total equity</b>	<b>(1,341)</b>	<b>(1,288)</b>	<b>(53)</b>
<b>Total liabilities and equity</b>	<b>\$ 10,006</b>	<b>\$ 10,153</b>	<b>\$ (147)</b>

Movements in current assets and liabilities are described in section 6.3 of this MD&A. Long-term debt and finance leases are discussed in section 6.2 of this MD&A.

Property and equipment amounted to \$5,513 million at March 31, 2011, a reduction of \$116 million from December 31, 2010. The reduction was mainly due to the impact of depreciation expense of \$175 million in the first quarter of 2011, partly offset by additions to property and equipment, consisting largely of capitalized aircraft maintenance events.

## 6.2 Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at March 31, 2011 and as at December 31, 2010.

(Canadian dollars in millions)	March 31, 2011	December 31, 2010	Change \$
Total long-term debt and finance leases	\$ 3,879	\$ 4,028	\$ (149)
Current portion of long-term debt and finance leases	421	567	(146)
Total long-term debt and finance leases, including current portion	4,300	4,595	(295)
Less cash, cash equivalents and short-term investments	(2,114)	(2,192)	78
<b>Net debt</b>	<b>\$ 2,186</b>	<b>\$ 2,403</b>	<b>\$ (217)</b>
Capitalized operating leases <sup>(1)</sup>	2,457	2,471	(14)
<b>Adjusted net debt</b>	<b>\$ 4,643</b>	<b>\$ 4,874</b>	<b>\$ (231)</b>

(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 7.0. This definition of capitalized operating leases is used by Air Canada and may not be comparable to similar measures presented by other public companies. Aircraft rent was \$351 million for the twelve months ended March 31, 2011 and \$353 million for the twelve months ended December 31, 2010.

Total debt and finance leases amounted to \$4,300 million at March 31, 2011, a decrease of \$295 million from December 31, 2010. The decrease in long-term debt and finance leases from December 31, 2010 was mainly due to repayments of \$267 million, including balloon maturities totaling \$178 million, as further described under section 6.4 of this MD&A, and the favourable impact of a stronger Canadian dollar on Air Canada's foreign currency denominated debt (mainly U.S. dollars), which accounted for a decrease of \$104 million. These decreases were largely offset by proceeds from borrowings of \$63 million.

At March 31, 2011, adjusted net debt decreased \$231 million from December 31, 2010, mainly due to positive free cash flow of \$190 million recorded during the first quarter of 2011.

## 6.3 Working Capital

The following table provides information on Air Canada's working capital balances at March 31, 2011 and at December 31, 2010.

(Canadian dollars in millions)	March 31, 2011	December 31, 2010	Change \$
Cash and short-term investments	\$ 2,114	\$ 2,192	\$ (78)
Accounts receivable	751	641	110
Other current assets	449	514	(65)
Accounts payable and accrued liabilities	(1,105)	(1,182)	77
Advance ticket sales	(1,698)	(1,375)	(323)
Current portion of long-term debt and finance leases	(421)	(567)	146
<b>Net working capital</b>	<b>\$ 90</b>	<b>\$ 223</b>	<b>\$ (133)</b>

The net positive working capital of \$90 million at March 31, 2011 represented a deterioration of \$133 million from December 31, 2010. This deterioration was caused by net cash flows required to retire certain balloon maturities on debt, as described further below under section 6.5 of this MD&A, exceeding positive free cash flow of \$190 million in the first quarter of 2011.

## 6.4 Consolidated Cash Flow Movements

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

(Canadian dollars in millions)	First Quarter		
	2011	2010	Change \$
Net cash from operating activities, before the under noted items	\$ 30	\$ 16	\$ 14
Net cash from (used for) fuel hedge settlements, premiums and collateral deposits	(7)	1	(8)
Excess of employee benefit funding over expense	(21)	(2)	(19)
Change in maintenance provisions	19	20	(1)
Changes in non-cash working capital balances	231	257	(26)
Cash flows from operating activities	252	292	(40)
Additions to property, equipment and intangible assets	(62)	(77)	15
<b>Free cash flow <sup>(1)</sup></b>	<b>190</b>	<b>215</b>	<b>(25)</b>
Proceeds from sale and leaseback transactions	-	20	(20)
Reduction to Aveos letter of credit	-	23	(23)
Short-term investments	90	(244)	334
Other	(33)	22	(55)
<b>Cash flows from (used for) investing activities (excluding additions to property, equipment and intangible assets)</b>	<b>57</b>	<b>(179)</b>	<b>236</b>
Proceeds from borrowings	63	100	(37)
Reduction of long-term debt and finance lease obligations	(267)	(164)	(103)
Other	(31)	(2)	(29)
<b>Cash flows used for financing activities</b>	<b>(235)</b>	<b>(66)</b>	<b>(169)</b>
Net increase (decrease) in cash and cash equivalents	12	(30)	42
Net increase (decrease) in short-term investments	(90)	244	(334)
<b>Net increase (decrease) in cash, cash equivalents and short-term investments</b>	<b>\$ (78)</b>	<b>\$ 214</b>	<b>\$ (292)</b>

(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.

Free cash flow amounted to \$190 million in the first quarter of 2011 compared to free cash flow of \$215 million in the first quarter of 2010, a year-over-year decrease of \$25 million. This decrease in free cash flow is largely due to an increase in pension funding of \$30 million due to payments of past service costs. As described in section 9.8 of Air Canada's 2010 MD&A dated February 10, 2011, starting on January 1, 2011, Air Canada resumed making past service contributions on its domestic registered plans pursuant to the terms of the Air Canada 2009 Pension Regulations whereas no such contributions were required or made in 2010.

In the first quarter of 2011, a reduction of long-term debt and finance lease obligations of \$267 million included scheduled end of lease balloon payments of approximately \$178 million.

