2014

MANAGEMENT’S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

February 11, 2015
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1. HIGHLIGHTS

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

<table>
<thead>
<tr>
<th>Financial Performance Metrics</th>
<th>Fourth Quarter</th>
<th>Full Year</th>
<th>$ Change</th>
<th>Fourth Quarter</th>
<th>Full Year</th>
<th>$ Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating revenues</td>
<td>3,104</td>
<td>2,894</td>
<td>210</td>
<td>13,272</td>
<td>12,382</td>
<td>890</td>
</tr>
<tr>
<td>Operating income</td>
<td>106</td>
<td>135</td>
<td>(29)</td>
<td>815</td>
<td>619</td>
<td>196</td>
</tr>
<tr>
<td>Non-operating expense (^1)</td>
<td>(206)</td>
<td>(141)</td>
<td>(65)</td>
<td>(710)</td>
<td>(617)</td>
<td>(93)</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>(100)</td>
<td>(6)</td>
<td>(94)</td>
<td>105</td>
<td>10</td>
<td>95</td>
</tr>
<tr>
<td>Adjusted net income (^2)</td>
<td>67</td>
<td>3</td>
<td>64</td>
<td>531</td>
<td>340</td>
<td>191</td>
</tr>
<tr>
<td>Operating margin, excluding the impact of benefit plan amendments (^3)</td>
<td>3.4%</td>
<td>1.8%</td>
<td>1.6 pp</td>
<td>6.1%</td>
<td>4.3%</td>
<td>1.8 pp</td>
</tr>
<tr>
<td>Operating margin (^3)</td>
<td>3.4%</td>
<td>4.7%</td>
<td>(1.3) pp</td>
<td>6.1%</td>
<td>5.0%</td>
<td>1.1 pp</td>
</tr>
<tr>
<td>EBITDA, excluding the impact of benefit plan amendments (^4)</td>
<td>319</td>
<td>277</td>
<td>42</td>
<td>1,671</td>
<td>1,433</td>
<td>238</td>
</tr>
<tr>
<td>EBITDA (^4)</td>
<td>319</td>
<td>359</td>
<td>(40)</td>
<td>1,671</td>
<td>1,515</td>
<td>156</td>
</tr>
<tr>
<td>EBITDA margin, excluding the impact of benefit plan amendments (^4)</td>
<td>10.3%</td>
<td>9.6%</td>
<td>0.7 pp</td>
<td>12.6%</td>
<td>11.6%</td>
<td>1.0 pp</td>
</tr>
<tr>
<td>EBITDA margin (^4)</td>
<td>10.3%</td>
<td>12.4%</td>
<td>(2.1) pp</td>
<td>12.6%</td>
<td>12.2%</td>
<td>0.4 pp</td>
</tr>
<tr>
<td>Unrestricted liquidity (^5)</td>
<td>2,685</td>
<td>2,364</td>
<td>321</td>
<td>2,685</td>
<td>2,364</td>
<td>321</td>
</tr>
<tr>
<td>Free cash flow (^6)</td>
<td>(366)</td>
<td>(276)</td>
<td>(90)</td>
<td>(560)</td>
<td>(231)</td>
<td>(329)</td>
</tr>
<tr>
<td>Adjusted net debt (^7)</td>
<td>5,132</td>
<td>4,351</td>
<td>781</td>
<td>5,132</td>
<td>4,351</td>
<td>781</td>
</tr>
<tr>
<td>Return on invested capital (&quot;ROIC&quot;) (^8)</td>
<td>12.1%</td>
<td>10.5%</td>
<td>1.6 pp</td>
<td>12.1%</td>
<td>10.5%</td>
<td>1.6 pp</td>
</tr>
<tr>
<td>Net income (loss) per share—diluted</td>
<td>$ (0.35)</td>
<td>$ (0.02)</td>
<td>$ (0.33)</td>
<td>$ 0.34</td>
<td>$ 0.02</td>
<td>$ 0.32</td>
</tr>
<tr>
<td>Adjusted net income per share—diluted (^2)</td>
<td>$ 0.23</td>
<td>$ 0.01</td>
<td>$ 0.22</td>
<td>$ 1.81</td>
<td>$ 1.20</td>
<td>$ 0.61</td>
</tr>
</tbody>
</table>

**Operating Statistics** \(^9\)

| Revenue passenger miles (millions) ("RPM") | 14,090 | 12,883 | 9.4 | 61,616 | 56,791 | 8.5 |
| Available seat miles (millions) ("ASM") | 17,403 | 16,033 | 8.5 | 73,889 | 68,573 | 7.8 |
| Passenger load factor % | 81.0% | 80.3% | 0.6 pp | 83.4% | 82.8% | 0.6 pp |
| Passenger revenue per RPM ("Yield") (cents) | 19.2 | 19.6 | (1.9) | 18.9 | 19.1 | (1.3) |
| Passenger revenue per ASM ("PRASM") (cents) | 15.6 | 15.7 | (1.2) | 15.8 | 15.9 | (0.6) |
| Operating revenue per ASM (cents) | 17.8 | 18.1 | (1.2) | 18.0 | 18.1 | (0.5) |
| Operating expense per ASM ("CASM") excluding the impact of benefit plan amendments (cents) | 17.2 | 17.7 | (2.8) | 16.9 | 17.3 | (2.4) |
| Adjusted CASM (cents) \(^10\) | 12.1 | 12.1 | - | 11.3 | 11.6 | (2.6) |
| Average number of full-time equivalent ("FTE") employees (thousands) \(^11\) | 24.1 | 24.2 | (0.3) | 24.4 | 24.5 | (0.4) |
| Aircraft in operating fleet at period-end | 364 | 352 | 3.4 | 364 | 352 | 3.4 |
| Average fleet utilization (hours per day) | 9.2 | 9.4 | (1.4) | 9.9 | 10.0 | (0.9) |
| Seats dispatched (thousands) | 11,948 | 11,246 | 6.2 | 49,351 | 46,832 | 5.4 |
| Aircraft frequencies (thousands) | 135 | 131 | 2.9 | 555 | 548 | 1.3 |
| Average stage length (miles) \(^12\) | 1,457 | 1,426 | 2.2 | 1,497 | 1,464 | 2.3 |
| Economic fuel cost per litre (cents) \(^13\) | 80.7 | 88.4 | (8.7) | 89.3 | 89.0 | 0.3 |
| Fuel litres (millions) | 992 | 943 | 5.2 | 4,213 | 3,993 | 5.5 |
| Revenue passengers carried (thousands) \(^14\) | 9,189 | 8,499 | 8.1 | 38,526 | 35,761 | 7.7 |

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\(^1\) Includes net finance expense, net income from continuing operations of unconsolidated associates, gains (loss) on assets held for sale and income tax adjustments.\n
\(^2\) Includes income tax adjustments.\n
\(^3\) Excluding amortization of intangible assets.\n
\(^4\) EBITDA, excluding the impact of benefit plan amendments.\n
\(^5\) Represents the change in the unrestricted cash balance.\n
\(^6\) Represents the change in cash from operations, adjusted for income tax payments.\n
\(^7\) Includes interest expense, foreign exchange gains (losses) and income tax adjustments.\n
\(^8\) Represents the ratio of net income to shareholders' equity.\n
\(^9\) Includes traffic, seat factor, and load factor.\n
\(^10\) Includes operating expenses excluding depreciation, amortization, and foreign exchange gains (losses).\n
\(^11\) Includes all employees, including seasonal employees.\n
\(^12\) Represents the average distance flown per aircraft.\n
\(^13\) Represents the average cost of fuel per litre.\n
\(^14\) Includes all passengers, including one-way and standby passengers.
(1) In the third quarter of 2013, Air Canada recorded an interest charge of $65 million related to the purchase of its senior secured notes which were to become due in 2015 and 2016.

(2) Adjusted net income (loss) and adjusted net income (loss) per share—diluted are non-GAAP financial measures. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

(3) In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans.

(4) EBITDA (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

(5) Unrestricted liquidity refers to the sum of cash, cash equivalents, short-term investments and the amount of available credit under Air Canada’s revolving credit facilities. At December 31, 2014, unrestricted liquidity was comprised of cash and short-term investments of $2.275 million and undrawn lines of credit of $410 million. At December 31, 2013, unrestricted liquidity was comprised of cash and short-term investments of $2.208 million and undrawn lines of credit of $156 million.

(6) 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 9.5 “Consolidated Cash Flow Movements” of this MD&A for additional information.

(7) 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 9.3 “Adjusted Net Debt” of this MD&A for additional information.

(8) Return on invested capital (“ROIC”) is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

(9) 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.

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

(11) 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.

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

(13) Includes fuel handling expenses. Economic fuel price per litre is a non-GAAP financial measure. Refer to sections 6 and 7 “Results of Operations” of this MD&A for additional information.

(14) 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, doing business as Air Canada Vacations® ("Air Canada Vacations") and Air Canada rouge LP, doing business as Air Canada rouge® ("Air Canada rouge"). This MD&A provides the reader with a review and analysis, from the perspective of management, of Air Canada’s financial results for the fourth quarter and the full year 2014. This MD&A should be read in conjunction with Air Canada’s audited consolidated financial statements and notes for 2014. 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 for any financial information specifically denoted otherwise.

Except as otherwise noted, monetary amounts are stated in Canadian dollars. For an explanation of certain terms used in this MD&A, refer to section 21 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of February 10, 2015. Certain comparative figures have been reclassified to conform to the financial statement presentation adopted in the current year. Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 18 "Risk Factors" of this MD&A. Air Canada issued a news release dated February 11, 2015 reporting on its results for the fourth quarter and the full year 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 this MD&A. The forward-looking statements contained in this MD&A represent Air Canada’s expectations as of February 10, 2015 (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 1.75% to 2.25% for 2015. In addition, Air Canada expects that the Canadian dollar will trade, on average, at C$1.25 per U.S. dollar in the first quarter of 2015 and for the full year 2015 and that the price of jet fuel will average 66 cents per litre for the first quarter of 2015 and 67 cents per litre for the full year 2015.
3. ABOUT AIR CANADA

Air Canada is Canada’s largest domestic, U.S. transborder and international airline and the largest provider of scheduled passenger services in the Canadian market, the Canada-U.S. transborder market and in the international market to and from Canada. In 2014, Air Canada, together with Jazz and other regional airlines operating flights on behalf of Air Canada under capacity purchase agreements, operated, on average, 1,519 daily scheduled flights to 186 direct destinations on five continents, comprised of 61 Canadian cities, 50 destinations in the United States and a total of 75 cities in Europe, the Middle East, Asia, Australia, the Caribbean, Mexico and South America. Domestic, U.S. transborder and international departures accounted for approximately 67%, 25% and 8%, respectively, of the 1,519 average daily departures. In 2014, Air Canada carried over 38.5 million passengers.

At December 31, 2014, Air Canada operated a mainline fleet of 172 aircraft, comprised of 69 Airbus narrow-body aircraft, 58 Boeing and Airbus wide-body aircraft and 45 Embraer 190 regional jets, while Air Canada rouge operated a fleet of 28 aircraft, comprised of 20 Airbus A319 aircraft and eight Boeing 767-300 aircraft, for a total of 200 aircraft.

Air Canada’s wide-body fleet is an important element of its strategy to develop its network internationally and further strengthen its position as a global player. In 2014, Air Canada took delivery of six of 37 Boeing 787 aircraft on order. These aircraft, with their lower operating costs, mid-size capacity and longer range, are driving new opportunities for profitable growth at Air Canada and allowing the airline to operate existing Boeing 767 mainline routes in a more efficient manner. In the last year, Air Canada also expanded its mainline wide-body fleet by adding five high-density Boeing 777-300ER aircraft, with an additional two such aircraft scheduled for delivery in 2016. These aircraft are being deployed on select routes where there is high demand for economy travel.

In order to improve the airline’s profitability and competitive position in the expanding leisure markets, a travel leisure group was created at Air Canada in 2012. The Air Canada Leisure Group represents a coordinated strategy which leverages the strengths of Air Canada, Air Canada rouge, the airline’s lower-cost leisure airline, and Air Canada Vacations. Through Air Canada rouge, Air Canada is improving margins on leisure routes previously operated by the mainline fleet and is pursuing opportunities in international leisure markets made viable by Air Canada rouge’s more competitive cost structure. Air Canada Vacations is a leading Canadian tour operator. Based in Montreal and Toronto, Air Canada Vacations operates its business in the outbound leisure travel market (Caribbean, Mexico, U.S., Europe, Central and South America, South Pacific, Australia and Asia) by developing, marketing and distributing vacation travel packages. Air Canada Vacations also offers cruise packages in North America, Europe and the Caribbean.

Air Canada enhances its domestic and transborder network through capacity purchase agreements (“CPAs”) with regional airlines, namely Jazz, Sky Regional, Air Georgian Limited (“Air Georgian”) and Exploits Valley Air Services Ltd. (“EVAS”), which operate flights on behalf of Air Canada under the Air Canada Express banner. These carriers form an integral part of the airline’s international network strategy as they provide valuable traffic feed to Air Canada mainline and rouge routes. At December 31, 2014, the Air Canada Express fleet was comprised of 46 Bombardier regional jets, 86 Bombardier Dash-8 turboprop aircraft, 15 Embraer 175 regional jets and 17 Beech 1900 aircraft. As part of Air Canada’s continued focus on cost reduction, on February 2, 2015, Air Canada and Jazz Aviation LP (‘Jazz’) concluded an amended and extended capacity purchase agreement (“Jazz CPA”) which allows for significant cost reductions, a stronger relationship and better alignment of interests over the long term. The agreement extends the Jazz CPA by five years to December 31, 2025.

Air Canada is a founding member of the Star Alliance® network. Through Star Alliance® network’s 27 member airlines, Air Canada is able to offer its customers access to approximately 1,321 destinations in 193 countries, as well as reciprocal participation in frequent flyer programs and use of airport lounges and other common airport facilities.

Air Canada participates in a transatlantic joint venture with United Airlines and Deutsche Lufthansa AG through which the carriers provide customers with more choice and streamlined service on routings between North and Central America, and Africa, India, Europe and the Middle East. This transatlantic joint venture, including its revenue sharing structure, was implemented effective January 1, 2010. Furthermore, in the fourth quarter of 2014, Air Canada concluded a memorandum of understanding with Air China which sets out the main principles for a comprehensive revenue sharing joint venture providing for an enhanced partnership on routes between Canada and China which will stimulate traffic growth between the two countries. Subject to Air Canada and Air China making the necessary filings, obtaining
competition and other regulatory approvals and finalizing documentation, the joint venture is expected to come into effect by the end of 2015. The airline also has the ability to create a transborder joint venture with United Airlines.

Through its long-term relationship with Aimia Canada Inc. (formerly Aeroplan Canada Inc. and referred to as “Aeroplan” in this MD&A), Air Canada’s loyalty program provider, Air Canada is able to build customer loyalty by offering those customers who are Aeroplan® members the opportunity to earn Aeroplan® Miles when they fly with Air Canada and with the 26 other Star Alliance® member airlines. Aeroplan is also Air Canada’s single largest customer. The relationship with Aeroplan is designed to provide a stable and recurring source of revenue from the purchase of Air Canada seats by Aeroplan, which in turn are provided to Aeroplan® members who choose to redeem their Aeroplan® Miles for travel on Air Canada. Additionally, Aeroplan® members may also choose to redeem their Aeroplan® Miles for travel with the Star Alliance® member airlines. Furthermore, Aeroplan® members who are among Air Canada’s most frequent flyers are recognized and rewarded through Air Canada Altitude™, a frequent flyer program delivering a range of premium travel privileges and benefits depending on the status level they have reached.

Air Canada also generates revenue from its cargo division. Air Canada Cargo provides direct cargo services to over 150 Canadian, U.S. transborder and international destinations and has sales representation in over 50 countries. Air Canada Cargo is Canada’s largest provider of air cargo services as measured by cargo capacity. Air cargo services are provided on domestic and U.S. transborder flights and on international flights on routes between Canada and major markets in Europe, Asia, South America and Australia.
4. STRATEGY

Air Canada’s goal is to fully develop as a leading global airline, to be among those with the highest levels of customer experience, employee engagement and value creation for shareholders and other stakeholders. This is being pursued through the following four key strategies:

- Continually identifying and implementing cost reduction and revenue generating initiatives;
- Expanding internationally and increasing connecting traffic through international gateways, on a sustainable and profitable basis, and competing effectively in the leisure market to and from Canada;
- Engaging customers by continually enhancing the travel experience and providing a consistently high level of customer experience, with additional emphasis on premium and business passengers and products; and
- Fostering positive culture change through employee engagement programs designed to promote an understanding of how the airline and its employees can work together to deliver on the customer promise and investing in the tools and training required to provide a culture of top customer care.

Revenue Enhancement and Cost Transformation

Margin improvement through sustainable cost transformation and profitable revenue enhancements remains a key priority at Air Canada. Over the last several years, Air Canada has taken significant actions to reduce costs and generate incremental revenue.

Key achievements in 2014

- Reduced adjusted CASM by 2.6% when compared to 2013.
- Increased ancillary revenue per passenger by 10% from 2013.
- Continued to successfully expand Air Canada rouge, the airline’s lower-cost leisure carrier.
- Introduced six Boeing 787 aircraft into the mainline fleet, allowing Air Canada to operate existing Boeing 767 routes in a more cost efficient manner and permitting the airline to pursue new, profitable international growth opportunities.
- Took delivery of one high-density Boeing 777-300ER aircraft, for a total of five of these aircraft in the mainline fleet. These aircraft are primarily being deployed to lower-yielding, high-volume markets.
- Exercised purchase rights for two additional Boeing 777-300ER aircraft to be delivered, in the second quarter of 2016, in the lower-cost, high density configuration.
- Announced plans to reconfigure 12 Boeing 777-300ER and six 777-200LR aircraft in the mainline fleet into the three-cabin international product and Boeing 787 seating standard and to harmonize the interior of the five higher-density Boeing 777-300 aircraft in the mainline fleet to Boeing 787 standards.
- Aligned Air Canada’s first checked bag policy for North American travel with prevailing North American industry practice.
- Aligned the airline’s operations to industry standards to allow for a ratio of one flight attendant for every 50 passenger seats on its narrow-body aircraft, with expected annual savings of $28 million.
**Ongoing Initiatives**

Air Canada continues to take tangible steps to implement its strategy for sustained value creation and profitability through the execution of ongoing and new strategic initiatives. These include:

**Air Canada rouge**

The continued strategic expansion of Air Canada rouge in conjunction with Air Canada’s mainline fleet expansion is a key driver of the airline’s strategy for sustainable, profitable growth. Air Canada rouge’s lower and more competitive cost structure has effectively delivered enhanced margins on leisure routes previously operated by Air Canada and provides new opportunities for profitable growth in international leisure markets. To date, Air Canada rouge has exceeded management expectations. Since its first flight in July 2013, Air Canada rouge has been deployed to a growing number of Caribbean destinations and select leisure destinations in the United States, as well as in international leisure markets where demand is highly-elastic and responds positively to lower-priced, non-stop capacity. In 2015, Air Canada also plans on deploying Air Canada rouge in certain domestic markets that have high volumes of leisure traffic. Air Canada rouge believes that its ability to leverage the strengths of Air Canada, including its extensive network with enhanced connection options, operational expertise and frequent flyer program, is a competitive advantage, generating additional customer benefits vis-à-vis its competitors in the leisure markets.

Air Canada rouge operates under the principle of maintaining a long-term cost structure consistent with that of its competitors in the leisure market. Air Canada has effectively lowered its CASM on leisure routes through increased seat density, lower wage rates, more efficient work rules, and reduced overhead costs. Air Canada rouge launched its operations in 2013 with four aircraft and, by the end of 2014 its fleet grew to 28 aircraft (20 Airbus A319 and 8 Boeing 767 aircraft). Six Boeing 767-300 aircraft (four of which will be transferred from the mainline fleet and two of which will be leased from third parties) and two Airbus A321 aircraft (which will be leased from third parties) will be added to the Air Canada rouge fleet during 2015 for a planned fleet of 36 aircraft by the end of 2015. Air Canada continues to seek additional opportunities to accelerate the growth of the Air Canada rouge fleet in order to further expand margins.

The 2014 collective agreement concluded with the Air Canada Pilots Association ("ACPA"), the union representing Air Canada’s pilots, further facilitates rouge’s evolution with improved fleet flexibility and terms. While the maximum number of aircraft Air Canada rouge may operate remains at 50, Air Canada rouge’s fleet may now have up to 25 wide-body aircraft (previously 20) and 25 Airbus narrow-body aircraft (previously 30).

**Continued Introduction of Fuel-Efficient Boeing 787 Aircraft**

Air Canada is generating fuel and maintenance cost savings with the arrival of its first seven Boeing 787-8 Dreamliners (six aircraft in 2014 and an additional aircraft in January 2015). Air Canada plans to take delivery of an additional 30 Boeing 787 aircraft by the end of 2019, comprised of eight Boeing 787-8 aircraft and 22 larger capacity Boeing 787-9 aircraft. The Boeing 787 Dreamliner is driving new opportunities for profitable growth at Air Canada. In addition to replacing Boeing 767s on existing mainline routes, these aircraft are also serving new international destinations made viable by its lower operating costs, mid-size capacity and longer range. The approximately 30% greater cargo capacity on the Boeing 787 aircraft when compared to the Boeing 767 aircraft also improves Air Canada’s revenue potential.

**Reconfiguration of Boeing 777 and Airbus A330-300 Aircraft**

In order to improve the economics of its standard configuration Boeing 777 long-haul fleet and to provide customers with a product consistent with its new Boeing 787 Dreamliners, the airline plans to convert 12 Boeing 777-300ER and six Boeing 777-200LR aircraft into a more cost effective and competitive configuration, adding a Premium Economy cabin and refurbishing the International Business Class cabin to the new Boeing 787 state-of-the-art standard. The capital expenditure related to this program is approximately $300 million with a projected payback period of less than three years. Air Canada also plans to reconfigure its fleet of eight Airbus A330-300 aircraft to lower unit costs, allowing the airline to compete more effectively, offer customers the option of its new Premium Economy cabin and to deliver a harmonized product offering across its flagship international fleet. Conversion of these Boeing 777 and Airbus A330 aircraft is scheduled from late 2015 to the second half of 2016.
Narrow-body Fleet Renewal Program

In March 2014, Air Canada entered into agreements with The Boeing Company ("Boeing") for firm orders, options and certain rights to purchase up to 109 Boeing 737 MAX narrow-body aircraft, to replace the existing mainline fleet of Airbus narrow-body aircraft. Deliveries are scheduled to begin in 2017 with two aircraft, with the remaining deliveries scheduled from 2018 to 2021. Air Canada estimates that the projected fuel burn and maintenance cost savings on a per seat basis of greater than 20% will generate an estimated CASM reduction of approximately 10% as compared to the airline’s existing narrow-body fleet. Refer to section 8 “Fleet” of this MD&A for additional information.

Regional Airline Diversification

Over the last several years, Air Canada has also focused on lowering its regional costs. The 2014 agreement concluded with ACPA provides increased flexibility in the airline’s relationships with regional airlines as Air Canada may replace Bombardier CRJ-100/200 and Bombardier Dash 8-100/300 aircraft with Bombardier Dash 8-Q400 aircraft under certain conditions. Furthermore, the airline has diversified its regional operations across multiple regional partners. For example, in 2013, Air Canada transferred all of its 15 Embraer 175 aircraft from the mainline fleet to Sky Regional which operates these aircraft on behalf of Air Canada at a much lower cost. In addition, since 2014, Air Georgian, also a lower-cost regional provider, operates a number of regional routes on Air Canada’s behalf using Bombardier CRJ-100 aircraft. In 2015, Air Canada plans to continue to seek opportunities to further reduce regional costs and optimize its regional fleet deployment.

On February 2, 2015, Air Canada announced that it had concluded an amended and extended capacity purchase agreement with Jazz, a wholly-owned subsidiary of Chorus Aviation Inc. The agreement provides both parties with greater stability and significant cost reductions through a better alignment of their interests. The agreement also provides for long-term stability by eliminating the risks, uncertainties and set-up costs of a potential transition to alternative regional providers in 2021. Post-2020, Air Canada expects Jazz will provide competitive costs and continued high service levels.

The highlights of the new capacity purchase agreement include:

- Extension of the term by five years to December 31, 2025;
- Establishment of a pilot mobility agreement that provides Jazz pilots with access to pilot vacancies at Air Canada, thus allowing a significant reduction in Jazz operating costs;
- Simplification and modernization of the Jazz fleet which will provide improved service and greater efficiency through the addition of 23 Bombardier Dash 8-Q400 aircraft;
- Reduction in Air Canada and Jazz costs derived from a combination of improved fleet economics, greater network flexibility and reduced operating and labour costs. This supports Air Canada’s cost reduction initiatives; and
- Modification of Jazz’s CPA fee structure, moving from a “cost plus” mark-up to a more industry standard fixed fee compensation structure. This provides a more competitive structure and better aligns the cost reduction goals of both Air Canada and Jazz. This change also eliminates non-value added costs and the necessity of the 2015 benchmarking exercise.

Other Revenue Optimization and Cost Reduction Initiatives

Air Canada continues to foster a culture of continuous cost transformation and revenue improvement across the organization. To this end, Air Canada’s Business Transformation team actively pursues its mission to identify and help implement initiatives through productivity enhancements, process reforms and other measures. Initiatives may include revising business and operational processes, including supply chain and maintenance operations, improving employee productivity and asset utilization, consolidating call centres and promoting workplace policies to drive revenue and reduce costs. The airline is also implementing a continuous improvement program at airports which will also optimize supplier arrangements and reduce aircraft turnaround times. Lowering distribution costs, including through the renegotiation of global distribution system ("GDS") and other agreements, is another key initiative aimed at increasing margins.
In the area of yield management, Air Canada is implementing a new passenger revenue management system to optimize its revenue performance on the basis of a passenger’s full trip itinerary rather than on individual flight legs. Given the number of connecting passengers Air Canada serves, this new system will allow the airline to better optimize passenger flows across the network. Air Canada estimates that this initiative, which will be implemented in the second quarter of 2015, will drive incremental annual revenues in excess of $100 million.

Air Canada is also increasing its ancillary revenues through onboard retail and other a la carte services, such as those related to ticket changes, baggage, seat selection, upgrades, preferred seating, as well as onboard offerings, including food, duty free shopping, in-flight entertainment and onboard Wi-Fi.

The airline is also generating revenues from its tri-partite credit card agreements and loyalty partnerships. New and renewed financial card partnerships in conjunction with Aeroplan help bolster overall ancillary revenues and enhance cardholders’ travel experience by providing complimentary travel benefits, such as first checked baggage, priority check-in and certain access to Maple leaf lounges. These Aeroplan co-brand financial card partner agreements included the introduction of TD co-branded cards as well as the renewal of the American Express and CIBC card partnerships.

To better monetize its ancillary offerings and increase related revenues, in August 2014, Air Canada introduced a new merchandising tool to help customize, differentiate and combine its offerings. This new tool also provides the airline with the ability to more quickly introduce new products.

In 2014, Air Canada's ancillary revenue per passenger increased 10% when compared to 2013.

**Pension**

In December 2013, the Government of Canada formally approved the Air Canada Pension Plan Funding Regulations, 2014 (the “2014 Regulations”).

Air Canada maintains several pension plans, including defined benefit and defined contribution pension plans and plans providing other retirement and post-employment benefits to its employees. As at January 1, 2014, the aggregate solvency surplus in the domestic registered pension plans was $89 million. The next required valuations to be made as at January 1, 2015, will be completed in the first half of 2015 but, as described in section 9.7 “Pension Funding Obligations” of this MD&A, they will not impact the 2015 pension past service cost funding obligations unless Air Canada opts out of the 2014 Regulations (described below), deciding instead to fund its domestic registered pension plans pursuant to normal funding rules. Based on preliminary estimates, including actuarial assumptions, as at January 1, 2015, the aggregate solvency surplus in Air Canada’s domestic registered pension plans is projected to be $780 million.

Air Canada is permitted to opt out of the 2014 Regulations and have past service payments in respect of all Air Canada pension plans, collectively, determined in accordance with normal funding rules.

Air Canada would consider opting out of the 2014 Regulations when the annual solvency deficit payments under normal funding rules, which are determined using deficit levels over three years, would be less than $200 million and when there would be a strong basis for confidence that the airline’s de-risking strategy would make a future significant deficit unlikely to re-occur. At December 31, 2014, approximately 72.5% of the pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk.

In the event that Air Canada opts out of the 2014 Regulations, based on the normal funding rules and subject to the finalization of the preliminary estimate of the pension solvency surplus of $780 million at January 1, 2015, Air Canada’s pension solvency payment would be approximately $90 million in 2015.

For a more detailed discussion on Air Canada’s pension and related funding matters, please see section 9.7 "Pension Funding Obligations" of this MD&A.

**International Growth**

Air Canada is specifically focused on seeking new international growth opportunities to generate sustainable profit, with approximately 90% of Air Canada’s planned growth in 2015 targeted to such initiatives. Air Canada now has at its disposal more cost-efficient aircraft, improved tools and processes and other competitive attributes to profitably pursue new international route opportunities. Air Canada also has access to Canada’s wide portfolio of international routes rights and
Canada’s multi-ethnic demographic profile provides the airline with further opportunities to profitably capture demand for international travel. These attributes combined with Air Canada’s powerful brand franchise and industry-leading products and services, allow Air Canada to leverage its network and benefit from the higher margins generally available in international markets. The airline will also continue to leverage its world class hub at Toronto Lester B. Pearson International Airport (“Toronto Pearson”) and other Canadian hubs with the objective of increasing global connecting traffic via Canada.

