

First Quarter 2014

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

May 15, 2014

TABLE OF CONTENTS

1. Highlights.....	1
2. Introduction and Key Assumptions.....	3
3. Overview.....	5
4. Results of Operations – FIRST Quarter 2014 versus FIRST Quarter 2013.....	7
5. Fleet.....	19
6. Financial and Capital Management.....	21
6.1. Liquidity.....	21
6.2. Financial Position.....	21
6.3. Adjusted Net Debt.....	22
6.4. Working Capital.....	23
6.5. Consolidated Cash Flow Movements.....	24
6.6. Capital Expenditures and Related Financing Arrangements.....	25
6.7. Pension Funding Obligations.....	26
6.8. Contractual Obligations.....	27
6.9. Share Information.....	28
7. Quarterly Financial Data.....	29
8. Financial Instruments and Risk Management.....	31
9. Critical Accounting Estimates.....	32
10. Accounting Policies.....	32
11. Off-Balance Sheet Arrangements.....	32
12. Related Party Transactions.....	32
13. Risk Factors.....	32
14. Controls and Procedures.....	33
15. Non-GAAP Financial Measures.....	34
16. Glossary.....	38

1. HIGHLIGHTS

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

(Canadian dollars in millions, except where indicated)	First Quarter		
	2014	2013	\$ Change
Financial Performance Metrics			
Operating revenues	3,065	2,952	113
Operating loss	(62)	(106)	44
Non-operating expense	(279)	(154)	(125)
Net loss	(341)	(260)	(81)
Adjusted net loss ⁽¹⁾	(132)	(143)	11
Operating margin %	(2.0)%	(3.6)%	1.6 pp
EBITDAR ⁽²⁾	147	145	2
EBITDAR margin % ⁽²⁾	4.8%	4.9%	(0.1) pp
Unrestricted liquidity ⁽³⁾	2,515	2,092	423
Free cash flow ⁽⁴⁾	34	147	(113)
Adjusted net debt ⁽⁵⁾	4,426	3,987	439
Return on invested capital ("ROIC") % ⁽⁶⁾	10.7%	8.0%	2.7 pp
Diluted loss per share	\$ (1.20)	\$ (0.95)	\$ (0.25)
Adjusted net loss per share – diluted ⁽¹⁾	\$ (0.46)	\$ (0.52)	\$ 0.06
Operating Statistics ⁽⁷⁾			% Change
Revenue passenger miles (millions) ("RPM")	13,466	13,087	2.9
Available seat miles (millions) ("ASM")	16,774	16,164	3.8
Passenger load factor %	80.3%	81.0%	(0.7) pp
Passenger revenue per RPM ("Yield") (cents)	19.1	19.0	0.4
Passenger revenue per ASM ("PRASM") (cents)	15.3	15.4	(0.5)
Operating revenue per ASM (cents)	18.3	18.3	-
Operating expense per ASM ("CASM") (cents)	18.6	18.9	(1.5)
Adjusted CASM (cents) ⁽⁸⁾	12.2	12.5	(2.5)
Average number of full-time equivalent ("FTE") employees (thousands) ⁽⁹⁾	24.3	24.5	(0.8)
Aircraft in operating fleet at period end	353	350	0.9
Average fleet utilization (hours per day)	9.8	10.1	(2.1)
Aircraft frequencies (thousands)	131	134	(2.2)
Average aircraft flight length (miles)	832	826	0.7
Economic fuel cost per litre (cents) ⁽¹⁰⁾	94.7	92.4	2.4
Fuel litres (millions)	973	953	2.1
Revenue passengers carried (millions) ⁽¹¹⁾	8.7	8.5	3.2

- (1) *Adjusted net income (loss) and adjusted net income (loss) per share – diluted are non-GAAP financial measures. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.*
- (2) *EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.*
- (3) *Unrestricted liquidity refers to the sum of cash, cash equivalents, short-term investments and the amount of available credit under Air Canada's revolving credit facilities. At March 31, 2014, unrestricted liquidity was comprised of cash and short-term investments of \$2,390 million and undrawn lines of credit of \$125 million. At March 31, 2013, unrestricted liquidity was comprised of cash and short-term investments of \$2,056 million and undrawn lines of credit of \$36 million.*
- (4) *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 6.5 of this MD&A for additional information.*
- (5) *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 6.3 of this MD&A for additional information.*
- (6) *Return on invested capital ("ROIC") is a non-GAAP financial measure. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information*
- (7) *Operating statistics (except for average number of FTE employees) include third party carriers (such as Jazz Aviation LP ("Jazz") and Sky Regional Airlines Inc. ("Sky Regional") operating under capacity purchase agreements with Air Canada.*
- (8) *Adjusted CASM is a non-GAAP financial measure. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.*
- (9) *Reflects FTE employees at Air Canada. Excludes FTE employees at third party carriers (such as Jazz and Sky Regional) operating under capacity purchase agreements with Air Canada.*
- (10) *Includes fuel handling expenses. Economic fuel price per litre is a non-GAAP financial measure. Refer to section 4 "Results of Operations" of this MD&A for additional information.*
- (11) *Revenue passengers are counted on a flight number basis which is consistent with the IATA definition of revenue passengers carried.*

2. INTRODUCTION AND KEY ASSUMPTIONS

In this Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A"), the "Corporation" refers, as the context may require, to Air Canada and/or one or more of Air Canada's subsidiaries, including its wholly-owned operating subsidiaries, Touram Limited Partnership ("Air Canada Vacations") and Air Canada *rouge* LP ("Air Canada *rouge*"). This MD&A provides the reader with a review and analysis, from the perspective of management, of Air Canada's financial results for the first quarter 2014. 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 2014 and Air Canada's annual audited consolidated financial statements and notes and its annual MD&A for 2013 dated February 12, 2014. Except as otherwise noted, all financial information has been prepared in accordance with generally accepted accounting principles in Canada ("GAAP"), as set out in the CPA Canada Handbook – Accounting ("CPA Handbook"), which incorporates International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB").

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 16 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of May 14, 2014. Certain comparative figures have been reclassified to conform to the financial statement presentation adopted for the current year. Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of Air Canada's 2013 MD&A dated February 12, 2014. Air Canada issued a news release dated May 15, 2014 reporting on its results for the first quarter 2014. This news release is available on Air Canada's website at www.aircanada.com and on SEDAR's website at www.sedar.com. For further information on Air Canada's public disclosures, including Air Canada's Annual Information Form, consult SEDAR at www.sedar.com.

CAUTION REGARDING FORWARD-LOOKING INFORMATION

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

Forward-looking statements, by their nature, are based on assumptions, including those described herein and are subject to important risks and uncertainties. Forward-looking statements cannot be relied upon due to, amongst other things, changing external events and general uncertainties of the business. Actual results may differ materially from results indicated in forward-looking statements due to a number of factors, including without limitation, industry, market, credit and economic conditions, the ability to reduce operating costs and secure financing, energy prices, currency exchange and interest rates, competition, employee and labour relations, pension issues, 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 2013 MD&A dated February 12, 2014. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of May 14, 2014 (or as of the date they are otherwise stated to be made), and are subject to change after such date. However, Air Canada disclaims any intention or obligation to update or revise any forward-looking statements whether as a result of new information, future events or otherwise, except as required under applicable securities regulations.

KEY ASSUMPTIONS

Assumptions were made by Air Canada in preparing and making forward-looking statements. As part of its assumptions, Air Canada assumes Canadian GDP growth of 2.0% to 3.0% for 2014. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C\$1.10 per U.S. dollar in the second quarter of 2014 and for the full year 2014 and that the price of jet fuel will average 91 cents per litre for the second quarter of 2014 and 92 cents per litre for the full year 2014.

3. OVERVIEW

In the first quarter of 2014, Air Canada generated EBITDAR of \$147 million compared to EBITDAR of \$145 million in the first quarter of 2013. An adjusted net loss of \$132 million reflected an improvement of \$11 million when compared to the same quarter in 2013. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information. On a GAAP basis, Air Canada reported a net loss of \$341 million or \$1.20 per diluted share compared to a net loss of \$260 million or \$0.95 per diluted share in the first quarter of 2013.

In April 2014, Air Canada completed a private offering of US\$400 million of 7.75% senior unsecured notes due 2021 (the "Notes"). Air Canada received net proceeds of approximately \$432 million from the sale of the Notes and will use these proceeds for general corporate purposes.

Strategy

Air Canada continues to make progress in pursuing its strategic initiatives to improve revenues and reduce costs in order to achieve sustainable profitability. Air Canada's business strategy and key priorities focuses on the following:

- Pursuing revenue generating opportunities and transforming costs to enhance its competitiveness;
- Expanding internationally and increasing connecting traffic through its international gateways;
- Engaging with customers, with a particular emphasis on premium class passengers and products; and
- Fostering positive changes to its culture.

Additional information on Air Canada's business strategy can be found in Air Canada's 2013 MD&A dated February 12, 2014.

First Quarter 2014 Financial Summary

The following is an overview of Air Canada's results of operations and financial position for the first quarter of 2014 compared to the first quarter of 2013.