In the first quarter of 2011, Air Canada received net financing proceeds of \$63 million (US\$63 million), after financing fees of \$1 million, through draws on a secured term loan facility (the "Facility") with GE Japan Corporation, PK Air Finance Japan ("GE Japan"). The draws on the Facility were utilized to refinance amounts related to four Airbus A319 aircraft and two Boeing 767-300ER aircraft, operated by Air Canada and previously leased from special purpose leasing entities as described above, with refinanced terms of seven and four years, respectively. For the remainder of 2011, an amount of US\$65 million from the Facility will be available for four Airbus A319 aircraft and two Boeing 767-300ER aircraft. The Facility will also be available in 2012 to refinance up to US\$42 million of the amount related to four Airbus A319 aircraft.

## 6.5 Capital Expenditures and Related Financing Arrangements

Air Canada has 37 firm orders for Boeing 787 aircraft with The Boeing Company ("Boeing"). Air Canada also holds purchase options for 13 Boeing 787 aircraft and purchase rights for 10 Boeing 787 aircraft and 18 Boeing 777 aircraft. Refer to section 9.6 of Air Canada's 2010 MD&A dated February 10, 2011 for additional information on the financing commitments from Boeing and the engine manufacturer covering 31 of the 37 Boeing 787 firm aircraft orders.

Boeing notified Air Canada that the first seven deliveries of its Boeing 787 aircraft, previously scheduled to be delivered in the second half of 2013, are now targeted for delivery during the fourth quarter of 2013 and the first half of 2014. This represents an average delay of between five and seven months from the previous schedule. Boeing also indicated that it continues to evaluate the schedule for deliveries of Air Canada's remaining 30 firm orders for Boeing 787 aircraft and would provide Air Canada with an update when available. The impact of this delay on projected committed expenditures beyond 2013 is not yet determinable.

The table below provides Air Canada's current projected, planned and committed capital expenditures for the remainder 2011, for the next two years and after 2013.

(Canadian dollars in millions)	Remainder of 2011	2012	2013	Thereafter
Projected committed expenditures	\$ 83	\$ 142	\$ 213	\$ 3,681 not available
Projected planned but uncommitted expenditures	43	128	127	
Total projected expenditures <sup>(1)(2)</sup>	126	270	340	3,681
Projected financing on committed expenditures	-	-	(161)	(2,511)
<b>Total projected expenditures, net of financing</b>	<b>\$ 126</b>	<b>\$ 270</b>	<b>\$ 179</b>	<b>\$ 1,170</b>

(1) U.S. dollar amounts are converted using the March 31, 2011 closing exchange rate of US\$1 = C\$0.9696. Final aircraft delivery prices include estimated escalation and interest on deferred delivery payments.

(2) Capital purchase commitments in the table above exclude maintenance events. Capital purchase commitments related to these maintenance events amount to \$34 million for the remainder of 2011 and amounted to \$42 million in the first quarter of 2011. Capital commitments for these maintenance events for 2012 and beyond are not yet determinable.



## 6.6 Contractual Obligations

Information on Air Canada's contractual obligations is described in section 9.7 of Air Canada's 2010 MD&A dated February 10, 2011. Updated information on Air Canada's capital expenditures and related financing arrangements can be found in section 6.5 of this MD&A.

The table below provides updated information on Air Canada's long-term debt and finance lease obligations, including interest and principal repayment obligations as at March 31, 2011. The updates from the information provided in the 2010 MD&A relate mainly to the impact of the changeover to IFRS. As described in section 10.1 of this MD&A, Air Canada consolidates certain aircraft leasing special purpose entities ("SPEs") that were not consolidated under Canadian GAAP. The additional debt consolidated in the SPEs relates to third party guarantees in the SPE leasing entities.

(Canadian dollars in millions)	Remainder of 2011	2012	2013	2014	2015	Thereafter	Total
<i>Principal</i>							
Long-term debt obligations	\$ 154	\$ 223	\$ 452	\$ 191	\$ 1,067	\$ 1,327	\$ 3,414
Finance lease obligations	138	157	127	98	166	276	962
	292	380	579	289	1,233	1,603	4,376
<i>Interest</i>							
Long-term debt obligations	161	206	188	169	127	113	964
Finance lease obligations	61	68	56	46	33	88	352
	222	274	244	215	160	201	1,316
<b>Total long-term debt, finance lease and interest repayment obligations<sup>(1)</sup></b>	<b>514</b>	<b>654</b>	<b>823</b>	<b>504</b>	<b>1,393</b>	<b>1,804</b>	<b>5,692</b>
Net impact of GE Japan loan facility	(31)	(21)	21	21	17	36	43
<b>Total long-term debt, finance lease and interest repayment obligations, including net impact of GE Japan loan facility</b>	<b>\$ 483</b>	<b>\$ 633</b>	<b>\$ 844</b>	<b>\$ 525</b>	<b>\$ 1,410</b>	<b>\$ 1,840</b>	<b>\$ 5,735</b>

(1) The interest repayment obligations relate to long-term debt, debt consolidated under special purpose entities and finance leases.

## 6.7 Pension Funding Obligations

Air Canada maintains several defined benefit pension plans. Based on preliminary estimates as at January 1, 2011, the aggregate solvency deficit in the registered pension plans is estimated to be approximately \$2.1 billion, whereas the aggregate solvency deficit in the registered pension plans as at January 1, 2010 was \$2.7 billion. The next required valuations are as of January 1, 2011, and will be completed in the first half of 2011, but as described below, they will not increase pension past service cost funding obligations projected for 2011 to 2013.

In July 2009, the Government of Canada adopted the Air Canada 2009 Pension Regulations. The Air Canada 2009 Pension Regulations relieve Air Canada from making any past service contributions (i.e. special payments to amortize the plan solvency deficits) to its ten domestic defined benefit registered pension plans in respect of the period beginning April 1, 2009, and ending December 31, 2010. Thereafter, in respect of the period from January 1, 2011 to December 31, 2013, the aggregate annual past service contribution shall equal the lesser of (i) \$150 million, \$175 million, and \$225 million in 2011, 2012, and 2013, respectively, on an accrued basis, and (ii) the maximum past service contribution permitted under the Canadian Income Tax Act.