**Key achievements in 2014**

- Introduced mainline service from Toronto Pearson to Milan and Tokyo-Haneda.
- Introduced non-stop mainline service between Toronto Pearson and Rio de Janeiro, reinforcing Air Canada’s market-leading position as the only carrier flying non-stop between Canada and South America.
- Introduced non-stop mainline service from Toronto Pearson to Panama City, making it the only Canadian network carrier operating between Canada and Panama.
- Introduced Air Canada rouge service from Montreal to Nice, Toronto Pearson to Lisbon and Toronto Pearson to Manchester.
- Converted the airline’s routes from Vancouver to Shanghai and Vancouver to Toyko-Narita to 787 Dreamliner service.
- Introduced a series of new codeshare routes with Air India to improve air travel connectivity between Canada and India.
- Concluded a memorandum of understanding with Air China which remains subject to certain conditions and which sets out the main principles for a comprehensive revenue sharing joint venture.
- Increased sixth freedom traffic (international-to-international, including U.S.) connecting at Air Canada major Canadian hubs by 23% from 2013.

In 2015, Air Canada plans on continuing to selectively and profitably expand its international services by leveraging its new aircraft, improved cost structure, as well as the following additional competitive advantages:

- A widely-recognized brand and a strong position in the market for transatlantic and transpacific travel to and from Canada and to and from South America via Canada.
- An extensive and expanding global network, enhanced by the airline’s membership in Star Alliance®, numerous codeshare agreements and participation in a revenue sharing transatlantic joint venture with United Airlines and Lufthansa.
- A flexible fleet mix with low-cost swing capacity, which helps the airline redeploy or otherwise manage capacity to match changes in demand.
- Air Canada Altitude®, Air Canada’s frequent flyer program, which recognizes the airline’s most frequent flyers by offering them a range of exclusive travel privileges, including the benefits derived from Air Canada’s partnership with the Aeroplan program, which allows all customers to earn and redeem Aeroplan® Miles with Canada’s leading coalition loyalty program.
- Competitive products and services, including lie-flat beds in the International Business Class cabin, concierge services and Maple Leaf® lounges.
- Geographically well-positioned hubs (Toronto, Montreal, Vancouver and Calgary) with excellent in-transit facilities, accentuating the advantages of flying Air Canada through an improved travel experience for customers travelling to or from the U.S. to Asia and Europe.
• The only non-U.S. carrier to offer TSA Pre-check, allowing eligible customers to experience expedited and more efficient security screening for flights out of the U.S.


Air Canada is enhancing its 2015 international offerings, including through:

• Year-round Air Canada service between Toronto Pearson and Amsterdam. Flights are scheduled to begin June 4, 2015 and will be operated up to six times weekly.

• Double-daily Air Canada service from both Toronto Pearson and Montreal to Paris-Charles de Gaulle. The additional flights will be offered from June to September 2015.

• New Air Canada rouge twice-weekly service between Montreal and Venice beginning May 14, 2015 and up to five flights per week between Vancouver and Osaka-Kansai beginning May 1, 2015.

• An increase to daily from five times a week on Air Canada rouge service from Toronto Pearson to Athens and Barcelona, and an increase to four times from three weekly service from Toronto Pearson to Venice. From Montreal, Air Canada rouge service to Athens will double to four-times-weekly and service to Barcelona will increase to three-times-weekly from twice-weekly in summer 2014. Overall, Air Canada rouge service to Athens, Barcelona, Lisbon, Manchester and Nice will operate a longer season during the summer of 2015 compared to the summer 2014.

• The transfer from mainline to Air Canada rouge of year-round service between Toronto Pearson and Lima, Peru, beginning May 2, 2015, subject to government approval.

• Air Canada four-times-weekly service between Toronto Pearson and Delhi, the only non-stop flight from Canada to India. This new route, which will be inaugurated on November 1, 2015, is the first to be dedicated for Air Canada’s Boeing 787-9 series aircraft and will open new opportunities in the Indian subcontinent, currently the largest international market not served by Air Canada.

• Air Canada three times-weekly service between Toronto Pearson and Dubai, the airline’s first non-stop flight to the UAE at a time when air travel between North America and the region is growing. Flights will be operated beginning November 3, 2015 with a Boeing 787-9 aircraft. This new route will increase Air Canada’s presence in the Middle East by providing its customers with direct, non-stop access to Dubai, complementing its other services in the region. Air Canada currently serves the region primarily through its transatlantic joint venture with Lufthansa over Frankfurt and Munich. This new route will also build on Air Canada’s existing codeshare relationship with Etihad Airways, with whom it codeshares on three flights a week between Toronto Pearson and Abu Dhabi, in the UAE.

**Star Alliance Membership, Codeshare and Joint Venture Agreements Enhance Market Presence**

The development of commercial alliances with major international carriers continues to be an important aspect of Air Canada’s business strategy. These arrangements provide Air Canada with an effective way to leverage expansion and broaden its network appeal. Air Canada extends its global reach through its membership in Star Alliance® which is comprised of 27 members. The airline also enhances its network through its participation in a transatlantic revenue sharing joint venture with United Airlines and Deutsche Lufthansa AG, referred to as A++. By coordinating pricing, scheduling and sales, Air Canada is better able to serve customers by offering more travel options, while reducing travel times. Air Canada is also achieving greater critical mass and network scope through numerous codeshare and interline agreements. Air Canada code shares with all Star Alliance members, with the exception of Adria Airways, Copa, Croatia Airlines, EVA Air, Shenzhen Airlines and Thai Airways. In October 2014, Air Canada and Air India introduced a series of new codeshare routes to improve air travel connectivity between Canada and India.

In November 2014, Air Canada concluded a memorandum of understanding with Air China which sets out the main principles for a comprehensive revenue sharing joint venture between the parties. The agreement provides for an
enhanced partnership on routes between Canada and China which will stimulate traffic growth between the two countries. The joint venture will generate additional service and pricing benefits for consumers travelling between the two countries as well as provide for enhanced cooperation between the two carriers in the areas of sales, marketing and airport operations. Subject to Air Canada and Air China making the necessary filings, obtaining competition and other regulatory approvals and finalizing documentation, the joint venture is expected to come into effect by the end of 2015.

Increasing International-to-International Traffic Flows through Major Canadian Hubs

Air Canada has made targeted and meaningful progress in increasing international-to-international traffic flows (also known as sixth freedom traffic) through its major Canadian hubs.

In 2015, Air Canada plans to continue to grow this traffic through its world-class hub in Toronto and its strong international gateways in Montreal, Vancouver and Calgary. The airline believes that it has the potential to grow sixth freedom traffic, particularly from the U.S., over the coming years given its award-winning products and services, geographically well-positioned hubs in Canada, extensive network and other competitive advantages.

In 2014, Air Canada increased sixth freedom traffic connecting at Air Canada major Canadian hubs by 23% from 2013. Based on an airline industry benchmark indicating the percentage of traffic from the U.S. to Europe and Asia by non-U.S. carriers, Air Canada’s current share is 0.8% (this market share is consistent with Air Canada’s previously reported 0.3% share but is now adjusted to include certain GDS and fuel surcharge revenue). Air Canada has determined that its fair share of this international-to-international transit traffic should be 1.5% and has estimated that a successful increase to this level (taking into account the above-referenced GDS and 2014 industry fuel surcharge levels) would drive incremental annual revenues of approximately $600 million.

For several years, Air Canada has worked closely with the Greater Toronto Pearson Airports Authority (“GTAA”) to transform Toronto Pearson into a leading North American airport and gain a greater share of the global sixth freedom market. In late 2013, the GTAA and Air Canada concluded an enhanced commercial relationship which is designed to deliver continued improvements to customer service and which has placed Air Canada in a better position to more profitably target a larger share of international traffic flows. Toronto Pearson has a strategic advantage due to its proximity to densely populated major markets in the U.S. and is also a destination for a large number of business and leisure travelers. Moreover, Air Canada and its Star Alliance® partners’ operations are consolidated in one terminal, and Toronto Pearson has efficient in-transit facilities which allow passengers and their bags to move seamlessly between Canada and U.S. Customs and Immigration.

Customer Engagement

Providing a consistently high level of customer experience and growing the airline’s premium customer base are important elements of Air Canada’s business strategy. Air Canada aims to give travelers every reason to fly Air Canada. The airline recognizes that its continued and growing success is dependent on consistently delivering superior value and innovative products, providing the highest levels of customer service and anticipating the changing needs of customers.

In 2014, Air Canada received the following important industry awards which demonstrate its customers’ appreciation of the airline’s extensive network, alliance relationships and leading products and services, as well as their recognition of the dedication and professionalism of Air Canada’s employees. Air Canada also continues to be the only international network carrier in North America ranked as a Four-Star airline by Skytrax.

Key achievements in 2014

- “Best Airline in North America” in the Skytrax 2014 World Airline Awards, the fifth consecutive year Air Canada has been recognized as the best airline in North America. The annual poll, based on surveys of nearly 19 million global passengers, is regarded as a key benchmarking tool for product excellence and customer satisfaction by the global airline industry.

- “Canada’s Favourite Airline for Business Travel!” in the 2014 Ipsos Reid Canadian Business Traveller Study. Air Canada was the preferred airline of 83% of Canadian frequent business travellers surveyed for 2014, an improvement of 14 percentage points in Air Canada’s ratings in the national survey over the past six years. The survey showed consistently strong ratings in customer preference for Air Canada’s frequent flyer reward program, flight schedule, business class service, Maple Leaf Lounges and complimentary in-flight entertainment.
• “Best Long Haul Airline (Americas)” by the respected airline safety and product reviewing website, AirlineRatings.com. The results are based on ratings of 450 airlines globally by hundreds of thousands of passengers.

Improving the Customer Experience through Industry-leading Products and Services

Air Canada recognizes that investing in products and services is vital to engaging customers. The Dreamliner, with its newly-designed cabins and next generation IFE, has been enthusiastically received, and Air Canada has announced plans to introduce the 787’s three-cabin international product and seating standard on all 25 Boeing 777-300ER and 777-200LR aircraft in its mainline fleet. The airline’s modern fleet, along with other attributes, such as its expansive global network, International Business Class service, Maple Leaf Lounges, concierge service, and Aeroplan and Altitude loyalty programs, are designed to further boost Air Canada’s leading position as the carrier of choice among Canadian business travelers.

Air Canada Altitude™, Air Canada’s frequent flyer program, is designed to enhance the travel experiences of its most frequent flyers. Air Canada continues to optimize its frequent flyer program to reward its most valuable and engaged members and remains committed to offering one of the world’s best frequent flyer programs. Air Canada Altitude™ members benefit from a wide range of privileges including priority travel services, upgrades to Business and Premium Economy classes and recognition across the Star Alliance® network. Air Canada Altitude members also benefit from Air Canada’s partnership with the Aeroplan® program, which provides a wide range of ways to earn and redeem valuable Aeroplan Miles, including flights to over 1,200 destinations worldwide. In 2015, the airline will continue to optimize the program constructs in an effort to continue improving the program’s value and its capacity to profitably affect member engagement.

Air Canada’s program entitled “Air Canada Corporate Rewards” offers powerful online tools to help businesses of all sizes better manage their travel, track and reduce costs and earn rewards to enhance travel while at the same time building loyalty to Air Canada. Members are eligible to receive offers for discounts on Air Canada flights and services along with rewards such as complimentary eUpgrades, Maple Leaf Lounge access, advance seat selection and other exclusive offers.

In 2014, Air Canada expanded its Preferred Seat program with the reconfiguration of the mainline narrow-body fleet. Preferred seats are available on the entire mainline fleet and Air Canada is making it easier for customers to conveniently purchase these seats when booking or at any time prior to boarding, including through its website, its airport kiosks or mobile devices. Most preferred seats are located near the front of the aircraft, enabling customers to disembark more quickly at their destination.

Air Canada is the first Canadian carrier to offer customers in-flight Wi-Fi connectivity. The airline began rolling out connectivity across its North American narrow-body fleet in 2014 under an agreement with Gogo® and continues to do so. Air Canada plans to outfit its Airbus A319, A320 and A321 and Embraer 190 aircraft, as well as its Air Canada Express Bombardier CRJ-705 and Embraer 175 aircraft, with Air-To-Ground Wi-Fi connectivity. At December 31, 2014, 31 aircraft were operating with the Wi-Fi system. The targeted completion date for the entire narrow-body fleet, with a designated 131 aircraft, is the first quarter of 2016.

In order to remain competitive within the digital ecosystem, Air Canada plans on enhancing its online presence to provide a responsive design experience for traditional web users, while also meeting the increased demands from its tablet and mobile users. The goal is to ensure that all customers, regardless of device and screen size, can seamlessly interact with Air Canada and access its products and services. A new mobile App is planned for the third quarter of 2015 while the transition to a new web platform is expected to be completed by the end of 2015.

New Global Operations Centre in Toronto

Air Canada opened its Global Operations Centre in January 2014. The new facility is the nerve centre for Air Canada’s entire operation, ensuring delivery of Air Canada’s schedule and the safe transport of Air Canada customers (over 38 million in 2014). Efficiencies have been gained by co-locating all key operational personnel under one roof outfitted with the latest in technological, acoustical and ergonomically sound design elements.

Customer Relationship Management System

Air Canada is planning to implement, later in 2015, a customer relationship management system which will allow it to gain valuable customer insights and deliver a more personalized and satisfying customer experience. This new system will also
allow Air Canada to more effectively target its product offerings in order to stimulate traffic, increase yields and improve customer loyalty.

Customer Service Training Programs

In 2014, Air Canada implemented a number of customer training initiatives, including “Standing Ovation” which is a dedicated customer service training program for the In-Flight Service branch. Similar training will be expanded for the airline’s customer sales and service agents in 2015.

In 2014, the Customer Service Council, which is comprised of leaders of those departments at Air Canada who have a direct impact on the customer experience, was formed with a vision to make Air Canada the global carrier of choice, known for its first-rate Canadian brand of customer service excellence and a mission to ensure Air Canada policies and projects are customer-oriented. The Council has been listening to customers through a number of forums that capture customer feedback and it is making adjustments to policies, procedures and programs as a result, such as those relating to the application of change fees, bereavement fares, military and jury duty travel and name changes for domestic travel. The Customer Service Council has also reached out to those best-placed to report on customer issues – Air Canada’s frontline employees. Focus groups have been held with frontline employees across Canada and in the U.S., and the information collected will help remove roadblocks and enable employees to better do their jobs, with greater empowerment and decision-making capabilities.

Improving the Airport Experience

Air Canada has implemented a number of important initiatives to improve the overall customer airport experience. For example, Air Canada is the only non-U.S. carrier to offer TSA Pre-check, allowing eligible customers to experience expedited, more efficient security screening for flights out of the U.S. In addition, the airline has recently instituted zonal boarding, aligning its boarding process with industry best practices.

Air Canada also introduced enhanced self-service check-in for passengers with checked baggage in collaboration with the Halifax International Airport Authority. This is the first in North America where passengers use the standard self-tagging process and then insert their own checked baggage using new generation bag drop technology. The airline has removed all the traditional check-in counters for economy check-in and, through the new self-service product, has eliminated queuing at the check-in desks. Air Canada plans on introducing this important process improvement in Montreal and Calgary, with other airports to follow.

In June 2014, Air Canada officially opened its latest International Maple Leaf Lounge® at London Heathrow Airport’s new Terminal 2. Located at Star Alliance’s largest airport hub, Air Canada’s newest International Maple Leaf Lounge was created as an extension of the overall travel experience for its International Business customers. Air Canada’s London International lounge is the airline’s 21st Maple Leaf Lounge and one of three lounges in Europe, along with departure lounges at Paris-Charles de Gaulle and Frankfurt. In the United States, Air Canada operates Maple Leaf Lounges at Los Angeles International Airport and at New York LaGuardia. In Canada, Air Canada has 13 Maple Leaf Lounges at airports across the country.

In 2015, Air Canada plans on enhancing its airport offerings to ensure it remains competitive with the world’s leading carriers. The airline intends on upgrading its airport facilities to create more exclusive check-in areas for Air Canada Altitude members and Business Class customers, in addition to refining its product offerings in its Maple Leaf lounges. To further improve the customer experience for its Altitude Super Elite 100K members and customers travelling in International Business Class, the airline will be opening additional concierge offices at Toronto Pearson, Montreal-Pierre Elliott Trudeau International Airport and Vancouver International Airport. Air Canada has also introduced airside car service for select premium customers at Toronto Pearson.

Culture Change

A healthy and dynamic corporate culture bestows a competitive advantage that can have a significant impact on Air Canada’s long-term performance. A cornerstone of Air Canada’s business strategy is the transformation of its corporate culture to one that embraces leadership, accountability and entrepreneurship. Air Canada continues to foster positive culture change by promoting entrepreneurship, engagement, empowerment and earnings for performance. Air Canada seeks to create a sense of purpose, shared values and common goals among employees, and regularly communicates through multiple channels the rationale behind its strategic initiatives and the importance of adapting to changing market conditions. This is reinforced by continual and consistent invocation of the four corporate priorities at every opportunity since their adoption in 2009.
Employee surveys conducted in 2010 and 2014 demonstrated a significant improvement in employee engagement over that period. Most notably, the results suggested that most employees are familiar with Air Canada’s key priorities and believe that the airline is on the right track towards stability. Generally, employees observed signs of increased and improved culture change occurring in the workplace and revealed their pride in working for Air Canada. Furthermore, the results indicated employees shared a heightened sense of community and teamwork.

The cross-functional approach of the airline’s operational excellence team is also driving employee engagement while increasing customer satisfaction levels. Air Canada has initiatives in place to ensure that all employees understand how the airline and its employees work together to deliver on the customer promise. These include a new employee onboarding experience and integrated management practices, as well as programs intended to nurture Air Canada’s leadership behaviours and values.

Air Canada believes that employees are more likely to embrace culture change if they take an active part in the transformation. As such, Air Canada continues to encourage employee feedback and ideas as employees are often in a good position to identify improvements and changes for success. In 2014, Air Canada’s HR and Operations Excellence teams partnered to conduct frontline focus groups across the system in order to gather meaningful feedback on numerous customer service improvements.

The airline is equally focused on ensuring that employees have the tools and training required to provide top customer care. Air Canada’s customized and adapted language training for frontline employees ensures that customers receive service in their language of choice. In addition, Air Canada also offers specific programs geared towards different employee groups to encourage professional development and growth. Internal networking opportunities and cross-branch projects allow Air Canada to remind employees of its priorities.

Air Canada regularly celebrates its employees and their achievements and will continue to host such employee recognition events going forward. A number of employee events in 2014 were aimed to foster a sense of pride and community, including a “World Skytrax Day”, where employees around the world celebrated being named by Skytrax as “Best Airline in North America” for the fifth consecutive year, Boeing 787 events held in Montreal, Vancouver, Toronto and Calgary, and Family Days in those same cities.

In October 2014, Air Canada concluded a 10-year collective agreement with ACPA, which the airline considers a tangible indication of the positive shift in culture that is taking shape.

Another indicator of culture change is Air Canada’s selection in 2015, for the second consecutive year, as one of “Canada’s Top 100 Employers”, in an annual survey by Mediacorp Canada. The national competition evaluates and identifies the country’s leading companies and organizations for attracting and retaining employees after a detailed review of their operations and human resources practices, including a comparison to others in their industry and region. It focuses on eight key areas: physical workplace; work and social atmosphere; health, financial and family benefits; vacation and time off; employee communications; performance management; training and skills development and community involvement. In citing Air Canada, Mediacorp noted that Air Canada “recognizes and encourages employee volunteers through the Volunteer Involvement Program – donating airline tickets to charitable organizations where employees volunteer.” Air Canada was also selected as one of “Montreal’s Top Employers” in an annual competition organized by the editors of Canada’s Top 100 Employers. This special designation recognizes the Montreal-area employers that lead their industries in offering exceptional places to work.

In August 2014, Air Canada released Citizens of the World, the airline’s third corporate sustainability report. The document evaluates Air Canada’s performance during 2013 in four key areas of sustainability: safety, the environment, the well-being of employees, and the company’s community involvement. Communities are important to Air Canada because they are home to its customers and employees and connecting people and communities is the essence of the airline’s business. For this reason, Air Canada ensures economic, environmental and social sustainability considerations are part of its decision-making and one way the airline does this is by reporting on its activities through Citizens of the World.
To encourage the development of a corporate culture, which is focused on transformation and performance, Air Canada has a profit sharing program which allows eligible employees to be rewarded for their contributions and share in the financial success of the airline. Based on the financial results for the year ended December 31, 2014, the profit sharing program will pay out $46 million in early 2015, an increase of $15 million or 48% when compared to 2013. Air Canada employees also have the ability to participate in the airline’s Employee Share Ownership Plan. As at December 31, 2014, in aggregate, 23,056,408 shares or almost 8% of total issued and outstanding shares of Air Canada were held by Air Canada employees and unions under various programs, including 17,647,059 shares held under a trust arrangement in connection with pension arrangements concluded in 2009.

In 2015, the airline will continue to promote employee awareness of the importance of Air Canada achieving its financial goals and will continue to communicate the message that a healthy financial profile can provide stability, lower risk and support growth opportunities.
5. OVERVIEW

In 2014, Air Canada generated adjusted net income of $531 million, the highest in Air Canada’s history and an improvement of $191 million from 2013. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information. On a GAAP basis, Air Canada reported net income of $105 million or $0.34 per diluted share compared to net income of $10 million or $0.02 per diluted share in 2013, an improvement of $95 million or $0.32 per diluted share.

Full Year 2014 Financial Summary

The following provides an overview of Air Canada’s results of operations and financial position for the full year 2014 compared to the full year 2013.

- Operating revenues of $13,272 million, an increase of $890 million or 7% from 2013.

- Passenger revenues of $11,804 million, an increase of $783 million or 7.1% from 2013, on traffic growth of 8.5% partly offset by a yield decline of 1.3%. An increase in average stage length of 2.3% had the effect of reducing system yield by 1.3 percentage points. On a stage length adjusted basis, system yield was unchanged from 2013.

- An ASM capacity increase of 7.8% from 2013, in line with the 7.0% to 8.0% full year 2014 ASM capacity growth projected in Air Canada’s news release dated November 6, 2014. The capacity growth in 2014 was primarily driven by increased seat density from Air Canada rouge and the introduction of six Boeing 787 aircraft and five higher-density Boeing 777 aircraft into the mainline fleet.

- The favourable impact of a weaker Canadian dollar on foreign currency denominated passenger revenues increased passenger revenues by $208 million in 2014. The unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses (mainly U.S.) increased operating expenses by approximately $397 million in 2014.

- An adjusted CASM reduction of 2.6% from 2013, in line with the 2.5% to 3.5% decrease projected in Air Canada’s news release dated November 6, 2014. Refer to section 20 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Operating income of $815 million compared to operating income of $619 million in 2013, an improvement of $196 million. In 2013, Air Canada recorded operating expense reductions related to benefit plan amendments of $82 million as a result of amendments to defined benefit pension plans. Air Canada reported an operating margin of 6.1% compared to an operating margin (excluding the impact of benefits plan amendments) of 4.3% in 2013, an improvement of 1.8 percentage points.

- Net income of $105 million or $0.34 per diluted share compared to net income of $10 million or $0.02 per diluted share in 2013. The net income in 2014 included foreign exchange losses of $307 million, favourable tax-related provision adjustments of $41 million, as well as one-time payments totaling $30 million made to ACPA members pursuant to the ACPA collective agreement concluded in October 2014. The net income in 2013 included foreign exchange losses of $120 million, an interest charge of $95 million pertaining to the purchase of the airline’s senior secured notes which were to become due in 2015 and 2016, impairment charges amounting to $30 million and the favourable impact of benefit plan amendments of $82 million.

- EBITDAR of $1,671 million compared to EBITDAR (excluding the impact of benefit plan amendments) of $1,433 million in 2013, an increase of $238 million. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

- Adjusted net income of $531 million or $1.81 per diluted share compared to adjusted net income of $340 million or $1.20 per diluted share in 2013, an improvement of $191 million or $0.61 per diluted share. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.
Cash flow from operations of $941 million, an improvement of $210 million versus 2013, consistent with the improvement in operating income. Free cash flow was negative $560 million, a decline of $329 million due to an increase in capital expenditures which included the acquisition of one Boeing 777-300 and six Boeing 787-8 aircraft in 2014. 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 9.5 “Consolidated Cash Flow Movements” of this MD&A for additional information.

Adjusted net debt amounted to $5,132 million at December 31, 2014, an increase of $781 million from December 31, 2013, mainly due to the purchase of six Boeing 787-8 and one Boeing 777 aircraft in 2014 and the unfavourable impact of a weaker Canadian dollar as at December 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 $365 million to long-term debt in 2014. The airline’s adjusted net debt to EBITDAR ratio was 3.1 at December 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 9.3 “Adjusted Net Debt” of this MD&A for additional information.

Unrestricted liquidity (cash, short-term investments and undrawn lines of credit) of $2,685 million at December 31, 2014 (December 31, 2013 – $2,364 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 December 31, 2014, cash and short-term investments amounted to $2,275 million and undrawn lines of credit amounted to $410 million. At December 31, 2013, cash and short-term investments amounted to $2,208 million and undrawn lines of credit amounted to $156 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 December 31, 2014 of 12.1% versus 10.5% at December 31, 2013. Air Canada’s goal is to achieve a sustainable ROIC of 10% to 13% by 2015. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

Fourth Quarter 2014 Financial Summary

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

Operating revenues of $3,104 million, an increase of $210 million or 7% from the fourth quarter of 2013.

An ASM capacity increase of 8.5% from the fourth quarter of 2013, in line with the 7.75% to 8.75% capacity increase projected in Air Canada's news release dated November 6, 2014. The capacity growth in the fourth quarter of 2014 was primarily driven by increased seat density from Air Canada rouge and the introduction of six Boeing 787 aircraft and one higher-density Boeing 777 aircraft into the mainline fleet.

Passenger revenues of $2,755 million, an increase of $195 million or 7.6% from the fourth quarter of 2013, on traffic growth of 9.4% partly offset by a yield decline of 1.9%. An increase in average stage length of 2.2% had the effect of reducing system yield by 1.2 percentage points. On a stage length adjusted basis, system yield decreased 0.7% year-over-year.

A PRASM decline of 1.2% from the fourth quarter of 2013, as the 1.9% decline in yield was partly offset by a passenger load factor improvement of 0.6 percentage points.

The favourable impact of a weaker Canadian dollar on foreign currency denominated passenger revenues increased passenger revenues by $33 million in the fourth quarter of 2014. The unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses (mainly U.S.) increased operating expenses by approximately $89 million in the fourth quarter of 2014.

An adjusted CASM which was unchanged from the fourth quarter of 2013 versus the 1.0% to 2.0% decrease projected in Air Canada’s news release dated November 6, 2014. This difference was primarily due to higher than forecasted employee benefits expense mainly due to revised actuarial valuations related to pension and post-employment benefits, an increase in accruals related to employee profit sharing programs, the timing of maintenance events versus
what was previously projected and, to a lesser extent, the impact of a weaker than anticipated Canadian dollar. Adjusted CASM is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

➤ Operating income of $106 million compared to operating income of $135 million in the fourth quarter of 2013, a decrease of $29 million. In the fourth quarter of 2014, one-time payments totaling $30 million were made to ACPA members pursuant to the ACPA collective agreement concluded in October 2014. In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans. Air Canada reported an operating margin of 3.4% compared to an operating margin (excluding the impact of benefits plan amendments) of 1.8% in the fourth quarter of 2013, an improvement of 1.6 percentage points.

➤ A net loss of $100 million or $0.35 per diluted share compared to a net loss of $6 million or $0.02 per diluted share in the fourth quarter of 2013. The net loss in the fourth quarter of 2014 included foreign exchange losses of $115 million and one-time payments totaling $30 million as discussed above. The net loss in the fourth quarter of 2013 included foreign exchange losses of $55 million and the favourable impact of benefit plan amendments of $82 million.