- Operating revenues of \$3,065 million, an increase of \$113 million or 4% from the first quarter of 2013.
- Passenger revenues of \$2,608 million, an increase of \$81 million or 3.2% from the first quarter of 2013, on traffic growth of 2.9% and a yield improvement of 0.4%.
- An ASM capacity increase of 3.8% from the first quarter of 2013, in line with the 3.5% to 4.5% first quarter 2014 ASM capacity growth reported in Air Canada's news release dated April 3, 2014.
- A PRASM decline of 0.5% from the first quarter of 2013, reflecting a passenger load factor decline of 0.7 percentage points partly offset by the yield growth of 0.4%.
- An adjusted CASM reduction of 2.5% from the first quarter of 2013, at the higher end of the 2.0% to 2.5% adjusted CASM decrease projected in Air Canada's news release dated April 3, 2014. Refer to section 15 "Non-GAAP Financial Measures" for additional information.
- An operating loss of \$62 million compared to an operating loss of \$106 million in the first quarter of 2013, an improvement of \$44 million
- A net loss of \$341 million or \$1.20 per diluted share compared to a net loss of \$260 million or \$0.95 per diluted share in the first quarter of 2013. The net loss in the first quarter of 2014 included foreign exchange losses of \$161 million due to a weaker Canadian dollar.

- EBITDAR of \$147 million compared to EBITDAR of \$145 million in the first quarter of 2013, an increase of \$2 million. Refer to section 15 "Non-GAAP Financial Measures" for additional information. Air Canada estimates that first quarter 2014 EBITDAR was negatively impacted by \$15 million as a result of severe weather conditions. EBITDAR of \$147 million in the first quarter of 2014 was in line with the projected EBITDAR in Air Canada's news release dated April 3, 2014 which forecasted EBITDAR in the first quarter of 2014 to be in line with last year's level.
- An adjusted net loss of \$132 million or \$0.46 per diluted share compared to an adjusted net loss of \$143 million or \$0.52 per diluted share in the first quarter of 2013, an improvement of \$11 million or \$0.06 per diluted share. Refer to section 15 "Non-GAAP Financial Measures" for additional information.
- Free cash flow of \$34 million, a decline of \$113 million from the first quarter of 2013. 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 6.5 "Consolidated Cash Flow Movements" of this MD&A for additional information.
- Adjusted net debt amounted to \$4,426 million at March 31, 2014, an increase of \$75 million from December 31, 2013. The airline's adjusted net debt to EBITDAR ratio was 3.1 at March 31, 2014 versus a ratio of 3.0 at December 31, 2013. Air Canada uses this ratio to manage its financial leverage risk and its objective is to maintain the ratio below 3.5. 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 6.3 "Adjusted Net Debt" of this MD&A for additional information.
- Unrestricted liquidity (cash, short-term investments and undrawn lines of credit) of \$2,515 million at March 31, 2014 (March 31, 2013 – \$2,092 million). Unrestricted liquidity refers to the sum of cash, cash equivalents, short-term investments and the amount of available credit under Air Canada's revolving credit facilities. At March 31, 2014, cash and short-term investments amounted to \$2,390 million and undrawn lines of credit amounted to \$125 million. At March 31, 2013, cash and short-term investments amounted to \$2,056 million and undrawn lines of credit amounted to \$36 million. Air Canada's principal objective in managing liquidity risk is to maintain a minimum unrestricted liquidity level of \$1.7 billion.
- Return on invested capital ("ROIC") at March 31, 2014 of 10.7% versus 8.0% at March 31, 2013. Air Canada's goal is to achieve a sustainable ROIC of 10 to 13% by 2015. Refer to section 15 "Non-GAAP Financial Measures" for additional information.

4. RESULTS OF OPERATIONS – FIRST QUARTER 2014 VERSUS FIRST QUARTER 2013

The following table and discussion compares results of Air Canada for the first quarter 2014 versus the first quarter of 2013.

(Canadian dollars in millions, except per share figures)	First Quarter		Change	
	2014	2013	\$	%
Operating revenues				
Passenger	\$ 2,608	\$ 2,527	\$ 81	3
Cargo	119	111	8	7
Other	338	314	24	8
Total revenues	3,065	2,952	113	4
Operating expenses				
Aircraft fuel	918	870	48	6
Wages, salaries, and benefits	569	564	5	1
Capacity purchase agreements	281	272	9	3
Airport and navigation fees	247	232	15	6
Aircraft maintenance	181	175	6	3
Sales and distribution costs	175	164	11	7
Depreciation, amortization and impairment	130	170	(40)	(24)
Aircraft rent	79	81	(2)	(2)
Food, beverages and supplies	70	66	4	6
Communications and information technology	53	49	4	8
Other	424	415	9	2
Total operating expenses	3,127	3,058	69	2
Operating loss	(62)	(106)	44	
Non-operating income (expense)				
Foreign exchange loss	(161)	(40)	(121)	
Interest income	9	7	2	
Interest expense	(77)	(73)	(4)	
Interest capitalized	5	8	(3)	
Net financing expense relating to employee benefits	(34)	(52)	18	
Loss on financial instruments recorded at fair value	(15)	(2)	(13)	
Other	(6)	(2)	(4)	
Total non-operating expense	(279)	(154)	(125)	
Loss before income taxes	(341)	(260)	(81)	
Income taxes	-	-	-	
Net loss	\$ (341)	\$ (260)	\$ (81)	
Basic and diluted loss per share	\$ (1.20)	\$ (0.95)	\$ (0.25)	
EBITDAR ⁽¹⁾	\$ 147	\$ 145	\$ 2	
Adjusted net loss ⁽²⁾	\$ (132)	\$ (143)	\$ 11	
Adjusted net loss) per share –diluted ⁽²⁾	\$ (0.46)	\$ (0.52)	\$ 0.06	

(1) EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.

(2) Adjusted net income (loss) and adjusted net income (loss) per share – diluted are non-GAAP financial measures. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.

System passenger revenues increased 3.2% from the first quarter of 2013

In the first quarter of 2014, on capacity growth of 3.8%, system passenger revenues of \$2,608 million increased \$81 million or 3.2% from 2013 first quarter system passenger revenues of \$2,527 million. The increase in first quarter system passenger revenues year-over-year was primarily due to a traffic increase of 2.9%, reflecting growth in all markets.

In the first quarter of 2014, system premium cabin revenues increased \$37 million or 7.0% on yield and traffic growth of 4.5% and 2.4%, respectively.

The table below provides passenger revenue by geographic region for the first quarter of 2014 and the first quarter of 2013.

Passenger Revenue	First Quarter 2014 \$ Million	First Quarter 2013 \$ Million	Change \$ Million	% Change
Canada	943	958	(15)	(1.5)
U.S. transborder	621	587	34	5.7
Atlantic	406	375	31	8.3
Pacific	371	367	4	1.2
Other	267	240	27	11.0
System	2,608	2,527	81	3.2

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the first quarter of 2014 versus the first quarter of 2013.

First Quarter 2014 Versus First Quarter 2013	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	PRASM % Change
Canada	(1.5)	3.9	1.7	(1.8)	(3.5)	(5.5)
U.S. transborder	5.7	1.9	5.7	2.9	0.3	4.0
Atlantic	8.3	7.6	1.2	(4.5)	7.1	0.7
Pacific	1.2	4.6	3.2	(1.1)	(1.6)	(2.8)
Other	11.0	(1.0)	3.1	3.3	8.5	12.9
System	3.2	3.8	2.9	(0.7)	0.4	(0.5)

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the first quarter of 2014 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q1'13	Q2'13	Q3'13	Q4'13	Q1'14
Passenger revenues	0.1	3.2	4.9	1.9	3.2
Capacity (ASMs)	(1.1)	2.2	3.0	3.5	3.8
Traffic (RPMs)	1.1	1.6	2.9	2.5	2.9
Passenger load factor (pp change)	1.8	(0.5)	(0.1)	(0.9)	(0.7)
Yield	(1.1)	1.5	2.0	(0.6)	0.4
PRASM	1.1	0.9	1.8	(1.7)	(0.5)

In the first quarter of 2014, Air Canada's system capacity was 3.8% higher than in the first quarter of 2013, with capacity growth reflected in all markets with the exception of the Other markets.

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

- The 2.9% traffic increase which reflected traffic growth in all markets.
- The 0.4% yield increase which reflected yield growth in the U.S. transborder, Atlantic and Other markets. A favourable currency impact of \$38 million also contributed to the yield improvement in the first quarter of 2014.

The 0.5% PRASM decrease was due to a passenger load factor decline of 0.7 percentage points partly offset by the yield improvement of 0.4%. PRASM improvements were recorded in the U.S. transborder, Atlantic and Other markets.

Domestic passenger revenues decreased 1.5% from the first quarter of 2013

In the first quarter of 2014, on capacity growth of 3.9%, domestic passenger revenues of \$943 million decreased \$15 million or 1.5% from the first quarter of 2013. The decrease in domestic passenger revenues was due to a yield decline of 3.5% partly offset by traffic growth of 1.7%.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the first quarter of 2014 and each of the previous four quarters.

Canada	Year-over-Year by Quarter (% Change)				
	Q1'13	Q2'13	Q3'13	Q4'13	Q1'14
Passenger revenues	1.5	3.1	2.1	(1.1)	(1.5)
Capacity (ASMs)	(0.6)	3.1	2.3	3.2	3.9
Traffic (RPMs)	1.8	3.0	1.7	2.6	1.7
Passenger load factor (pp change)	2.0	-	(0.5)	(0.4)	(1.8)
Yield	(0.1)	0.1	0.5	(3.6)	(3.5)
PRASM	2.3	-	-	(4.1)	(5.5)

In the first quarter of 2014, the 3.9% domestic capacity growth mainly reflected capacity increases on transcontinental routes, linking Toronto, Montreal and Ottawa with major western Canadian cities, and on routes within western Canada and to the Maritimes.

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

- The 1.7% traffic increase which reflected traffic growth on transcontinental routes, linking Toronto, Montreal and Ottawa with major western Canadian cities, and on routes within western Canada and to the Maritimes. The traffic growth in the first quarter of 2014 also reflected incremental connecting traffic to international destinations.
- The 3.5% yield decrease which reflected yield declines on all major domestic services, the result of increased industry capacity, significant competitive pricing activities and commercial initiatives in the marketplace related to channels of distribution.