Additional information on Air Canada's pension funding obligations is described in section 9.8 of Air Canada's 2010 MD&A dated February 10, 2011.

## 6.8 Share Information

As at April 30, 2011, an aggregate of 279,148,009 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 of the dates indicated below, as follows:

	Number of Shares at	
	April 30, 2011	December 31, 2010
<b>Issued and outstanding shares</b>		
Class A variable voting shares	42,922,035	64,275,209
Class B voting shares	234,556,798	214,697,175
<b>Total issued and outstanding shares</b>	<b>277,478,833</b>	<b>278,972,384</b>
<b>Class A variable voting and Class B voting shares potentially issuable</b>		
Warrants	89,430,300	89,430,300
Shares held in trust	1,669,176	-
Stock options	6,716,027	3,287,931
Performance share units	2,500	2,500
<b>Total shares potentially issuable</b>	<b>97,818,003</b>	<b>92,720,731</b>
<b>Total outstanding and potentially issuable shares</b>	<b>375,296,836</b>	<b>371,693,115</b>

### Stock-based compensation

In the first quarter of 2011, the Board of Directors approved a special one-time Employee Recognition Award in the form of Air Canada shares granted to all eligible unionized and certain non-unionized employees worldwide, where permitted. Under the award, eligible employees were granted an aggregate of approximately 3.3 million shares with a grant date fair value of \$11 million. Half of these shares vested immediately upon issuance and the other half will vest over three years. Pursuant to the award, Air Canada purchased approximately 3.3 million shares for \$11 million, of which half were distributed to the eligible employees and the other half are held in trust over the vesting period. The shares held in trust are excluded from the outstanding shares total and shown separately as potentially issuable shares. Compensation expense for these shares will be recognized over the vesting period.

### Shareholder rights plan

In March 2011, the Board of Directors of Air Canada adopted a shareholder rights plan agreement (the "Plan") designed to foster fair treatment of all shareholders in connection with any take-over bid for Air Canada. While the Plan came into effect immediately, it is subject to shareholder ratification within six months of its adoption. Air Canada will seek shareholder ratification of the Plan at the next annual and special shareholder meeting to be held on May 5, 2011.

The Plan is scheduled to expire at the close of business on the date immediately following the date of Air Canada's annual meeting of shareholders to be held in 2014, unless terminated earlier in accordance with the terms of the Plan.

## 7. Quarterly Financial Data

The following table summarizes quarterly financial results and major operating statistics for Air Canada for the last eight quarters. The information for the last three quarters of 2009 is reported on a Canadian GAAP basis (prior to the adoption of IFRS) while the information for the four quarters of 2010 and the first quarter of 2011 is reported on an IFRS basis. Accordingly, the financial information for the three quarters of 2009 may not be comparable to subsequent periods.

	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
(Canadian dollars in millions)	2009	2009	2009	2010	2010	2010	2010	2011
	CGAAP	CGAAP	CGAAP	IFRS	IFRS	IFRS	IFRS	IFRS
<b>Operating revenues</b>	\$ 2,330	\$ 2,670	\$ 2,348	\$ 2,519	\$ 2,625	\$ 3,026	\$ 2,616	\$ 2,753
Aircraft fuel	572	682	601	619	660	733	640	742
Ownership (DAR) <sup>(1)</sup>	248	252	250	286	281	274	313	273
Other operating expenses	1,623	1,668	1,580	1,750	1,637	1,713	1,648	1,804
<b>Operating expenses</b>	<b>2,443</b>	<b>2,602</b>	<b>2,431</b>	<b>2,655</b>	<b>2,578</b>	<b>2,720</b>	<b>2,601</b>	<b>2,819</b>
<b>Operating income (loss) before the undernoted item</b>	<b>(113)</b>	<b>68</b>	<b>(83)</b>	<b>(136)</b>	<b>47</b>	<b>306</b>	<b>15</b>	<b>(66)</b>
Provision adjustment for cargo investigations, net <sup>(2)</sup>	-	-	-	-	-	-	46	-
<b>Operating income (loss)</b>	<b>(113)</b>	<b>68</b>	<b>(83)</b>	<b>(136)</b>	<b>47</b>	<b>306</b>	<b>61</b>	<b>(66)</b>
<b>Total non-operating income (expense)</b>	<b>275</b>	<b>212</b>	<b>25</b>	<b>23</b>	<b>(365)</b>	<b>11</b>	<b>28</b>	<b>47</b>
Non-controlling interest	(4)	(3)	(4)	-	-	-	-	-
Recovery of (provision for) income taxes	(3)	-	6	1	-	-	-	-
<b>Net income (loss)</b>	<b>\$ 155</b>	<b>\$ 277</b>	<b>\$ (56)</b>	<b>\$ (112)</b>	<b>\$ (318)</b>	<b>\$ 317</b>	<b>\$ 89</b>	<b>\$ (19)</b>

(Canadian dollars in millions, except where indicated)	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
	2009	2009	2009	2010	2010	2010	2010	2011
	CGAAP	CGAAP	CGAAP	IFRS	IFRS	IFRS	IFRS	IFRS
Revenue passenger miles (millions)	11,862	14,153	10,885	11,692	12,896	15,531	11,756	12,355
Available seat miles (millions)	14,735	16,946	13,841	14,727	15,523	18,328	14,918	15,859
Passenger load factor (%)	80.5	83.5	78.6	79.4	83.1	84.7	78.8	77.9
RASM (cents) <sup>(3)</sup>	13.9	14.1	14.6	14.2	14.8	14.8	15.1	14.5
CASM (cents)	16.6	15.4	17.6	18.0	16.6	14.8	17.4	17.8
CASM, excluding fuel expense (cents)	12.7	11.3	13.2	13.8	12.3	10.8	13.2	13.1
Fuel price per litres (cents) <sup>(4)</sup>	65.4	68.6	72.6	70.7	71.1	66.9	70.2	78.7
<b>EBITDAR before the provision adjustment for cargo investigations, net</b> <sup>(2) (5)</sup>	<b>\$ 135</b>	<b>\$ 320</b>	<b>\$ 167</b>	<b>\$ 150</b>	<b>\$ 328</b>	<b>\$ 580</b>	<b>\$ 328</b>	<b>\$ 207</b>
<b>EBITDAR</b> <sup>(5)</sup>	<b>\$ 135</b>	<b>\$ 320</b>	<b>\$ 167</b>	<b>\$ 150</b>	<b>\$ 328</b>	<b>\$ 580</b>	<b>\$ 374</b>	<b>\$ 207</b>
<b>Earnings (loss) per share</b>								
- Basic	<b>\$ 1.55</b>	<b>\$ 2.77</b>	<b>\$ (0.25)</b>	<b>\$ (0.41)</b>	<b>\$ (1.14)</b>	<b>\$ 1.13</b>	<b>\$ 0.31</b>	<b>\$ (0.07)</b>
- Diluted	<b>\$ 1.55</b>	<b>\$ 2.44</b>	<b>\$ (0.25)</b>	<b>\$ (0.41)</b>	<b>\$ (1.14)</b>	<b>\$ 1.10</b>	<b>\$ 0.27</b>	<b>\$ (0.07)</b>