➤ EBITDAR of $319 million compared to EBITDAR (excluding the impact of benefit plan amendments) of $277 million in the fourth quarter of 2013, an increase of $42 million. In the fourth quarter of 2014, as discussed above, one-time payments totaling $30 million were made to ACPA members. Air Canada previously estimated that EBITDAR was negatively impacted in December 2013 by $15 million as a result of severe weather conditions. EBITDAR is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

➤ Adjusted net income of $67 million or $0.23 per diluted share compared to adjusted net income of $3 million or $0.01 per diluted share in the fourth quarter of 2013, an improvement of $64 million or $0.22 per diluted share. Adjusted net-income is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

➤ Negative free cash flow of $366 million, $90 million less than 2013, driven by the addition of two Boeing 787-8 aircraft, as well as changes in non-cash working capital, particularly the timing of fuel payments when compared to the same quarter in 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 9.5 “Consolidated Cash Flow Movements” of this MD&A for additional information.
6. RESULTS OF OPERATIONS – FULL YEAR 2014 VERSUS FULL YEAR 2013

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

(Canadian dollars in millions, except per share figures)

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2013</th>
<th>$</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Passenger</td>
<td>$11,804</td>
<td>$11,021</td>
<td>$783</td>
<td>7</td>
</tr>
<tr>
<td>Cargo</td>
<td>502</td>
<td>474</td>
<td>28</td>
<td>6</td>
</tr>
<tr>
<td>Other</td>
<td>966</td>
<td>887</td>
<td>79</td>
<td>9</td>
</tr>
<tr>
<td>Total revenues</td>
<td>13,272</td>
<td>12,382</td>
<td>890</td>
<td>7</td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aircraft fuel</td>
<td>3,747</td>
<td>3,534</td>
<td>213</td>
<td>6</td>
</tr>
<tr>
<td>Wages, salaries, and benefits (1)</td>
<td>2,282</td>
<td>2,247</td>
<td>35</td>
<td>2</td>
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<tr>
<td>Benefit plan amendments (2)</td>
<td>-</td>
<td>(82)</td>
<td>82</td>
<td>100</td>
</tr>
<tr>
<td>Capacity purchase agreements</td>
<td>1,182</td>
<td>1,123</td>
<td>59</td>
<td>5</td>
</tr>
<tr>
<td>Airport and navigation fees</td>
<td>1,031</td>
<td>983</td>
<td>48</td>
<td>5</td>
</tr>
<tr>
<td>Aircraft maintenance</td>
<td>728</td>
<td>632</td>
<td>96</td>
<td>15</td>
</tr>
<tr>
<td>Sales and distribution costs</td>
<td>672</td>
<td>613</td>
<td>59</td>
<td>10</td>
</tr>
<tr>
<td>Depreciation, amortization and impairment (3)</td>
<td>543</td>
<td>578</td>
<td>(35)</td>
<td>(6)</td>
</tr>
<tr>
<td>Ground package costs</td>
<td>377</td>
<td>327</td>
<td>50</td>
<td>15</td>
</tr>
<tr>
<td>Aircraft rent</td>
<td>313</td>
<td>318</td>
<td>5</td>
<td>(2)</td>
</tr>
<tr>
<td>Food, beverages and supplies</td>
<td>309</td>
<td>289</td>
<td>20</td>
<td>7</td>
</tr>
<tr>
<td>Communications and information technology</td>
<td>204</td>
<td>190</td>
<td>14</td>
<td>7</td>
</tr>
<tr>
<td>Other (4)</td>
<td>1,069</td>
<td>1,011</td>
<td>58</td>
<td>6</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>12,457</td>
<td>11,763</td>
<td>694</td>
<td>6</td>
</tr>
<tr>
<td>Operating income</td>
<td>815</td>
<td>619</td>
<td>196</td>
<td></td>
</tr>
</tbody>
</table>

Non-operating income (expense)

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2013</th>
<th>$</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign exchange loss</td>
<td>(307)</td>
<td>(120)</td>
<td>(187)</td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>39</td>
<td>32</td>
<td>7</td>
<td></td>
</tr>
<tr>
<td>Interest expense (5)</td>
<td>(322)</td>
<td>(397)</td>
<td>75</td>
<td></td>
</tr>
<tr>
<td>Interest capitalized</td>
<td>30</td>
<td>46</td>
<td>(16)</td>
<td></td>
</tr>
<tr>
<td>Net financing expense relating to employee benefits</td>
<td>(134)</td>
<td>(208)</td>
<td>74</td>
<td></td>
</tr>
<tr>
<td>Fuel and other derivatives</td>
<td>(1)</td>
<td>37</td>
<td>(38)</td>
<td></td>
</tr>
<tr>
<td>Other (6)</td>
<td>(15)</td>
<td>(7)</td>
<td>(8)</td>
<td></td>
</tr>
<tr>
<td>Total non-operating expense</td>
<td>(710)</td>
<td>(617)</td>
<td>(93)</td>
<td></td>
</tr>
<tr>
<td>Income before income taxes</td>
<td>105</td>
<td>2</td>
<td>103</td>
<td></td>
</tr>
<tr>
<td>Income taxes</td>
<td>-</td>
<td>8</td>
<td>(8)</td>
<td></td>
</tr>
<tr>
<td>Net income</td>
<td>$105</td>
<td>$10</td>
<td>$95</td>
<td></td>
</tr>
<tr>
<td>Net income per share – diluted</td>
<td>$0.34</td>
<td>$0.02</td>
<td>$0.32</td>
<td></td>
</tr>
<tr>
<td>EBITDAR, excluding the impact of benefit plan amendments (7)(8)</td>
<td>$1,671</td>
<td>$1,433</td>
<td>$238</td>
<td></td>
</tr>
<tr>
<td>EBITDAR (8)</td>
<td>$1,671</td>
<td>$1,515</td>
<td>$156</td>
<td></td>
</tr>
<tr>
<td>Adjusted net income (7)</td>
<td>$531</td>
<td>$340</td>
<td>$191</td>
<td></td>
</tr>
<tr>
<td>Adjusted net income per share – diluted (7)</td>
<td>$1.81</td>
<td>$1.20</td>
<td>$0.61</td>
<td></td>
</tr>
</tbody>
</table>

(1) In 2014, one-time payments totaling $30 million were made to ACA members under a collective agreement concluded in October 2014.
(2) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans.
(3) In 2013, Air Canada recorded impairment charges amounting to $30 million.
(4) In 2014, Air Canada recorded favourable tax-related provision adjustments of $41 million.
(5) In 2013, Air Canada recorded an interest charge of $55 million related to the purchase of its senior secured notes due in 2015 and 2016.
(6) EBITDAR is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.
(7) Adjusted net income (loss) and adjusted net income (loss) per share – diluted are non-GAAP financial measures. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.
System passenger revenues increased 7.1% from 2013

In 2014, on capacity growth of 7.8%, system passenger revenues of $11,804 million increased $783 million or 7.1% from 2013. This increase was mainly due to traffic growth of 8.5% partly offset by a yield decline of 1.3%. Modest yield declines are an anticipated and natural consequence of the successful implementation of Air Canada’s business strategy to profitably increase long-haul international and leisure flying.

In 2014, system business cabin revenues increased $109 million or 4.9% from 2013 due to a yield improvement.

The table below provides passenger revenue by geographic region for 2014 and 2013.

<table>
<thead>
<tr>
<th>Passenger Revenue</th>
<th>2014 $ Million</th>
<th>2013 $ Million</th>
<th>Change $ Million</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>4,381</td>
<td>4,237</td>
<td>144</td>
<td>3.4</td>
</tr>
<tr>
<td>U.S. transborder</td>
<td>2,379</td>
<td>2,176</td>
<td>203</td>
<td>9.4</td>
</tr>
<tr>
<td>Atlantic</td>
<td>2,554</td>
<td>2,263</td>
<td>291</td>
<td>12.8</td>
</tr>
<tr>
<td>Pacific</td>
<td>1,710</td>
<td>1,618</td>
<td>92</td>
<td>5.6</td>
</tr>
<tr>
<td>Other</td>
<td>780</td>
<td>727</td>
<td>53</td>
<td>7.3</td>
</tr>
<tr>
<td>System</td>
<td>11,804</td>
<td>11,021</td>
<td>783</td>
<td>7.1</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Full Year 2014 Versus Full Year 2013</th>
<th>Passenger Revenue % Change</th>
<th>Capacity (ASMs) % Change</th>
<th>Traffic (RPMs) % Change</th>
<th>Passenger Load Factor % Change</th>
<th>Yield % Change</th>
<th>PRASM % Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>3.4</td>
<td>4.8</td>
<td>5.3</td>
<td>0.4</td>
<td>(2.3)</td>
<td>(1.8)</td>
</tr>
<tr>
<td>U.S. transborder</td>
<td>9.4</td>
<td>9.8</td>
<td>13.1</td>
<td>2.4</td>
<td>(2.8)</td>
<td>0.1</td>
</tr>
<tr>
<td>Atlantic</td>
<td>12.8</td>
<td>14.3</td>
<td>13.6</td>
<td>(0.5)</td>
<td>(0.6)</td>
<td>(1.1)</td>
</tr>
<tr>
<td>Pacific</td>
<td>5.6</td>
<td>4.3</td>
<td>4.6</td>
<td>0.3</td>
<td>1.3</td>
<td>1.7</td>
</tr>
<tr>
<td>Other</td>
<td>7.3</td>
<td>3.3</td>
<td>5.7</td>
<td>1.9</td>
<td>2.1</td>
<td>4.5</td>
</tr>
<tr>
<td>System</td>
<td>7.1</td>
<td>7.8</td>
<td>8.5</td>
<td>0.6</td>
<td>(1.3)</td>
<td>(0.6)</td>
</tr>
</tbody>
</table>

In 2014, Air Canada’s system capacity was 7.8% higher than in 2013, with capacity growth reflected in all markets.

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

- The 8.5% traffic increase which reflected traffic growth in all markets. Consistent with the airline’s objective of increasing global international-to-international connecting traffic through its major Canadian hubs, the traffic growth in 2014 also reflected incremental connecting traffic to international destinations.

- The 1.3% yield decrease which was the result of an increase in average stage length of 2.3%, which had the effect of reducing system yield by 1.3 percentage points, the impact of higher proportional growth of lower-yielding international-to-international passenger flows in support of the airline’s international expansion strategy, a higher proportion of seats into long-haul leisure markets, and the use of lower-cost Boeing 777 high-density aircraft which have a larger economy cabin. On a stage length adjusted basis, system yield was unchanged from 2013. These decreases were offset by a favourable currency impact of $208 million and improvements in Air Canada’s business cabin revenue performance.

The 0.6% PRASM decrease was due to the lower yield largely offset by a passenger load factor improvement of 0.6 percentage points.
Refer to section 7 “Results of Operations” of this MD&A for year-over-year percentage changes in passenger revenues, capacity, traffic, passenger load factor, yield and PRASM by quarter for the fourth quarter 2014 and each of the previous four quarters.

**Domestic passenger revenues increased 3.4% from 2013**

In 2014, on a capacity increase of 4.8%, domestic passenger revenues of $4,381 million increased $144 million or 3.4% from 2013 due to traffic growth of 5.3% as well as an increase in baggage fee revenue year-over-year (baggage fee revenues are not included in Air Canada’s yield and PRASM results). These increases were partly offset by a yield decline of 2.3%.

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

- The 5.3% traffic increase which reflected traffic growth on all major domestic services. The traffic growth in 2014 reflected increases on services within Canada, as well as incremental connecting traffic to international destinations.
- An increase in baggage fee revenue following an adjustment to the airline’s first checked bag policy which became effective for travel on or after November 2, 2014.
- The yield decline of 2.3% which reflected increased industry capacity and significant competitive pricing activities on routes within Ontario and Quebec and on routes within Western Canada. Also, early in 2014, domestic yields were under pressure due to certain commercial initiatives in the market place related to channels of distribution. In addition, in 2014, Air Canada experienced higher proportional growth of lower-yielding international and U.S. transborder passenger flows connecting onto domestic flights. These yield decreases were partly offset by a favourable currency impact of $29 million.

The 1.8% PRASM decrease was due to the yield decline as passenger load factor improved 0.4 percentage points year-over-year.

**U.S. transborder passenger revenues increased 9.4% from 2013**

In 2014, on capacity growth of 9.8%, U.S. transborder passenger revenues of $2,379 million increased $203 million or 9.4% from 2013 mainly due to traffic growth of 13.1% partly offset by a yield decrease of 2.8%.

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

- The traffic increase of 13.1% 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. The traffic growth was achieved by successfully filling long-haul capacity and through traffic growth on U.S. short-haul routes. Air Canada also experienced higher proportional growth of international-to-international passenger flows from the U.S. when compared to 2013 in addition to traffic growth between Canada and the U.S.
- The 2.8% yield decline which reflected a 3.4% longer average stage length, driven by route composition changes as long-haul (lower-yielding) capacity grew while short-haul (higher-yielding) capacity was slightly reduced when compared to 2013. This increase in average stage length had the effect of reducing U.S. transborder yield by 1.9 percentage points. Long-haul growth was led by lower-cost Air Canada rouge flying allowing Air Canada to effectively compete on lower-yielding leisure routes. Additionally, 2014 experienced a significantly higher proportion of lower-yielding incremental international-to-international passenger flows in support of the airline’s international expansion strategy. These yield declines were largely offset by improvements in Air Canada’s business cabin revenue performance, traffic growth on high-yielding short-haul routes, and a favourable currency impact of $47 million.

The 0.1% PRASM increase was due to a passenger load factor improvement of 2.4 percentage points which was almost fully offset by the yield decline.
Atlantic passenger revenues increased 12.8% from 2013

In 2014, on capacity growth of 14.3%, Atlantic passenger revenues of $2,554 million increased $291 million or 12.8% from 2013 due to traffic growth of 13.6% partly offset by a yield decrease of 0.6%.

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

- The 13.6% traffic increase which reflected traffic growth on all major Atlantic services.
- The 0.6% yield decline which reflected a longer average stage length, which had the effect of reducing Atlantic yield by 0.4 percentage points, a higher proportion of seats into leisure-focused long-haul markets, additional Atlantic services being served with lower-cost Boeing 777 higher-density aircraft which have a larger economy cabin, as well as new and increased lower-cost flying by Air Canada rouge which offers a Premium rouge product but has no international business cabin. These yield decreases were largely offset by improvements in Air Canada’s business cabin revenue performance, an increase in premium economy traffic which resulted in higher average fares, and a favourable currency impact of $82 million.

The 1.1% PRASM decrease was due to the yield decline and a 0.5 percentage point decrease in passenger load factor.

Pacific passenger revenues increased 5.6% from 2013

In 2014, on capacity growth of 4.3%, Pacific passenger revenues of $1,710 million increased $92 million or 5.6% from 2013 due to traffic and yield growth of 4.6% and 1.3%, respectively.

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

- The 4.6% traffic increase which reflected traffic growth on services to Hong Kong, Japan and Australia where capacity was increased year-over-year partly offset by traffic decreases on services to Korea and China where capacity was reduced year-over-year.
- The 1.3% yield increase which reflected yield growth on all Pacific services with the exception of Hong Kong, a strong yield performance on services to Korea, China and Australia and, to a lesser extent, Japan, improvements in the airline’s business cabin revenue performance, growth in premium economy traffic which resulted in higher average fares, and a favourable currency impact of $36 million. With respect to the airline’s services to Hong Kong, Air Canada operates a lower-cost Boeing 777 higher-density aircraft on its Vancouver-Hong Kong route which has a larger economy cabin. The use of this lower-cost aircraft on high-volume routes, such as Vancouver-Hong Kong, is allowing the airline to access traditionally lower-yielding traffic while improving profitability of the routes.

The 1.7% PRASM increase was due to the higher yield and to a passenger load factor improvement of 0.3 percentage points.

Other passenger revenues increased 7.3% from 2013

In 2014, on a capacity increase of 3.3%, Other passenger revenues (comprised of routes to the Caribbean, Mexico and Central and South America) of $780 million increased $53 million or 7.3% from 2013 due to traffic and yield growth of 5.7% and 2.1%, respectively.

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

- The overall 5.7% traffic increase which reflected traffic growth on all major services in the Other markets with the exception of South America where capacity was reduced year-over-year.
- The overall 2.1% yield increase which reflected yield growth on the airline’s routes to Mexico and to traditional sun destinations on higher average fares and a favourable currency impact of $14 million. These yield increases were partly offset by a yield decline on services to South America, in large part due to the airline’s suspension of service to Venezuela.
The 4.5% PRASM increase was due to the yield growth and a 1.9 percentage point improvement in passenger load factor. PRASM improvements were recorded on all major services in the Other markets.

**Cargo revenues increased 5.9% from 2013**

In 2014, cargo revenues of $502 million increased $28 million or 5.9% from 2013 due to traffic growth of 8.0% partly offset by a yield decline of 1.9%.

The table below provides cargo revenue by geographic region for 2014 and 2013.

<table>
<thead>
<tr>
<th>Cargo Revenue</th>
<th>2014 $ Million</th>
<th>2013 $ Million</th>
<th>Change $ Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>66</td>
<td>63</td>
<td>3</td>
</tr>
<tr>
<td>U.S. transborder</td>
<td>20</td>
<td>18</td>
<td>2</td>
</tr>
<tr>
<td>Atlantic</td>
<td>191</td>
<td>171</td>
<td>20</td>
</tr>
<tr>
<td>Pacific</td>
<td>190</td>
<td>185</td>
<td>5</td>
</tr>
<tr>
<td>Other</td>
<td>35</td>
<td>37</td>
<td>(2)</td>
</tr>
<tr>
<td><strong>System</strong></td>
<td><strong>502</strong></td>
<td><strong>474</strong></td>
<td><strong>28</strong></td>
</tr>
</tbody>
</table>

The table below provides year-over-year percentage changes in cargo revenues and operating statistics for 2014 and 2013.

<table>
<thead>
<tr>
<th>Full Year 2014 Versus Full Year 2013</th>
<th>Cargo Revenue % Change</th>
<th>Capacity (ETMs) % Change</th>
<th>Rev / ETM % Change</th>
<th>Traffic (RTMs) % Change</th>
<th>Yield / RTM % Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>5.6</td>
<td>21.0</td>
<td>(12.8)</td>
<td>32.3</td>
<td>(20.2)</td>
</tr>
<tr>
<td>U.S. transborder</td>
<td>11.7</td>
<td>25.1</td>
<td>(10.7)</td>
<td>13.6</td>
<td>(1.7)</td>
</tr>
<tr>
<td>Atlantic</td>
<td>11.8</td>
<td>10.6</td>
<td>1.1</td>
<td>16.2</td>
<td>(3.8)</td>
</tr>
<tr>
<td>Pacific</td>
<td>2.1</td>
<td>0.7</td>
<td>1.4</td>
<td>(0.5)</td>
<td>2.6</td>
</tr>
<tr>
<td>Other</td>
<td>(4.3)</td>
<td>1.3</td>
<td>(5.5)</td>
<td>(4.1)</td>
<td>(0.2)</td>
</tr>
<tr>
<td><strong>System</strong></td>
<td><strong>5.9</strong></td>
<td><strong>8.5</strong></td>
<td><strong>(2.4)</strong></td>
<td><strong>8.0</strong></td>
<td><strong>(1.9)</strong></td>
</tr>
</tbody>
</table>

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

- The 8.0% traffic increase which reflected traffic growth in all markets with the exception of the Pacific and Other markets. The overall traffic growth reflected more favourable economic conditions in the U.S. and Europe.

- The 1.9% overall yield decrease which reflected increased industry capacity and aggressive competitive pricing activities when compared to 2013. These yield decreases were partly offset by yield growth in the Pacific market and a favourable currency impact.

**Other revenues increased 9% from 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 2014, Other revenues of $966 million increased $79 million or 9% from 2013 mainly due to higher ground package revenues at Air Canada Vacations, the result of higher passenger volumes, as well as growth in passenger-related fees.
CASM (excluding the impact of benefit plan amendments) decreased 2.4% from 2013. Adjusted CASM decreased 2.6% from 2013.

The following table compares Air Canada’s CASM for 2014 versus 2013.

<table>
<thead>
<tr>
<th>(cents per ASM)</th>
<th>Full Year</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Aircraft fuel</td>
<td>5.07</td>
<td>5.15</td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>2.42</td>
<td>2.48</td>
</tr>
<tr>
<td>Benefits</td>
<td>0.67</td>
<td>0.79</td>
</tr>
<tr>
<td>Benefit plan amendments (1)</td>
<td>-</td>
<td>(0.12)</td>
</tr>
<tr>
<td>Capacity purchase agreements</td>
<td>1.60</td>
<td>1.64</td>
</tr>
<tr>
<td>Airport and navigation fees</td>
<td>1.40</td>
<td>1.43</td>
</tr>
<tr>
<td>Aircraft maintenance</td>
<td>0.99</td>
<td>0.92</td>
</tr>
<tr>
<td>Sales and distribution costs</td>
<td>0.91</td>
<td>0.89</td>
</tr>
<tr>
<td>Depreciation, amortization and impairment</td>
<td>0.73</td>
<td>0.84</td>
</tr>
<tr>
<td>Ground package costs</td>
<td>0.51</td>
<td>0.48</td>
</tr>
<tr>
<td>Aircraft rent</td>
<td>0.42</td>
<td>0.46</td>
</tr>
<tr>
<td>Food, beverages and supplies</td>
<td>0.42</td>
<td>0.42</td>
</tr>
<tr>
<td>Communications and information technology</td>
<td>0.28</td>
<td>0.28</td>
</tr>
<tr>
<td>Other</td>
<td>1.44</td>
<td>1.49</td>
</tr>
<tr>
<td>CASM</td>
<td>16.86</td>
<td>17.15</td>
</tr>
<tr>
<td>Remove:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benefit plan amendments (1)</td>
<td>-</td>
<td>0.12</td>
</tr>
<tr>
<td>CASM (excluding the impact of benefit plan amendments)</td>
<td>16.86</td>
<td>17.27</td>
</tr>
</tbody>
</table>

(1) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans.

### Adjusted CASM

|CASM| 16.86 | 17.15 | (0.29) | (1.7)| Remove: Fuel expense, ground package costs at Air Canada Vacations, benefit plan amendments and unusual items (1)(3)(4) (5.57) | (5.55) | (0.02) | (0.4)| Adjusted CASM (5) | 11.29 | 11.60 | (0.31) | (2.6)| (1) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans. (2) In 2013, Air Canada recorded impairment charges amounting to $30 million. (3) In 2014, Air Canada recorded favourable tax-related provision adjustments of $41 million. (4) In 2014, one-time payments totaling $30 million were made to ACPA members under a collective agreement concluded in October 2014. (5) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information. Operating expenses increased 6% from 2013

In 2014, operating expenses of $12,457 million increased $694 million or 6% from 2013 on capacity growth of 7.8%. The unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars) in 2014, when compared to 2013, increased operating expenses by approximately $397 million. Refer to section 12 “Financial Instruments and Risk Management” of this MD&A for information on Air Canada’s foreign exchange risk management strategy. In 2013, Air Canada recorded an operating expense reduction of $82 million in Benefit plan amendments and impairment charges amounting to $30 million in Depreciation, amortization and impairment expense.
Fuel expense increased 6% from 2013

In 2014, fuel expense of $3,747 million increased $213 million or 6% from 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 2013, which accounted for an increase of $221 million or 7%, and a higher volume of fuel litres consumed, which accounted for an increase of $192 million. These increases were partly offset by the impact of a 6% year-over-year decline in jet fuel prices, which accounted for a decrease of $200 million to fuel expense in 2014.

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

<table>
<thead>
<tr>
<th>(Canadian dollars in millions, except where indicated)</th>
<th>Full Year</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Aircraft fuel expense – GAAP</td>
<td>$ 3,747</td>
<td>$ 3,534</td>
</tr>
<tr>
<td>Add: Net cash payments on fuel derivatives(^{(1)})</td>
<td>16</td>
<td>21</td>
</tr>
<tr>
<td>Economic cost of fuel – Non-GAAP(^{(2)})</td>
<td>$ 3,763</td>
<td>$ 3,555</td>
</tr>
<tr>
<td>Fuel consumption (thousands of litres)</td>
<td>4,213,214</td>
<td>3,992,617</td>
</tr>
<tr>
<td>Fuel cost per litre (cents) – GAAP</td>
<td>88.9</td>
<td>88.5</td>
</tr>
<tr>
<td>Economic fuel cost per litre (cents) – Non-GAAP(^{(2)})</td>
<td>89.3</td>
<td>89.0</td>
</tr>
</tbody>
</table>

\(^{(1)}\) 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 $2,282 million in 2014, an increase of $35 million or 2% from 2013

In 2014, wages and salaries expense of $1,786 million increased $82 million or 5% from 2013, mainly due to higher average salaries, Air Canada having recorded one-time payments totaling $30 million related to its collective agreement with ACPA in 2014 while no such payments were recorded in 2013, and an increase in expense accruals related to the annual employee profit sharing programs. These increases were partly offset by the favourable impact of Air Canada having outsourced its London ground handling operations to a third party provider in 2014.

In 2014, employee benefits expense of $496 million decreased $47 million or 9% from 2013, reflecting a reduction in foreign pension plan liabilities and the impact of higher discount rates which decreased the current service cost of defined benefit pension plans. These decreases were partly offset by an increase in Air Canada’s match of employee contributions in the Employee Share Ownership Plan.

Capacity purchase costs increased 5% from 2013

In 2014, capacity purchase costs of $1,182 million increased $59 million or 5% from 2013, mainly due to an increase in block hours flown by Sky Regional and, to a lesser extent, other third party carriers (excluding Jazz) operating under capacity purchase agreements with Air Canada, higher rates under the Jazz CPA and an unfavourable currency impact. These increases were partly offset by a decline in block hours flown by Jazz under the Jazz CPA.

Airport and navigation fees increased 5% from 2013

In 2014, airport and navigation fees of $1,031 million increased $48 million or 5% from 2013, largely due to the addition of Boeing 777 and 787 aircraft to Air Canada’s operating fleet, an unfavourable currency impact, and rate increases in certain stations. These increases were partly offset by the favourable impact of the agreement, concluded in October 2013, with the GTAA which is allowing the airline to grow its share of international connecting traffic at Toronto Pearson on a more cost effective basis.
Aircraft maintenance expense increased 15% from 2013

In 2014, aircraft maintenance expense of $728 million increased $96 million or 15% from 2013. This increase in aircraft maintenance expense was due to a $43 million unfavourable currency impact, an increase in expenses related to maintenance provisions, a higher volume of engine and airframe activity, as well as the impact of Air Canada having recorded favourable accrual adjustments of $15 million in 2013 while no such adjustments were recorded in 2014. The increase in expenses related to maintenance provisions was mainly due to a fewer number of aircraft lease extensions when compared to 2013 which resulted in an expense increase of $27 million. Lease term extensions postpone the expected timing of the end of lease costs and lengthen the period over which expenses are recorded, and result in a cumulative adjustment to reflect the revised provision required as at the balance sheet date, thus reducing maintenance expense in the period. These increases were partly offset by the impact of favourable terms and discounts negotiated on new maintenance service agreements.

Sales and distribution costs increased 10% from 2013

In 2014, sales and distribution costs of $672 million increased $59 million or 10% from 2013 on passenger revenue growth of 7.1%. This growth in sales and distribution costs was mainly due to the impact of a higher volume of ticket sales generated through GDS providers, a change in commission structure to drive higher passenger revenues, and an increase in credit card expenses which was in line with sales and revenue growth. An unfavourable currency impact was also a contributing factor to the increase in sales and distribution costs year-over-year.

Depreciation, amortization and impairment expense decreased 6% from 2013

In 2014, depreciation, amortization and impairment expense of $543 million decreased $35 million or 6% from 2013.

In 2013, Air Canada recorded an impairment charge of $30 million, including $24 million related to four Airbus A340-300 aircraft (none of which were being operated by Air Canada), while no such charge was recorded in 2014.

The impact of the addition of five Boeing 777 and six Boeing 787 aircraft to the airline’s operating fleet was largely offset by the impact of certain engine and airframe maintenance events becoming fully amortized, the disposal of Airbus A340-300 aircraft (none of which were being operated by Air Canada) and by a decrease in depreciation expense related to the airline’s interior refurbishment programs.

Ground package costs increased 15% from 2013

In 2014, the cost of ground packages at Air Canada Vacations amounted to $377 million, an increase of $50 million or 15% from 2013. This increase was primarily due to higher passenger volumes and an unfavourable currency impact.

Aircraft rent expense decreased 2% from 2013

In 2014, aircraft rent expense of $313 million decreased $5 million or 2% from 2013. A decrease in aircraft rent expense due to more favourable rates on lease renewals was largely offset by an unfavourable currency impact of $20 million.

Other operating expenses increased 6% from 2013

In 2014, Other operating expenses of $1,069 million increased $58 million or 6% from 2013. The increase in Other expenses was driven by the 7.8% capacity growth, an increase in terminal handling expenses as a result of Air Canada’s international expansion and the impact of the airline having outsourced its London ground handling operations to a third party provider in 2014 (the savings associated with this initiative are included in other expense categories, such as wages and salaries expense, for a net overall cost reduction), and by higher advertising and promotion expenses. Partly offsetting these increases was the impact of Air Canada having recorded favourable tax-related provision adjustments of $41 million in 2014 while no such adjustments were recorded in 2013. 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 2013 while no such charges were recorded in 2014.
The following table provides a breakdown of the more significant items included in Other expenses:

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>2014</th>
<th>2013</th>
<th>$</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Terminal handling</td>
<td>$235</td>
<td>$196</td>
<td>$39</td>
<td>20</td>
</tr>
<tr>
<td>Building rent and maintenance</td>
<td>147</td>
<td>131</td>
<td>16</td>
<td>12</td>
</tr>
<tr>
<td>Crew cycle</td>
<td>141</td>
<td>120</td>
<td>21</td>
<td>18</td>
</tr>
<tr>
<td>Miscellaneous fees and services</td>
<td>122</td>
<td>128</td>
<td>(6)</td>
<td>(5)</td>
</tr>
<tr>
<td>Remaining other expenses</td>
<td>424</td>
<td>436</td>
<td>(12)</td>
<td>(3)</td>
</tr>
<tr>
<td><strong>Other operating expenses</strong></td>
<td>$1,069</td>
<td>$1,011</td>
<td>$58</td>
<td>6</td>
</tr>
</tbody>
</table>

Non-operating expense amounted to $710 million in 2014 compared to non-operating expense of $617 million in 2013.

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

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>2014</th>
<th>2013</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign exchange loss</td>
<td>$ (307)</td>
<td>$ (120)</td>
<td>$ (187)</td>
</tr>
<tr>
<td>Interest income</td>
<td>39</td>
<td>32</td>
<td>7</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(322)</td>
<td>(397)</td>
<td>75</td>
</tr>
<tr>
<td>Interest capitalized</td>
<td>30</td>
<td>46</td>
<td>(16)</td>
</tr>
<tr>
<td>Net financing expense relating to employee benefits</td>
<td>(134)</td>
<td>(208)</td>
<td>74</td>
</tr>
<tr>
<td>Fuel and other derivatives</td>
<td>(1)</td>
<td>37</td>
<td>(38)</td>
</tr>
<tr>
<td>Other</td>
<td>(15)</td>
<td>(7)</td>
<td>(8)</td>
</tr>
<tr>
<td><strong>Total non-operating expense</strong></td>
<td>$ (710)</td>
<td>$ (617)</td>
<td>$ (93)</td>
</tr>
</tbody>
</table>

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

- Losses on foreign exchange which amounted to $307 million in 2014 compared to losses of $120 million in 2013. These losses were mainly related to unrealized foreign exchange losses on the translation of U.S. dollar denominated debt. Partly offsetting these foreign exchange losses were revaluation gains related to foreign currency derivatives of $74 million and favourable foreign currency derivative settlements of $58 million. The December 31, 2014 closing exchange rate was US$1 = C$1.1601 while the December 30, 2013 closing exchange rate was US$1 = C$1.0636. Refer to section 12 “Financial Instruments and Risk Management” of this MD&A for additional information.