Domestic PRASM decreased 5.5% from the first quarter of 2013 on a 1.8 percentage point decline in passenger load factor and the yield decrease.

U.S. transborder passenger revenues increased 5.7% from the first quarter of 2013

In the first quarter of 2014, on a capacity growth of 1.9%, U.S. transborder passenger revenues of \$621 million increased \$34 million or 5.7% from the first quarter of 2013. The increase in U.S. transborder passenger revenues was due to traffic growth of 5.7% and, to a lesser extent, a yield improvement of 0.3%.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the first quarter of 2014 and each of the previous four quarters.

U.S. transborder	Year-over-Year by Quarter (% Change)				
	Q1'13	Q2'13	Q3'13	Q4'13	Q1'14
Passenger revenues	(2.6)	(0.3)	4.7	8.1	5.7
Capacity (ASMs)	0.4	(0.8)	(1.6)	1.6	1.9
Traffic (RPMs)	1.0	1.6	0.5	4.0	5.7
Passenger load factor (pp change)	0.4	1.9	1.7	1.8	2.9
Yield	(5.5)	(1.7)	4.7	4.2	0.3
PRASM	(4.9)	0.7	7.0	6.6	4.0

In the first quarter of 2014, the U.S. transborder capacity growth of 1.9% reflected capacity increases on certain U.S. long-haul routes, such as San Francisco and Los Angeles, and on services to Florida and Las Vegas. This capacity growth was largely offset by capacity reductions on U.S. short-haul routes, such as New York, Washington, D.C. and Boston, and on certain U.S. long-haul routes, such as Hawaii.

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

- The 5.7% traffic increase which reflected traffic growth on all major U.S. transborder services, with the exception of services to Hawaii where capacity was reduced year-over-year. Consistent with the airline's objective of increasing global international to international connecting traffic through Toronto Pearson International Airport, the first quarter of 2014 experienced higher proportional growth of international to international passenger flows from the U.S.
- The 0.3% yield improvement which reflected higher average fares and a favourable currency impact of \$10 million. The yield growth was achieved in spite of the impact of a higher proportion of longer-haul flying and incremental international to international connecting traffic when compared to the first quarter of 2013.

The 4.0% PRASM increase was mainly due to a 2.9 percentage point improvement in passenger load factor. PRASM improvements were recorded on most major U.S. transborder services.

Atlantic passenger revenues increased 8.3% from the first quarter of 2013

In the first quarter of 2014, on capacity growth of 7.6%, Atlantic passenger revenues of \$406 million increased \$31 million or 8.3% from the first quarter of 2013. The increase in Atlantic passenger revenues was due to yield and traffic growth of 7.1% and 1.2%, respectively.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the first quarter of 2014 and each of the previous four quarters.

Atlantic	Year-over-Year by Quarter (% Change)				
	Q1'13	Q2'13	Q3'13	Q4'13	Q1'14
Passenger revenues	1.9	8.8	11.0	2.7	8.3
Capacity (ASMs)	(2.9)	2.5	2.1	5.9	7.6
Traffic (RPMs)	2.2	0.9	3.1	1.7	1.2
Passenger load factor (pp change)	3.8	(1.3)	0.8	(3.1)	(4.5)
Yield	0.8	7.7	7.6	0.7	7.1
PRASM	6.1	6.0	8.6	(3.2)	0.7

In the first quarter of 2014, the Atlantic capacity growth of 7.6% reflected capacity increases on all major Atlantic services with the exception of services to Scandinavia and Belgium.

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

- The 7.1% yield improvement which reflected higher average fares and a greater proportion of higher-yielding traffic in all cabins, including the airline's premium economy cabin on Montreal – Paris and Vancouver – London. Yield growth was recorded on all major Atlantic services. A favourable currency impact of \$14 million also contributed to the yield improvement year-over-year.
- The 1.2% traffic increase which reflected traffic growth on most major Atlantic services. While a shift of Easter and European spring breaks into April negatively impacted many services in the Atlantic market, the impact was greater on services to the United Kingdom and Germany.

The 0.7% PRASM increase was due to the yield improvement largely offset by a 4.5 percentage point decline in passenger load factor.

Pacific passenger revenues increased 1.2% from the first quarter of 2013

In the first quarter of 2014, on capacity growth of 4.6%, Pacific passenger revenues of \$371 million increased \$4 million or 1.2% from the first quarter of 2013. The increase in Pacific passenger revenues was due to traffic growth of 3.2% partly offset by a yield decline of 1.6%.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the first quarter of 2014 and each of the previous four quarters.

Pacific	Year-over-Year by Quarter (% Change)				
	Q1'13	Q2'13	Q3'13	Q4'13	Q1'14
Passenger revenues	9.2	3.7	3.8	(3.2)	1.2
Capacity (ASMs)	4.0	5.7	12.1	4.4	4.6
Traffic (RPMs)	5.4	2.3	8.5	0.7	3.2
Passenger load factor (pp change)	1.2	(2.9)	(2.9)	(3.0)	(1.1)
Yield	4.0	1.1	(4.8)	(4.0)	(1.6)
PRASM	5.5	(2.3)	(7.9)	(7.4)	(2.8)

In the first quarter of 2014, the 4.6% Pacific capacity growth reflected capacity increases on all major Pacific services with the exception of services to Australia.

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

- The 3.2% traffic increase which reflected traffic growth on all major Pacific services with the exception of services to Australia, where capacity was reduced year-over-year, and on services to Korea which were impacted by increased industry capacity to North America.
- The 1.6% yield decrease which reflected yield declines on services to Japan and Hong Kong. Air Canada's Japan service was adversely impacted by increased industry capacity in the Pacific, aggressive pricing activities and a weaker Japanese Yen when compared to the first quarter of 2013. Significant increased industry capacity and a higher proportion of lower-yielding traffic put pressure on yields on services to Hong Kong. A net favourable currency impact of \$5 million partly offset the yield decline in the first quarter of 2014.

The 2.8% PRASM decrease was due to the yield decline of 1.6% and a 1.1 percentage point decline in passenger load factor.

Other passenger revenues increased 11.0% from the first quarter of 2013

In the first quarter of 2014, on a capacity reduction of 1.0%, Other passenger revenues (comprised of routes to the Caribbean, Mexico and Central and South America) of \$267 million increased \$27 million or 11.0% from the first quarter of 2013. The increase in Other passenger revenues was due to yield and traffic growth of 8.5% and 3.1%, respectively.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the first quarter of 2014 and each of the previous four quarters.

Other	Year-over-Year by Quarter (% Change)				
	Q1'13	Q2'13	Q3'13	Q4'13	Q1'14
Passenger revenues	(12.0)	(5.1)	0.6	11.5	11.0
Capacity (ASMs)	(8.5)	(4.8)	(3.9)	0.6	(1.0)
Traffic (RPMs)	(7.8)	(3.2)	(3.7)	5.0	3.1
Passenger load factor (pp change)	0.6	1.3	0.1	3.4	3.3
Yield	(4.7)	(2.6)	4.1	6.5	8.5
PRASM	(4.0)	(1.0)	4.2	11.1	12.9

In the first quarter of 2014, the 1.0% capacity reduction reflected capacity decreases on services to South America largely offset by capacity growth on routes to sun destinations.

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

- The overall 8.5% yield improvement which reflected higher fares on routes to sun destinations and on services to South America. A favourable currency impact of \$4 million also contributed to the yield improvement year-over-year.
- The overall 3.1% traffic increase which reflected strong passenger demand on routes to sun destinations and on services to South America.

The overall 12.9% PRASM increase was due to the yield growth and a passenger load factor improvement of 3.3 percentage points. PRASM improvements were recorded on all major services in the Other markets.

Cargo revenues increased 7.0% from the first quarter of 2013

In the first quarter of 2014, cargo revenues of \$119 million increased \$8 million or 7.0% from the first quarter of 2013, due to traffic and yield growth of 6.4% and 0.5%, respectively.

The table below provides cargo revenue by geographic region for the first quarter of 2014 and the first quarter of 2013.

Cargo Revenue	First Quarter 2014 \$ Million	First Quarter 2013 \$ Million	Change \$ Million
Canada	14	14	-
U.S. transborder	5	4	1
Atlantic	47	41	6
Pacific	43	41	2
Other	10	11	(1)
System	119	111	8

The table below provides year-over-year percentage changes in system cargo revenues and operating statistics for the first quarter of 2014 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q1'13	Q2'13	Q3'13	Q4'13	Q1'14
Cargo revenues	(8.8)	(6.5)	1.7	1.6	7.0
Capacity (ETMs)	(2.4)	3.5	1.2	3.5	4.1
Revenue per ETM	(6.5)	(9.7)	1.1	(2.2)	2.8
Traffic (RTMs)	(5.1)	(0.2)	2.9	4.3	6.4
Yield per RTM	(3.8)	(6.3)	(0.6)	(2.9)	0.5

The table below provides year-over-year percentage changes in cargo revenues and operating statistics for the first quarter of 2014 versus the first quarter of 2013.

First Quarter 2014 Versus First Quarter 2013	Cargo Revenue % Change	Capacity (ETMs) % Change	Rev / ETM % Change	Traffic (RTMs) % Change	Yield / RTM % Change
Canada	(1.0)	16.3	(14.9)	13.4	(12.7)
U.S. transborder	9.6	8.9	0.6	8.4	1.1
Atlantic	13.4	6.7	6.3	16.1	(2.3)
Pacific	7.0	-	7.0	1.8	5.1
Other	(7.6)	(6.6)	(1.0)	(13.4)	6.7
System	7.0	4.1	2.8	6.4	0.5

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

- The 6.4% traffic increase which reflected traffic growth in all markets with the exception of the Other markets where capacity was reduced year-over-year.
- The 0.5% yield increase which reflected yield growth in all markets with the exception of the domestic and Atlantic markets. The favourable impact of a weaker Canadian dollar on foreign currency denominated cargo revenues was largely offset by the negative impact of increased industry capacity in all markets.