(1) DAR refers to the combination of depreciation, amortization and impairment and aircraft rent expense.

(2) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of \$125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of \$46 million to this provision.

(3) System RASM excludes the impact of a \$40 million favourable adjustment recorded in the first quarter of 2010.

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

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

## 8. Financial Instruments and Risk Management

### Summary of gain on financial instruments recorded at fair value

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

(Canadian dollars in millions)	First Quarter	
	2011	2010
Fuel derivatives	\$ 36	\$ 1
Interest rate swaps	(3)	1
Share forward contracts	(3)	-
Other	(3)	-
<b>Gain on financial instruments recorded at fair value</b>	<b>\$ 27</b>	<b>\$ 2</b>

### *Risk Management*

Under its risk management policy, Air Canada manages its interest rate risk, foreign exchange risk, share-based compensation risk and market risk through the use of various interest rate, foreign currency, fuel and other derivative financial instruments.

### *Interest Rate Risk Management*

Interest rate risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Commencing in the second quarter of 2011, certain payments based upon aircraft rental amounts will be based on medium-term U.S. interest rates at the time of delivery. To hedge against the exposure to increases in interest rate until the expected delivery date, in the first quarter of 2011, Air Canada entered into forward start interest rate swaps with an aggregate notional value of US\$234 million. The swaps have contractual terms of maturity that coincide with the term of the rental agreements. However, the derivatives will be settled on each expected delivery date of the aircraft with maturities ranging from May 2011 to July 2012. The fair value of these contracts as at March 31, 2011 was \$4 million in favour of the counterparties, with the loss recorded in "gain on financial instruments recorded at fair value" on Air Canada's consolidated statement of operations.

### *Fuel Price Risk Management*

Fuel price risk is the risk that future cash flows relating to jet fuel purchases will fluctuate because of changes in jet fuel prices. In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, Air Canada enters into derivative contracts with financial intermediaries.

During the first quarter of 2011:

- Air Canada purchased crude-oil option contracts covering 2011 and 2012 fuel exposure, for which the cash premium related to these contracts was \$10 million (\$8 million the first quarter of 2010).
- Fuel derivative contracts cash settled with a net fair value of \$11 million in favour of Air Canada (\$14 million in favour of the counterparties in the first quarter of 2010).

As of March 31, 2011, approximately 29% of Air Canada's anticipated purchases of jet fuel for the remainder of 2011 are hedged at an average West Texas Intermediate ("WTI") capped price of US\$100 per barrel and approximately 7% is subject to an average floor price of US\$85 per barrel. Air Canada's contracts to hedge anticipated jet fuel purchases over the 2011 period are crude-oil based contracts, comprised of call options, collars, call spreads and 3-way option structures. Air Canada has also hedged approximately 1% of its 2012 anticipated jet fuel purchases in crude-oil based contracts hedged at an average capped price of US\$119 per barrel. The fair value of the fuel derivatives portfolio at March 31, 2011 is \$68 million in favour of Air Canada (\$33 million in favour of Air Canada as at December 31, 2010) and is recorded within "prepaid expenses and other current assets" on Air Canada's consolidated statement of financial position.

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 March 31, 2011.

Derivative Instruments	Term	Volume (bbls)	WTI Weighted Average Floor Price (US\$/bbl)	WTI Weighted Average Capped Price (US\$/bbl)
Call options	2011	4,095,000	n/a	\$ 99
Call options	2012	240,000	n/a	\$ 119
Call spreads <sup>(1)</sup>	2011	120,000	n/a	\$ 115
Collars	2011	810,000	\$ 84	\$ 96
3-way options <sup>(1)</sup>	2011	480,000	\$ 86	\$ 110

(1) Call spreads and 3-way options are subject to a maximum price protection of US\$155 per barrel and US\$150 per barrel, respectively.

The following information summarizes the impact of fuel derivatives on Air Canada's consolidated statement of operations and consolidated statement of comprehensive income.

(Canadian dollars in millions)		First Quarter	
		2011	2010
<b>Consolidated Statement of Operations</b>			
<u>Operating expenses</u>			
Aircraft fuel	Realized effective loss on derivatives designated under hedge accounting	n/a	\$ (58)
<u>Non-operating income (expense)</u>			
Gain on financial instruments recorded at fair value	Fair market value gain on economic hedges	\$ 36	\$ 1
<b>Consolidated Other Comprehensive Income</b>			
	Reclassification of net realized loss on fuel derivatives designated under hedge accounting to aircraft fuel expense	n/a	\$ 58
	Tax on reclassification	n/a	\$ -

## 9. Critical Accounting Estimates

Critical accounting estimates are those that are most important to the portrayal of Air Canada's financial condition and results of operations. Information on Air Canada's critical accounting estimates is disclosed in section 15 of Air Canada's 2010 MD&A dated February 10, 2011. The following updates are provided for those areas that contain critical accounting estimates utilized in the preparation of Air Canada's consolidated financial statements that have changed as a result of adopting IFRS on January 1, 2011.