- In 2013, Air Canada recorded a charge of $95 million in interest expense pertaining to the purchase of its senior secured notes due in 2015 and 2016, comprised of $61 million related to premium costs paid, in respect of notes purchased, and $34 million related to the write-off of existing transaction costs and discounts. No such charge was recorded in 2014.

- A decrease in net financing expense relating to employee benefits of $74 million which was mainly due to the impact of lower pension liabilities.

- Losses related to fuel and other derivatives which amounted to $1 million in 2014 versus gains of $37 million in 2013. Refer to section 12 “Financial Instruments and Risk Management” of this MD&A for additional information.
7. RESULTS OF OPERATIONS—FOURTH QUARTER 2014 VERSUS FOURTH QUARTER 2013

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

<table>
<thead>
<tr>
<th>(Canadian dollars in millions, except per share figures)</th>
<th>Fourth Quarter</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Operating revenues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Passenger</td>
<td>$ 2,755</td>
<td>$ 2,560</td>
</tr>
<tr>
<td>Cargo</td>
<td>133</td>
<td>128</td>
</tr>
<tr>
<td>Other</td>
<td>216</td>
<td>206</td>
</tr>
<tr>
<td>Total revenues</td>
<td>3,104</td>
<td>2,894</td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aircraft fuel</td>
<td>791</td>
<td>831</td>
</tr>
<tr>
<td>Wages, salaries, and benefits (1)</td>
<td>604</td>
<td>553</td>
</tr>
<tr>
<td>Benefit plan amendments (2)</td>
<td>-</td>
<td>(82)</td>
</tr>
<tr>
<td>Capacity purchase agreements</td>
<td>295</td>
<td>280</td>
</tr>
<tr>
<td>Airport and navigation fees</td>
<td>247</td>
<td>232</td>
</tr>
<tr>
<td>Aircraft maintenance</td>
<td>201</td>
<td>158</td>
</tr>
<tr>
<td>Sales and distribution costs</td>
<td>153</td>
<td>138</td>
</tr>
<tr>
<td>Depreciation, amortization and impairment</td>
<td>134</td>
<td>148</td>
</tr>
<tr>
<td>Ground package costs</td>
<td>74</td>
<td>66</td>
</tr>
<tr>
<td>Aircraft rent</td>
<td>79</td>
<td>76</td>
</tr>
<tr>
<td>Food, beverages and supplies</td>
<td>74</td>
<td>71</td>
</tr>
<tr>
<td>Communications and information technology</td>
<td>52</td>
<td>45</td>
</tr>
<tr>
<td>Other</td>
<td>294</td>
<td>243</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>2,998</td>
<td>2,759</td>
</tr>
<tr>
<td>Operating income</td>
<td>106</td>
<td>135</td>
</tr>
<tr>
<td>Non-operating income (expense)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign exchange loss</td>
<td>(115)</td>
<td>(55)</td>
</tr>
<tr>
<td>Interest income</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(83)</td>
<td>(73)</td>
</tr>
<tr>
<td>Interest capitalized</td>
<td>9</td>
<td>10</td>
</tr>
<tr>
<td>Net financing expense relating to employee benefits</td>
<td>(32)</td>
<td>(53)</td>
</tr>
<tr>
<td>Fuel and other derivatives</td>
<td>9</td>
<td>22</td>
</tr>
<tr>
<td>Other</td>
<td>(4)</td>
<td>(2)</td>
</tr>
<tr>
<td>Total non-operating expense</td>
<td>(206)</td>
<td>(141)</td>
</tr>
<tr>
<td>Loss before income taxes</td>
<td>(100)</td>
<td>(6)</td>
</tr>
<tr>
<td>Income taxes</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Net loss</td>
<td>$ (100)</td>
<td>$ (6)</td>
</tr>
<tr>
<td>Net loss per share—diluted</td>
<td>$ (0.35)</td>
<td>$ (0.02)</td>
</tr>
<tr>
<td>EBITDAR, excluding the impact of benefit plan amendments (3)(4)</td>
<td>$ 319</td>
<td>$ 277</td>
</tr>
<tr>
<td>EBITDAR (3)</td>
<td>$ 319</td>
<td>$ 359</td>
</tr>
<tr>
<td>Adjusted net income (4)</td>
<td>$ 67</td>
<td>$ 3</td>
</tr>
<tr>
<td>Adjusted net income per share—diluted (4)</td>
<td>$ 0.23</td>
<td>$ 0.01</td>
</tr>
</tbody>
</table>

(1) In the fourth quarter of 2014, one-time payments totaling $30 million were made to ACFA members under a collective agreement concluded in October 2014.
(2) In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of $22 million related to amendments to defined benefit pension plans.
(3) EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.
(4) Adjusted net income (loss) and adjusted net income (loss) per share—diluted are non-GAAP financial measures. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.
System passenger revenues increased 7.6% from the fourth quarter of 2013

In the fourth quarter of 2014, on capacity growth of 8.5%, system passenger revenues of $2,755 million increased $195 million or 7.6% from the fourth quarter of 2013. The increase in system passenger revenues was due to traffic growth of 9.4% partly offset by a yield decline of 1.9%. Modest yield declines are an anticipated and natural consequence of the successful implementation of Air Canada’s business strategy to profitably increase long-haul international and leisure flying.

In the fourth quarter of 2014, system business cabin revenues increased $28 million or 5.0% from 2013 due to a yield improvement of 6.7% partly offset by a traffic decrease of 1.5%.

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

<table>
<thead>
<tr>
<th>Passenger Revenue</th>
<th>Fourth Quarter 2014 $ Million</th>
<th>Fourth Quarter 2013 $ Million</th>
<th>Change $ Million</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>1,099</td>
<td>1,040</td>
<td>59</td>
<td>5.7</td>
</tr>
<tr>
<td>U.S. transborder</td>
<td>572</td>
<td>523</td>
<td>49</td>
<td>9.5</td>
</tr>
<tr>
<td>Atlantic</td>
<td>525</td>
<td>462</td>
<td>63</td>
<td>13.6</td>
</tr>
<tr>
<td>Pacific</td>
<td>377</td>
<td>353</td>
<td>24</td>
<td>6.5</td>
</tr>
<tr>
<td>Other</td>
<td>182</td>
<td>182</td>
<td>-</td>
<td>0.4</td>
</tr>
<tr>
<td>System</td>
<td>2,755</td>
<td>2,560</td>
<td>195</td>
<td>7.6</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Fourth Quarter 2014 Versus Fourth Quarter 2013</th>
<th>Passenger Revenue % Change</th>
<th>Capacity (ASMs) % Change</th>
<th>Traffic (RPMs) % Change</th>
<th>Passenger Load Factor % Change</th>
<th>Yield % Change</th>
<th>PRASM % Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>5.7</td>
<td>6.1</td>
<td>6.6</td>
<td>0.4</td>
<td>(1.8)</td>
<td>(1.3)</td>
</tr>
<tr>
<td>U.S. transborder</td>
<td>9.5</td>
<td>14.0</td>
<td>15.5</td>
<td>1.1</td>
<td>(5.0)</td>
<td>(3.7)</td>
</tr>
<tr>
<td>Atlantic</td>
<td>13.6</td>
<td>8.7</td>
<td>12.8</td>
<td>2.9</td>
<td>0.8</td>
<td>4.7</td>
</tr>
<tr>
<td>Pacific</td>
<td>6.5</td>
<td>9.5</td>
<td>7.6</td>
<td>(1.4)</td>
<td>(0.8)</td>
<td>(2.5)</td>
</tr>
<tr>
<td>Other</td>
<td>0.4</td>
<td>3.9</td>
<td>3.0</td>
<td>(0.6)</td>
<td>(2.7)</td>
<td>(3.4)</td>
</tr>
<tr>
<td>System</td>
<td>7.6</td>
<td>8.5</td>
<td>9.4</td>
<td>0.6</td>
<td>(1.9)</td>
<td>(1.2)</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>System</th>
<th>Year-over-Year by Quarter (% Change)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q4’13</td>
</tr>
<tr>
<td>Passenger revenues</td>
<td>1.9</td>
</tr>
<tr>
<td>Capacity (ASMs)</td>
<td>3.5</td>
</tr>
<tr>
<td>Traffic (RPMs)</td>
<td>2.5</td>
</tr>
<tr>
<td>Passenger load factor (pp change)</td>
<td>(0.9)</td>
</tr>
<tr>
<td>Yield</td>
<td>(0.6)</td>
</tr>
<tr>
<td>PRASM</td>
<td>(1.7)</td>
</tr>
</tbody>
</table>
In the fourth quarter of 2014, Air Canada's system capacity was 8.5% higher than in the fourth quarter of 2013, with capacity growth reflected in all markets.

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

- The 9.4% traffic increase which reflected traffic growth in all markets. Consistent with the airline's objective of increasing global international-to-international connecting traffic through its major Canadian hubs, the traffic growth in 2014 also reflected lower-yielding incremental connecting traffic to international destinations.

- The 1.9% yield decrease which was largely due to an increase in average stage length of 2.2%, which had the effect of reducing system yield by 1.2 percentage points, higher proportional growth of lower-yielding international-to-international passenger flows in support of the airline’s international expansion strategy, a higher proportion of seats into long-haul leisure markets, and the use of lower-cost Boeing 777 high-density aircraft which have a larger economy cabin. These decreases were largely offset by a favourable currency impact of $33 million and improvements in Air Canada’s business cabin revenue performance.

The 1.2% PRASM decrease was due to the lower yield partly offset by a passenger load factor improvement of 0.6 percentage points.

**Domestic passenger revenues increased 5.7% from the fourth quarter of 2013**

In the fourth quarter of 2014, on capacity growth of 6.1%, domestic passenger revenues of $1,099 million increased $59 million or 5.7% from the fourth quarter of 2013. The increase in domestic passenger revenues was due to traffic growth of 6.6% and an increase in baggage fee revenues (baggage fee revenues are not included in Air Canada’s yield and PRASM results). These increases were partly offset by a yield decline of 1.8%.

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

<table>
<thead>
<tr>
<th>Canada</th>
<th>Year-over-Year by Quarter (% Change)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q4'13</td>
</tr>
<tr>
<td>Passenger revenues</td>
<td>(1.1)</td>
</tr>
<tr>
<td>Capacity (ASMs)</td>
<td>3.2</td>
</tr>
<tr>
<td>Traffic (RPMs)</td>
<td>2.6</td>
</tr>
<tr>
<td>Passenger load factor (pp change)</td>
<td>(0.4)</td>
</tr>
<tr>
<td>Yield</td>
<td>(3.6)</td>
</tr>
<tr>
<td>PRASM</td>
<td>(4.1)</td>
</tr>
</tbody>
</table>

In the fourth quarter of 2014, the 6.1% domestic capacity growth reflected capacity increases on all major domestic services.

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

- The 6.6% traffic increase which reflected traffic growth on all major domestic services. The traffic growth in the fourth quarter of 2014 reflected increases on services within Canada, as well as incremental connecting traffic to U.S. and international destinations.

- An increase in baggage fee revenues following an adjustment to the airline’s first checked bag policy which became effective for travel on or after November 2, 2014. Baggage fee revenues are not included in Air Canada’s yield and PRASM results.
The 1.8% yield decrease which reflected an increase in average stage length which had the effect of reducing domestic yield by 0.9 percentage points, higher proportional growth of lower-yielding international and U.S. transborder passenger flows, as well as declines on regional routes within Ontario and Quebec and on routes within Western Canada. These yield decreases were partly offset by yield growth on transcontinental services.

The domestic PRASM decrease of 1.3% was due to the yield decrease, partly offset by a 0.4 percentage point improvement in passenger load factor.

**U.S. transborder passenger revenues increased 9.5% from the fourth quarter of 2013**

In the fourth quarter of 2014, on a capacity growth of 14.0%, U.S. transborder passenger revenues of $572 million increased $49 million or 9.5% from the fourth quarter of 2013. The increase in U.S. transborder passenger revenues was due to traffic growth of 15.5% partly offset by a yield decline of 5.0%.

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

<table>
<thead>
<tr>
<th>U.S. transborder</th>
<th>Year-over-Year by Quarter (% Change)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q4'13</td>
</tr>
<tr>
<td>Passenger revenues</td>
<td>8.1</td>
</tr>
<tr>
<td>Capacity (ASMs)</td>
<td>1.6</td>
</tr>
<tr>
<td>Traffic (RPMs)</td>
<td>4.0</td>
</tr>
<tr>
<td>Passenger load factor (pp-change)</td>
<td>1.8</td>
</tr>
<tr>
<td>Yield</td>
<td>4.2</td>
</tr>
<tr>
<td>PRASM</td>
<td>6.6</td>
</tr>
</tbody>
</table>

In the fourth quarter of 2014, the 14.0% U.S. transborder capacity growth reflected capacity increases on certain U.S. long-haul routes such as Los Angeles and San Francisco, on certain U.S. short-haul routes, such as Chicago, and on services to Florida, Las Vegas and Hawaii. This capacity growth was partly offset by capacity reductions on certain long-haul routes such as Denver.

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

- The 15.5% traffic increase which reflected traffic growth on all major U.S. transborder services with the exception of services from eastern Canada to the U.S. where capacity was reduced year-over-year. The traffic growth was achieved through additional long-haul capacity and improved load factors on short-haul flying. The year-over-year increase in traffic was largely due to significantly higher proportional growth of lower-yielding international-to-international passenger flows from the U.S., as well as strong passenger demand on services between Canada and the U.S.

- The 5.0% yield decline which largely reflected a 3.6% longer average stage length, driven by route composition changes as long-haul (lower-yielding) capacity grew while short-haul (higher-yielding) capacity was unchanged when compared to the fourth quarter of 2013. This increase in average stage length had the effect of reducing U.S. transborder yield by 2.0 percentage points. Long-haul growth was led by lower-cost Air Canada rouge flying allowing Air Canada to effectively compete on lower-yielding leisure routes. Additionally, the fourth quarter of 2014 experienced a higher proportion of lower-yielding incremental international-to-international passenger flows in support of the airline’s international expansion strategy. These yield decreases were partly offset by a favourable currency impact of $9 million and a significant increase in high-yielding short-haul traffic.

PRASM decreased 3.7% as the lower yield was partly offset by a passenger load factor improvement of 1.1 percentage points.
Atlantic passenger revenues increased 13.6% from the fourth quarter of 2013

In the fourth quarter of 2014, on capacity growth of 8.7%, Atlantic passenger revenues of $525 million increased $63 million or 13.6% from the fourth quarter of 2013. The increase in Atlantic passenger revenues was due to traffic growth of 12.8% and, to a lesser extent, a yield improvement of 0.8%.

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

<table>
<thead>
<tr>
<th>Atlantic</th>
<th>Year-over-Year by Quarter (% Change)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q4’13</td>
</tr>
<tr>
<td>Passenger revenues</td>
<td>2.7</td>
</tr>
<tr>
<td>Capacity (ASMs)</td>
<td>5.9</td>
</tr>
<tr>
<td>Traffic (RPMs)</td>
<td>1.7</td>
</tr>
<tr>
<td>Passenger load factor (pp change)</td>
<td>(3.1)</td>
</tr>
<tr>
<td>Yield</td>
<td>0.7</td>
</tr>
<tr>
<td>PRASM</td>
<td>(3.2)</td>
</tr>
</tbody>
</table>

In the fourth quarter of 2014, the Atlantic capacity growth of 8.7% reflected capacity increases on all major Atlantic services.

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

- The 12.8% traffic increase which reflected traffic growth on all major Atlantic services, including traffic growth between the U.S. and Europe via the airline’s major Canadian hubs, in line with Air Canada’s international growth strategy.

- The 0.8% yield growth which reflected improvements in Air Canada’s business cabin revenue performance, an increase in premium economy traffic which resulted in higher average fares, and a favourable currency impact of $10 million. This yield growth was largely offset by the impact of having a higher proportion of seats in long-haul leisure markets due to additional Atlantic services being served with lower-cost Boeing 777 higher-density aircraft which have a larger economy cabin, and new and increased lower-cost leisure flying by Air Canada rouge which offers a Premium rouge product but has no international business cabin. The yield growth was also achieved despite an increase in average stage length which reduced Atlantic yield by 0.4 percentage points.

The 4.7% PRASM growth was mainly due to a passenger load factor improvement of 2.9 percentage points and, to a lesser extent, the yield growth.

Pacific passenger revenues increased 6.5% from the fourth quarter of 2013

In the fourth quarter of 2014, on capacity growth of 9.5%, Pacific passenger revenues of $377 million increased $24 million or 6.5% from the fourth quarter of 2013. The increase in Pacific passenger revenues was due to traffic growth of 7.6% partly offset by a yield decline of 0.8%.
The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the fourth quarter of 2014 and each of the previous four quarters.

<table>
<thead>
<tr>
<th>Pacific</th>
<th>Year-over-Year by Quarter (% Change)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q4’13</td>
</tr>
<tr>
<td>Passenger revenues</td>
<td>(3.2)</td>
</tr>
<tr>
<td>Capacity (ASMs)</td>
<td>4.4</td>
</tr>
<tr>
<td>Traffic (RPMs)</td>
<td>0.7</td>
</tr>
<tr>
<td>Passenger load factor (ppchange)</td>
<td>(3.0)</td>
</tr>
<tr>
<td>Yield</td>
<td>(4.0)</td>
</tr>
<tr>
<td>PRASM</td>
<td>(7.4)</td>
</tr>
</tbody>
</table>

In the fourth quarter of 2014, the 9.5% Pacific capacity growth reflected capacity increases on all services with the exception of Korea.

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

- The 7.6% traffic increase which reflected traffic growth on all major Pacific services.
- The 0.8% yield decline which mainly reflected yield decreases on services to Hong Kong and China. Air Canada operates a lower-cost Boeing 777 higher-density aircraft on its Vancouver-Hong Kong service which has a larger economy cabin. The use of this lower-cost aircraft on high-volume routes, such as Vancouver-Hong Kong, is allowing the airline to access traditionally lower-yielding traffic while improving profitability. Hong Kong’s “Occupy Central” political protest movement also negatively impacted Hong Kong yields in the fourth quarter of 2014. The yield reduction on services to China was largely driven by increased industry capacity from the U.S. and aggressive pricing activities. These yield decreases were largely offset by improvements in Air Canada’s business cabin revenue performance, an increase in premium economy traffic which resulted in higher average fares, and a favourable currency impact of $6 million.

The 2.5% PRASM decrease was due to a decrease in passenger load factor of 1.4 percentage points and the yield decline.

Other passenger revenues increased 0.4% from the fourth quarter of 2013

In the fourth quarter of 2014, on capacity growth of 3.9%, Other passenger revenues (comprised of routes to the Caribbean, Mexico and Central and South America) of $182 million increased 0.4% from the fourth quarter of 2013. The increase in Other passenger revenues was due to traffic growth of 3.0% partly offset by a yield decline of 2.7%.

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

<table>
<thead>
<tr>
<th>Other</th>
<th>Year-over-Year by Quarter (% Change)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q4’13</td>
</tr>
<tr>
<td>Passenger revenues</td>
<td>11.5</td>
</tr>
<tr>
<td>Capacity (ASMs)</td>
<td>0.6</td>
</tr>
<tr>
<td>Traffic (RPMs)</td>
<td>5.0</td>
</tr>
<tr>
<td>Passenger load factor (ppchange)</td>
<td>3.4</td>
</tr>
<tr>
<td>Yield</td>
<td>6.5</td>
</tr>
<tr>
<td>PRASM</td>
<td>11.1</td>
</tr>
</tbody>
</table>
In the fourth quarter of 2014, the 3.9% capacity growth reflected capacity increases on routes to Mexico and to traditional sun destinations largely offset by a capacity reduction on services to South America.

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

- The overall 3.0% traffic increase which reflected traffic growth on routes to Mexico and to traditional sun destinations largely offset by a traffic decrease on services to South America where capacity was reduced year-over-year.

- The overall 2.7% yield decrease which reflected a decline on routes to South America and to traditional sun destinations partly offset by yield growth on routes to Mexico. South American yields were impacted by the airline’s suspension of service to Venezuela while routes to traditional sun destinations were affected by increased industry capacity and aggressive pricing activities.

The overall 3.4% PRASM decrease was due to the lower yield and, to a lesser extent, a passenger load factor decline of 0.6 percentage points.

**Cargo revenues increased 3.9% from the fourth quarter of 2013**

In the fourth quarter of 2014 cargo revenues of $133 million increased $5 million or 3.9% from the fourth quarter of 2013 due to traffic growth of 7.5% partly offset by a yield decline of 3.3% year-over-year.

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

<table>
<thead>
<tr>
<th>Cargo Revenue</th>
<th>Fourth Quarter 2014 $ Million</th>
<th>Fourth Quarter 2013 $ Million</th>
<th>Change $ Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>17</td>
<td>16</td>
<td>1</td>
</tr>
<tr>
<td>U.S. transborder</td>
<td>5</td>
<td>5</td>
<td>-</td>
</tr>
<tr>
<td>Atlantic</td>
<td>48</td>
<td>46</td>
<td>2</td>
</tr>
<tr>
<td>Pacific</td>
<td>51</td>
<td>50</td>
<td>1</td>
</tr>
<tr>
<td>Other</td>
<td>12</td>
<td>11</td>
<td>1</td>
</tr>
<tr>
<td><strong>System</strong></td>
<td><strong>133</strong></td>
<td><strong>128</strong></td>
<td><strong>5</strong></td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>System</th>
<th>Year-over-Year by Quarter (% Change)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q4’13</td>
</tr>
<tr>
<td>Cargo revenues</td>
<td>1.6</td>
</tr>
<tr>
<td>Capacity (ETMs)</td>
<td>3.5</td>
</tr>
<tr>
<td>Revenue per ETM</td>
<td>(2.2)</td>
</tr>
<tr>
<td>Traffic (RTMs)</td>
<td>4.3</td>
</tr>
<tr>
<td>Yield per RTM</td>
<td>(2.9)</td>
</tr>
</tbody>
</table>
The table below provides year-over-year percentage changes in cargo revenues and operating statistics for the fourth quarter of 2014 versus the fourth quarter of 2013.

<table>
<thead>
<tr>
<th>Fourth Quarter 2014 Versus Fourth Quarter 2013</th>
<th>Cargo Revenue % Change</th>
<th>Capacity (ETMs) % Change</th>
<th>Rev / ETM % Change</th>
<th>Traffic (RTMs) % Change</th>
<th>Yield / RTM % Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>9.8</td>
<td>24.3</td>
<td>(11.6)</td>
<td>38.8</td>
<td>(20.9)</td>
</tr>
<tr>
<td>U.S. transborder</td>
<td>9.7</td>
<td>39.3</td>
<td>(21.2)</td>
<td>19.9</td>
<td>(8.5)</td>
</tr>
<tr>
<td>Atlantic</td>
<td>5.6</td>
<td>8.1</td>
<td>(2.3)</td>
<td>15.3</td>
<td>(8.4)</td>
</tr>
<tr>
<td>Pacific</td>
<td>(1.2)</td>
<td>5.8</td>
<td>(6.6)</td>
<td>(5.3)</td>
<td>4.3</td>
</tr>
<tr>
<td>Other</td>
<td>9.0</td>
<td>12.4</td>
<td>(3.1)</td>
<td>11.8</td>
<td>(2.5)</td>
</tr>
<tr>
<td>System</td>
<td>3.9</td>
<td>11.6</td>
<td>(6.9)</td>
<td>7.5</td>
<td>(3.3)</td>
</tr>
</tbody>
</table>

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

- The 7.5% traffic increase which reflected traffic growth in all markets with the exception of the Pacific market which was impacted by load restrictions on certain key routes such as Sydney and Hong Kong. The overall growth in traffic was mainly due to increased capacity, market share gains and strong demand from North America to Europe.

- The 3.3% yield decrease which reflected yield declines in all markets with the exception of the Pacific market. The overall yield decline was due to the impact of increased industry capacity and aggressive competitive pricing activities. The deployment of additional wide-body aircraft on transcontinental routes has allowed the airline to increase cargo revenues by carrying a new mix of traffic and larger shipments at a lower yield. The yield decrease was partly offset by the favourable impact of a weaker Canadian dollar on foreign currency denominated cargo revenues and strong demand out of Asia which enabled price increases.

Other revenues increased 5% from the fourth quarter of 2013

In the fourth quarter of 2014, Other revenues of $216 million increased $10 million or 5% from the fourth quarter of 2013 mainly due to growth in passenger-related fees and higher ground package revenues at Air Canada Vacations, the result of higher passenger volumes.
CASM (excluding the impact of benefit plan amendments) decreased 2.8% from the fourth quarter of 2013. Adjusted CASM was unchanged from the fourth quarter of 2013.

The following table compares Air Canada’s fourth quarter 2014 and fourth quarter 2013 CASM.

<table>
<thead>
<tr>
<th>(cents per ASM)</th>
<th>Fourth Quarter</th>
<th>Change</th>
<th>cents</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aircraft fuel</td>
<td>4.54</td>
<td>5.18</td>
<td>(0.64)</td>
<td>(12.4)</td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>2.74</td>
<td>2.68</td>
<td>0.06</td>
<td>2.2</td>
</tr>
<tr>
<td>Benefits</td>
<td>0.73</td>
<td>0.76</td>
<td>(0.03)</td>
<td>(3.9)</td>
</tr>
<tr>
<td>Benefit plan amendments (1)</td>
<td>-</td>
<td>(0.51)</td>
<td>0.51</td>
<td>100.0</td>
</tr>
<tr>
<td>Capacity purchase agreements</td>
<td>1.70</td>
<td>1.74</td>
<td>(0.04)</td>
<td>(2.3)</td>
</tr>
<tr>
<td>Airport and navigation fees</td>
<td>1.42</td>
<td>1.45</td>
<td>(0.03)</td>
<td>(2.1)</td>
</tr>
<tr>
<td>Aircraft maintenance</td>
<td>1.16</td>
<td>0.99</td>
<td>0.17</td>
<td>17.2</td>
</tr>
<tr>
<td>Sales and distribution costs</td>
<td>0.88</td>
<td>0.86</td>
<td>0.02</td>
<td>2.3</td>
</tr>
<tr>
<td>Depreciation, amortization and impairment</td>
<td>0.77</td>
<td>0.92</td>
<td>(0.15)</td>
<td>(16.3)</td>
</tr>
<tr>
<td>Ground package costs</td>
<td>0.42</td>
<td>0.41</td>
<td>0.01</td>
<td>2.4</td>
</tr>
<tr>
<td>Aircraft rent</td>
<td>0.45</td>
<td>0.48</td>
<td>(0.03)</td>
<td>(6.2)</td>
</tr>
<tr>
<td>Food, beverages and supplies</td>
<td>0.42</td>
<td>0.44</td>
<td>(0.02)</td>
<td>(4.5)</td>
</tr>
<tr>
<td>Communications and information technology</td>
<td>0.30</td>
<td>0.28</td>
<td>0.02</td>
<td>7.1</td>
</tr>
<tr>
<td>Other</td>
<td>1.70</td>
<td>1.53</td>
<td>0.17</td>
<td>11.1</td>
</tr>
<tr>
<td>CASM</td>
<td>17.23</td>
<td>17.21</td>
<td>0.02</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Remove:

| Benefit plan amendments (1) | - | 0.51 | (0.51) | (100.0) |

CASM (excluding the impact of benefit plan amendments) | 17.23 | 17.72 | (0.49) | (2.8) |

(1) In the fourth quarter of 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans.

Operating expenses increased 9% from the fourth quarter of 2013.

In the fourth quarter of 2014, operating expenses of $2,998 million increased $239 million or 9% from the fourth quarter of 2013 on capacity growth of 8.5%. The unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses (mainly U.S. dollars) in the fourth quarter of 2014, when compared to the fourth quarter of 2013, increased operating expenses by approximately $89 million. Refer to section 12 “Financial Instruments and Risk Management” of this MD&A for information on Air Canada’s foreign exchange risk management strategy. In the fourth quarter of 2014, Air Canada recorded one-time payments totaling $30 million in Wages, salaries and benefits relating to its collective agreement with ACPA (which was concluded in October 2014). In 2013, Air Canada recorded an operating expense reduction of $82 million in Benefit plan amendments.
Fuel expense decreased 5% from the fourth quarter of 2013

In the fourth quarter of 2014, fuel expense of $791 million decreased $40 million or 5% from the fourth quarter of 2013. The decrease in fuel expense year-over-year was due to the impact of a 16% decline in jet fuel prices year-over-year, which accounted for a decrease of $133 million to fuel expenses in the fourth quarter of 2014. These decreases were largely offset by the unfavourable impact of a weaker Canadian dollar versus the U.S. dollar when compared to the fourth quarter of 2013, which accounted for an increase of $50 million, as well as a higher volume of fuel litres consumed, which accounted for an increase of $43 million.

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

<table>
<thead>
<tr>
<th>(Canadian dollars in millions, except where indicated)</th>
<th>Fourth Quarter</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Aircraft fuel expense – GAAP</td>
<td>$791</td>
<td>$831</td>
</tr>
<tr>
<td>Add: Net cash payments on fuel derivatives (1)</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Economic cost of fuel – Non-GAAP (2)</td>
<td>$801</td>
<td>$834</td>
</tr>
<tr>
<td>Fuel consumption (thousands of litres)</td>
<td>992,320</td>
<td>942,940</td>
</tr>
<tr>
<td>Fuel cost per litre (cents) – GAAP</td>
<td>79.7</td>
<td>88.2</td>
</tr>
<tr>
<td>Economic fuel cost per litre (cents) – Non-GAAP (2)</td>
<td>80.7</td>
<td>88.4</td>
</tr>
</tbody>
</table>

(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 $604 million in the fourth quarter of 2014, an increase of $51 million or 9% from the fourth quarter of 2013

In the fourth quarter of 2014, wages and salaries expense of $477 million increased $46 million or 11% from the fourth quarter of 2013, mainly due to Air Canada having recorded one-time payments totaling $30 million related to its collective agreement with ACPA in 2014 while no such payments were recorded in the fourth quarter of 2013. Higher average salaries and an increase in expense accruals related to the annual employee profit sharing programs were also contributing factors to the increase year-over-year. These increases were partly offset by the favourable impact of Air Canada having outsourced its London ground handling operations to a third party provider.