Other revenues increased 8% from the first quarter of 2013

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. In the first quarter of 2014, Other revenues of \$338 million increased \$24 million or 8% from the first quarter of 2013, largely due to higher ground package revenues at Air Canada Vacations, the result of higher passenger volumes. This increase was partly offset by a decrease in aircraft sublease revenues, in part due to the expiry of certain Airbus A340 subleases, when compared to the first quarter of 2013.

CASM decreased 1.5% from the first quarter of 2013. Adjusted CASM decreased 2.5% from the first quarter of 2013

The following table compares Air Canada's first quarter 2014 and first quarter 2013 CASM.

(cents per ASM)	First Quarter		Change	
	2014	2013	cents	%
Aircraft fuel	5.47	5.38	0.09	1.7
Wages and salaries	2.51	2.54	(0.03)	(1.2)
Benefits	0.88	0.95	(0.07)	(7.4)
Capacity purchase agreements	1.68	1.68	-	-
Airport and navigation fees	1.47	1.43	0.04	2.8
Aircraft maintenance	1.08	1.08	-	-
Sales and distribution costs	1.04	1.02	0.02	2.0
Depreciation, amortization and impairment	0.78	1.05	(0.27)	(25.7)
Aircraft rent	0.47	0.50	(0.03)	(6.0)
Food, beverages and supplies	0.42	0.41	0.01	2.4
Communications and information technology	0.32	0.30	0.02	6.7
Other	2.52	2.57	(0.06)	(2.3)
CASM	18.64	18.92	(0.28)	(1.5)
Remove:				
Fuel expense, the cost of ground packages at Air Canada Vacations and unusual items ⁽¹⁾	(6.49)	(6.46)	(0.03)	(0.5)
Adjusted CASM ⁽²⁾	12.15	12.46	(0.31)	(2.5)

(1) In the first quarter of 2013, Air Canada recorded an impairment charge of \$24 million related to Airbus A340-300 aircraft.

(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses increased 2% from the first quarter of 2013

In the first quarter of 2014, operating expenses of \$3,127 million increased \$69 million or 2% from the first quarter of 2013, due to the unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars), when compared to the first quarter of 2013, which increased operating expenses by approximately \$130 million in the first quarter of 2013. Refer to section 8 "Financial Instruments and Risk Management" for information on Air Canada's foreign exchange risk management strategy. These increases were largely offset by the favourable impact of lower jet fuel prices, which reduced operating expenses by \$41 million the first quarter of 2014. In addition, depreciation, amortization and impairment expenses decreased \$40 million when compared to the same quarter in 2013.

Fuel expense increased 6% from the first quarter of 2013

In the first quarter of 2014, fuel expense of \$918 million increased \$48 million or 6% from the first quarter of 2013. The increase in fuel expense year-over-year was due to the unfavourable impact of a weaker Canadian dollar versus the U.S. dollar when compared to the first quarter of 2013, which accounted for a \$71 million increase, and to an increase in the volume of fuel litres consumed, which accounted for an increase of \$18 million. Partly offsetting these increases was the impact of a 5% year-over-year decline in jet fuel prices, which accounted for a decrease of \$41 million to fuel expense in the first quarter of 2014.

The table below provides Air Canada's fuel cost per litre and economic fuel cost per litre for the periods indicated.

(Canadian dollars in millions, except where indicated)	First Quarter		Change	
	2014	2013	\$	%
Aircraft fuel expense – GAAP	\$ 918	\$ 870	\$ 48	6
Add: Net cash payments on fuel derivatives ⁽¹⁾	3	11	(8)	(73)
Economic cost of fuel – Non-GAAP ⁽²⁾	\$ 921	\$ 881	\$ 40	5
Fuel consumption (thousands of litres)	973,021	953,282	19,739	2.1
Fuel cost per litre (cents) – GAAP	94.3	91.3	3.1	3.4
Economic fuel cost per litre (cents) – Non-GAAP ⁽²⁾	94.7	92.4	2.2	2.4

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

(2) The economic cost of fuel is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning, and may not be comparable to similar 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.

Wages, salaries and benefits expense amounted to \$569 million in the first quarter of 2014, an increase of \$5 million or 1% from the first quarter of 2013

In the first quarter of 2014, wages and salaries expense of \$421 million increased \$11 million or 3% from the first quarter of 2013, in large part due to higher average salaries when compared to the same quarter in 2013.

In the first quarter of 2014, employee benefits expense of \$148 million decreased \$6 million or 4% from the first quarter of 2013, mainly due to the impact of higher discount rates which decreases the current service cost of pension and other employee benefits.

Capacity purchase costs increased 3% from the first quarter of 2013

In the first quarter of 2014, capacity purchase costs of \$281 million increased \$9 million or 3% from the first quarter of 2013, mainly due to an increase in block hours flown by Sky Regional under its capacity purchase agreement with Air Canada, an unfavourable currency impact and higher rates under the Jazz CPA. These increases were partly offset by a decline in block hours flown by Jazz under the Jazz CPA.

Airport and navigation fees increased 6% from the first quarter of 2013

In the first quarter of 2014, airport and navigation fees of \$247 million increased \$15 million or 6% from the first quarter of 2013, largely due to the addition of five Boeing 777 aircraft to Air Canada's operating fleet, an unfavourable currency impact and rate increases in certain stations.

Aircraft maintenance expense increased 3% from the first quarter of 2013

In the first quarter of 2014, aircraft maintenance expense of \$181 million increased \$6 million or 3% from the first quarter of 2013. This increase in aircraft maintenance expense was mainly due to the impact of Air Canada having recorded favourable accrual adjustments of \$15 million in 2013 while no such adjustments were recorded in the first quarter of 2014. A \$13 million unfavourable currency impact was also a contributing factor in the increase in aircraft maintenance expense year-over-year. These increases were largely offset by the impact of a lower volume of engine and airframe maintenance activity, mainly driven by the timing of scheduled maintenance events, when compared to the same quarter in 2013.

Sales and distribution costs increased 7% from the first quarter of 2013

In the first quarter of 2014, sales and distribution costs of \$175 million increased \$11 million or 7% from the first quarter of 2013 on passenger revenue growth of 3.2%. This growth in sales and distribution costs was due to an increase in transaction fees paid to global distribution service providers, the result of a higher volume of transactions, in part due to commercial initiatives put in place in the first quarter of 2014. An increase in credit card expenses, which

was in line with sales and revenue growth, and an unfavourable currency impact were also contributing factors to the increase in sales and distribution costs year-over-year. Partly offsetting these increases was a decrease in commission expense when compared to the first quarter of 2013.

Depreciation, amortization and impairment expense decreased 24% from the first quarter of 2013

In the first quarter of 2014, depreciation, amortization and impairment expense of \$130 million decreased \$40 million or 24% from the first quarter of 2013. In the first quarter of 2013, Air Canada recorded an impairment charge of \$24 million related to certain A340-300 aircraft. No such charge was recorded in the first quarter of 2014. In addition, the expense decrease was also due to the impact of certain engine and airframe maintenance events becoming fully amortized, the disposal of CRJ-100 aircraft (previously operated by Jazz) and Airbus A340-300 aircraft (none of which were operated by Air Canada), as well as a decrease in depreciation expense related to the airline's interior refurbishment programs.. These decreases were partly offset by the impact of the addition of five Boeing 777 aircraft.

Aircraft rent expense decreased 2% from the first quarter of 2013

In the first quarter of 2014, aircraft rent expense of \$79 million decreased \$2 million or 2% from the first quarter of 2013. A decrease in aircraft rent expense due to more favourable rates on lease renewals was largely offset by an unfavourable currency impact of \$7 million.

Other operating expenses increased 2% from the first quarter of 2013

In the first quarter of 2014, Other operating expenses of \$424 million increased \$9 million or 2% from the first quarter of 2013, mainly due to higher expenses relating to ground packages at Air Canada Vacations, the result of higher rates (including an unfavourable currency impact) and increased passenger volumes. Largely offsetting this increase was a decrease in miscellaneous fees and services and various other expense reductions, including lower engine and rotatable equipment rental costs. In addition, one-time start-up expenses related to the transfer of Embraer 175 aircraft from the mainline fleet to Sky Regional were incurred in the first quarter of 2013 while no such charges were recorded in the first quarter of 2014.