### Employee future benefits

The cost and related liabilities of Air Canada's pensions, other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations involve assumptions, including in relation to discount rates, expected rates of return on assets, future salary increases, mortality rates and future benefit increases. Also, due to the long-term nature of these programs, such estimates are subject to significant uncertainty.

#### Sensitivity Analysis

Sensitivity analysis on 2011 employee benefits expense and on net financing expense relating to employee benefit liabilities, based on different actuarial assumptions with respect to discount rate and expected return on plan assets, is as follows:

(Canadian dollars in millions)	0.25 Percentage Point	
	Decrease	Increase
<b>Discount rate on obligation assumption</b>		
Employee benefits expense	\$ 15	\$ (15)
Net financing expense relating to employee benefit liabilities	(11)	11
	<b>4</b>	<b>(4)</b>
<b>Long-term rate of return on plan assets assumption</b>		
Net financing expense relating to employee benefit liabilities	28	(28)
	<b>\$ 28</b>	<b>\$ (28)</b>

### Impairment of long-lived assets

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



## **Property and equipment**

In accordance with IFRS 1, Air Canada elected to value its aircraft and spare engines at the date of transition to IFRS on January 1, 2010 at their fair value and to use this fair value as deemed cost. Subsequent to transition, property and equipment is recognized using the cost method.

Air Canada makes estimates about the expected useful lives of long-lived assets and the expected residual values of the assets based on the estimated current fair value of the assets, Air Canada's fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by changes to maintenance programs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. These estimates and assumptions are evaluated at least on an annual basis or when events or circumstances indicate a change in assumptions may be warranted. Generally, these adjustments are accounted for on a prospective basis, through depreciation, amortization and impairment expense.

Airframe and engines are depreciated over 20 to 25 years, with 10% to 20% estimated residual values. Cabin interior equipment and modifications are depreciated over the lesser of 5 years or the remaining life of the aircraft. Spare engines and related parts ("rotables") are depreciated over the average remaining life of the fleet to which they relate with 10% to 20% estimated residual values. Cabin interior equipment and modifications to aircraft on operating leases are amortized over the term of the lease. Major maintenance of airframes and engines, including replacement spares and labour costs, are capitalized and amortized over the average expected life between major maintenance events.

Buildings and building leasehold improvements are depreciated on a straight-line basis over their useful lives not exceeding 50 years or the term of any related lease, whichever is less.

Residual values are reviewed at least annually against prevailing market values for equivalently aged assets and depreciation rates adjusted accordingly on a prospective basis.

## **Lease return provisions**

Maintenance and repair costs related to return conditions on aircraft leases are recorded over the term of the lease for the end of lease maintenance return condition obligations within Air Canada'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 based on management's estimate of the future costs associated with the maintenance events required under the lease return condition and taking into account the expected future maintenance condition of the aircraft at the time of lease expiry. The provision is discounted using a rate specific to the liability. Interest accretion on the provision is recorded in non-operating expense. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in aircraft maintenance expense in the period.

## 10. Accounting Policies

### 10.1 Future Accounting Standards

The following is an overview of an accounting standard change that Air Canada will be required to adopt in future years:

IFRS 9 Financial Instruments introduces new requirements for the classification and measurement of financial assets. IFRS 9 requires all recognized financial assets that are within the scope of IAS 39 Financial Instruments: Recognition and Measurement to be subsequently measured at amortized cost or fair value. Specifically, debt investments that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortized cost at the end of subsequent accounting periods. All other debt investments and equity investments are measured at their fair values at the end of subsequent accounting periods.

IFRS 9 is effective for annual periods beginning on or after January 1, 2013, with earlier application permitted. Air Canada continues to evaluate the impact of IFRS 9 on its consolidated statement of operations and financial position.

### 10.2 Transition to International Financial Reporting Standards

Effective January 1, 2011 and as further described in Air Canada's interim unaudited condensed consolidated financial statements and notes for the first quarter of 2011, Air Canada began reporting its financial results in accordance with International Financial Reporting Standards ("IFRS").

Air Canada uses various metrics when evaluating its operational and financial performance. Management continually monitors and evaluates these metric and updates these metrics as required to ensure they provide decision useful information on Air Canada's performance.

The following table summarizes Air Canada's relevant key metrics for the year ended December 31, 2010 under IFRS versus those reported under Canadian GAAP ("CGAAP"):

(Canadian dollars in millions, except where indicated)	Full Year 2010 <sup>(1)</sup>		
	IFRS	CGAAP	Change \$
<b>Financial Performance Metrics</b>			
Operating revenues	10,786	10,786	-
Operating income before provision adjustment for cargo investigations, net <sup>(1)</sup>	232	361	(129)
Operating income	278	407	(129)
Income (loss) for the period	(24)	107	(131)
Operating margin % before provision adjustment for cargo investigations, net <sup>(1)</sup>	2.2%	3.3%	(1.1) pp
Operating margin %	2.6%	3.8%	(1.2) pp
EBITDAR before provision adjustment for cargo investigations, net <sup>(1) (2)</sup>	1,386	1,386	-
EBITDAR <sup>(2)</sup>	1,432	1,432	-
EBITDAR margin % before provision adjustment for cargo investigations, net <sup>(1) (2)</sup>	12.9	12.9%	-
EBITDAR margin % <sup>(2)</sup>	13.3%	13.3%	-
Cash, cash equivalents and short-term investments	2,192	2,192	-
Free cash flow <sup>(3)</sup>	746	746	-
Adjusted net debt <sup>(4)</sup>	4,874	4,687	187
Earnings (loss) per share – Diluted	(\$0.12)	\$0.37	(\$0.49)
<b>Operating Performance Metrics</b>			<b>Change ¢</b>
Passenger revenue per RPM ("Yield") (cents) <sup>(5)</sup>	18.1	18.1	-
Passenger revenue per ASM ("RASM") (cents) <sup>(5)</sup>	14.8	14.8	-
Operating revenue per ASM (cents) <sup>(5)</sup>	17.0	17.0	-
Operating expense per ASM ("CASM") (cents)	16.6	16.4	0.2
CASM, excluding fuel expense (cents)	12.4	12.2	0.2

(1) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of \$125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of \$46 million to this provision.