In the fourth quarter of 2014, employee benefits expense of $127 million increased $5 million or 4% from the fourth quarter of 2013, mainly due to an increase in expenses related to post-employment benefits, which included premiums with the transition to an insured model for new long-term disability claims. This increase was largely offset by the impact of higher discount rates which decreased the current service cost of defined benefit pension plans.

Capacity purchase costs increased 5% from the fourth quarter of 2013

In the fourth quarter of 2014, capacity purchase costs of $295 million increased $15 million or 5% from the fourth quarter of 2013, mainly due to higher rates under the capacity purchase agreement with Jazz and an unfavourable currency impact. 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 fourth quarter of 2013

In the fourth quarter of 2014, airport and navigation fees of $247 million increased $15 million or 6% from the fourth quarter of 2013, largely due to the addition of Boeing 777 and 787 aircraft to Air Canada's operating fleet, an unfavourable currency impact, and rate increases in certain stations.
Aircraft maintenance expense increased 27% from the fourth quarter of 2013

In the fourth quarter of 2014, aircraft maintenance expense of $201 million increased $43 million or 27% from the fourth quarter of 2013, largely due to a higher volume of engine and airframe maintenance activity versus the fourth quarter of 2013 and an unfavourable currency impact of $12 million.

Sales and distribution costs increased 11% from the fourth quarter of 2013

In the fourth quarter of 2014, sales and distribution costs of $153 million increased $15 million or 11% from the fourth quarter of 2013 on passenger revenue growth of 7.6%. This growth in sales and distribution costs was mainly due to the impact of a higher volume of ticket sales generated through GDS providers, a change in commission structure to drive higher passenger revenues, and an increase in credit card expenses which was in line with sales and revenue growth. An unfavourable currency impact was also a contributing factor to the increase in sales and distribution costs year-over-year.

Depreciation, amortization and impairment expense decreased 9% from the fourth quarter of 2013

In the fourth quarter of 2014, depreciation, amortization and impairment expense of $134 million decreased $14 million or 9% from the fourth quarter of 2013. This decrease in depreciation, amortization and impairment expense was due to Air Canada having recorded an impairment charge of $6 million in the fourth quarter of 2013 while no such charge was recorded in the fourth quarter of 2014 and to the impact of certain maintenance events becoming fully amortized. These decreases were partly offset by the impact of additional Boeing 777 and 787 aircraft in the airline’s operating fleet.

Ground package costs increased 12% from the fourth quarter of 2013

In the fourth quarter of 2014, the cost of ground packages at Air Canada Vacations amounted to $74 million, an increase of $8 million or 12% from the fourth quarter of 2013. This increase was mainly due to higher passenger volumes and, to a lesser extent, an increase in the price of ground packages and an unfavourable currency impact.

Other operating expenses increased 21% from the fourth quarter of 2013

In the fourth quarter of 2014, Other operating expenses of $294 million increased $51 million or 21% from the fourth quarter of 2013 mainly due to the 8.5% capacity growth and an increase in Remaining other expenses of $32 million or 31%. The increase in Remaining other expenses included growth in advertising and promotion expenses and higher customer inconvenience costs as well as certain unfavourable accrual variances of $15 million, which were mainly related to various commodity taxes and which are not expected to re-occur. The increase in advertising and promotion expenses was driven by additional promotional programs, such as those related to Air Canada’s new Boeing 787 Dreamliners, while the higher customer inconvenience costs was mainly driven by an increase in passenger volumes and higher passenger compensation pursuant to a Canadian Transportation Agency ruling. An increase in terminal handling expenses of $10 million or 21% was due to Air Canada’s international expansion, as well as the airline having outsourced its London ground handling operations to a third party provider in 2014 (the savings associated with this initiative are included in other expense categories, such as wages and salaries expense, for a net overall cost reduction).
The following table provides a breakdown of the more significant items included in Other expenses:

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>Fourth Quarter</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Terminal handling</td>
<td>$ 58</td>
<td>$ 48</td>
</tr>
<tr>
<td>Building rent and maintenance</td>
<td>35</td>
<td>34</td>
</tr>
<tr>
<td>Crew cycle</td>
<td>36</td>
<td>30</td>
</tr>
<tr>
<td>Miscellaneous fees and services</td>
<td>30</td>
<td>28</td>
</tr>
<tr>
<td>Remaining other expenses</td>
<td>135</td>
<td>103</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>$ 294</td>
<td>$ 243</td>
</tr>
</tbody>
</table>

Non-operating expense amounted to $206 million in the fourth quarter of 2014 compared to non-operating expense of $141 million in the fourth quarter of 2013.

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

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>Fourth Quarter</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Foreign exchange loss</td>
<td>$ (115)</td>
<td>$ (55)</td>
</tr>
<tr>
<td>Interest income</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(83)</td>
<td>(73)</td>
</tr>
<tr>
<td>Interest capitalized</td>
<td>9</td>
<td>10</td>
</tr>
<tr>
<td>Net financing expense relating to employee benefits</td>
<td>(32)</td>
<td>(53)</td>
</tr>
<tr>
<td>Fuel and other derivatives</td>
<td>9</td>
<td>22</td>
</tr>
<tr>
<td>Other</td>
<td>(4)</td>
<td>(2)</td>
</tr>
<tr>
<td>Total non-operating expense</td>
<td>$ (206)</td>
<td>$ (141)</td>
</tr>
</tbody>
</table>

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

- Losses on foreign exchange, mainly related to U.S. denominated long-term debt, which amounted to $115 million in the fourth quarter of 2014 compared to losses of $55 million in the fourth quarter of 2013. The losses in the fourth quarter of 2014 were mainly attributable to a weaker Canadian dollar at December 31, 2014 when compared to December 31, 2013. Partially offsetting these losses were gains of $41 million on foreign currency derivatives. The December 31, 2014 closing exchange rate was US$1 = C$1.1601 while the September 30, 2014 closing exchange rate was US$1 = C$1.1200. Refer to section 12 "Financial Instruments and Risk Management" of this MD&A for additional information.

- A decrease in net financing expense relating to employee benefits of $21 million which was mainly due to the impact of lower pension liabilities.

- Gains on fuel and other derivatives which amounted to $9 million in the fourth quarter of 2014 versus gains of $22 million in the fourth quarter of 2013. Refer to section 12 "Financial Instruments and Risk Management" of this MD&A for additional information.
8. FLEET

Mainline and Air Canada rouge

The following table provides Air Canada’s and Air Canada rouge’s operating fleet as at December 31, 2014 (refer to the Air Canada Express section below for information on the fleet of aircraft operated by regional airlines operating flights on behalf of Air Canada under capacity purchase agreements with Air Canada).

<table>
<thead>
<tr>
<th>Mainline</th>
<th>Total Seats</th>
<th>Number of Operating Aircraft</th>
<th>Average Age</th>
<th>Owned</th>
<th>Finance Lease</th>
<th>Owned – Special Purpose Entities (1)</th>
<th>Operating Lease</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Wide-body Aircraft</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Boeing 787-8</td>
<td>251</td>
<td>6</td>
<td>0.4</td>
<td>6</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Boeing 777-300ER</td>
<td>349,458</td>
<td>17</td>
<td>5.2</td>
<td>8</td>
<td>1</td>
<td>-</td>
<td>8</td>
</tr>
<tr>
<td>Boeing 777-200LR</td>
<td>270</td>
<td>6</td>
<td>7.1</td>
<td>4</td>
<td>-</td>
<td>-</td>
<td>2</td>
</tr>
<tr>
<td>Boeing 767-300ER</td>
<td>211</td>
<td>21</td>
<td>21.7</td>
<td>5</td>
<td>5</td>
<td>2</td>
<td>9</td>
</tr>
<tr>
<td>Airbus A330-300</td>
<td>265</td>
<td>8</td>
<td>14.2</td>
<td>-</td>
<td>-</td>
<td>8</td>
<td>-</td>
</tr>
<tr>
<td><strong>Narrow-body Aircraft</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Airbus A321</td>
<td>174</td>
<td>10</td>
<td>12.8</td>
<td>-</td>
<td>-</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Airbus A320</td>
<td>146</td>
<td>41</td>
<td>21.7</td>
<td>1</td>
<td>-</td>
<td>-</td>
<td>40</td>
</tr>
<tr>
<td>Airbus A319</td>
<td>120</td>
<td>18</td>
<td>16.7</td>
<td>5</td>
<td>10</td>
<td>-</td>
<td>3</td>
</tr>
<tr>
<td>Embraer 190</td>
<td>97</td>
<td>45</td>
<td>7.8</td>
<td>45</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total Mainline</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>172</td>
<td>13.8</td>
<td>74</td>
<td>16</td>
<td>15</td>
<td>67</td>
<td></td>
</tr>
</tbody>
</table>

| Air Canada rouge  |                         |                              |             |       |               |                                      |                 |
| **Wide-body Aircraft** |             |                              |             |       |               |                                      |                 |
| Boeing 767-300ER  | 282         | 8                            | 17.6        | -     | 1             | -                                    | 7               |
| **Narrow-body Aircraft** |         |                              |             |       |               |                                      |                 |
| Airbus A319 (2)   | 142         | 20                           | 16.5        | 17    | -             | -                                    | 3               |
| **Total Air Canada rouge** |         |                              |             |       |               |                                      |                 |
|                    | 28          | 16.8                         | 17          | 1     | -             |                                      | 10              |

| Total Mainline and Air Canada rouge |                         |                              |             |       |               |                                      |                 |
|                                   | 200         | 14.2                         | 91          | 17    | 15            | 77                                   |                 |

(1) Aircraft under finance leases and aircraft under lease from special purpose entities that are consolidated by Air Canada are carried on Air Canada’s consolidated statement of financial position.

(2) The 17 Airbus A319 aircraft reflected as owned in the table above are owned by Air Canada and leased to Air Canada rouge.
The following table provides the number of aircraft in Air Canada’s operating fleet as at December 31, 2014 as well as Air Canada's planned operating fleet, including aircraft currently operating and expected to be operated by Air Canada rouge, as at December 31, 2015, December 31, 2016 and December 31, 2017.

<table>
<thead>
<tr>
<th></th>
<th>Actual</th>
<th>Planned</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mainline</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Wide-body Aircraft</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Boeing 787-8</td>
<td>6</td>
<td>2</td>
</tr>
<tr>
<td>Boeing 787-9</td>
<td>-</td>
<td>3</td>
</tr>
<tr>
<td>Boeing 777-300ER</td>
<td>17</td>
<td>-</td>
</tr>
<tr>
<td>Boeing 777-200LR</td>
<td>6</td>
<td>-</td>
</tr>
<tr>
<td>Boeing 767-300ER</td>
<td>21</td>
<td>(4)</td>
</tr>
<tr>
<td>Airbus A330-300</td>
<td>8</td>
<td>-</td>
</tr>
<tr>
<td><strong>Narrow-body Aircraft</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Boeing 737 MAX</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Airbus A321</td>
<td>10</td>
<td>3</td>
</tr>
<tr>
<td>Airbus A320</td>
<td>41</td>
<td>2</td>
</tr>
<tr>
<td>Airbus A319</td>
<td>18</td>
<td>-</td>
</tr>
<tr>
<td>Embraer 190</td>
<td>45</td>
<td>(13)</td>
</tr>
<tr>
<td><strong>Total Mainline</strong></td>
<td>172</td>
<td>(7)</td>
</tr>
</tbody>
</table>

| **Air Canada rouge** |        |         |        |        |        |        |                    |
| **Wide-body Aircraft** |        |         |        |        |        |        |                    |
| Boeing 767-300ER    | 8      | 6       | 14     | 4      | 18     | 7      | 25                 |
| **Narrow-body Aircraft** |        |         |        |        |        |        |                    |
| Airbus A321          | -      | 2       | 2      | 3      | 5      | -      | 5                  |
| Airbus A319          | 20     | -       | 20     | -      | 20     | -      | 20                 |
| **Total Air Canada rouge** | 28 | 8 | 36 | 7 | 43 | 7 | 50 |

| **Total wide-body Aircraft** | 66 | 7 | 73 | 14 | 87 | 11 | 98 |
| **Total narrow-body Aircraft** | 134 | (6) | 128 | (3) | 125 | 2 | 127 |

| **Total Mainline and Air Canada rouge** | 200 | 1 | 201 | 11 | 212 | 13 | 225 |
In 2014, Air Canada exercised purchase rights for two Boeing 777-300ER aircraft, with scheduled deliveries in the second quarter of 2016. The configuration of these aircraft will be high-density in a three-cabin configuration, including a premium economy cabin and an International Business Class cabin that will offer Air Canada’s new international product standard as introduced on the airline’s Boeing 787 aircraft. Air Canada also announced that it plans on harmonizing the interior of its existing five higher-density Boeing 777-300 aircraft to Boeing 787 standards.

On March 31, 2014, Air Canada concluded an agreement with Boeing for the purchase of Boeing 737 MAX aircraft to replace the airline’s narrow-body aircraft. Refer to section 9.6 “Capital Expenditures and Related Financing Arrangements” 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 by three Airbus A321 and two Airbus A320 aircraft (which have been leased from third parties) until the airline takes delivery of the Boeing 737 MAX aircraft. In addition, Air Canada expects to retain five Boeing 767 aircraft in 2016 which it had originally planned to return to lessors.

**Air Canada Express**

The following table provides, as at December 31, 2014, the number of aircraft operated on behalf of Air Canada 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.

<table>
<thead>
<tr>
<th></th>
<th>Jazz</th>
<th>Sky Regional</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Embraer 175</td>
<td>-</td>
<td>15</td>
<td>-</td>
<td>15</td>
</tr>
<tr>
<td>Bombardier CRJ-100</td>
<td>-</td>
<td>-</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Bombardier CRJ-200</td>
<td>25</td>
<td>-</td>
<td>-</td>
<td>25</td>
</tr>
<tr>
<td>Bombardier CRJ-705</td>
<td>16</td>
<td>-</td>
<td>-</td>
<td>16</td>
</tr>
<tr>
<td>Bombardier Dash 8-100</td>
<td>34</td>
<td>-</td>
<td>-</td>
<td>34</td>
</tr>
<tr>
<td>Bombardier Dash 8-300</td>
<td>26</td>
<td>-</td>
<td>-</td>
<td>26</td>
</tr>
<tr>
<td>Bombardier Dash 8-Q400</td>
<td>21</td>
<td>5</td>
<td>-</td>
<td>26</td>
</tr>
<tr>
<td>Beech 1900</td>
<td>-</td>
<td>-</td>
<td>17</td>
<td>17</td>
</tr>
<tr>
<td><strong>Total Air Canada Express</strong></td>
<td><strong>122</strong></td>
<td><strong>20</strong></td>
<td><strong>22</strong></td>
<td><strong>164</strong></td>
</tr>
</tbody>
</table>
The following table provides, as at December 31, 2015, 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. On February 2, 2015, Air Canada announced that it had concluded an amended and extended capacity purchase agreement with Jazz. The fleet information provided below reflects the amended Jazz CPA. Refer to section 4 “Strategy” of this MD&A for additional information.

<table>
<thead>
<tr>
<th></th>
<th>Jazz</th>
<th>Sky Regional</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Embraer 175</td>
<td>-</td>
<td>15</td>
<td>-</td>
<td>15</td>
</tr>
<tr>
<td>Bombardier CRJ-100</td>
<td>-</td>
<td>-</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Bombardier CRJ-200</td>
<td>18</td>
<td>-</td>
<td>4</td>
<td>22</td>
</tr>
<tr>
<td>Bombardier CRJ-705</td>
<td>16</td>
<td>-</td>
<td>-</td>
<td>16</td>
</tr>
<tr>
<td>Bombardier Dash 8-100</td>
<td>28</td>
<td>-</td>
<td>-</td>
<td>28</td>
</tr>
<tr>
<td>Bombardier Dash 8-300</td>
<td>26</td>
<td>-</td>
<td>-</td>
<td>26</td>
</tr>
<tr>
<td>Bombardier Dash 8-Q400</td>
<td>27</td>
<td>5</td>
<td>-</td>
<td>32</td>
</tr>
<tr>
<td>Beech 1900</td>
<td>-</td>
<td>-</td>
<td>17</td>
<td>17</td>
</tr>
<tr>
<td><strong>Total Air Canada Express</strong></td>
<td><strong>115</strong></td>
<td><strong>20</strong></td>
<td><strong>23</strong></td>
<td><strong>158</strong></td>
</tr>
</tbody>
</table>
9. FINANCIAL AND CAPITAL MANAGEMENT

9.1. Liquidity

Air Canada manages its liquidity needs through a variety of strategies including by seeking to sustain and improve cash from operations, 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 9.6, 9.7 and 9.8 of this MD&A for information on Air Canada’s capital commitments, pension funding obligations and contractual obligations. Air Canada monitors and manages liquidity risk by preparing rolling cash flow forecasts, monitoring the condition and value of assets available to be used as well as those assets being used as security in financing arrangements, seeking flexibility in financing arrangements, and establishing programs to monitor and maintain compliance with terms of financing agreements. Air Canada’s principal objective in managing liquidity risk is to maintain a minimum unrestricted liquidity level of $1.7 billion. This minimum target level was determined in conjunction with Air Canada’s liquidity risk management strategy. At December 31, 2014, unrestricted liquidity amounted to $2,685 million (comprised of cash and short-term investments of $2,275 million and undrawn lines of credit of $410 million). This compared to unrestricted liquidity of $2,364 million (comprised of cash and short-term investments of $2,208 million and undrawn lines of credit of $156 million) at December 31, 2013.

In January 2015, in order to effectively manage financing costs, the amount outstanding under an undrawn line of credit was reduced by $116 million. As at January 31, 2015, the amount available under undrawn lines of credit was $315 million.
9.2. Financial Position

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

<table>
<thead>
<tr>
<th>Assets</th>
<th>December 31, 2014</th>
<th>December 31, 2013</th>
<th>$ Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash, cash equivalents and short-term investments</td>
<td>$ 2,275</td>
<td>$ 2,208</td>
<td>$ 67</td>
</tr>
<tr>
<td>Other current assets</td>
<td>1,203</td>
<td>1,080</td>
<td>123</td>
</tr>
<tr>
<td>Current assets</td>
<td>3,478</td>
<td>3,288</td>
<td>190</td>
</tr>
<tr>
<td>Property and equipment</td>
<td>5,998</td>
<td>5,073</td>
<td>925</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>305</td>
<td>304</td>
<td>1</td>
</tr>
<tr>
<td>Goodwill</td>
<td>311</td>
<td>311</td>
<td>-</td>
</tr>
<tr>
<td>Deposits and other assets</td>
<td>556</td>
<td>494</td>
<td>62</td>
</tr>
<tr>
<td>Total assets</td>
<td>$ 10,648</td>
<td>$ 9,470</td>
<td>$ 1,178</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td>$ 3,537</td>
<td>$ 3,190</td>
<td>347</td>
</tr>
<tr>
<td>Long-term debt and finance leases</td>
<td>4,732</td>
<td>3,959</td>
<td>773</td>
</tr>
<tr>
<td>Pension and other benefit liabilities</td>
<td>2,403</td>
<td>2,687</td>
<td>(284)</td>
</tr>
<tr>
<td>Maintenance provisions</td>
<td>796</td>
<td>656</td>
<td>140</td>
</tr>
<tr>
<td>Other long-term liabilities</td>
<td>313</td>
<td>375</td>
<td>(62)</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>11,781</td>
<td>10,867</td>
<td>914</td>
</tr>
<tr>
<td>Total equity</td>
<td>(1,133)</td>
<td>(1,397)</td>
<td>264</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>$ 10,648</td>
<td>$ 9,470</td>
<td>$ 1,178</td>
</tr>
</tbody>
</table>

Movements in current assets and current liabilities are described in section 9.4 “Working Capital” of this MD&A. Long-term debt and finance leases are discussed in sections 9.3 “Adjusted Net Debt” and 9.5 “Consolidated Cash Flow Movements” of this MD&A.

At December 31, 2014, Property and equipment amounted to $5,998 million, an increase of $925 million from December 31, 2013. The increase in Property and equipment was mainly due to additions to Property and equipment of $1,521 million in 2014, partially offset by the impact of depreciation expense of $502 million. The additions to Property and equipment included flight equipment purchases of $937 million, which included one Boeing 777-300ER aircraft delivered in February and six Boeing 787-8 aircraft delivered in 2014, progress payments on future aircraft deliveries of $229 million, and capitalized maintenance costs of $177 million.

At December 31, 2014, Pension and other benefit liabilities decreased $284 million from December 31, 2013, mainly due to strong investment returns on pension plan assets partly offset by the impact of lower prescribed pension plan discount rates as at December 31, 2014 versus 2013 with respect to its pension plans. Pension funding payments of $445 million were made in 2014. Refer to section 9.7 “Pension Funding Obligations” of this MD&A for additional information.
9.3. Adjusted Net Debt

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

<table>
<thead>
<tr>
<th>(Canadian dollars in millions, except where indicated)</th>
<th>December 31, 2014</th>
<th>December 31, 2013</th>
<th>$ Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total long-term debt and finance leases</td>
<td>$ 4,732</td>
<td>$ 3,959</td>
<td>$ 773</td>
</tr>
<tr>
<td>Current portion of long-term debt and finance leases</td>
<td>484</td>
<td>374</td>
<td>110</td>
</tr>
<tr>
<td>Total long-term debt and finance leases, including current portion</td>
<td>5,216 (2,275)</td>
<td>4,333 (2,208)</td>
<td>883 (67)</td>
</tr>
<tr>
<td>Less cash, cash equivalents and short-term investments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net debt</td>
<td>$ 2,941</td>
<td>$ 2,125</td>
<td>$ 816</td>
</tr>
<tr>
<td>Capitalized operating leases (1)</td>
<td>2,191</td>
<td>2,226</td>
<td>(35)</td>
</tr>
<tr>
<td>Adjusted net debt</td>
<td>$ 5,132</td>
<td>$ 4,351</td>
<td>$ 781</td>
</tr>
<tr>
<td>EBITDAR (excluding the impact of benefit plan amendments) (trailing 12 months)</td>
<td>$ 1,671</td>
<td>$ 1,433</td>
<td>$ 238</td>
</tr>
<tr>
<td>Adjusted net debt to EBITDAR ratio</td>
<td>3.1</td>
<td>3.0</td>
<td>0.1</td>
</tr>
</tbody>
</table>

(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. 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 $313 million for the twelve months ended December 31, 2014 and $318 million for the twelve months ended December 31, 2013.

At December 31, 2014, total long-term debt and finance leases, including current portion, amounted to $5,216 million, an increase of $883 million from December 31, 2013. This increase was due to new borrowings of $1,178 million partly offset by debt repayments of $677 million. In 2014, Air Canada completed a private offering of US$400 million of 7.75% senior unsecured notes due 2021 which is further described below. In addition, Air Canada took delivery of the fifth Boeing 777-300ER aircraft, which was financed under the private offering of enhanced equipment trust certificates, as well as the first six of 37 Boeing 787 aircraft, which were financed with support from the Export-Import Bank of the United States ("EXIM"). Refer to section 9.6 “Capital Expenditures and Related Financing Arrangements” of this MD&A for additional information. Debt repayments included an optional repayment of $182 million on the outstanding balance under a revolving loan facility. In addition, in 2014, Air Canada disposed of its two Airbus A340-500 aircraft and repaid the financing related to these aircraft in the amount of $90 million. No gain or loss was recorded on the sale. The unfavourable impact of a weaker Canadian dollar as at December 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 $365 million, was also a contributing factor to the increase in long-term debt.

Adjusted net debt amounted to $5,132 million at December 31, 2014, an increase of $781 million from December 31, 2013, mainly due to the higher long-term debt and finance lease balances.

At December 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 December 31, 2014, Air Canada’s weighted average cost of capital ("WACC"), on a pre-tax basis, was approximately 10.1%. WACC is based on an estimate by management and consists of an estimated cost of equity of 20.1% and an average cost of debt and finance leases of 5.6%.

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. 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.

9.4. Working Capital

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

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>December 31, 2014</th>
<th>December 31, 2013</th>
<th>$ Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash, cash equivalents and short-term investments</td>
<td>$ 2,275</td>
<td>$ 2,208</td>
<td>$ 67</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>656</td>
<td>589</td>
<td>67</td>
</tr>
<tr>
<td>Other current assets</td>
<td>547</td>
<td>491</td>
<td>56</td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>(1,259)</td>
<td>(1,129)</td>
<td>(130)</td>
</tr>
<tr>
<td>Advance ticket sales</td>
<td>(1,794)</td>
<td>(1,687)</td>
<td>(107)</td>
</tr>
<tr>
<td>Current portion of long-term debt and finance leases</td>
<td>(484)</td>
<td>(374)</td>
<td>(110)</td>
</tr>
<tr>
<td><strong>Net working capital</strong></td>
<td><strong>$ (59)</strong></td>
<td><strong>$ 98</strong></td>
<td><strong>$ (157)</strong></td>
</tr>
</tbody>
</table>

The net negative working capital of $59 million at December 31, 2014 represented a decrease of $157 million from December 31, 2013 and was largely due to capital expenditures of $1,501 million (or $732 million net of the financing drawn upon the delivery of the fifth Boeing 777-300ER aircraft and the six Boeing 787-8 aircraft received in 2014) and pension funding payments of $445 million. Air Canada also repaid a revolving credit facility in the amount of $182 million as the liquidity was no longer required, which decreased net working capital by this amount. These factors were largely offset by the impact of strong operating results, with cash from operations of $941 million, as well as the proceeds from the US$400 million senior unsecured notes completed in the second quarter of 2014.
9.5. Consolidated Cash Flow Movements

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

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>Fourth Quarter</th>
<th>Full Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Net cash flows from operating activities</td>
<td>$20</td>
<td>$68</td>
</tr>
<tr>
<td>Proceeds from borrowings</td>
<td>200</td>
<td>304</td>
</tr>
<tr>
<td>Reduction of long-term debt and finance lease obligations</td>
<td>(121)</td>
<td>(238)</td>
</tr>
<tr>
<td>Issue of common shares, net</td>
<td>-</td>
<td>8</td>
</tr>
<tr>
<td>Other</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Net cash flows from financing activities | 79 | 74 | $5 | 502 | 326 | 176
Short-term investments | 37 | 59 | (22) | 100 | 210 | 110
Additions to property, equipment and intangible assets | (386) | (344) | (42) | (1,501) | (962) | (539)
Proceeds from sale of assets | 4 | 35 | (31) | 72 | 70 | 2
Other | 10 | 46 | (36) | (3) | 41 | (44)

Net cash flows used in investing activities | (335) | (204) | (131) | (1,532) | (1,061) | (471)
Decrease in cash and cash equivalents | (236) | (62) | (174) | (89) | (4) | (85)
Cash and cash equivalents, beginning of period | 897 | 812 | 85 | 750 | 754 | (4)
Cash and cash equivalents, end of period | $661 | $750 | $(89) | $661 | $750 | $(89)

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

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>Fourth Quarter</th>
<th>Full Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Cash flows from operating activities</td>
<td>$20</td>
<td>$68</td>
</tr>
<tr>
<td>Additions to property, equipment and intangible assets</td>
<td>(386)</td>
<td>(344)</td>
</tr>
<tr>
<td>Free cash flow&lt;sup&gt;(1)&lt;/sup&gt;</td>
<td>$ (366)</td>
<td>$(276)</td>
</tr>
</tbody>
</table>

<sup>(1)</sup> Free cash flow is not a recognized measure for financial presentation under GAAP, does not have a standardized meaning and 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

Cash from operations of $941 million for the full year 2014 improved $210 million versus 2013, consistent with the improvement in operating income. Negative free cash flow deteriorated $90 million in the fourth quarter of 2014 and $329 million in the full year 2014 from the same periods in 2013. Free cash flow was impacted by the addition of one Boeing 777-300 and six Boeing 787-8 aircraft in 2014. The decline in free cash flow in the fourth quarter of 2014 was driven by the addition of two Boeing 787-8 aircraft, as well as changes in non-cash working capital, particularly the timing of fuel payments when compared to the same quarter in 2013.
Net cash flows used in financing activities

Proceeds from borrowings amounted to $200 million in the fourth quarter of 2014 and $1,178 million in the full year 2014. In the fourth quarter and the full year 2014, reduction of long-term debt and finance lease obligations amounted to $121 million and $677 million, respectively. Refer to section 9.3 “Adjusted Net Debt” of this MD&A for additional information on Air Canada’s financing activities.

9.6. Capital Expenditures and Related Financing Arrangements

Aircraft and Related Financing

As at December 31, 2014, Air Canada had outstanding purchase commitments with Boeing for the acquisition of 31 Boeing 787 aircraft. Deliveries for these aircraft are scheduled from 2015 to 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).

Subject to certain conditions, Air Canada has financing or sale and leaseback commitments covering up to 26 of the remaining 31 Boeing 787 firm aircraft orders, which such commitments are summarized as follows:

- Final commitment from EXIM, subject to documentation and other conditions, for one 787 aircraft scheduled for delivery in February 2015.
- For one 787 aircraft, the financing under the commitment, which is subject to conditions, 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.
- For 22 787 aircraft, the financing, which is subject to conditions, covers terms for 80% of the aircraft delivery price and the term to maturity is 12 years with straight-line principal repayments.
- In the fourth quarter of 2014, Air Canada entered into a sale and leaseback transaction with a third party for two Boeing 787 firm aircraft.