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

(Canadian dollars in millions)	First Quarter		Change	
	2014	2013	\$	%
Air Canada Vacations' land costs	\$ 170	\$ 150	\$ 20	13
Terminal handling	52	46	6	13
Building rent and maintenance	38	33	5	15
Crew cycle	32	30	2	7
Miscellaneous fees and services	26	34	(8)	(24)
Remaining other expenses	106	122	(16)	(13)
Other operating expenses	\$ 424	\$ 415	\$ 9	2

Non-operating expense amounted to \$279 million in the first quarter of 2014 compared to non-operating expense of \$154 million in the first quarter of 2013

The following table provides a breakdown of Non-operating expense for the periods indicated:

(Canadian dollars in millions)	First Quarter		Change
	2014	2013	\$
Foreign exchange loss	\$ (161)	\$ (40)	\$ (121)
Interest income	9	7	2
Interest expense	(77)	(73)	(4)
Interest capitalized	5	8	(3)
Net financing expense relating to employee benefits	(34)	(52)	18
Loss on financial instruments recorded at fair value	(15)	(2)	(13)
Other	(6)	(2)	(4)
Total non-operating expense	\$ (279)	\$ (154)	\$ (125)

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

- Losses on foreign exchange, mainly related to U.S. denominated long-term debt, which amounted to \$161 million in the first quarter of 2014 compared to losses of \$40 million in the first quarter of 2013. The losses in the first quarter of 2014 were mainly attributable to a weaker Canadian dollar at March 31, 2014 when compared to December 31, 2013. The March 31, 2014 closing exchange rate was US\$1 = C\$1.1055 while the December 31, 2013 closing exchange rate was US\$1 = C\$1.0636. The loss on foreign exchange in the first quarter of 2014 included a loss of \$21 million related to the exchange rate changes in Venezuela applicable to funds held in the local currency. As at March 31, 2014 Air Canada had cash of \$27 million held in Venezuela, and the airline is working on repatriating these funds.
- A decrease in net financing expense relating to employee benefits of \$18 million which was mainly due to the impact of lower pension liabilities.
- Losses related to fair value adjustments on financial instruments which amounted to \$15 million in the first quarter of 2014 versus losses of \$2 million in the first quarter of 2013. Refer to section 8 "Financial Instruments and Risk Management" of this MD&A for additional information.

5. FLEET

Mainline and Air Canada rouge

The following table provides the number of aircraft in Air Canada's operating fleet as at March 31, 2014 and December 31, 2013, as well as Air Canada's expected operating fleet, including aircraft currently operated and expected to be operated by Air Canada *rouge*, as at December 31, 2014, December 31, 2015 and December 31, 2016.

	Actual			Planned					
	December 31, 2013	First Quarter 2014 Fleet Changes	March 31, 2014	2014 Fleet Changes	December 31, 2014	2015 Fleet Changes	December 31, 2015	2016 Fleet Changes	December 31, 2016
Mainline									
Boeing 787-8	-	-	-	6	6	4	10	3	13
Boeing 787-9	-	-	-	-	-	2	2	5	7
Boeing 777-300	16	1	17	1	17	-	17	-	17
Boeing 777-200	6	-	6	-	6	-	6	-	6
Boeing 767-300	27	(2)	25	(6)	21	(4)	17	(4)	13
Boeing 737 MAX	-	-	-	-	-	-	-	-	-
Airbus A330-300	8	-	8	-	8	-	8	-	8
Airbus A321 ⁽¹⁾	10	-	10	-	10	5	15	-	15
Airbus A320 ⁽¹⁾	41	-	41	-	41	5	46	-	46
Airbus A319	30	(5)	25	(17)	13	(5)	8	-	8
EMBRAER 190	45	-	45	-	45	(20)	25	-	25
Total Mainline	183	(6)	177	(16)	167	(13)	154	4	158
Air Canada rouge									
Boeing 767-300	2	2	4	6	8	4	12	2	14
Airbus A319	8	5	13	17	25	5	30	-	30
Total Air Canada rouge	10	7	17	23	33	9	42	2	44
Total Mainline and Air Canada rouge	193	1	194	7	200	(4)	196	6	202

(1) In 2015, Air Canada plans to replace 20 Embraer 190 aircraft with 10 larger narrow-body leased aircraft. As of the date of this MD&A, the type of replacement aircraft has not yet been determined; solely for illustrative purposes, Air Canada has assumed these to be five Airbus A320 and five Airbus A321 aircraft.

On March 31, 2014, Air Canada concluded an agreement with The Boeing Company (“Boeing”) for the purchase of Boeing 737 MAX aircraft to replace the airline’s narrow-body aircraft. Refer to section 6.6 of this MD&A for additional information. The renewal of its narrow-body fleet with more fuel efficient aircraft is a key element of Air Canada’s on-going cost transformation program. As part of the Boeing 737 MAX order, Boeing will be purchasing 20 of the 45 Embraer 190 aircraft currently in the airline’s fleet. The Embraer 190 aircraft exiting the fleet will initially be replaced with larger leased narrow-body aircraft until the airline takes delivery of the Boeing 737 MAX aircraft. Air Canada has also been reviewing its options regarding its remaining 25 Embraer 190 aircraft and, after a comprehensive analysis, the airline has decided to continue to operate these aircraft as part of its mainline narrow-body fleet.

Air Canada Express

The following table provides, as at March 31, 2014, the number of aircraft operated by Jazz, Sky Regional and other airlines operating flights on behalf of Air Canada under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada.

	As at March 31, 2014			
	Jazz	Sky Regional	Other	Total
EMBRAER 175	–	15	–	15
CRJ-200	25	–	–	25
CRJ-705	16	–	–	16
Dash 8-100	34	–	–	34
Dash 8-300	26	–	–	26
Dash 8-400	21	5	–	26
Beech 1900	–	–	17	17
Total	122	20	17	159

The following table provides, as at December 31, 2014, the number of aircraft planned to be operated by Jazz, Sky Regional and other airlines operating flights on behalf of Air Canada under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada.

	Planned - December 31, 2014			
	Jazz	Sky Regional	Other	Total
EMBRAER 175	–	15	–	15
CRJ-100	–	–	5	5
CRJ-200	25	–	–	25
CRJ-705	16	–	–	16
Dash 8-100	34	–	–	34
Dash 8-300	26	–	–	26
Dash 8-400	21	5	–	26
Beech 1900	–	–	17	17
Total	122	20	22	164

6. FINANCIAL AND CAPITAL MANAGEMENT

6.1. Liquidity

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

Liquidity needs are primarily related to meeting obligations associated with financial liabilities, capital commitments, ongoing operations, contractual and other obligations (including pension funding obligations), and covenants in credit card and other agreements. Refer to sections 6.6, 6.7 and 6.8 of this MD&A for information on Air Canada's capital commitments, pension funding obligations and contractual obligations. At March 31, 2014, unrestricted liquidity amounted to \$2,515 million, comprised of cash and short-term investments of \$2,390 million and undrawn lines of credit of \$125 million. This compared to unrestricted liquidity of \$2,092 million (comprised of cash and short-term investments of \$2,056 million and undrawn lines of credit of \$36 million). Air Canada's principal objective in managing liquidity risk is to maintain a minimum unrestricted liquidity level of \$1.7 billion.

6.2. Financial Position

The following table provides a condensed consolidated statement of financial position of Air Canada as at March 31, 2014 and as at December 31, 2013.

(Canadian dollars in millions)	March 31, 2014	December 31, 2013	\$ Change
Assets			
Cash, cash equivalents and short-term investments	\$ 2,390	\$ 2,208	\$ 182
Other current assets	1,201	1,080	121
Current assets	3,591	3,288	303
Property and equipment	5,264	5,073	191
Intangible assets	302	304	(2)
Goodwill	311	311	-
Deposits and other assets	496	494	2
Total assets	\$ 9,964	\$ 9,470	\$ 494
Liabilities			
Current liabilities	\$ 3,776	\$ 3,190	586
Long-term debt and finance leases	4,191	3,959	232
Pension and other benefit liabilities	2,877	2,687	190
Maintenance provisions	693	656	37
Other long-term liabilities	374	375	(1)
Total liabilities	11,911	10,867	1,044
Total equity	(1,947)	(1,397)	(550)
Total liabilities and equity	\$ 9,964	\$ 9,470	\$ 494

Movements in current assets and current liabilities are described in section 6.4 of this MD&A. Long-term debt and finance leases are discussed in sections 6.3, 6.5 and 6.8 of this MD&A.

At March 31, 2014, Property and equipment amounted to \$5,264 million, an increase of \$191 million from December 31, 2013. The increase in Property and equipment was mainly due to additions to property and equipment of \$303 million in the first quarter of 2014, largely offset by the impact of depreciation expense of \$117 million. The additions to Property and equipment included flight equipment purchases of \$132 million, which included one Boeing 777-300ER aircraft delivered in February 2014, purchase deposits and assets under development of \$127 million and capitalized maintenance costs of \$17 million.

At March 31, 2014, Pension and other benefit liabilities increased \$190 million from December 31, 2013, mainly due to the impact of a decrease in the discount rate used to value the liabilities, largely offset by actuarial gains on the market value of plan assets, resulting in a net loss in Other comprehensive income of \$203 million in the first quarter of 2014. At March 31, 2014, 70% of the pension liabilities are matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk. Pension funding payments of \$107 million were made in the first quarter of 2014. Refer to section 9.7 "Pension Funding Obligations" of Air Canada's 2013 MD&A dated February 12, 2014 for additional information on Air Canada's pension funding obligations.

6.3. Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at March 31, 2014 and as at December 31, 2013.

(Canadian dollars in millions, except where indicated)	March 31, 2014	December 31, 2013	\$ Change
Total long-term debt and finance leases	\$ 4,191	\$ 3,959	\$ 232
Current portion of long-term debt and finance leases	413	374	39
Total long-term debt and finance leases, including current portion	4,604	4,333	271
Less cash, cash equivalents and short-term investments	(2,390)	(2,208)	(182)
Net debt	\$ 2,214	\$ 2,125	\$ 89
Capitalized operating leases ⁽¹⁾	2,212	2,226	(14)
Adjusted net debt	\$ 4,426	\$ 4,351	\$ 75
EBITDAR (excluding benefit plan amendments) (trailing 12 months)	\$ 1,435	\$ 1,433	\$ 2
Adjusted net debt to EBITDAR ratio	3.1	3.0	0.1

(1) Adjusted net debt is a non-GAAP financial measure used by Air Canada and may not be comparable to measures presented by other public companies. Adjusted net debt is a key component of the capital managed by Air Canada and provides management with a measure of its net indebtedness. Air Canada includes capitalized operating leases which is a measure commonly used in the industry to ascribe a value to obligations under operating leases. Common industry practice is to multiply annualized aircraft rent expense by 7.0. 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 \$316 million for the twelve months ended March 31, 2014 and \$318 million for the twelve months ended December 31, 2013.