(2) EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, 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).

(3) Free cash flow (cash flows from operating activities less additions to property, equipment and intangible assets) is a non-GAAP financial measure. See section 15 of this MD&A for additional information.

(4) 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 15 of this MD&A for additional information.

(5) A favourable revenue adjustment of \$40 million related to Air Canada's transatlantic joint venture, which was finalized in December 2010 but with effect as of January 1, 2010, with United Airlines and to other interline agreements was recorded in the fourth quarter of 2010. For comparative purposes, these measures were adjusted to exclude the impact of the \$40 million favourable adjustment recorded in the fourth quarter of 2010.

### **Summary impacts on the key metrics as a result of the adoption of IFRS**

The following summarizes certain of the impacts on the key metrics as a result of the adoption of IFRS for the year ended December 31, 2010:

- No change to operating revenues.
- A decrease to operating income, after a provision adjustment for cargo investigations, of \$129 million to \$278 million, which includes impairment charges under IFRS of \$49 million recognized on A340-300 and 767-200 aircraft, which were not recognized under Canadian GAAP.
- No net change to EBITDAR.
- An increase to adjusted net debt of \$187 million, as a result of the consolidation of certain aircraft leasing special purpose entities ("SPEs") under IFRS. The consolidation of these entities does not change any of the underlying cash flows in these leasing agreements. The additional debt consolidated in these SPEs relates to third party debt in the SPE leasing entities.
- No net change to free cash flow and no change to cash, cash equivalents and short-term investments.

### **Exemptions and exceptions applied on transition to IFRS**

Air Canada's interim unaudited condensed consolidated financial statements and notes for the first quarter of 2011 contain the accounting policies adopted under IFRS as well as reconciliations of the impacts to the consolidated financial statements on transition. IFRS 1 allows first-time adopters certain exemptions from the general requirements contained in IFRS. Air Canada has elected to apply the following optional exemptions from full retrospective application:

#### Business combinations

Air Canada has elected 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. Such election has the effect of leaving past business combinations as previously reported.

#### Fair value or revaluation as deemed cost

Air Canada has elected 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. The fair value election was done in part because fair value generally provides more relevant information and it also facilitates the componentization of aircraft values upon transition to IFRS.

Under Canadian GAAP, Air Canada 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, Air Canada has elected to apply those fair values as deemed cost for IFRS as at the date of the revaluation, with the exception of (i) owned and finance leased aircraft and engines, which are being measured at fair value as at January 1, 2010 as described above, and (ii) intangible assets and goodwill, which, in such case, would be measured at historical cost without the application of the fresh start fair values. As a result, Intangible assets decreased by \$587 million, representing the de-recognition of existing Canadian GAAP intangible assets that were established in accordance with fresh start reporting, offset by the recognition of goodwill of \$311 million and the reduction of future income tax liabilities of \$40 million.

#### Employee benefits

Air Canada has elected to recognize all cumulative actuarial gains and losses on pension and other post-retirement benefit plans as at January 1, 2010 directly in the Deficit. This election resulted in a net charge to the deficit of \$840 million as at January 1, 2010. In addition, Air Canada recognized an additional minimum funding liability on transition to IFRS in the amount of \$1,937 million.

### Borrowing costs

Air Canada has applied IAS 23R for annual periods beginning on or after January 1, 2010, the date of transition to IFRS. Under Canadian GAAP, Air Canada had an accounting policy of capitalizing interest. This election had no impact on transition to IFRS.

### **Adjustments to the consolidated statement of financial position on adoption of IFRS**

The following table provides the Canadian GAAP consolidated statement of financial position as at January 1, 2010 and the IFRS transitional adjustments to arrive at the opening position under IFRS.

<b>As at January 1, 2010 (Canadian dollars in millions)</b>	<b>CGAAP</b>	<b>Adjustment</b>	<b>IFRS</b>
<b>Assets</b>			
Current assets	\$ 2,651	\$ -	\$ 2,651
Property and equipment	6,369	(82)	6,287
Intangible assets	916	(587)	329
Goodwill	-	311	311
Deposits and other assets	470	77	547
	<b>\$ 10,406</b>	<b>\$ (281)</b>	<b>\$ 10,125</b>
<b>Liabilities</b>			
Current liabilities	\$ 3,002	\$ -	\$ 3,002
Long-term debt and finance leases	4,054	259	4,313
Deferred income taxes	85	(40)	45
Pension and other benefit liabilities	1,163	2,777	3,940
Maintenance provisions	14	447	461
Other long-term liabilities	441	(57)	384
	<b>8,759</b>	<b>3,386</b>	<b>12,145</b>
Non-controlling interest	201	(201)	-
<b>Shareholders' equity</b>			
Share capital	532	312	844
Contributed surplus	1,825	(1,772)	53
Deficit	(727)	(2,154)	(2,881)
Accumulated other comprehensive loss	(184)	-	(184)
	<b>1,446</b>	<b>(3,614)</b>	<b>(2,168)</b>
Non-controlling interest	-	148	148
<b>Total equity</b>	<b>1,647</b>	<b>(3,667)</b>	<b>(2,020)</b>
<b>Total liabilities and equity</b>	<b>\$ 10,406</b>	<b>\$ (281)</b>	<b>\$ 10,125</b>

The main impacts on the consolidated statement of financial position are summarized as follows:

- No change to current assets or current liabilities;
- A decrease to property and equipment of \$82 million mainly reflecting the fair value adjustments on owned and finance leased aircraft and engines at January 1, 2010;
- A decrease to the value of Intangible assets of \$587 million partially offset by the recording of goodwill of \$311 million due to the recognition of these assets at historical cost;
- An increase to long-term debt and finance leases of \$259 million as a result of consolidating additional special purpose leasing entities covering third party guarantees under 21 aircraft leases;
- An increase to pension and other benefit liabilities of \$2,777 million reflecting the recognition of cumulative actuarial losses and an additional minimum funding liability on Air Canada's registered pension plans; and
- Maintenance provisions related to return conditions on aircraft leases increased by \$447 million.