In March 2014, Air Canada concluded an agreement with Boeing for the purchase of Boeing 737 MAX aircraft. This 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 purchase options for 18 Boeing 737 aircraft and certain rights to purchase an additional 30 Boeing 737 aircraft. Deliveries are scheduled to begin in 2017 with two aircraft, and with the remaining deliveries between 2018 and 2021, subject to deferral and acceleration rights.

Air Canada has financing commitments, subject to certain conditions, covering up to all 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.

In 2014, Air Canada exercised purchase rights for two Boeing 777 aircraft, with scheduled deliveries in the second quarter of 2016. Financing alternatives will be considered prior to the planned delivery dates of these aircraft. As at December 31, 2014, Air Canada has purchase rights for 11 Boeing 777 aircraft (entitling Air Canada to purchase aircraft based on previously determined pricing).

Certain of the financing commitments for the Boeing 787 aircraft and/or the Boeing 737 MAX aircraft will be reduced based on allocation of the commitment between aircraft type to be determined by Air Canada, although the specifics of the reduction have not yet been determined. Taking the estimated financing reduction into consideration, the total committed financing on these Boeing 787 aircraft and/or the Boeing 737 MAX aircraft, including commitments from EXIM and the sale and leaseback transaction with a third party, will be at least $4,643 million.
Capital Commitments

As outlined in the table below, the estimated aggregate cost of the future firm Boeing 787, Boeing 777 and Boeing 737 MAX aircraft deliveries and other capital purchase commitments as at December 31, 2014 approximates $8,256 million.

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>Thereafter</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Projected committed expenditures</td>
<td>$1,067</td>
<td>$2,122</td>
<td>$1,598</td>
<td>$1,362</td>
<td>$1,066</td>
<td>$1,041</td>
<td>$8,256</td>
</tr>
<tr>
<td>Projected planned but uncommitted expenditures</td>
<td>134</td>
<td>254</td>
<td>302</td>
<td>286</td>
<td>331</td>
<td>not available</td>
<td>not available</td>
</tr>
<tr>
<td>Projected planned but uncommitted capitalized maintenance</td>
<td>200</td>
<td>159</td>
<td>109</td>
<td>109</td>
<td>109</td>
<td>not available</td>
<td>not available</td>
</tr>
<tr>
<td>Total projected expenditures</td>
<td>$1,401</td>
<td>$2,535</td>
<td>$2,009</td>
<td>$1,757</td>
<td>$1,506</td>
<td>not available</td>
<td>not available</td>
</tr>
</tbody>
</table>

(1) Future capitalized maintenance amounts for 2018 and beyond are not yet determinable however an estimate of $109 million has been made for 2018 and 2019.

(2) U.S. dollar amounts are converted using the December 31, 2014 closing exchange rate of US$1 = C$1.1601. The estimated aggregate cost of aircraft is based on delivery prices that include estimated escalation and, where applicable, deferred price delivery payment interest calculated based on the 90-day U.S. LIBOR rate at December 31, 2014.

9.7. Pension Funding Obligations

Air Canada maintains several pension plans, including defined benefit and defined contribution pension plans and plans providing other retirement and post-employment benefits to its employees. As at January 1, 2014, the aggregate solvency surplus in the domestic registered pension plans was $89 million. The next required valuations to be made as at January 1, 2015, will be completed in the first half of 2015, but as described below, they will not impact the 2015 pension past service cost funding obligations unless Air Canada opts out of the 2014 Regulations (described below), deciding instead to fund its domestic registered pension plans pursuant to normal funding rules. Based on preliminary estimates, including actuarial assumptions, as at January 1, 2015, the aggregate solvency surplus in Air Canada's domestic registered pension plans is projected to be $780 million.

Pension funding obligations under the normal funding rules are generally dependent on a number of factors, including the assumptions used in the most recently filed actuarial valuation reports for current service (including the applicable discount rate used or assumed in the actuarial valuation), the plan demographics at the valuation date, the existing plan provisions, existing pension legislation and changes in economic conditions (mainly the return on fund assets and changes in interest rates). Actual contributions that are determined on the basis of future valuation reports filed annually may vary significantly from projections. In addition to changes in plan demographics and experience, actuarial assumptions and methods may be changed from one valuation to the next, including due to changes in plan experience, financial markets, future expectations, and changes in legislation and other factors.

In December 2013, the Government of Canada formally approved the Air Canada Pension Plan Funding Regulations, 2014 (the “2014 Regulations”) under the Pension Benefits Standards Act, 1985 in respect of special payments required to be made to amortize the deficit under Air Canada’s defined benefit plans applicable to the period between 2014 and 2020 inclusively, expiring December 31, 2020. According to the terms of the 2014 Regulations, Air Canada will be required to make payments of at least $150 million annually with an average of $200 million per year, to contribute an aggregate minimum of $1,400 million over seven years in solvency deficit payments, in addition to its pension current service payments.

Under an agreement reached with the Government of Canada, in respect of the plan years during which Air Canada funds its plans pursuant to the 2014 Regulations, Air Canada is subject to a series of covenants and undertakings, including a prohibition on dividends and share repurchases, as well as certain limitations on executive compensation arrangements. As requested by the Government of Canada, Air Canada has also agreed to use reasonable efforts, during the negotiations of the next collective agreements with Air Canada’s Canadian-based unions, to seek to include in those

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collective agreements provisions which would have employees contribute fifty per cent of their pension plan normal costs, and has agreed not to implement pension plan benefit improvements without regulatory approval.

Giving effect to the 2014 Regulations as outlined above, total employer pension funding contributions during 2014 amounted to $445 million.

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Past service domestic registered plans</td>
<td>$ 222</td>
</tr>
<tr>
<td>Current service domestic registered plans</td>
<td>127</td>
</tr>
<tr>
<td>Other pension arrangements(^{(1)})</td>
<td>96</td>
</tr>
<tr>
<td><strong>Total pension funding obligations</strong></td>
<td><strong>$ 445</strong></td>
</tr>
</tbody>
</table>

\(^{(1)}\) Includes retirement compensation arrangements, supplemental plans and international plans.

Air Canada is permitted to opt out of the 2014 Regulations and have past service payments in respect of all Air Canada pension plans, collectively, determined in accordance with normal funding rules.

Air Canada would consider opting out of the 2014 Regulations when the annual solvency deficit payments under normal funding rules, which are determined using deficit levels over three years, would be less than $200 million and when there would be a strong basis for confidence that the airline’s de-risking strategy would make a future significant deficit unlikely to re-occur. At December 31, 2014, approximately 72.5% of the pension liabilities were matched with fixed income products to mitigate a significant portion of the interest rate (discount rate) risk.

In the event that Air Canada opts out of the 2014 Regulations, based on the normal funding rules and subject to the finalization of the preliminary estimate of the pension solvency surplus of $780 million at January 1, 2015, Air Canada’s past service payments to the domestic registered plans would be approximately $90 million in 2015.

In the event that Air Canada does not opt out and continues funding its domestic registered pension plans under the 2014 Regulations, Air Canada’s projected pension funding obligations, on a cash basis, for the years 2015 to 2019 would be as follows:

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Past service domestic registered plans</td>
<td>$ 200</td>
<td>$ 200</td>
<td>$ 200</td>
<td>$ 200</td>
<td>$ 200</td>
</tr>
<tr>
<td>Current service domestic registered plans</td>
<td>143</td>
<td>142</td>
<td>141</td>
<td>139</td>
<td>137</td>
</tr>
<tr>
<td>Other pension arrangements(^{(1)})</td>
<td>81</td>
<td>84</td>
<td>88</td>
<td>89</td>
<td>89</td>
</tr>
<tr>
<td><strong>Total projected pension funding obligations</strong></td>
<td><strong>$ 424</strong></td>
<td><strong>$ 426</strong></td>
<td><strong>$ 429</strong></td>
<td><strong>$ 428</strong></td>
<td><strong>$ 426</strong></td>
</tr>
</tbody>
</table>

\(^{(1)}\) Includes retirement compensation arrangements, supplemental plans and international plans.
9.8. Contractual Obligations

The table below provides Air Canada’s contractual obligations as at December 31, 2014 including those relating to interest and principal repayment obligations on Air Canada’s long-term debt and finance lease obligations, operating lease obligations and committed capital expenditures.

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>Thereafter</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Principal</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term debt obligations</td>
<td>$ 418</td>
<td>$ 381</td>
<td>$ 505</td>
<td>$ 484</td>
<td>$ 1,485</td>
<td>$ 1,751</td>
<td>$ 5,024</td>
</tr>
<tr>
<td>Finance lease obligations</td>
<td>66</td>
<td>28</td>
<td>29</td>
<td>32</td>
<td>35</td>
<td>93</td>
<td>283</td>
</tr>
<tr>
<td><strong>Total principal obligations</strong></td>
<td>$ 484</td>
<td>$ 409</td>
<td>$ 534</td>
<td>$ 516</td>
<td>$ 1,520</td>
<td>$ 1,844</td>
<td>$ 5,307</td>
</tr>
<tr>
<td><strong>Interest</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-term debt obligations</td>
<td>$ 262</td>
<td>$ 242</td>
<td>$ 243</td>
<td>$ 194</td>
<td>$ 167</td>
<td>$ 152</td>
<td>$ 1,260</td>
</tr>
<tr>
<td>Finance lease obligations</td>
<td>25</td>
<td>20</td>
<td>17</td>
<td>14</td>
<td>11</td>
<td>27</td>
<td>114</td>
</tr>
<tr>
<td><strong>Total interest obligations</strong></td>
<td>$ 287</td>
<td>$ 262</td>
<td>$ 260</td>
<td>$ 208</td>
<td>$ 178</td>
<td>$ 179</td>
<td>$ 1,374</td>
</tr>
<tr>
<td><strong>Total long-term debt and finance lease obligations</strong></td>
<td>$ 771</td>
<td>$ 671</td>
<td>$ 794</td>
<td>$ 724</td>
<td>$ 1,698</td>
<td>$ 2,023</td>
<td>$ 6,681</td>
</tr>
<tr>
<td>Operating lease obligations</td>
<td>$ 359</td>
<td>$ 300</td>
<td>$ 266</td>
<td>$ 227</td>
<td>$ 185</td>
<td>$ 296</td>
<td>$ 1,633</td>
</tr>
<tr>
<td>Committed capital expenditures</td>
<td>$ 1,067</td>
<td>$ 2,122</td>
<td>$ 1,598</td>
<td>$ 1,362</td>
<td>$ 1,066</td>
<td>$ 1,041</td>
<td>$ 8,256</td>
</tr>
<tr>
<td><strong>Total contractual obligations (1)</strong></td>
<td>$ 2,197</td>
<td>$ 3,093</td>
<td>$ 2,658</td>
<td>$ 2,313</td>
<td>$ 2,949</td>
<td>$ 3,360</td>
<td>$ 16,570</td>
</tr>
</tbody>
</table>

(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 commitments under CPA arrangements which, at December 31, 2014 for the year 2015, amounted to approximately $856 million with Jazz and $115 million for the other regional carriers. In February 2015, Air Canada and Jazz concluded an amendment to the Jazz CPA, effective as of January 1, 2015. Air Canada is assessing the impact to the minimum non-cancelable commitment under the amended Jazz CPA, which includes modification to the fee structure by creating a fixed fee compensation structure to replace the current variable mark-up structure.

Covenants in Credit Card Agreements

Air Canada has various agreements with companies that process customer credit card transactions. Approximately 85% of Air Canada’s sales are processed using credit cards, with remaining sales processed through cash based transactions. Air Canada receives payment for a credit card sale generally in advance of when the passenger transportation is provided.

Air Canada’s principal credit card processing agreements for credit card processing services in North America contain triggering events upon which Air Canada is required to provide the credit card processor with cash deposits. The obligation to provide cash deposits and the required amount of deposits are each based upon a matrix measuring, on a quarterly basis, both a fixed charge coverage ratio for Air Canada and the unrestricted cash and short-term investments of Air Canada. In 2014, Air Canada made no cash deposits under these agreements (nil in 2013).

Air Canada also has agreements with another processor for the provision of certain credit card processing services requirements for markets other than North America and for its cargo operations worldwide where such agreements also contain deposit obligations. In 2014, Air Canada made no cash deposits under these agreements (nil in 2013).
Ratings

Air Canada’s corporate credit and/or Air Canada’s Senior Notes are rated by the following rating agencies:

- Moody’s Investors Service, Inc. ("Moody’s");
- Standard & Poor’s Rating Services ("Standard & Poor’s");
- Fitch Ratings, Inc. ("Fitch"); and
- DBRS Limited ("DBRS").

Moody’s Ratings

On September 17, 2014, Moody’s upgraded the following ratings relating to Air Canada:

- Air Canada’s corporate family rating to B2 from B3 and probability of default ratings to B2-PD from B3-PD.
- Senior First Lien Notes rating to Ba3 from B1 and Senior Second Lien Notes rating to B3 from Caa1.
- Senior Unsecured Notes rating to Caa1 from Caa2.
- Air Canada’s speculative grade liquidity rating was affirmed at SGL-2.
- The ratings on Air Canada’s 2013-1 Class A, Class B and Class C Enhanced Equipment Trust Certificates ("EETCs") were upgraded by one notch to Baa1, Ba2, and B1, respectively.
- The rating outlooks for Air Canada and the EETCs were changed to stable from positive.

Standard & Poor’s Ratings

On February 2, 2015, Standard & Poor’s upgraded the following ratings relating to Air Canada:

- Air Canada’s corporate credit rating to B+ from B, stable trend.
- Senior Unsecured Notes rating to B from B-.
  - No change to the recovery rating: Senior Unsecured Notes rating of 5.
- Senior First Lien Notes rating to BB from BB- and Senior Second Lien Notes rating to BB from B-.
  - No change to the recovery rating: Senior First Lien Notes rating of 1.
  - Senior Second Lien Notes rating revised to 1 from 5.
- The rating on Air Canada’s 2013-1 Class A enhanced equipment trust certificate ("EETC") was reaffirmed at A and the ratings on Air Canada’s 2013-1 Class B and Class C EETCs were raised by one notch each to BBB- from BB+ and to BB- from B+, respectively.

Fitch Ratings

On April 8, 2014, Fitch undertook the following actions relating to Air Canada:

- Fitch affirmed the following ratings:
  - Air Canada’s long-term issuer default rating (IDR) of B;
  - Senior First Lien Notes rating of BB with a recovery rating of RR1;
o Air Canada’s 2013-1 Class A, Class B and Class C EETCs of A, BB+ and BB-, respectively.

• Fitch upgraded the following ratings:
  o Senior Second Lien Notes rating to BB with a recovery rating of RR1 from BB- with a recovery rating of RR2.

• Fitch assigned the following rating:
  o Senior Unsecured Notes rating of B- with a recovery rating of RR5 (EXP).

DBRS Ratings
On November 11, 2014, DBRS reaffirmed Air Canada’s Issuer Rating of “B”, and changed the trend to positive from stable.

Ratings are intended to provide investors with an independent view of credit quality. They are not a recommendation to buy, sell or hold securities and may be subject to revision or withdrawal at any time by the rating organization. Each rating should be evaluated independently of any other rating.

9.9. Share Information

The issued and outstanding shares of Air Canada, along with shares potentially issuable, as of December 31, 2014, are as follows:

<table>
<thead>
<tr>
<th>Issued and outstanding shares</th>
<th>December 31, 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class A variable shares</td>
<td>69,232,535</td>
</tr>
<tr>
<td>Class B voting shares</td>
<td>217,256,759</td>
</tr>
<tr>
<td>Total issued and outstanding shares</td>
<td>286,489,294</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shares potentially issuable</th>
<th>December 31, 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares held in trust for employee recognition award</td>
<td>-</td>
</tr>
<tr>
<td>Stock options</td>
<td>10,002,975</td>
</tr>
<tr>
<td>Total shares potentially issuable</td>
<td>10,002,975</td>
</tr>
<tr>
<td>Total outstanding and potentially issuable shares</td>
<td>296,492,269</td>
</tr>
</tbody>
</table>

Effective November 3, 2014, Air Canada’s Class B voting shares and Class A variable voting shares are listed for trading on the Toronto Stock Exchange under the single ticker “AC”.

Earnings per Share

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

<table>
<thead>
<tr>
<th>(in millions)</th>
<th>Fourth Quarter</th>
<th>Full Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Weighted average number of shares outstanding — basic</td>
<td>286</td>
<td>282</td>
</tr>
<tr>
<td>Effect of potential dilution</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>Add back anti-dilutive impact</td>
<td>(8)</td>
<td>(9)</td>
</tr>
<tr>
<td>Weighted average number of shares outstanding — diluted</td>
<td>286</td>
<td>282</td>
</tr>
</tbody>
</table>
10. QUARTERLY FINANCIAL DATA

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

<table>
<thead>
<tr>
<th>(Canadian dollars in millions except where indicated)</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q1</td>
<td>Q2</td>
</tr>
<tr>
<td>Operating revenues</td>
<td>$2,952</td>
<td>$3,057</td>
</tr>
<tr>
<td>Aircraft fuel</td>
<td>870</td>
<td>831</td>
</tr>
<tr>
<td>Ownership (DAR)</td>
<td>251</td>
<td>211</td>
</tr>
<tr>
<td>Other operating expenses (9)(10)</td>
<td>1,937</td>
<td>1,841</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>3,058</td>
<td>2,883</td>
</tr>
<tr>
<td>Operating income (loss)</td>
<td>(106)</td>
<td>174</td>
</tr>
<tr>
<td>Total non-operating income (expense) (9)</td>
<td>(154)</td>
<td>(197)</td>
</tr>
<tr>
<td>Income taxes</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>$ (260)</td>
<td>$ (23)</td>
</tr>
<tr>
<td>Earnings (loss) per share— diluted</td>
<td>$ (0.95)</td>
<td>$ (0.09)</td>
</tr>
<tr>
<td>EBITDAR, excluding the impact of benefit plan amendments (9)(10)</td>
<td>$145</td>
<td>$385</td>
</tr>
<tr>
<td>EBITDAR (7)</td>
<td>$145</td>
<td>$385</td>
</tr>
<tr>
<td>Adjusted net income (loss) (8)</td>
<td>$ (143)</td>
<td>$ 115</td>
</tr>
<tr>
<td>Adjusted net income (loss) per diluted share (8)</td>
<td>$(0.52)</td>
<td>$ 0.41</td>
</tr>
</tbody>
</table>

(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 $32 million related to changes to early retirement provisions in Air Canada’s defined benefit pension plans.
(4) In the second quarter of 2014, Air Canada recorded favourable tax-related provision adjustments of $41 million.
(5) In the fourth quarter of 2014, one-time payments totaling $30 million were made to ACPA members under a collective agreement concluded in October 2014.
(6) In the third quarter of 2013, Air Canada recorded an interest charge of $95 million related to the purchase of its senior searced notes which were to be redeemed in 2015 and 2016.
(7) EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.
(8) Adjusted net income (loss) and adjusted net income (loss) per diluted share are non-GAAP financial measures. Refer to section 20 “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.

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q1</td>
<td>Q2</td>
</tr>
<tr>
<td>Revenue passenger miles (millions)</td>
<td>13,087</td>
<td>14,093</td>
</tr>
<tr>
<td>Available seat miles (millions)</td>
<td>16,164</td>
<td>16,972</td>
</tr>
<tr>
<td>Passenger load factor (%)</td>
<td>81.0</td>
<td>83.0</td>
</tr>
<tr>
<td>Passenger PRASM (cents)</td>
<td>15.4</td>
<td>16.0</td>
</tr>
<tr>
<td>CASM, excluding the impact of benefit plan amendments (cents) (1)</td>
<td>18.9</td>
<td>17.0</td>
</tr>
<tr>
<td>Adjusted CASM (cents) (2)</td>
<td>12.5</td>
<td>11.7</td>
</tr>
<tr>
<td>Economic fuel price per litre (cents) (3)</td>
<td>92.4</td>
<td>85.7</td>
</tr>
</tbody>
</table>

(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.

(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 “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 7 “Results of Operations” of this MD&A for additional information.
11. SELECTED ANNUAL INFORMATION

The following table provides selected annual information for Air Canada for the years 2012 through to 2014.

<table>
<thead>
<tr>
<th>(Canadian dollars in millions, except per share figures)</th>
<th>2014</th>
<th>2013</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating revenues</td>
<td>$13,272</td>
<td>$12,382</td>
<td>$12,114</td>
</tr>
<tr>
<td>Operating expenses(1)(2)(3)</td>
<td>12,457</td>
<td>11,763</td>
<td>11,672</td>
</tr>
<tr>
<td>Operating income</td>
<td>815</td>
<td>619</td>
<td>442</td>
</tr>
<tr>
<td>Total non-operating expense and income taxes (4)(6)</td>
<td>(710)</td>
<td>(609)</td>
<td>(523)</td>
</tr>
<tr>
<td>Net income (loss) from continuing operations</td>
<td>105</td>
<td>10</td>
<td>(81)</td>
</tr>
<tr>
<td>Net loss from discontinued operations—Aveos</td>
<td>-</td>
<td>-</td>
<td>(55)</td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>$105</td>
<td>$10</td>
<td>$(136)</td>
</tr>
</tbody>
</table>

| EBITDA( excluding the impact of benefit plan amendments (1)(6) | $1,671 | $1,433 | $1,320 |
| EBITDA (8)                                                   | $1,671 | $1,515 | $1,447 |
| Adjusted net income                                         | $531   | $340   | 55    |
| Basic earnings (loss) per share from continuing operations | $0.35  | $0.02  | $(0.31) |
| Diluted earnings (loss) per share from continuing operations| $0.34  | $0.02  | $(0.31) |
| Basic and diluted loss per share from discontinued operations| -     | -     | $(0.20) |
| Diluted earnings (loss) per share                          | $0.34  | $0.02  | $(0.51) |
| Adjusted net income per diluted share                      | $1.81  | $1.20  | 0.20  |
| Cash, cash equivalents and short-term investments           | $2,275 | $2,208 | $1,973 |
| Total assets                                               | $10,648 | $9,470 | $8,847 |
| Total long-term liabilities (7)                            | $8,728 | $8,051 | $9,434 |
| Total liabilities                                          | $11,781 | $10,867 | $12,194 |

(1) In 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 2012, Air Canada recorded an operating expense reduction of $127 million related to changes to the terms of the ACA collective agreement pertaining to retirement age.

(2) In 2014, one-time payments totaling $30 million were made to ACA members under a collective agreement concluded in October 2014 and favourable tax-related provision adjustments of $41 million.

(3) In 2013, Air Canada recorded impairment charges amounting to $30 million.

(4) In 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) In 2012, Air Canada recorded a $65 million loss on its investment in Aveos’ parent holding company.

(6) EBITDA (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

(7) Total long-term liabilities include long-term debt (including current portion) and finance leases, pension and other benefit liabilities, maintenance provisions and other long-term liabilities.
12. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Summary of Fuel and Other Derivatives

The following is a summary of fuel and other derivatives included in non-operating income (expense) on Air Canada’s consolidated statement of operations for the periods indicated:

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>Fourth Quarter</th>
<th></th>
<th>Full Year</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Fuel derivatives</td>
<td>$ (18)</td>
<td>$ (9)</td>
<td>$ (36)</td>
<td>$ (6)</td>
</tr>
<tr>
<td>Share forward contracts</td>
<td>24</td>
<td>29</td>
<td>31</td>
<td>42</td>
</tr>
<tr>
<td>Prepayment options on senior secured notes</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Interest rate swaps</td>
<td>1</td>
<td>-</td>
<td>2</td>
<td>(1)</td>
</tr>
<tr>
<td>Fuel and other derivatives</td>
<td>$ 9</td>
<td>$ 22</td>
<td>$ (1)</td>
<td>$ 37</td>
</tr>
</tbody>
</table>

Risk Management

Under its risk management policy, Air Canada manages its interest rate risk, foreign exchange risk, share based compensation risk and market risk through the use of various derivative financial instruments. Air Canada uses derivative financial instruments only for risk management purposes, not for generating trading profit. As such, any change in cash flows associated with derivative instruments is designed to be offset by changes in cash flows related to the risk being hedged.

As noted below, Air Canada engages in derivative hedging in an effort to mitigate various risks. The derivative fair values represent the amount of the consideration that could be exchanged in an arm’s length transaction between willing parties who are under no compulsion to act. Fair value of these derivatives is determined using active markets, where available. When no such market is available, valuation techniques are applied such as discounted cash flow analysis. Where practical, the valuation technique incorporates all factors that would be considered in setting a price, including Air Canada’s own credit risk and the credit risk of the counterparty.

Fuel Price Risk Management

Fuel price risk is the risk that future cash flows will fluctuate because of changes in jet fuel prices. In order to manage its exposure to jet fuel prices and to help mitigate volatility in operating cash flows, Air Canada enters into derivative contracts with financial intermediaries. Air Canada uses derivative contracts based on jet fuel, heating oil and crude oil-based contracts. Air Canada’s policy permits hedging of up to 75% of the projected jet fuel purchases for the next 12 months, 50% for the next 13 to 24 months and 25% for the next 25 to 36 months. These are maximum (but not mandated) limits. There is no minimum monthly hedging requirement. There are regular reviews to adjust the strategy in light of market conditions.

In 2014:

- Air Canada recorded a loss of $36 million in Fuel and other derivatives on Air Canada’s consolidated statement of operations related to fuel derivatives (loss of $6 million in 2013).

- Air Canada purchased crude-oil and refined products-based call options covering a portion of 2014 and 2015 fuel exposure. The cash premium related to these contracts was $44 million ($39 million in 2013 for 2013 and 2014 exposures).

- Fuel derivative contracts cash settled with a fair value of $24 million in favour of Air Canada ($29 million in favour of Air Canada in 2013).

As of December 31, 2014, approximately 22% of Air Canada’s anticipated purchases of jet fuel for 2015 was hedged at an average West Texas Intermediate ("WTI") equivalent capped price of US$97 per barrel. Air Canada’s contracts to hedge anticipated jet fuel purchases over the 2015 period are comprised of call options with notional volumes of
6,267,000 barrels. The fair value of the fuel derivatives portfolio at December 31, 2014 was $4 million in favour of Air Canada ($20 million in favour of Air Canada in 2013) and is recorded within Prepaid expenses and other current assets on Air Canada’s consolidated statement of financial condition.

Foreign Exchange Risk Management

Air Canada’s financial results are reported in Canadian dollars, while a large portion of its expenses, debt obligations and capital commitments are in foreign currencies, primarily in U.S. dollars. Foreign exchange risk is the risk that fluctuations in foreign exchange rates may have on operating results and cash flows.

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 result 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).

Air Canada’s risk management objective is to reduce cash flow risk related to foreign denominated cash flows.

Air Canada’s cash inflows are primarily in Canadian dollars, while a large portion of its outflows are in U.S. dollars. This unbalanced mix results in an annual U.S. dollar shortfall from operations. In order to mitigate this imbalance, Air Canada has adopted a program to convert excess revenues from offshore currencies into U.S. dollars. In 2014, this conversion generated coverage for approximately 23% of the imbalance.

For the remainder of the currency imbalance (i.e. the net U.S. dollar shortfall), Air Canada has a target coverage of 60% on a rolling 18-month basis utilizing the following risk management strategies:

- Holding U.S. dollar cash reserves as an economic hedge against changes in the value of the U.S. dollar. U.S. dollar cash and short-term investment balances as at December 31, 2014 amounted to $717 million (US$620 million) ($791 million (US$743 million) as at December 31, 2013). In 2014, an unrealized gain of $38 million (unrealized gain of $44 million in 2013) 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.

- Locking in the foreign exchange rate through the use of a variety of foreign exchange derivatives which have maturity dates corresponding to the forecasted dates of U.S. dollar net outflows.

The target coverage of the above strategies is to cover 60% of the net U.S dollar exposure on a rolling 18-month basis. The level of foreign exchange derivatives entered into and their related maturity dates are dependent upon a number of factors, which include the amount of foreign revenue conversion available, U.S. dollar net cash flows, as well as the amount attributed to aircraft and debt payments. Based on the notional amount of currency derivatives outstanding at December 31, 2014, as further described below, approximately 69% of net U.S. cash outflows are hedged for 2015 and 13% for 2016, resulting in derivative coverage of 52% over the next 18 months.

As at December 31, 2014, Air Canada had outstanding foreign currency options and swap agreements, settling in 2015 and 2016, to purchase at maturity $2,658 million (US$2,292 million) of U.S. dollars at a weighted average rate of $1.0884 per $1.00 U.S. dollar (2013 – $1.645 million US$1,547 million) with settlements in 2014 and 2015 at a weighted average rate of $1.0341 per $1.00 U.S. dollar. Air Canada also has protection in place to sell a portion of its excess Euros and Sterling (EUR $35 million, GBP $27 million) which settle in 2015 at weighted average rates of $1.2806 and $1.6217 per $1.00 U.S. dollar respectively (2013 – EUR $34 million, GBP $16 million with settlement in 2014 at weighted average rates of $1.3511 and $1.6130 respectively per $1.00 U.S. dollar).

The hedging structures put in place have various option pricing features, such as knock-out terms and profit cap limitations, and based on the assumed volatility used in the fair value calculation, the fair value of these foreign currency contracts as at December 31, 2014 was $30 million in favour of Air Canada (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 2014, a gain of $75 million was recorded in Foreign exchange gain (loss) on Air Canada’s consolidated statement of operations related to these derivatives (2013 – $68 million gain). In 2014, foreign exchange derivative contracts cash settled with a net fair value of $58 million in favour of Air Canada ($56 million in 2013 in favour of Air Canada).
Interest Rate Risk Management

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.