At March 31, 2014, total long-term debt and finance leases, including current portion, amounted to \$4,604 million, an increase of \$271 million from December 31, 2013. Air Canada took delivery of the fifth and final Boeing 777-300ER aircraft which was financed under the private offering of enhanced equipment trust certificates, which is further discussed in section 6.8 of Air Canada's 2013 MD&A dated February 12, 2014. The unfavourable impact of a weaker Canadian dollar as at March 31, 2014 compared to December 31, 2013 on Air Canada's foreign currency denominated debt (mainly U.S. dollars), which accounted for an increase of \$155 million, was also a contributing factor to the increase to long-term debt and finance leases.

Adjusted net debt amounted to \$4,426 million at March 31, 2014, an increase of \$75 million from December 31, 2013, mainly due to the higher long-term debt and finance lease balances partially offset by higher cash balances.

At March 31, 2014, the adjusted net debt to EBITDAR ratio amounted to 3.1 versus a ratio of 3.0 at December 31, 2013. Air Canada uses this ratio to manage its financial leverage risk and has an objective to maintain the ratio below 3.5.

At March 31, 2014, Air Canada's weighted average cost of capital ("WACC") was approximately 8.8%. WACC is based on an estimate by management and consists of an estimated cost of equity of 22% and an average cost of debt and finance leases of 6%.

Unsecured Financing

In April 2014, Air Canada completed a private offering of US\$400 million of 7.75% senior unsecured notes due 2021 (the "Notes"). Air Canada received net proceeds of approximately \$432 million from the sale of the Notes and will use these proceeds for general corporate purposes. The Notes were sold at par and provide for interest payable semi-annually. The Notes are senior unsecured obligations of Air Canada, and are guaranteed on a senior unsecured basis by one of Air Canada's subsidiaries.

6.4. Working Capital

The following table provides information on Air Canada's working capital balances as at March 31, 2014 and as at December 31, 2013.

(Canadian dollars in millions)	March 31, 2014	December 31, 2013	\$ Change
Cash, cash equivalents and short-term investments	\$ 2,390	\$ 2,208	\$ 182
Accounts receivable	756	589	167
Other current assets	445	491	(46)
Accounts payable and accrued liabilities	(1,239)	(1,129)	(110)
Advance ticket sales	(2,124)	(1,687)	(437)
Current portion of long-term debt and finance leases	(413)	(374)	(39)
Net working capital	\$ (185)	\$ 98	\$ (283)

The net negative working capital of \$185 million at March 31, 2014 represented a deterioration of \$283 million from December 31, 2013. This deterioration in net working capital was largely due to the impact of capital expenditures of \$310 million (or \$152 million net of the financing drawn upon the delivery of the Boeing 777-300ER received during the first quarter of 2014), pension funding payments of \$107 million and the impact of operating results in the first quarter of 2014. The increase in Accounts receivable and Advance ticket sales is consistent with the seasonal growth in demand leading into the second and third quarters at Air Canada.

6.5. 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		
	2014	2013	\$ Change
Net cash flows from operating activities	\$ 344	\$ 261	\$ 83
Proceeds from borrowings	197	13	184
Reduction of long-term debt and finance lease obligations	(81)	(96)	15
Net cash flows from (used in) financing activities	116	(83)	199
Short-term investments	(30)	17	(47)
Additions to property, equipment and intangible assets	(310)	(114)	(196)
Proceeds from sale of assets	2	4	(2)
Other	3	10	(7)
Net cash flows used in investing activities	(335)	(83)	(252)
Increase in cash and cash equivalents	125	95	30
Cash and cash equivalents, beginning of period	750	754	(4)
Cash and cash equivalents, end of period	\$ 875	\$ 849	\$ 26

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

(Canadian dollars in millions)	First Quarter		
	2014	2013	\$ Change
Net cash flows from operating activities	\$ 344	\$ 261	\$ 83
Additions to property, equipment and intangible assets	(310)	(114)	(196)
Free cash flow ⁽¹⁾	\$ 34	\$ 147	\$ (113)

(1) Free cash flow is a non-GAAP financial 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 generated from the business after investing in capital assets, which is available to meet ongoing financial obligations, including repaying debt, and reinvesting in Air Canada.

Free cash flow

Free cash flow declined \$113 million in the first quarter of 2014 compared to the first quarter of 2013. While operating cash flows improved year-over-year, which was consistent with the improvement in net cash flows from operating activities, free cash flow was impacted by the addition of the fifth and final Boeing 777-300ER aircraft delivered in February 2014. This aircraft was financed through the proceeds from the private offering of enhanced equipment trust certificates, which is further described in section 6.6 of Air Canada's 2013 MD&A dated February 12, 2014.

Net cash flows from (used in) financing activities

Proceeds from borrowings amounted to \$197 million in the first quarter of 2014. Air Canada received proceeds of \$158 million representing the portion of the proceeds under the private offering of enhanced equipment trust certificates available upon the delivery of the last of five Boeing 777-300ER aircraft in February 2014. Reduction of long-term debt and finance lease obligations amounted to \$81 million in the first quarter of 2014.

6.6. Capital Expenditures and Related Financing Arrangements

Aircraft and Related Financing

As at December 31, 2013, Air Canada had outstanding purchase commitments with Boeing for the acquisition of 37 Boeing 787 aircraft. The first six deliveries are scheduled for 2014 and the remaining 31 between 2015 and 2019. Air Canada also has purchase options for 13 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing and delivery positions) and purchase rights for 10 Boeing 787 aircraft (entitling Air Canada to purchase aircraft based on Boeing's then current pricing). In addition, Air Canada has purchase rights for 13 Boeing 777 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing). The last of five Boeing 777-300ER aircraft purchased by Air Canada was delivered in February 2014, and financed through proceeds from the private offering of enhanced equipment trust certificates, which is further described in section 6.6 of Air Canada's 2013 MD&A dated February 12, 2014.

In the first quarter of 2014, Air Canada concluded an agreement with Boeing for the purchase of Boeing 737 MAX aircraft. The agreement includes firm orders for 33 737 MAX 8 and 28 737 MAX 9 aircraft, with substitution rights between them as well as for the 737 MAX 7 aircraft. It also provides for options for 18 aircraft and certain rights to purchase an additional 30 aircraft. Deliveries are scheduled to begin in 2017 with two aircraft, and the remaining deliveries between 2018 and 2021, subject to certain deferral and acceleration rights.

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

Subject to certain conditions, Air Canada has financing commitments covering up to 31 of the 37 Boeing 787 firm aircraft orders. This includes final commitments from Export-Import Bank of the United States ("EXIM"), subject to documentation and other conditions, for five Boeing 787 aircraft scheduled for delivery in 2014, and preliminary commitments from EXIM for two 787 aircraft scheduled for delivery in 2015.

The financing terms for the remaining 24 of the 31 financing commitments for the Boeing 787 aircraft are as follows: For 22 of the 787 aircraft, the financing terms are for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments. For the other two 787 aircraft, the financing under the commitment covers up to 90% of the capital expenditure and the term to maturity is 15 years with principal payments made on a mortgage-style basis resulting in equal installment payments of principal and interest over the term to maturity.

As a result of certain agreements finalized in the first quarter of 2014, certain of the financing commitments for the Boeing 787 aircraft and/or the Boeing 737 MAX aircraft will be reduced, although the specifics of the reduction have not yet been determined. Taking the financing reduction into consideration, the total committed financing on these aircraft will be at least \$4.8 billion.

In order to improve the economics of the airline's existing Boeing 777 long-haul fleet and to provide customers with a consistent product to its new Boeing 787 Dreamliners, Air Canada is planning on converting 12 Boeing 777-300ER and six Boeing 777-200LR aircraft into a higher density configuration, including the addition of a premium economy cabin and the refurbishing of the International Business Class cabin to Boeing 787 standards. The reconfiguration is designed to both lower unit costs and to allow Air Canada to compete more effectively with a harmonized product offering across its international wide-body Boeing 777 fleet. The reconfiguration project is planned to start in late 2015 and be completed in the second half of 2016. The capital expenditures related to this reconfiguration program have been included in the table below.

Capital Commitments

As outlined in the table below, the estimated aggregate cost of the future firm Boeing 787 and Boeing 737 MAX aircraft deliveries and other capital purchase commitments as at March 31, 2014 approximates \$8,474 million.

(Canadian dollars in millions)	Remainder of 2014	2015	2016	2017	2018	Thereafter	Total
Projected committed expenditures	\$ 884	\$ 985	\$ 1,353	\$ 1,704	\$ 1,431	\$ 2,177	\$ 8,474
Projected planned but uncommitted expenditures	12	249	211	248	286	not available	not available
Projected planned but uncommitted capitalized maintenance ⁽¹⁾	161	149	123	123	123	not available	not available
Total projected expenditures ⁽²⁾	1,057	1,383	1,687	2,075	1,840	not available	not available

(1) The table above includes certain maintenance events which are capitalized under IFRS. Future capitalized maintenance amounts for 2016 and beyond are not yet determinable however an estimate of \$123 million has been made.

(2) U.S. dollar amounts are converted using the March 31, 2014 closing exchange rate of US\$1 = C\$1.1055. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day U.S. LIBOR rate at March 31, 2014.