As a result of the adjustments, the opening deficit position under IFRS is \$2,881 million.

The table below provides the 2010 quarterly and full year consolidated statement of operations for Air Canada under IFRS:

(Canadian dollars in millions except per share figures)	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Full Year 2010
<b>Operating revenues</b>					
Passenger	\$ 2,095	\$ 2,314	\$ 2,722	\$ 2,296	\$ 9,427
Cargo	104	115	123	124	466
Other	320	196	181	196	893
	2,519	2,625	3,026	2,616	10,786
<b>Operating expenses</b>					
Aircraft fuel	619	660	733	640	2,652
Wages, salaries and benefits	474	479	473	487	1,913
Airport and navigation fees	226	236	270	229	961
Capacity purchase agreements	235	238	257	241	971
Depreciation, amortization and impairment	196	193	185	227	801
Aircraft maintenance	186	147	157	164	654
Sales and distribution costs	142	142	151	146	581
Food, beverages and supplies	74	75	76	54	279
Communications and information technology	49	49	47	50	195
Aircraft rent	90	88	89	86	353
Other	364	271	282	277	1,194
	2,655	2,578	2,720	2,601	10,554
<b>Operating income (loss) before undernoted item</b>	<b>(136)</b>	<b>47</b>	<b>306</b>	<b>15</b>	<b>232</b>
Provision adjustment for cargo investigations, net <sup>(1)</sup>	-	-	-	46	46
<b>Operating income (loss)</b>	<b>(136)</b>	<b>47</b>	<b>306</b>	<b>61</b>	<b>278</b>
<b>Non-operating income (expense)</b>					
Foreign exchange gain (loss)	123	(190)	115	136	184
Interest income	2	4	4	9	19
Interest expense	(83)	(138)	(90)	(86)	(397)
Net financing expense relating to employee benefit liabilities	(19)	(19)	(19)	(18)	(75)
Loss on assets	-	(1)	-	-	(1)
Gain (loss) on financial instruments recorded at fair value	2	(18)	5	8	(3)
Other	(2)	(3)	(4)	(21)	(30)
	23	(365)	11	28	(303)
<b>Income (loss) before income taxes</b>	<b>(113)</b>	<b>(318)</b>	<b>317</b>	<b>89</b>	<b>(25)</b>
Recovery of (provision for) income taxes					
Current	1	2	-	1	4
Deferred	-	(2)	-	(1)	(3)
<b>Income (loss) for the period</b>	<b>\$ (112)</b>	<b>\$ (318)</b>	<b>\$ 317</b>	<b>\$ 89</b>	<b>\$ (24)</b>
<b>EBITDAR before the provision adjustment for cargo investigations, net <sup>(1)(2)</sup></b>	<b>\$ 150</b>	<b>\$ 328</b>	<b>\$ 580</b>	<b>\$ 328</b>	<b>\$ 1,386</b>
<b>EBITDAR <sup>(2)</sup></b>	<b>\$ 150</b>	<b>\$ 328</b>	<b>\$ 580</b>	<b>\$ 374</b>	<b>\$ 1,432</b>
<b>Income (loss) per share – Diluted</b>	<b>\$ (0.41)</b>	<b>\$ (1.14)</b>	<b>\$ 1.10</b>	<b>\$ 0.27</b>	<b>\$ (0.12)</b>

(1) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of \$125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of \$46 million to this provision.

(2) EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, 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).

The table below provides the 2010 quarterly and full year consolidated statement of cash flow for Air Canada under IFRS:

(Canadian dollars in millions)	Q1 2010	Q2 2010	Q3 2010	Q4 2010	Full Year 2010
<b>Cash flows from (used for)</b>					
<b>Operating</b>					
Income (loss) for the period	\$ (112)	\$ (318)	\$ 317	\$ 89	\$ (24)
Adjustments to reconcile to net cash from operations					
Depreciation, amortization and impairment	196	193	185	227	801
Loss on assets	-	1	-	-	1
Foreign exchange (gain) loss	(134)	177	(97)	(158)	(212)
Deferred income taxes	-	2	-	1	3
Excess of employee future benefit funding over expense	(2)	8	(21)	(9)	(24)
Fuel and other derivatives	35	41	21	5	102
Fuel hedge collateral deposits, net	23	7	11	2	43
Change in maintenance provisions	20	11	11	15	57
Provision adjustment for cargo investigations, net <sup>(1)</sup>	-	-	-	(46)	(46)
Changes in non-cash working capital balances	257	160	(303)	25	139
Other	9	50	27	7	93
	<b>292</b>	<b>332</b>	<b>151</b>	<b>158</b>	<b>933</b>
<b>Financing</b>					
Proceeds from borrowings	100	-	1,075	-	1,175
Shares issued	-	-	-	2	2
Reduction of long-term debt and finance lease obligations	(164)	(96)	(808)	(100)	(1,168)
Other	(2)	-	-	-	(2)
	<b>(66)</b>	<b>(96)</b>	<b>267</b>	<b>(98)</b>	<b>7</b>
<b>Investing</b>					
Short-term investments	(244)	(174)	48	(440)	(810)
Additions to property, equipment and intangible assets	(77)	(35)	(39)	(36)	(187)
Proceeds from sale of assets	-	1	27	1	29
Proceeds from sale-leaseback transactions	20	-	-	-	20
Reduction to Aveos letter of credit	23	-	-	-	23
Other	22	(8)	(48)	(6)	(40)
	<b>(256)</b>	<b>(216)</b>	<b>(12)</b>	<b>(481)</b>	<b>(965)</b>
<b>Increase (decrease) in cash and cash equivalents</b>	<b>\$ (30)</b>	<b>\$ 20</b>	<b>\$ 406</b>	<b>\$ (421)</b>	<b>\$ (25)</b>

(1) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of \$125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of \$46 million to this provision.