Air Canada enters into both fixed and floating rate debt and leases certain assets where the rental amount fluctuates based on changes in short-term interest rates. Air Canada manages interest rate risk on a portfolio basis and seeks financing terms in individual arrangements that are most advantageous taking into account all relevant factors, including credit margin, term and basis. The risk management objective is to minimize the potential for changes in interest rates to cause adverse changes in cash flows to Air Canada. The cash and short-term investment portfolio, which earns a floating rate of return, is an economic hedge for a portion of the floating rate debt.

The ratio of fixed to floating rate obligations outstanding is designed to maintain flexibility in Air Canada’s capital structure and is based upon a long-term objective of 60% fixed and 40% floating but allows the flexibility in the short-term to adjust to prevailing market conditions. The ratio at December 31, 2014, was 75% fixed and 25% floating, including the effects of interest rate swap positions (74% and 26%, respectively, as at December 31, 2013).

The following are the current derivatives employed in interest rate risk management activities and the adjustments recorded during 2014:

- As at December 31, 2014, Air Canada had two interest rate swap agreements in place with terms to July 2022 and January 2024 relating to two Boeing 767 aircraft financing agreements with an aggregate notional value of $60 million (US$52 million) (2013 – $62 million (US$58 million)). These swaps convert the lease payments on the two aircraft leases from fixed to floating rates. The fair value of these contracts as at December 31, 2014 was $8 million in favour of Air Canada (2013 – $10 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 2014, a gain of $2 million was recorded on the two interest rate swaps in Fuel and other derivatives on Air Canada’s consolidated statement of operations (2013 – $1 million loss).

Interest income includes $35 million (2013 – $29 million) related to Cash and cash equivalents and Short-term investments, which are classified as held for trading. Interest expense reflected on Air Canada’s consolidated statement of operations relates to financial liabilities recorded at amortized cost.

13. CRITICAL ACCOUNTING ESTIMATES

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

Air Canada has identified the following areas that contain critical accounting estimates utilized in the preparation of its consolidated financial statements.

Employee Future Benefits

Air Canada maintains several defined benefit plans providing pension, other retirement and post-employment benefits to its employees. The cost and related liabilities of Air Canada’s pensions, other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations involve assumptions, including discount rates, future salary increases, mortality rates and future benefit increases. Also, due to the long-term nature of these programs, such estimates are subject to significant uncertainty.
Assumptions
Management is required to make significant estimates about actuarial and financial assumptions to determine the cost and related liabilities of Air Canada’s employee future benefits.

Financial Assumptions

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

Future increases in compensation are based upon the current compensation policies, labour agreements and economic forecasts.

The significant weighted average assumptions used to determine Air Canada’s accrued benefit obligations and cost are as follows:

<table>
<thead>
<tr>
<th>Discount rate used to determine:</th>
<th>Pension Benefits</th>
<th>Other Employee Future Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Accrued benefit cost for the year ended December 31</td>
<td>4.90%</td>
<td>4.30%</td>
</tr>
<tr>
<td>Accrued benefit liability as at December 31</td>
<td>4.00%</td>
<td>4.90%</td>
</tr>
</tbody>
</table>

Rate of future increases in compensation used to determine:

<table>
<thead>
<tr>
<th></th>
<th>Pension Benefits</th>
<th>Other Employee Future Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>Accrued benefit cost for the year ended December 31</td>
<td>2.50%</td>
<td>2.50%</td>
</tr>
<tr>
<td>Accrued benefit obligation as at December 31</td>
<td>2.50%</td>
<td>2.50%</td>
</tr>
</tbody>
</table>

Actuarial assumptions

Mortality rates
The cost and related liabilities of Air Canada’s pension plans and other post-retirement and post-employment benefit programs are determined using actuarial valuations. The actuarial valuations include several economic and demographic assumptions including mortality rates. For the December 31, 2013 accounting valuations, the mortality assumption has been updated to reflect the results of a mortality study specific to Air Canada pension plan membership. The change in mortality rate assumptions resulted in an actuarial remeasurement of the accounting liabilities with the impact being recorded in Other comprehensive income. The improvements in assumed mortality rates are consistent with those presented by the Canadian Institute of Actuaries (“CIA”) which issued new mortality tables for use in the valuation of Canadian pension and benefit plans in early 2014.

Sensitivity Analysis
Sensitivity analysis is based on changing one assumption while holding all other assumptions constant. In practice, this may be unlikely to occur, and changes in some of the assumptions may be correlated. When calculating the sensitivity of the defined benefit obligation to variations in significant actuarial assumptions, the same method (present value of the defined benefit obligation calculated with the projected unit credit method at the end of the reporting period) has been applied as for calculating the liability recognized in the consolidated statement of financial position.

Sensitivity analysis on 2014 pension expense and net financing expense relating to pension benefit liabilities, based on different actuarial assumptions with respect to discount rate is set out below. The effects on each pension plan of a change in an assumption are weighted proportionately to the total plan obligation to determine the total impact for each assumption presented.
<table>
<thead>
<tr>
<th>Discount rate on obligation assumption</th>
<th>Decrease</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension expense</td>
<td>$ 17</td>
<td>$ (16)</td>
</tr>
<tr>
<td>Net financing expense relating to pension benefit liabilities</td>
<td>18</td>
<td>(8)</td>
</tr>
<tr>
<td>Total</td>
<td>$ 35</td>
<td>$ (24)</td>
</tr>
</tbody>
</table>

Increase (decrease) in pension obligation

<table>
<thead>
<tr>
<th>0.25 Percentage Point</th>
<th>Decrease</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase (decrease) in pension obligation</td>
<td>$ 652</td>
<td>$ (630)</td>
</tr>
</tbody>
</table>

An increase of one year life expectancy would increase the pension benefit obligation by $447 million.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A 5.5% annual rate of increase in the per capita cost of covered health care benefits was assumed for 2014 (2013 – 6.0%). The rate is assumed to decrease to 5% by 2019. A one percentage point increase in assumed health care trend rates would have increased the total of current service and interest costs by $5 million and the obligation by $61 million. A one percentage point decrease in assumed health care trend rates would have decreased the total of current service and interest costs by $4 million and the obligation by $60 million.

A 0.25 percentage point decrease in discount rate would have increased the total of current and interest costs by $1 million and the obligation by $52 million. A 0.25 percentage point increase in discount rate would have decreased the total of current and interest costs by $1 million and the obligation by $41 million.

**Impairment Considerations of Long-Lived Assets**

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

**Depreciation and Amortization Period for Long-Lived Assets**

Air Canada makes estimates about the expected useful lives of long-lived assets and the expected residual values of the assets based on the estimated current fair value of the assets, Air Canada’s fleet plans and the cash flows they generate. Changes to these estimates, which can be significant, could be caused by a variety of factors, including changes to maintenance programs, changes in jet fuel prices and other operating costs, changes in utilization of the aircraft, and changing market prices for new and used aircraft of the same or similar types. Estimates and assumptions are evaluated at least annually. Generally, these adjustments are accounted for on a prospective basis, through depreciation and amortization expense. For the purposes of sensitivity analysis on these estimates, a 50% reduction to residual values on aircraft with remaining useful lives greater than five years results in an increase of $32 million to annual depreciation expense. For aircraft with shorter remaining useful lives, the residual values are not expected to change significantly.

**Maintenance Provisions**

The recording of maintenance provisions related to return conditions on aircraft leases requires management to make estimates of the future costs associated with the maintenance events required under the lease return condition and estimates of the expected future maintenance condition of the aircraft at the time of lease expiry. These estimates take
into account current costs of these maintenance events, estimates of inflation surrounding these costs as well as assumptions surrounding utilization of the related aircraft. Any difference in the actual maintenance cost incurred and the amount of the provision is recorded in maintenance expense in the period. The effect of any changes in estimates, including changes in discount rates, inflation assumptions, cost estimates or lease expiries, is also recognized in maintenance expense in the period. Assuming the aggregate cost for return conditions increases by 5%, holding all other factors constant, there would be a cumulative balance sheet adjustment to increase the provision by $40 million at December 31, 2014 and an increase to maintenance expense in 2015 of approximately $3 million. For illustrative purposes, if the discount rates were to increase by 1%, holding all other factors constant, there would be a cumulative balance sheet adjustment to decrease the provision by $17 million at December 31, 2014. Due to low market rates of interest, a 1% decrease in discount rates was not considered a reasonable scenario.

Income taxes
Deferred income tax assets are recognized only to the extent that it is probable that future taxable income will be available to realize them. In making this assessment, consideration is given to available positive and negative evidence and relevant assumptions. Consideration is given to, among other things, future projections of taxable income, overall business environment, historical financial results, and industry-wide trends and outlook. At December 31, 2014, no deferred income tax assets have been recorded.

14. ACCOUNTING POLICIES

The following is an overview of accounting standard changes that Air Canada will be required to adopt in future years. Air Canada continues to evaluate the impact of these standards on its consolidated financial statements.

IFRS 15 – Revenue from Contracts with Customers

IFRS 15 replaces IAS 18 Revenue and related interpretations. The core principle of the new standard is to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. The new standard is intended to enhance disclosures about revenue, provide more comprehensive guidance for transactions that were not previously addressed and improve guidance for multiple-element arrangements. IFRS 15 is effective for annual periods beginning on January 1, 2017, with early adoption permitted.

IFRS 9 – Financial Instruments

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

Requirements for classification and measurement of financial liabilities were added in October 2010 and they largely carried forward existing requirements in IAS 39, Financial Instruments – Recognition and Measurement, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss would generally be recorded in other comprehensive income.

IFRS 9 was amended in November 2013, to (i) include guidance on hedge accounting, and (ii) allow entities to early adopt the requirement to recognize changes in fair value attributable to changes in an entity’s own credit risk, from financial liabilities designated under the fair value option, in OCI, without having to adopt the remainder of IFRS 9.

The final version of IFRS 9 was issued in July 2014 and includes (i) a third measurement category for financial assets – fair value through other comprehensive income; (ii) a single, forward-looking expected loss impairment model, and (iii) a mandatory effective date for IFRS 9 of annual periods beginning on or after January 1, 2018, with early adoption permitted.
15. OFF-BALANCE SHEET ARRANGEMENTS

Guarantees

Performance Obligations Relating to Aircraft Leasing Agreements

With respect to 12 aircraft leases, the difference between the reduced rents as a result of the implementation of the Plan of Reorganization, Compromise and Arrangement under the Companies’ Creditors Arrangement Act (“CCAA”) on September 30, 2004 and amounts which would have been due under the original lease contracts will be forgiven at the expiry date of the leases if no material default has occurred by such date. In the event of a material default which does not include any cross defaults to other unrelated agreements (including unrelated agreements with the counterparties to these aircraft leases), this difference plus interest will become due and payable and all future rent will be based on the original contracted rates. Rent expense is being recorded on the renegotiated lease agreements and any additional liability would be recorded only at the time management believes the amount is likely to be incurred.

Guarantees in Fuel Facilities Arrangements

Air Canada participates in fuel facility arrangements operated through eight Fuel Facility Corporations, along with other airlines that contract for fuel services at various major airports in Canada. The Fuel Facility Corporations operate on a cost recovery basis. The purpose of the Fuel Facility Corporations is to own and finance the system that distributes the fuel to the contracting airlines, including leasing the land rights under the land leases. The aggregate debt of the five Fuel Facility Corporations in Canada that have not been consolidated by Air Canada under IFRS 10 Consolidated Financial Statements is approximately $399 million as at December 31, 2014 (December 31, 2013 - $394 million), which is Air Canada’s maximum exposure to loss before taking into consideration the value of the assets that secure the obligations and any cost sharing that would occur amongst the other contracting airlines. Air Canada views this loss potential as remote. Each contracting airline participating in a Fuel Facility Corporation shares pro-rata, based on system usage, in the guarantee of this debt. The maturities of these debt arrangements vary but generally extend beyond five years.

Indemnification Agreements

In the ordinary course of Air Canada’s business, Air Canada enters into a variety of agreements, some of which may provide for indemnifications to counterparties that may require Air Canada to pay for costs and/or losses incurred by such counterparties. Air Canada cannot reasonably estimate the potential amount, if any, it could be required to pay under such indemnifications. Such amount would also depend on the outcome of future events and conditions, which cannot be predicted. While certain agreements specify a maximum potential exposure, certain others do not specify a maximum amount or a limited period. Historically, Air Canada has not made any significant payments under these indemnifications.

Air Canada enters into real estate leases or operating agreements, which grant a license to Air Canada to use certain premises, in substantially all cities that it serves. It is common in such commercial lease transactions for Air Canada, as the lessee, to agree to indemnify the lessor and other related third parties for tort liabilities that arise out of or relate to Air Canada’s use or occupancy of the leased or licensed premises. Exceptionally, this indemnity extends to related liabilities arising from the negligence of the indemnified parties, but usually excludes any liabilities caused by their gross negligence or willful misconduct. Additionally, Air Canada typically indemnifies such parties for any environmental liability that arises out of or relates to its use or occupancy of the leased or licensed premises.

In aircraft financing or leasing agreements, Air Canada typically indemnifies the financing parties, trustees acting on their behalf and other related parties and/or lessors against liabilities that arise from the manufacture, design, ownership, financing, use, operation and maintenance of the aircraft and for tort liability, whether or not these liabilities arise out of or relate to the negligence of these indemnified parties, except for their gross negligence or willful misconduct. In addition, in aircraft financing or leasing transactions, including those structured as leveraged leases, Air Canada typically provides indemnities in respect of various tax consequences including in relation to the leased or financed aircraft, the use, possession, operation maintenance, leasing, subleasing, repair, insurance, delivery, import, export of such aircraft, the lease or finance arrangements entered in connection therewith, changes of law and certain income, commodity and withholding tax consequences.

When Air Canada, as a customer, enters into technical service agreements with service providers, primarily service providers who operate an airline as their main business, Air Canada has from time to time agreed to indemnify the
service provider against certain liabilities that arise from third party claims, which may relate to services performed by the service provider.

Under its general by-laws and pursuant to contractual agreements between Air Canada and each of its officers and directors, Air Canada has indemnification obligations to its directors and officers. Pursuant to such obligations, Air Canada indemnifies these individuals, to the extent permitted by law, against any and all claims or losses (including amounts paid in settlement of claims) incurred as a result of their service to Air Canada.

16. RELATED PARTY TRANSACTIONS

At December 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.

17. SENSITIVITY OF RESULTS

Air Canada’s financial results are subject to many different internal and external factors which can have a significant impact on operating results. The following table describes, on an indicative basis, the financial impact that changes in certain assumptions would generally have had on Air Canada’s operating results. These guidelines were derived from 2014 levels of activity and make use of management estimates. The impacts are not additive, do not reflect the interdependent relationship of the elements and actual results may vary significantly due to a wide range of factors many of which are beyond the control of Air Canada. An equivalent but opposite movement of the sensitivity factor in the table below would generally result in a similar impact in the opposite direction.

<table>
<thead>
<tr>
<th>(Canadian dollars in millions, Except where indicated) Key Variable</th>
<th>2014 Measure</th>
<th>Sensitivity Factor</th>
<th>Favourable/(Unfavourable) Estimated Operating Income Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue Measures</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Passenger yield (cents)</td>
<td>System 18.9</td>
<td>1% increase in yield</td>
<td>$ 110</td>
</tr>
<tr>
<td></td>
<td>Canada 24.5</td>
<td></td>
<td>$ 41</td>
</tr>
<tr>
<td>Traffic (RPMs) (millions)</td>
<td>System 61,616</td>
<td>1% increase in traffic</td>
<td>$ 105</td>
</tr>
<tr>
<td></td>
<td>Canada 17,662</td>
<td></td>
<td>$ 39</td>
</tr>
<tr>
<td>Passenger load factor (%)</td>
<td>System 83.4</td>
<td>1 percentage point increase in passenger load factor</td>
<td>$ 126</td>
</tr>
<tr>
<td>PRASM (cents)</td>
<td>System 15.8</td>
<td>1% increase in PRASM</td>
<td>$ 107</td>
</tr>
<tr>
<td><strong>Cost Measures</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fuel – Jet fuel price (US$/barrel)(^{(1)})</td>
<td>124</td>
<td>US$1/barrel increase in price of jet fuel</td>
<td>$ (29)</td>
</tr>
<tr>
<td>Fuel – Jet fuel price (CAD cents/litre)(^{(1)})</td>
<td>89</td>
<td>1% increase in price of jet fuel (CAD cents/litre)</td>
<td>$ (33)</td>
</tr>
<tr>
<td>Cost per ASM (cents)</td>
<td>16.9</td>
<td>1% increase in CASM</td>
<td>$ (125)</td>
</tr>
<tr>
<td>Adjusted cost per ASM (cents)(^{(2)})</td>
<td>11.3</td>
<td>1% increase in adjusted CASM</td>
<td>$ (83)</td>
</tr>
</tbody>
</table>

\(^{(1)}\) Excludes the impact of fuel surcharges and fuel hedging. Refer to section 12 “Financial Instruments and Risk Management” of this MD&A for information on Air Canada’s fuel derivative instruments.

\(^{(2)}\) Adjusted CASM is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.
<table>
<thead>
<tr>
<th>Key Variable</th>
<th>2014 Measure</th>
<th>Sensitivity Factor</th>
<th>Favourable/(Unfavourable) Estimated Pre-Tax Income Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Currency Exchange</strong></td>
<td></td>
<td>1 cent increase in exchange rate (i.e. $1.16 to $1.15 per U.S. dollar)</td>
<td></td>
</tr>
<tr>
<td>CS$ to US$</td>
<td>CS$1 = US$1.16</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating income(^{(1)})</td>
<td>$</td>
<td>33</td>
<td></td>
</tr>
<tr>
<td>Net interest expense</td>
<td>$</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Revaluation of long-term debt, U.S. dollar cash and short-term investments and other long-term monetary items, net</td>
<td>$</td>
<td>33</td>
<td></td>
</tr>
<tr>
<td>Remeasurement of outstanding currency derivatives</td>
<td>$</td>
<td>(23)</td>
<td></td>
</tr>
<tr>
<td><strong>Pre-tax Income Impact</strong></td>
<td>$</td>
<td>45</td>
<td></td>
</tr>
</tbody>
</table>

\(^{(1)}\) The operating income impact of currency exchange movements is before the impact of hedging activities, such as through the use of foreign currency derivatives and holding U.S. dollar cash reserves. The gains and losses related to these hedging activities are recorded in non-operating income (expense) on Air Canada's consolidated statement of operations.
18. RISK FACTORS

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

Risks Relating to Air Canada

Operating Results

Air Canada has sustained significant losses in the past and Air Canada may sustain significant losses in the future. A variety of factors, including economic conditions and other factors described in this Risk Factors section, may result in Air Canada incurring significant losses. Despite ongoing strategic and business initiatives, including efforts at securing cost reductions, revenue improvements as well as efforts relating to expansion of Air Canada rouge, Air Canada may not be able to successfully achieve or sustain positive net profitability or realize the objectives of any or all of its initiatives, including those which seek to decrease costs, improve yield or offset or mitigate risks facing Air Canada, including those relating to economic conditions, foreign exchange rates, labour issues, liquidity, competition, and volatility in fuel costs and other expenses.

Leverage

Air Canada has, and is expected to continue to have and incur, a significant amount of indebtedness, including substantial fixed obligations under aircraft leases, aircraft purchases, and other financings, and as a result of any challenging economic or other conditions affecting Air Canada, Air Canada may incur greater levels of indebtedness than currently exist. The amount of indebtedness that Air Canada currently has and which it may incur in the future could have a material adverse effect on Air Canada, for example, by (i) limiting Air Canada's ability to obtain additional financing, (ii) requiring Air Canada to dedicate a substantial portion of its cash flow from operations to payments on its indebtedness and fixed cost obligations, thereby reducing the funds available for other purposes, (iii) making Air Canada more vulnerable to economic downturns, and (iv) limiting Air Canada's flexibility in planning for, or reacting to, competitive pressures or changes in its business environment.

The ability of Air Canada to make scheduled payments under its indebtedness will depend on, among other things, its future operating performance and its ability to refinance its indebtedness, if necessary. In addition, as Air Canada incurs indebtedness which bears interest at fluctuating interest rates, to the extent these interest rates increase, its interest expense will increase. There can be no assurance that Air Canada will at all times be able to generate sufficient cash from its operations to pay its debts and lease obligations. Each of these factors is, to a large extent, subject to economic, financial, competitive, regulatory, operational and other factors, many of which are beyond Air Canada's control.

Need for Additional Capital and Liquidity

Air Canada faces a number of challenges in its business, including in relation to economic conditions, foreign exchange rates, labour issues, volatile fuel prices, contractual covenants (which require Air Canada to maintain minimum cash reserves and which could require Air Canada to deposit cash collateral with third parties), and increased competition from international, U.S. transborder and low-cost domestic carriers. Air Canada's liquidity levels may be adversely impacted by these as well as by other factors and risks identified in this MD&A. As part of Air Canada's efforts to meet such challenges and to support Air Canada's business strategy, significant liquidity and significant on-going operating and capital expenditures are required. There can be no assurance that Air Canada will continue to be able to obtain, on a timely basis, sufficient funds on terms acceptable to Air Canada to provide adequate liquidity and to finance the operating and capital expenditures necessary to overcome challenges and support its business strategy if cash flows from operations and cash on hand are insufficient.

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

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

**Foreign Exchange**

Air Canada’s financial results are sensitive to the fluctuating value of the Canadian dollar. In particular, Air Canada has a significant annual net outflow of U.S. dollars and is affected by fluctuations in the U.S./Canada dollar exchange rate. Management estimates that during 2014, a $0.01 strengthening of the Canadian dollar versus the U.S. dollar (i.e. $1.16 to $1.15 per U.S. dollar) would have had an estimated $33 million favourable impact on operating income and a $45 million favourable impact on pre-tax income. Conversely, a corresponding opposite change in the exchange rate would have had the corresponding opposite effect. Air Canada incurs significant expenses in U.S. dollars for items such as fuel, aircraft rental and purchases and maintenance charges, interest payments, debt servicing and computerized reservations system fees, while a substantial portion of its revenues are generated in Canadian dollars. A significant deterioration of the Canadian dollar relative to the U.S. dollar would increase the costs of Air Canada relative to its U.S. competitors and could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Due to the competitive nature of the airline industry and consumer sensitivity to travel costs, Air Canada may not be able to pass on increases in Canadian dollar costs to its customers by increasing its fares. In addition, Air Canada may be unable to appropriately hedge the risks associated with fluctuations in exchange rates.

**Economic and Geopolitical Conditions**

Airline operating results are sensitive to economic and geopolitical conditions which can have a significant impact on Air Canada. For example, economic and geopolitical conditions may impact demand for air transportation in general or to or from certain destinations, and may also impact Air Canada’s operating costs, costs and availability of fuel, foreign exchange costs, pension plan contributions, and costs and availability of capital and supplies required by Air Canada. Especially in light of Air Canada’s substantial fixed cost structure, any prolonged or significant impact arising from economic and geopolitical conditions, including weakness of the Canadian, U.S. or world economies or threatened or actual outbreaks of hostilities in or adjacent to regions Air Canada serves or operates flights over, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Airline fares and passenger demand have fluctuated significantly in the past and may fluctuate significantly in the future. Air Canada is not able to predict with certainty market conditions and the fares that Air Canada may be able to charge. Customer expectations can change rapidly and the demand for lower fares may limit revenue opportunities. Travel, especially leisure travel, is a discretionary consumer expense. Demand for business and premium travel are also impacted by economic conditions. Depressed economic conditions in North America and other areas served by Air Canada as well as geopolitical instability in various areas of the world, concerns about the environmental impacts of air travel and tendencies towards “green” travel initiatives where consumers reduce their travel activities, could have the effect of reducing demand for air travel in Canada and abroad and could materially adversely impact Air Canada, its business, results from operations and financial condition.

**Fuel Costs**

Fuel costs constituted the largest percentage of the total operating costs of Air Canada in 2014. Fuel prices have and may continue to fluctuate widely depending on many factors including international market conditions, geopolitical events, jet fuel refining costs and the Canada/U.S. dollar exchange rate. Air Canada cannot accurately predict fuel prices. Significant fluctuations (including increases) in fuel prices could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Due to the competitive nature of the airline industry, Air Canada may not be able to pass on increases in fuel prices to its customers by increasing its fares. Furthermore, the impact of lower aircraft fuel prices could be offset by increased price competition, and a resulting decrease in revenues, for all air carriers. Based on 2014 volumes, management estimates that a US$1 per barrel movement in the average price of jet fuel would have resulted in an approximate $29 million change in 2014 fuel expense for Air Canada (excluding any impact of surcharges, foreign exchange rates and fuel hedging), assuming flying capacity remained unchanged and that refining spreads between WTI crude oil and jet fuel as well as foreign exchange rates remained constant.
**Competition**

**North America**

Air Canada operates within a highly competitive industry. Over the past few years, several carriers have entered or announced their intention to enter or expand into the domestic (including regional), the U.S. transborder and international markets in which Air Canada operates.

Canadian low-cost and other carriers have entered and/or expanded or announced their intention to compete in many of Air Canada’s key domestic (including regional) markets and, along with some U.S. carriers have also entered and/or expanded their operations in the U.S. transborder and leisure-oriented markets. Carriers against which Air Canada competes, including U.S. carriers, may undergo (and some have undergone) substantial reorganizations (including by way of merger with or acquisition by another carrier), creating reduced levels of indebtedness and lower operating costs and may therefore be in a position to more effectively compete with Air Canada.

The proximity of several American airports in cities close to the Canadian border (such as Plattsburgh, Buffalo and Bellingham) has also presented an additional challenge for Air Canada. Higher taxes, charges and fees for passengers departing from Canada travelling to the U.S. has redirected appreciable passenger traffic away from Canadian airports.

Low-cost carriers based in the U.S. have and may continue to increase their capacity at these airports and attract Canadian-originating, price-sensitive customers.

**International**

Air Canada is also facing increasing competition in international markets as carriers increase their international capacity, both by expansion and by shifting existing domestic capacity to international operations to avoid low-cost domestic competition.

Given Canada’s diverse, sustained immigration levels and multicultural population, Canadian gateways such as Toronto, Montreal, and Vancouver are deemed attractive by international carriers. In 2014, foreign carriers such as Air France-KLM, AeroMexico, EVA Air, China Airlines, China Eastern Airlines, Hainan Airlines, COPA Airlines, Icelandair, All Nippon Airways and LATAM Airlines have entered or announced their intention to enter or expand their international operations into Canada.

Increased competition in the domestic, transborder or international markets could have a material adverse effect on Air Canada’s business, results from operations and financial condition.

**Labour Costs and Labour Relations**

Labour costs constituted another one of Air Canada’s largest operating cost items in 2014. There can be no assurance that Air Canada will be able to maintain such costs at levels that do not negatively affect its business, results from operations and financial condition. There can be no assurance that future agreements with employees’ unions or the outcome of arbitrations will be on terms consistent with Air Canada’s expectations or comparable to agreements entered into by Air Canada’s competitors. Any future agreements or outcome of negotiations or arbitrations, including in relation to wages or other labour costs or work rules, may result in increased labour costs or other charges, or terms and conditions restricting or reducing Air Canada’s ability to sustain its business objectives or pursue its strategic initiatives, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Most of Air Canada’s employees are unionized and collective agreements with certain unions are coming up for renewal and negotiation. In 2011, tentative collective agreements with UNIFOR (formerly called CAW), the union representing Air Canada’s customer service employees at airports and call centres, as well as with CUPE, the union representing Air Canada’s flight attendants, were concluded and, respectively, ratified or conclusively settled through arbitration. The agreement with UNIFOR is in effect until February 28, 2015 and the agreement with CUPE is in effect until March 31, 2015. In the first quarter of 2012, Air Canada concluded agreements with UNIFOR, in relation to in-flight crew schedulers and flight operations crew schedulers, and with CALDA, in relation to flight dispatchers. In June 2012, the decision of the arbitrator was issued in respect of the IAMAW final offer selection arbitration conducted in accordance with the process legislated by the federal government in the Protecting Air Service Act. The arbitrator’s final offer selection concluded a new five-year collective agreement between Air Canada and the IAMAW which is in effect until March 31, 2016. On October 6, 2014, Air Canada reached a new agreement with ACPA which provides collective agreement terms for ten years, ending September 29, 2024, subject to certain openers and benchmarks over this period.
ACP and the IAMAW have, each, independently, instituted proceedings to contest the constitutional validity of the legislation which referred to arbitration the resolution of the issues that had not been resolved in bargaining. Air Canada is not currently a party to these proceedings. Air Canada expects that in both cases the legislation (and therefore the collective agreements concluded through the arbitration process) will be upheld.

There can be no assurance that collective agreements, including any which may be expiring in the near term, will be further renewed without labour conflict or action or that there will not otherwise be any labour conflict or action that could also lead to a degradation, interruption or stoppage in Air Canada's service or otherwise adversely affect the ability of Air Canada to conduct its operations, any of which could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In respect of the unions for Canadian-based employees, strikes or lockouts may lawfully occur following the term and negotiations of the renewal of collective agreements once a number of pre-conditions prescribed by the Canada Labour Code have been satisfied.