6.7. Pension Funding Obligations

Information on Air Canada's pension funding obligations is disclosed in section 9.7 "Pension Funding Obligations" of Air Canada's 2013 MD&A dated February 12, 2014.

6.8. Contractual Obligations

The table below provides interest and principal repayment obligations on Air Canada's long-term debt and finance lease obligations as at March 31, 2013.

(Canadian dollars in millions)	Remainder of 2014	2015	2016	2017	2018	Thereafter	Total
<i>Principal</i>							
Long-term debt obligations	\$ 266	\$ 375	\$ 558	\$ 452	\$ 436	\$ 2,263	\$ 4,350
Finance lease obligations	48	63	27	28	30	125	322
Total principal obligations	314	438	585	480	466	2,388	4,671
<i>Interest</i>							
Long-term debt obligations	184	230	189	196	146	200	1,145
Finance lease obligations	23	24	19	17	14	37	134
Total interest obligations	207	254	208	213	160	237	1,279
Total long-term debt and finance lease obligations	\$ 521	\$ 692	\$ 793	\$ 693	\$ 626	\$ 2,625	\$ 5,950
Operating lease obligations	\$ 282	\$ 323	\$ 269	\$ 239	\$ 206	\$ 442	\$ 1,761
Committed capital expenditures	\$ 884	\$ 985	\$ 1,353	\$ 1,704	\$ 1,431	\$ 2,117	\$ 8,474
Total contractual obligations	\$ 1,687	\$ 2,000	\$ 2,414	\$ 2,636	\$ 2,264	\$ 5,184	\$ 16,185

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

(2) The table above excludes the future minimum non-cancelable commitment under the Jazz CPA of \$801 million in 2014, the future minimum non-cancelable commitment under capacity purchase agreements with other regional carriers of \$109 million in 2014 and the minimum annual commitment to purchase Aeroplan® Miles from Aeroplan of \$218 million for 2014. Future commitments for 2015 and beyond are not yet determinable.

6.9. Share Information

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

	Number of Shares at		
	April 30, 2014	March 31, 2014	December 31, 2013
Issued and outstanding shares			
Class A variable voting shares	38,868,505	38,950,109	26,577,512
Class B voting shares	247,029,423	246,930,230	257,954,927
Total issued and outstanding shares	285,897,928	285,880,339	284,532,439
Class A variable voting and Class B voting shares potentially issuable			
Shares held in trust for employee recognition award	-	-	1,337,377
Stock options	11,188,442	10,047,321	10,079,694
Total shares potentially issuable	11,188,442	10,047,321	11,417,071
Total outstanding and potentially issuable shares	297,086,370	295,927,660	295,949,510

Earnings per Share

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

	First Quarter	
	2014	2013
Weighted average number of shares outstanding – basic	285	274
Effect of dilution	8	8
add back anti-dilutive impact	(8)	(8)
Weighted average number of shares outstanding - diluted	285	274

7. QUARTERLY FINANCIAL DATA

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

(Canadian dollars in millions, except where indicated)	2012			2013				2014
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Operating revenues	\$ 2,988	\$ 3,326	\$ 2,839	\$ 2,952	\$ 3,057	\$ 3,479	\$ 2,894	\$ 3,065
Aircraft fuel	888	963	821	870	831	1,002	831	918
Ownership (DAR) ⁽¹⁾⁽²⁾	249	255	236	251	211	210	224	209
Other operating expenses ⁽³⁾	1,788	1,685	1,735	1,937	1,841	1,851	1,704	2,000
Operating expenses	2,925	2,903	2,792	3,058	2,883	3,063	2,759	3,127
Operating income (loss)	63	423	47	(106)	174	416	135	(62)
Total non-operating income (expense) ⁽⁴⁾	(223)	(64)	(107)	(154)	(197)	(125)	(141)	(279)
Income taxes	(1)	-	-	-	-	8	-	
Net income (loss)	\$ (161)	\$ 359	\$ (60)	\$ (260)	\$ (23)	\$ 299	\$ (6)	\$ (341)
Diluted earnings (loss) per share	\$ (0.59)	\$ 1.28	\$ (0.22)	\$ (0.95)	\$ (0.09)	\$ 1.05	\$ (0.02)	\$ (1.20)
EBITDAR, excluding benefit plan amendments ⁽³⁾⁽⁵⁾	\$ 312	\$ 551	\$ 283	\$ 145	\$ 385	\$ 626	\$ 277	\$ 147
EBITDAR ⁽⁵⁾	\$ 312	\$ 678	\$ 283	\$ 145	\$ 385	\$ 626	\$ 359	\$ 147
Adjusted net income (loss) ⁽⁶⁾	\$ (7)	\$ 229	\$ (5)	\$ (143)	\$ 115	\$ 365	\$ 3	\$ (132)
Adjusted net income (loss) per diluted share ⁽⁶⁾	\$ (0.02)	\$ 0.82	\$ (0.02)	\$ (0.52)	\$ 0.41	\$ 1.29	\$ 0.01	\$ (0.46)

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

(2) In the first quarter of 2013, Air Canada recorded an impairment charge of \$24 million related to Airbus A340-300 aircraft.

(3) In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of \$82 million related to changes to early retirement provisions in Air Canada's defined benefit pension plans. In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(4) In the third quarter of 2013, Air Canada recorded an interest charge of \$95 million related to the purchase of its senior secured notes which were to become due in 2015 and 2016.

(5) EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.

(6) Adjusted net income (loss) and adjusted net income (loss) per diluted share are non-GAAP financial measures. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.

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

	2012			2013				2014
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Revenue passenger miles (millions)	13,868	16,258	12,574	13,087	14,093	16,726	12,882	13,466
Available seat miles (millions)	16,606	18,835	15,484	16,164	16,972	19,404	16,033	16,774
Passenger load factor (%)	83.5	86.3	81.2	81.0	83.0	86.2	80.3	80.3
Passenger PRASM (cents)	15.9	15.9	16.0	15.4	16.0	16.2	15.7	15.3
CASM, excluding benefit plan amendments (cents) ⁽¹⁾	17.6	16.1	18.0	18.9	17.0	15.8	17.7	18.6
Adjusted CASM (cents) ⁽²⁾	11.9	10.7	12.4	12.5	11.7	10.4	12.1	12.2
Economic fuel price per litre (cents) ⁽³⁾	90.8	87.7	88.1	92.4	85.7	89.6	88.4	94.7

(1) In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of \$82 million related to changes to early retirement provisions in Air Canada's defined benefit pension plans. In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 15 "Non-GAAP Financial Measures" of this MD&A for additional information.

(3) Includes fuel handling expenses. Economic fuel price per litre is a non-GAAP financial measure. Refer to section 4 "Results of Operations" of this MD&A for additional information.

8. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Summary of "Gain (Loss) on Financial Instruments Recorded at Fair Value"

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

(Canadian dollars in millions)	First Quarter	
	2014	2013
Fuel derivatives	\$ (2)	\$ (11)
Share forward contracts	(14)	9
Interest rate swaps	1	-
Loss on financial instruments recorded at fair value	\$ (15)	\$ (2)

Fuel Price Risk Management

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

In the first quarter of 2014:

- Air Canada recorded a loss of \$2 million in Loss on financial instruments recorded at fair value on Air Canada's consolidated statement of operations related to fuel derivatives (\$11 million loss in the first quarter of 2013).
- Air Canada purchased crude-oil and refined products-based call options and call spreads covering a portion of 2014 fuel exposure. The cash premium related to these contracts was \$10 million.
- Fuel derivative contracts cash settled with a fair value of \$7 million in favour of Air Canada.

As at March 31, 2014, approximately 27% of Air Canada's anticipated purchases of jet fuel for the remainder of 2014 is hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US\$103 per barrel. Air Canada's contracts to hedge anticipated jet fuel purchases over the 2014 period are comprised of call options with notional volumes of 5,562,000 barrels. The fair value of the fuel derivatives portfolio at March 31, 2014 was \$21 million in favour of Air Canada (\$20 million in favour of Air Canada as at December 31, 2013) and is recorded within Prepaid expenses and other current assets on Air Canada's consolidated statement of financial position.

Foreign Exchange Risk

In order to manage exposure to the U.S dollar and other foreign exchange exposures, Air Canada holds U.S. dollar cash reserves and enters into currency derivative contracts. These derivatives and U.S. dollar cash reserves serve to mitigate the cash flow exposure from adverse currency movements. The benefit of these hedging activities is recorded as a foreign exchange gain or loss in non-operating expense on Air Canada's consolidated statement of operations (not within operating income).

As at March 31, 2014, Air Canada had outstanding foreign currency options and swap agreements, settling in 2014 and 2015, to purchase at maturity \$3,094 million of U.S. dollars at a weighted average rate at maturity of \$1.0551 per US\$1.00. Air Canada also has protection in place to sell a portion of its excess Euros and Sterling against U.S. dollars. The increase in level of foreign exchange derivatives outstanding at March 31, 2014 reflects the significant capital expenditure program for 2014 and an increase in target coverage from 50% to 60% of the net U.S. dollar exposure on a rolling 15-month basis. As at March 31, 2014, based on the notional amount of currency derivatives outstanding at that time, approximately 75% of net U.S. cash outflows were hedged for the remainder of 2014 and approximately 53% for 2015.

While the weighted average foreign exchange rate of the derivative portfolio is favourable as compared to the closing exchange rate on March 31, 2014, the hedging structures put in place have various option pricing features, such as knock-out terms and multipliers, and based on the assumed volatility used in the fair value calculation, the fair value of these foreign currency contracts as at March 31, 2014 was \$14 million in favour of the counterparties (December 31, 2013 – \$13 million in favour of Air Canada). These derivative instruments have not been designated as hedges for accounting purposes and are recorded at fair value. In the first three months of 2014, an unrealized loss of \$4 million was recorded in Foreign exchange gain (loss) on Air Canada's consolidated statement of operations related to these derivatives (2013 – \$23 million gain). In the first three months of 2014, foreign exchange derivative contracts cash settled with a net fair value of \$23 million in favour of Air Canada (2013 - \$12 million in favour of Air Canada).