## **11. Off-Balance Sheet Arrangements**

Information on Air Canada's off-balance sheet arrangements is disclosed in section 13 of Air Canada's 2010 MD&A dated February 10, 2011. 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**

At March 31, 2011, Air Canada had no transactions with related parties as defined in the CICA Handbook, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

## **13. Risk Factors**

For a detailed description of risk factors associated with Air Canada, refer to section 18 "Risk Factors" of Air Canada's 2010 MD&A dated February 10, 2011. 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 2010 MD&A dated February 10, 2011 related to *Current Legal Proceedings* is updated to account for the fact that the usual five-year statute of limitations period during which the U.S. Department of Justice could seek the indictment of a party for a violation in respect of alleged anti-competitive cargo pricing activities expired on February 14, 2011 without any such proceedings having been instituted against Air Canada.

## 14. Controls and Procedures

### **Disclosure controls and procedures and internal controls over financial reporting**

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

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

In the Corporation's 2010 filings, the Corporation's CEO and CFO certified, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design and effectiveness of the Corporation's disclosure controls and procedures, and the design and effectiveness of internal controls over financial reporting.

In the Corporation's first quarter 2011 filings, the Corporation's CEO and CFO certify, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design of the Corporation's disclosure controls and procedures, and the design of internal controls over financial reporting.

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

### **Changes in internal controls over financial reporting**

As a result of the transition from Canadian GAAP to IFRS, there have been material changes in internal controls over financial reporting in the following process areas:

- Accounting policy selection (including controls over changes in accounting policies)
- Property and equipment
- Provisions (lease return conditions)
- Impairment of long-lived assets
- Employee benefits

Management has considered the control risks of the transition to IFRS and has performed procedures to obtain reasonable assurance on the design of internal controls over financial reporting that are new or significantly modified as a result of the transition.

## 15. Non-GAAP Financial Measures

### EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation, amortization and impairment, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. EBITDAR is not a recognized measure for financial statement presentation under 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 is reconciled to operating loss as follows:

(Canadian dollars in millions)	First Quarter		
	2011	2010	Change \$
GAAP operating loss	\$ (66)	\$ (136)	\$ 70
<b>Add back:</b>			
Aircraft rent	88	90	(2)
Depreciation, amortization and impairment	185	196	(11)
<b>EBITDAR</b>	<b>\$ 207</b>	<b>\$ 150</b>	<b>\$ 57</b>

EBITDAR (before a net reduction of \$46 million to a provision for cargo investigations) is reconciled to operating income (before a net reduction of \$46 million to a provision for cargo investigations) on an IFRS basis and on a Canadian GAAP basis as follows:

(Canadian dollars in millions)	Full Year 2010		
	IFRS	CGAAP	Change \$
GAAP operating income before the provision adjustment for cargo investigations, net <sup>(1)</sup>	\$ 232	\$ 361	\$ (129)
<b>Add back:</b>			
Aircraft rent	353	346	7
Depreciation, amortization and impairment	801	679	122
<b>EBITDAR before the provision adjustment for cargo investigations, net <sup>(1)</sup></b>	<b>\$ 1,386</b>	<b>\$ 1,386</b>	<b>\$ -</b>
<b>Add back:</b>			
Provision adjustment for cargo investigations, net <sup>(1)</sup>	46	46	-
<b>EBITDAR</b>	<b>\$ 1,432</b>	<b>\$ 1,432</b>	<b>\$ -</b>

(1) In the first quarter of 2008, Air Canada recorded a provision for cargo investigations of \$125 million. In the fourth quarter of 2010, Air Canada recorded a net reduction of \$46 million to this provision.

### 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 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:

(Canadian dollars in millions)	First Quarter		
	2011	2010	Change \$
GAAP operating expense	\$ 2,819	\$ 2,655	\$ 164
<b>Remove:</b>			
Aircraft fuel	(742)	(619)	(123)
<b>Operating expense, excluding fuel expense</b>	<b>\$ 2,077</b>	<b>\$ 2,036</b>	<b>\$ 41</b>

### Adjusted net debt

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 7.0. This definition of capitalized operating leases is used by Air Canada and may not be comparable to similar measures presented by other public companies.

Adjusted net debt on an IFRS basis is compared to adjusted net debt on a Canadian GAAP basis as follows:

(Canadian dollars in millions)	Full Year Ended December 31, 2010		
	IFRS	CGAAP	Change \$
Total long-term debt and finance leases	\$ 4,028	\$ 3,952	\$ (76)
Current portion of long-term debt and finance leases	567	505	(62)
Total long-term debt and finance leases, including current portion	4,595	4,457	(138)
Less cash, cash equivalents and short-term investments	(2,192)	(2,192)	-
<b>Net debt</b>	<b>\$ 2,403</b>	<b>\$ 2,265</b>	<b>\$ (138)</b>
Capitalized operating leases	2,471	2,422	(49)
<b>Adjusted net debt</b>	<b>\$ 4,874</b>	<b>\$ 4,687</b>	<b>\$ (187)</b>

### Consolidated cash flow movements

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.

Free cash flow on an IFRS basis is compared to free cash flow on a Canadian GAAP basis as follows:

(Canadian dollars in millions)	Full Year 2010		
	IFRS	CGAAP	Change \$
Net cash from operating activities, before the under noted items	\$ 818	\$ 836	\$ (18)
Excess of employee benefit funding over expense	(24)	(126)	102
Changes in non-cash working capital balances	139	154	(15)
Cash flows from operating activities	933	864	69
Additions to property, equipment and intangible assets	(187)	(118)	(69)
<b>Free cash flow</b>	<b>\$ 746</b>	<b>\$ 746</b>	<b>\$ -</b>

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

**Effective Ton Miles or ETMs** — Refers to the mathematical product of tonnage capacity times distance hauled.

**Other passenger and cargo revenues** — Refers to revenues from flights with origins and destinations principally in Central and 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.

**Revenue Ton Miles or RTMs** — Refers to the mathematical product of weight in tons of a shipment being transported by the number of miles that it is transported.

**Yield** — Average passenger revenue per RPM.