Air Canada also holds U.S. cash reserves as an economic hedge against changes in the value of the U.S. dollar. U.S. dollar cash and short-term investment balances as at March 31, 2014 amounted to \$803 million (US\$726 million) (\$791 million (US\$743 million) as at December 31, 2013). In the first three months of 2014, an unrealized gain of \$29 million (2013 – unrealized gain of \$12 million) was recorded in Foreign exchange gain (loss) on Air Canada's consolidated statement of operations reflecting the change in Canadian equivalent market value of the U.S. dollar cash and short-term investment balances held.

9. CRITICAL ACCOUNTING ESTIMATES

Information on Air Canada's critical accounting estimates is disclosed in section 13 "Critical Accounting Estimates" of Air Canada's 2013 MD&A dated February 12, 2014. There have been no material changes to Air Canada's critical accounting estimates from what was disclosed at that time.

10. ACCOUNTING POLICIES

Air Canada's accounting policies are as disclosed in Air Canada's audited consolidated financial statements and notes for 2013. There have been no material changes to Air Canada's accounting policies from what was disclosed at that time.

11. OFF-BALANCE SHEET ARRANGEMENTS

Information on Air Canada's off-balance sheet arrangements is disclosed in section 15 "Off-Balance Sheet Arrangements" of Air Canada's 2013 MD&A dated February 12, 2014. 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, 2014, Air Canada had no transactions with related parties as defined in the CPA Handbook, except those pertaining to transactions with key management personnel in the ordinary course of their employment or directorship agreements.

13. RISK FACTORS

For a detailed description of risk factors associated with Air Canada and its business, refer to section 18 "Risk Factors" of Air Canada's 2013 MD&A dated February 12, 2014. Air Canada is not aware of any significant changes to its risk factors from those disclosed at that time.

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 2013 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 2014 filings, the Corporation's CEO and CFO, certified, 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 unaudited condensed consolidated financial statements and notes, and the Corporation's Board of Directors approved these documents prior to their release.

Changes in Internal Controls over Financial Reporting

There have been no changes to the Corporation's internal controls over financial reporting during the quarter ended March 31, 2014 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

15. NON-GAAP FINANCIAL MEASURES

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, 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, does not have a standardized meaning, and may not be comparable to similar measures presented by other public companies.

EBITDAR is reconciled to operating income as follows:

(Canadian dollars in millions)	First Quarter		
	2014	2013	\$ Change
GAAP operating income (loss)	\$ (62)	\$ (106)	\$ 44
Add back:			
Aircraft rent	79	81	(2)
Depreciation, amortization and impairment	130	170	(40)
EBITDAR	\$ 147	\$ 145	\$ 2

Adjusted CASM

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

Adjusted CASM is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning and may not be comparable to similar measures presented by other public companies.

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

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

Adjusted CASM is reconciled to GAAP operating expense as follows:

(Canadian dollars in millions, except where indicated)	First Quarter		
	2014	2013	\$ Change
GAAP operating expense	\$ 3,127	\$ 3,058	\$ 69
Adjusted for:			
Aircraft fuel	(918)	(870)	(48)
Cost of ground packages at Air Canada Vacations	(170)	(150)	(20)
Impairment charge ⁽¹⁾	-	(24)	24
Operating expense, adjusted for the above-noted items	\$ 2,039	\$ 2,014	\$ 25
ASMs (millions)	16,774	16,164	3.8%
Adjusted CASM (cents)	¢ 12.2	¢ 12.5	(2.5)%

(1) In the first quarter of 2013, Air Canada recorded an impairment charge of \$24 million related to Airbus A340-300 aircraft.

Adjusted Net Loss and Adjusted Net Loss Per Share – Diluted

Air Canada uses adjusted net loss and adjusted net loss per share – diluted to assess the performance of its business without the effects of foreign exchange, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value and unusual items. These measures are not recognized measures for financial statement presentation under GAAP, do not have a standardized meaning and may not be comparable to similar measures presented by other public companies.

(Canadian dollars in millions, except where indicated)	First Quarter		
	2014	2013	\$ Change
Net loss for the period attributable to shareholders	\$ (342)	\$ (261)	\$ (81)
Adjusted for:			
Impairment charge ⁽¹⁾	-	24	(24)
Foreign exchange loss	161	40	121
Net financing expense (income) relating to employee benefits	34	52	(18)
Loss on financial instruments recorded at fair value	15	2	13
Adjusted net loss	\$ (132)	\$ (143)	\$ 11
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	285	274	11
Adjusted net loss per share – diluted	\$ (0.46)	\$ (0.52)	\$ 0.06

(1) In first quarter of 2013, Air Canada recorded an impairment charge of \$24 million related to Airbus A340-300 aircraft.

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

	First Quarter	
	2014	2013
Weighted average number of shares outstanding – basic	285	274
Effect of dilution	8	8
add back anti-dilutive impact	(8)	(8)
Weighted average number of shares outstanding – diluted	285	274

Return on Invested Capital

Air Canada uses Return on invested capital (or ROIC) to assess the efficiency with which it allocates its capital to generate returns. Return is based on Adjusted net income (loss) (as defined above), excluding interest expense and implicit interest on operating leases. Invested capital includes average long-term debt, average finance lease obligations, the value of capitalized operating leases (calculated by multiplying annualized aircraft rent expense by 7) and the average market capitalization of Air Canada's outstanding shares. This measure is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning and may not be comparable to similar measures presented by other public companies.

(Canadian dollars in millions, except where indicated)	March 31, 2014	March 31, 2013	\$ Change
Net income (loss) for the period attributable to shareholders of Air Canada (trailing 12 months)	\$ (75)	\$ (126)	\$ 51
Remove:			
Benefit plan amendments ⁽¹⁾	(82)	(127)	45
Impairment charge ⁽²⁾	7	24	(17)
Foreign exchange (gain) loss	241	21	220
Interest expense charge ⁽³⁾	95	-	95
Net financing expense relating to employee benefits	190	267	(77)
Gain (loss) on financial instruments recorded at fair value	(24)	15	(39)
Adjusted net income (trailing 12 months)	\$ 352	\$ 74	\$ 278
Adjusted for:			
Interest expense ⁽⁴⁾	306	297	9
Implicit interest on operating leases ⁽⁵⁾	155	161	(6)
Adjusted income before interest (trailing 12 months)	\$ 813	\$ 532	\$ 281
Invested capital:			
Average long-term debt and finance leases ⁽⁶⁾	4,172	3,907	265
Average market capitalization	1,234	439	795
Capitalized operating leases ⁽⁷⁾	2,212	2,303	(91)
Invested capital	\$ 7,618	\$ 6,649	\$ 969
Return on invested capital (%)	10.7%	8.0%	2.7 pp

(1) In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of \$82 million related to changes to early retirement provisions in Air Canada's defined benefit pension plans. In the third quarter of 2012, Air Canada recorded an operating expense reduction of \$127 million related to changes to the terms of the ACPA collective agreement pertaining to retirement age.

(2) In the first quarter of 2013, Air Canada recorded an impairment charge of \$24 million related to Airbus A340-300 aircraft.

- (3) *In the third quarter of 2013, Air Canada recorded an interest charge of \$95 million related to the purchase of its senior secured notes which were to become due in 2015 and 2016.*
- (4) *Interest expense excludes the non-recurring interest expense charge on the repayment of the senior secured notes recognized in 2013 as described in (3) above.*
- (5) *Interest implicit on operating leases is equal to 7.0% of 7 times the trailing 12 months of aircraft rent. 7.0% is a proxy and does not necessarily represent the actual implicit interest on operating leases for any given period.*
- (6) *Average long-term debt and finance leases include the current portion and long-term portion.*
- (7) *Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totaled \$316 million for the twelve months ended March 31, 2014 (for the twelve months ended March 31, 2013 - \$329 million).*

16. GLOSSARY

Adjusted CASM – Refers to operating expense per ASM adjusted to remove the effects of fuel expense, the cost of ground packages at Air Canada Vacations and unusual items. Refer to section 15 “Non-GAAP Financial Measures” of this MD&A for additional information.

Adjusted net income (loss) – Refers to the consolidated net income (loss) of Air Canada attributable to the shareholders of Air Canada adjusted to remove the effects of (to the extent included in consolidated net income (loss)) foreign exchange gains or losses, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value and unusual items. Refer to section 15 “Non-GAAP Financial Measures” of this MD&A for additional information.

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

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

CASM – Refers to operating expense per ASM.

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

EBITDAR – Refers to earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent. EBITDAR is a non-GAAP financial measure. Refer to section 15 “Non-GAAP Financial Measures” 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 – Refer to revenues from flights with origins and destinations principally in Central and South America and the Caribbean and Mexico.

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

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

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

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

Return on invested capital or ROIC – Refers to return on invested capital and is a measure used to assess the efficiency with which a company allocates its capital to generate returns. Refer to section 15 “Non-GAAP Financial Measures” of this MD&A for additional information.

Revenue Passenger Carried – Refers to IATA’s definition of passenger carried whereby passengers are counted on a flight no. basis rather than by journey/itinerary or by leg.

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

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

Weighted average cost of capital or WACC – Refers to management's estimate of its cost of capital, in which each category of capital is proportionately weighted, and consists of an estimated cost of equity of 20% and an average cost of debt and finance leases of 6%.