Any labour disruption or work stoppage by any of the unionized work groups of Jazz or other parties with whom Air Canada conducts business could have a material adverse effect on Air Canada, its business, results from operations and financial condition. In addition, labour conflicts at Star Alliance® partners could result in lower demand for connecting traffic with Air Canada and, ultimately, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Strategic, Business, Technology and Other Important Initiatives

In order to operate its business, achieve its goals and remain competitive, Air Canada continuously seeks to identify and devise, invest in, implement and pursue strategic, business, technology and other important initiatives, such as those relating to participation in the leisure or low-cost market (including the planned growth of Air Canada rouge), the aircraft fleet restructuring (including the scheduled delivery of Boeing 787 aircraft and the planned re-fleeting of narrow-body aircraft with Boeing 737 MAX aircraft), revenue enhancement initiatives, business processes, information technology, revenue management (including the planned implementation of Air Canada's revenue management system), cost transformation, improving premium passenger revenues, expansion of flying capacity (including in respect of new aircraft and routes), corporate culture transformation, initiatives seeking to ensure a consistently high quality customer service experience and others. These initiatives, including activities relating to their development and implementation, may be adversely impacted by a wide range of factors, many of which are beyond Air Canada's control. Such factors include the need to seek legal or regulatory approvals, the performance of third parties, including suppliers, the implementation and integration of such initiatives into Air Canada's other activities and processes as well as the adoption and acceptance of these initiatives by Air Canada's customers, suppliers, unions and personnel. A delay or failure to sufficiently and successfully identify and devise, invest in or implement these initiatives could adversely affect Air Canada's ability to operate its business, achieve its goals and remain competitive and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

For instance, a key component of Air Canada’s business plan is the acquisition of new and more efficient Boeing 787 and Boeing 737 MAX aircraft. A delay or failure in the completion of Air Canada's fleet restructuring, including delays by the manufacturers in the delivery of the aircraft, or an inability to remove, as planned, certain aircraft from the fleet in coordination with the planned entry into service of new aircraft, could adversely affect the implementation of Air Canada's business plan which may, in turn, have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Pension Plans

Canadian federal pension legislation requires that the funded status of registered pension plans be determined periodically, on both a going concern basis (essentially assuming indefinite plan continuation) and a solvency basis (essentially assuming immediate plan termination).

Pension plan solvency valuations are influenced primarily by long-term interest rates and by the investment return on plan assets, which in turn may be dependent on a variety of factors, including economic conditions. The interest rate used to calculate benefit obligations for solvency purposes is a prescribed rate derived from the interest rates on long-term Government of Canada bonds. Deteriorating economic conditions or prolonged period of low or decreasing interest rates may result in significant increases in Air Canada's funding obligations, which could have a material adverse effect on Air Canada, its business, results from operations and financial condition.
Refer to section 9.7 “Pension Funding Obligations” of this MD&A for additional information relating to Air Canada’s pension funding obligations. In December 2013, further to an agreement reached with Air Canada in March 2013, the Government of Canada formally approved the Air Canada Pension Plan Funding Regulations, 2014 (the “2014 Regulations”) under the Pension Benefits Standards Act, 1985. Absent the 2014 Regulations and under generally applicable regulations, Air Canada’s pension funding obligations would be determined by a variety of factors, including regulatory developments, assumptions and methods used and changes in the economic conditions (mainly the return on fund assets and changes in interest rates) as well as the application of normal past service contribution rules which would generally require one fifth of any solvency deficit, determined on the basis of an average over the previous three years, to be funded each year in addition to required current service contributions.

Underfunded pension plans or a failure or inability by Air Canada to make required cash contributions to its registered pension plans may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Revenue and Alliance Environment

Air Canada encounters substantial price competition. The prevalence of low-cost carriers, Internet travel websites and other travel products distribution channels, have resulted in a substantial increase in discounted and promotional fares initiates by Air Canada’s competitors. A decision to match competitors’ fares to maintain passenger traffic results in reduced yields which, in turn, could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Furthermore, Air Canada’s ability to reduce its fares in order to effectively compete with other carriers is dependent on Air Canada’s ability to achieve acceptable operating margins and may also be limited by government policies to encourage competition. Likewise, competitors continue to pursue commissions/incentive actions and, in many cases, increase these payments. The decision to modify Air Canada’s current programs in order to remain competitive and maintain passenger traffic could result in increased costs to Air Canada’s business.

Furthermore, consolidation within the airline industry could result in increased competition as some airlines emerging from such consolidations and entering into integrated commercial cooperation arrangements, such as joint ventures, may be able to compete more effectively, which could have a material adverse effect on Air Canada.

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

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

Limitations Due to Restrictive Covenants

Some of the financing and other major agreements to which Air Canada is a party contain, and in the future may contain, restrictive, financial (including in relation to asset valuations, liquidity, minimum EBITDAR results, fixed charge coverage ratio and debt coverage ratios) and other covenants which affect and, in some cases, significantly limit or prohibit, among other things, the manner in which Air Canada may structure or operate its business, including by reducing Air Canada’s liquidity, limiting Air Canada’s ability to incur indebtedness, create liens, sell assets, pay dividends, make capital expenditures, and engage in acquisitions, mergers or restructurings or a change of control. Future financing and other major agreements may also be subject to similar covenants which limit Air Canada’s operating and financial flexibility, which could materially and adversely affect Air Canada’s ability to operate its business and its profitability.

A failure by Air Canada to comply with its contractual obligations (including restrictive, financial and other covenants), or to pay its indebtedness and fixed costs could result in a variety of material adverse consequences, including the acceleration of its indebtedness, the withholding of credit card proceeds by the credit card service providers and the exercise of remedies by its creditors, lessors or other co-contracting parties, and such defaults could trigger additional defaults under other indebtedness or agreements. In such a situation, Air Canada may not be able to repay the
accelerated indebtedness or fulfill its obligations under certain contracts, make required aircraft lease payments or otherwise cover its fixed costs. Also, the lenders under the financing arrangements could foreclose upon all or substantially all of the assets of Air Canada which secure Air Canada’s obligations.

Refer to section 9.8 “Contractual Obligations” of this MD&A for information on Air Canada’s credit card processing agreements.

Airport User Fees and Air Navigation Fees
With the privatization of airports and air navigation authorities in Canada, airport and air navigation authorities have significantly increased their fees. Air Canada may not be in a position to prevent or develop alternatives to overcome fee increases. Though certain authorities have implemented some fee reductions, if authorities in Canada or elsewhere were to significantly increase their fees, Air Canada, its business, results from operations and financial condition could be materially adversely affected.

Dependence on Technology
Air Canada relies heavily on technology, including computer and telecommunications equipment and software and internet-based systems, to operate its business, increase its revenues and reduce its costs. These systems include those relating to Air Canada’s telecommunications, websites, computerized airline reservations and airport customer services and flight operations. Air Canada also depends on the performance of its key suppliers, whose performance is in turn dependent upon their respective technology systems.

Technology systems may be vulnerable to a variety of sources of failure, interruption or misuse, including by reason of third party suppliers’ acts or omissions, natural disasters, terrorist attacks, telecommunications failures, power failures, computer viruses, unauthorized or fraudulent users, and other operational and security issues. While Air Canada continues to invest in initiatives, including security initiatives and disaster recovery plans, these measures may not be adequate or implemented properly. Any such technology systems failure, interruption or misuse, whether at Air Canada or a third party on whom Air Canada relies, could materially and adversely affect Air Canada’s operations and could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key Supplies and Suppliers
Air Canada is dependent upon its ability to source, on favourable terms and costs, sufficient quantities of goods and services in a timely manner, including those available at airports or from airport authorities or otherwise required for Air Canada’s operations such as fuel, aircraft and related parts and aircraft maintenance services. In certain cases, Air Canada may only be able to access goods and services from a limited number of suppliers and transition to new suppliers may take a significant amount of time and require significant resources. A failure, refusal or inability of a supplier may arise as a result of a wide range of causes, many of which are beyond Air Canada’s control. In addition, there can be no assurance as to the continued viability of any of Air Canada’s suppliers. Any failure or inability of Air Canada to successfully source goods and services, including by reason of a failure, refusal or inability of a supplier, or to source goods and services on terms and pricing and within the timeframes acceptable to Air Canada, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.
Aeroplan®

Through its commercial agreement with Aeroplan, Air Canada is able to offer its customers who are Aeroplan® members the opportunity to earn Aeroplan® Miles. Based on customer surveys, management believes that rewarding customers with Aeroplan® Miles is a significant factor in customers’ decision to travel with Air Canada and contributes to building customer loyalty. The failure by Aeroplan to adequately fulfill its obligations towards Air Canada under the Aeroplan Commercial Participation and Services Agreement and in connection with the Aeroplan program, or other unexpected interruptions or disruptions of Aeroplan services which are beyond Air Canada’s control, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Regional Carriers

Air Canada seeks to enhance its network through capacity purchase agreements, including the Jazz CPA and other capacity purchase agreements with regional airlines, such as Sky Regional, operating flights on behalf of Air Canada.

Under the Jazz CPA, Jazz provides Air Canada’s customers service in lower density markets and higher density markets at off-peak times throughout Canada and to and from certain destinations in the United States and also provides valuable traffic feed to Air Canada’s mainline and rouge routes. Pursuant to the terms of the Jazz CPA, Air Canada pays Jazz a number of fees, some which are fixed and others which are determined based upon certain costs incurred by Jazz. Air Canada also reimburses Jazz for certain pass-through costs incurred by Jazz, such as fuel, navigation, landing and terminal fees and certain other costs. In addition, the Jazz CPA requires that Jazz maintain a minimum fleet size and contains a minimum average daily utilization guarantee which requires Air Canada to utilize Jazz for that amount of flying. Significant increases in Jazz’s costs, the failure by Jazz to adequately fulfill its obligations under the Jazz CPA, factors which may reduce the utilization of Jazz fleet, including economic or market downturns, and unexpected interruptions or cessation of Jazz’s services could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

The failure by Air Canada’s other regional carriers to fulfill their obligations under their respective agreements, or unexpected interruptions or disruptions of their services, as well as minimum guarantees in capacity purchase agreements which may limit Air Canada’s ability to effectively manage regional capacity in response to economic downturns, market pressures or other external events, could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Star Alliance®

The strategic and commercial arrangements with Star Alliance® members provide Air Canada with important benefits, including codesharing, efficient connections and transfers, reciprocal participation in frequent flyer programs and use of airport lounges from the other members. Should a key member leave Star Alliance® or otherwise fail to meet its obligations thereunder, Air Canada, its business, results from operations and financial condition could be materially adversely affected.

Interruptions or Disruptions in Service

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

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

Investigations by Competition Authorities Relating to Cargo

The European Commission and the United States Department of Justice investigated, and the Competition Bureau in Canada is investigating, alleged anti-competitive cargo pricing activities, including the levying of certain fuel surcharges, of a number of airlines and cargo operators, including Air Canada. Competition authorities in several jurisdictions have sought or requested information from Air Canada as part of their investigations. Air Canada has been cooperating with these investigations, which are likely to lead, or have led, to proceedings against Air Canada and a number of airlines and other cargo operators in certain jurisdictions. Air Canada is also named as a defendant and has, and may otherwise, become implicated, in a number of class action lawsuits and other proceedings in Canada, Europe and the United States in connection with these allegations. In the United States, the investigation by the US Department of Justice concluded with no proceedings having been instituted against Air Canada, and in 2012, the Corporation entered into a settlement agreement relating to class action proceedings in the United States in connection with these allegations under which Air Canada made a payment of $8 million without any admission of liability.

In 2010, the European Commissions rendered a decision finding that 12 air cargo carriers (including groups of related carriers) had infringed European Union competition law in the setting of certain cargo charges and rates for various periods between 1999 and 2006. Air Canada was among the carriers subject to the decision and a fine of 21 million Euros (approximately C$29 million) was imposed on Air Canada. Air Canada is appealing this decision and filed an application for appeal before the European General Court. In 2011, Air Canada paid the fine, as required, pending the outcome of its appeal.

As at December 31, 2014, Air Canada has a provision of $27 million relating to outstanding claims in this matter, which is recorded in accounts payable and accrued liabilities on Air Canada’s consolidated statement of financial position. This provision is an estimate based upon the status of the investigations and proceedings at this time and Air Canada’s assessment as to the potential outcome for certain of them. The provision does not address the proceedings and investigations in all jurisdictions, but only where there is sufficient information to do so. Air Canada has determined it is not possible at this time to predict with any degree of certainty the outcome of all proceedings and investigations. As stated above, Air Canada is appealing the decision issued by the European Commission and, if and as appropriate, based on the outcome of any updates regarding this appeal as well as developments regarding proceedings and investigations in other jurisdictions, may record adjustments to the provision and/or its income in subsequent periods as required.

Mandatory Retirement

Air Canada is engaged in a number of proceedings involving challenges to the mandatory retirement provisions of certain of its collective agreements, including the previous Air Canada-ACPA collective agreement, which incorporated provisions of the pension plan terms and conditions applicable to pilots requiring them to retire at age 60. Air Canada has fully or partially resolved some of these complaints and is defending others. At this time, it is not possible to determine with any degree of certainty the extent of any financial liability that may arise from Air Canada being unsuccessful in its defence of these proceedings, though any such financial liability, if imposed, would not be expected to be material.

Future Legal Proceedings

Airlines are susceptible to various claims and litigation, including class action claims, in the course of operating their business or with respect to the interpretation of existing agreements. Any future claims or litigation could also have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Key Personnel

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

Terrorist Attacks and Security Measures

The potential for terrorist attacks and terrorist activity causes uncertainty in the minds of the traveling public. The occurrence of a terrorist attack (or attempted attacks) (whether domestic or international and whether involving Air Canada or another carrier or no carrier at all) and increasingly restrictive security measures, such as those relating to the content of carry-on baggage, passenger identification document requirements, and passenger screening procedures could have a material adverse effect on passenger demand for air travel and on the number of passengers traveling on Air Canada’s flights. It could also lead to a substantial increase in insurance, airport security and other costs. Any resulting reduction in passenger revenues and/or increases in costs, including insurance, security or other costs could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Epidemic Diseases (Severe Acute Respiratory Syndrome (SARS), H1N1 Influenza, Ebola or Other Epidemic Diseases)

The international outbreaks of Severe Acute Respiratory Syndrome (SARS) in 2003, and the resulting actions of the World Health Organization (the “WHO”), including a travel advisory against non-essential travel to Toronto, Canada, had a significant adverse effect on passenger demand for air travel in Air Canada’s markets and resulted in a major negative impact on traffic on the entire network. An outbreak of influenza, SARS, H1N1 influenza virus, Ebola or of another virus or epidemic disease (whether domestic or international) or any WHO or similar travel advisories (whether relating to Canadian cities or regions or other cities, regions or countries) could have a material adverse effect on passenger demand for air travel. Any resulting reduction in traffic in the markets served by Air Canada could have a material adverse effect on Air Canada, its business, results from operations and financial condition.

Casualty Losses

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

Seasonal Nature of the Business, Other Factors and Prior Performance

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

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

Regulatory Matters

The airline industry is subject to extensive Canadian and foreign government regulations relating to, among other things, security, safety, consumer rights, privacy, data security, licensing, competition, environment (including noise levels and carbon emissions) and in some measure, pricing. For example, new and proposed legislation have been considered or adopted concerning carbon emissions emanating from the aviation industry. Such legislative initiatives include, for example, market-based mechanisms called emissions trading systems, which are being proposed and implemented to reduce the amount of carbon emissions through the setting of emissions allowances and charging aircraft operators for a certain percentage of theses allowances. The implementation of additional regulations or decisions, including potentially inconsistent or conflicting regulations, including in relation to carbon emissions, and others, whether by Transport Canada, the Competition Bureau and/or the Competition Tribunal, the Canadian Transportation Agency or other local,
domestic or foreign governmental entities, may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

The European Union passed legislation for an Emissions Trading System, which included carbon emissions from aviation commencing in January 2012, including for flights operated between Canada and countries within the European Union. As a result of on-going international opposition, the European Parliament and Council announced that they are exempting all flights between Europe and third countries from the EU ETS until and inclusive of 2016, pending the creation by 2020, of an ICAO led global market-based measure (MBM) that is likely to reduce greenhouse-gas emissions. If reinstated, the EU ETS would be expected to result in increased costs relating to the purchase of emissions allowances. The net financial impact would, in part, depend upon how much of such cost, if any, would be recovered, including in the form of higher passenger fares and cargo rates. Management cannot predict the outcome of or of ICAO’s efforts to set-up a global MBM or the impact such global MBM may have on Air Canada, its business, results from operations and financial condition.

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

Air Canada is subject to domestic and foreign laws regarding privacy and security of passenger, employee and other data, including advance passenger information and access to airline reservation systems, which are not consistent in all countries in which Air Canada operates. The need to comply with these regulatory regimes results in additional operating costs and further regulation in this area could have a material adverse effect on Air Canada, its business, results from operations and financial condition. Non-compliance with data privacy and security requirements may have a material adverse effect on Air Canada, its business (including by impacting Air Canada’s goodwill and reputation), results from operations and financial condition.

Foreign jurisdictions (including the United States, European Union countries and other jurisdictions where Air Canada operates) have enacted and implemented and they and domestic regulators may in the future enact and implement consumer protection and passenger rights measures. Such measures may impose significant, unique, inconsistent or even conflicting obligations on Air Canada, which may result in increased liability and costs to Air Canada and which may adversely impact Air Canada, its business, results from operations and financial condition.

There can be no assurances that new laws, regulations or revisions to same, or decisions, will not be adopted or rendered, from time to time, and these could impose additional requirements or restrictions, which may adversely impact Air Canada, its business, results from operations and financial condition.

**Availability of Insurance Coverage and Increased Insurance Costs**

The aviation insurance industry has been continually re-evaluating the terrorism risks that it covers, and this activity may adversely affect some of Air Canada’s existing insurance carriers or Air Canada’s ability to obtain future insurance coverage. To the extent that Air Canada’s existing insurance carriers are unable or unwilling to provide it with insurance coverage, and in the absence of measures by the Government of Canada to provide the required coverage, Air Canada’s insurance costs may increase further and may result in Air Canada being in breach of regulatory requirements or contractual arrangements requiring that specific insurance be maintained, which may have a material adverse effect on Air Canada, its business, results from operations and financial condition.

**Third Party War Risk Insurance**

There is a risk that the Government of Canada may not continue to provide an indemnity for third party war risk liability coverage, which it is currently providing to Air Canada and certain other carriers in Canada until December 31, 2015 or that it may amend, in a manner adverse to Air Canada, the terms of the indemnity which it is providing. In the event that the Government of Canada does not continue to provide such indemnity or amends such indemnity (in a manner adverse to Air Canada), Air Canada and other industry participants would have to turn to the commercial insurance market to seek such coverage. Air Canada estimates that such coverage would cost Air Canada approximately US$2.5 million per year. Alternative solutions, such as those envisioned by the International Civil Aviation Organization (“ICAO”) and the International Air Transport Association (“IATA”), have not developed as planned, due to actions taken by other countries and the recent availability of supplemental insurance products. ICAO and IATA are continuing their efforts in this area; however, the achievement of a global solution is not likely in the immediate or near future. The U.S. federal
government has set up its own facility to provide war risk coverage to U.S. carriers, thus removing itself as a key component of any global plan.

19. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

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

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

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

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

Management’s Report on Disclosure Controls and Procedures

Management, under the supervision of and with the participation of the Corporation’s CEO and CFO, evaluated the effectiveness of the Corporation’s disclosure controls and procedures (as defined under National Instrument 52-109) and concluded, as at December 31, 2014, that such disclosure controls and procedures were effective.

Management’s Report on Internal Controls over Financial Reporting

Management, under the supervision of and with the participation of the Corporation’s CEO and CFO, evaluated the effectiveness of the Corporation’s internal controls over financial reporting (as defined under National Instrument 52-109). In making this evaluation, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commissions ("COSO") in Internal Control - Integrated Framework (2013). Based on that evaluation, management and the CEO and CFO have concluded that, as at December 31, 2014, the Corporation’s internal controls over financial reporting were effective. This evaluation took into consideration the Corporation’s Corporate Disclosure Policy and the functioning of its Disclosure Policy Committee.

Changes in Internal Controls over Financial Reporting

There have been no changes to the Corporation’s internal controls over financial reporting during the year ended December 31, 2014 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.
20. NON-GAAP FINANCIAL MEASURES

Operating Income, Excluding the Impact of Benefit Plan Amendments

Air Canada uses Operating income, excluding the impact of benefit plan amendments, to assess the operating performance of its ongoing airline business without the effects of unusual items, such as benefit plan amendments, as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful.

Operating income, excluding the impact of benefit plan amendments, 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.

Operating income, excluding the impact of benefit plan amendments, is reconciled to operating income as follows:

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>Fourth Quarter</th>
<th>Full Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>GAAP operating income</td>
<td>$106</td>
<td>$135</td>
</tr>
<tr>
<td>Add back:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benefit plan amendments (1)</td>
<td>-</td>
<td>(82)</td>
</tr>
<tr>
<td>Operating income, excluding the impact of benefit plan amendments</td>
<td>$106</td>
<td>$53</td>
</tr>
</tbody>
</table>

(1) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans.

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 and EBITDAR, excluding the impact of benefit plan amendments, are reconciled to operating income as follows:

<table>
<thead>
<tr>
<th>(Canadian dollars in millions)</th>
<th>Fourth Quarter</th>
<th>Full Year</th>
</tr>
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<tbody>
<tr>
<td></td>
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<td>GAAP operating income</td>
<td>$106</td>
<td>$135</td>
</tr>
<tr>
<td>Add back:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aircraft rent</td>
<td>79</td>
<td>76</td>
</tr>
<tr>
<td>Depreciation, amortization and impairment</td>
<td>134</td>
<td>148</td>
</tr>
<tr>
<td>EBITDAR</td>
<td>$319</td>
<td>$359</td>
</tr>
<tr>
<td>Add back:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Benefit plan amendments (1)</td>
<td>-</td>
<td>(82)</td>
</tr>
<tr>
<td>EBITDAR, excluding the impact of benefit plan amendments</td>
<td>$319</td>
<td>$277</td>
</tr>
</tbody>
</table>

(1) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans.
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:

<table>
<thead>
<tr>
<th>(Canadian dollars in millions, except where indicated)</th>
<th>Fourth Quarter</th>
<th>Full Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
</tr>
<tr>
<td>GAAP operating expense</td>
<td>$2,998</td>
<td>$2,759</td>
</tr>
<tr>
<td>Adjusted for:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aircraft fuel</td>
<td>(791)</td>
<td>(831)</td>
</tr>
<tr>
<td>One-time payments - ACPA (1)</td>
<td>(30)</td>
<td>-</td>
</tr>
<tr>
<td>Benefit plan amendments (3)</td>
<td>-</td>
<td>82</td>
</tr>
<tr>
<td>Tax-related provision adjustments (3)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Ground packages costs at Air Canada Vacations</td>
<td>(74)</td>
<td>(66)</td>
</tr>
<tr>
<td>Impairment charge (4)</td>
<td>-</td>
<td>(6)</td>
</tr>
<tr>
<td>Operating expense, adjusted for the above-noted items</td>
<td>$2,103</td>
<td>$1,938</td>
</tr>
<tr>
<td>ASMs (millions)</td>
<td>17,403</td>
<td>16,033</td>
</tr>
<tr>
<td>Adjusted CASM (cents)</td>
<td>c 12.08</td>
<td>c 12.09</td>
</tr>
</tbody>
</table>

(1) In 2014, one-time payments totaling $30 million were made to ACPA members under a collective agreement concluded in October 2014.
(2) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans.
(3) In 2014, Air Canada recorded favourable tax-related provision adjustments of $41 million.
(4) In 2013, Air Canada recorded impairment charges amounting to $30 million.
Adjusted Net Income and Adjusted Net Income per Share – Diluted

Air Canada uses adjusted net income and adjusted net income 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 fuel and other derivatives 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.

<table>
<thead>
<tr>
<th>(Canadian dollars in millions, except per share values)</th>
<th>Fourth Quarter</th>
<th></th>
<th></th>
<th>Full Year</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
<td>$ Change</td>
<td>2014</td>
<td>2013</td>
<td>$ Change</td>
</tr>
<tr>
<td>Net income (loss) for the period attributable to shareholders</td>
<td>$(101)</td>
<td>$(7)</td>
<td>$(94)</td>
<td>$100</td>
<td>$6</td>
<td>$94</td>
</tr>
<tr>
<td>Adjusted for:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>One-time payments - ACPA (1)</td>
<td>30</td>
<td>-</td>
<td>30</td>
<td>30</td>
<td>-</td>
<td>30</td>
</tr>
<tr>
<td>Benefit plan amendments (2)</td>
<td>-</td>
<td>(82)</td>
<td>82</td>
<td>-</td>
<td>(82)</td>
<td>82</td>
</tr>
<tr>
<td>Tax-related provision adjustments (3)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(41)</td>
<td>-</td>
<td>(41)</td>
</tr>
<tr>
<td>Impairment charge (4)</td>
<td>-</td>
<td>6</td>
<td>(6)</td>
<td>-</td>
<td>30</td>
<td>(30)</td>
</tr>
<tr>
<td>Foreign exchange loss</td>
<td>115</td>
<td>55</td>
<td>60</td>
<td>307</td>
<td>120</td>
<td>187</td>
</tr>
<tr>
<td>Interest charge (5)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>95</td>
<td>(95)</td>
</tr>
<tr>
<td>Net financing expense relating to employee benefits</td>
<td>32</td>
<td>53</td>
<td>(21)</td>
<td>134</td>
<td>208</td>
<td>(74)</td>
</tr>
<tr>
<td>(Gain) loss on fuel and other derivatives</td>
<td>(9)</td>
<td>(22)</td>
<td>13</td>
<td>1</td>
<td>(37)</td>
<td>38</td>
</tr>
<tr>
<td>Adjusted net income</td>
<td>$67</td>
<td>$3</td>
<td>$64</td>
<td>$531</td>
<td>$340</td>
<td>$191</td>
</tr>
<tr>
<td>Weighted average number of outstanding shares used in computing diluted income per share (in millions)</td>
<td>294</td>
<td>291</td>
<td>3</td>
<td>293</td>
<td>284</td>
<td>9</td>
</tr>
<tr>
<td>Adjusted net income per share – diluted</td>
<td>$0.23</td>
<td>$0.01</td>
<td>$0.22</td>
<td>$1.81</td>
<td>$1.20</td>
<td>$0.61</td>
</tr>
</tbody>
</table>

(1) In 2014, one-time payments totaling $30 million were made to ACPA members under a collective agreement concluded in October 2014.
(2) In 2013, Air Canada recorded an operating expense reduction of $82 million related to amendments to defined benefit pension plans.
(3) In 2014, Air Canada recorded favourable tax-related provision adjustments of $41 million.
(4) In 2013, Air Canada recorded impairment charges amounting to $30 million.
(5) In 2013, Air Canada recorded an interest charge of $95 million related to the purchase of its senior secured notes due in 2015 and 2016.

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:

<table>
<thead>
<tr>
<th>(in millions)</th>
<th>Fourth Quarter</th>
<th></th>
<th></th>
<th>Full Year</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2014</td>
<td>2013</td>
<td></td>
<td>2014</td>
<td>2013</td>
<td></td>
</tr>
<tr>
<td>Weighted average number of shares outstanding – basic</td>
<td>286</td>
<td>282</td>
<td>286</td>
<td>277</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effect of potential dilution</td>
<td>8</td>
<td>9</td>
<td>7</td>
<td>7</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weighted average number of shares outstanding – diluted</td>
<td>294</td>
<td>291</td>
<td>293</td>
<td>284</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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 (i) average year-over-year total assets, net of average year-over-year non-interest-bearing operating liabilities, and (ii) the value of capitalized operating leases (calculated by multiplying annualized aircraft rent by 7). 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.

In the second quarter of 2014, Air Canada changed its approach in calculating invested capital from a financing method to an operating method. Management believes this change provides more relevant information as the return is based on the book value of invested capital used for operations and is not subject to changes in the market price of Air Canada’s outstanding shares. For comparative purposes, the information as at December 31, 2013 provided below reflects this new methodology.

The following table provides Air Canada’s return on invested capital for the periods indicated:

<table>
<thead>
<tr>
<th>(Canadian dollars in millions, except where indicated)</th>
<th>December 31, 2014</th>
<th>December 31, 2013</th>
<th>$ Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income for the period attributable to shareholders (trailing 12 months)</td>
<td>$ 100</td>
<td>$ 6</td>
<td>$ 94</td>
</tr>
<tr>
<td>Remove:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>One-time payments - ACPA(^{(1)})</td>
<td>30</td>
<td>-</td>
<td>30</td>
</tr>
<tr>
<td>Benefit plan amendments(^{(2)})</td>
<td>-</td>
<td>(82)</td>
<td>82</td>
</tr>
<tr>
<td>Tax-related provision adjustments(^{(3)})</td>
<td>(41)</td>
<td>-</td>
<td>(41)</td>
</tr>
<tr>
<td>Impairment charge(^{(4)})</td>
<td>-</td>
<td>30</td>
<td>(30)</td>
</tr>
<tr>
<td>Foreign exchange loss</td>
<td>307</td>
<td>120</td>
<td>187</td>
</tr>
<tr>
<td>Interest expense charge(^{(5)})</td>
<td>-</td>
<td>95</td>
<td>(95)</td>
</tr>
<tr>
<td>Net financing expense relating to employee benefits</td>
<td>134</td>
<td>208</td>
<td>(74)</td>
</tr>
<tr>
<td>(Gain) loss on fuel and other derivatives</td>
<td>1</td>
<td>(37)</td>
<td>38</td>
</tr>
<tr>
<td>Adjusted net income (trailing 12 months)</td>
<td>$ 531</td>
<td>$ 340</td>
<td>$ 191</td>
</tr>
<tr>
<td>Adjusted for:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense (^{(6)})</td>
<td>322</td>
<td>302</td>
<td>20</td>
</tr>
<tr>
<td>Implicit interest on operating leases (^{(7)})</td>
<td>153</td>
<td>156</td>
<td>(3)</td>
</tr>
<tr>
<td>Adjusted income before interest (trailing 12 months)</td>
<td>$ 1,006</td>
<td>$ 798</td>
<td>$ 208</td>
</tr>
<tr>
<td>Invested capital:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Working capital, excluding current portion of long-term debt and finance leases</td>
<td>449</td>
<td>357</td>
<td>92</td>
</tr>
<tr>
<td>Long-term non-financial assets</td>
<td>6,676</td>
<td>6,014</td>
<td>662</td>
</tr>
<tr>
<td>Maintenance provisions</td>
<td>(726)</td>
<td>(614)</td>
<td>(112)</td>
</tr>
<tr>
<td>Other operating long-term liabilities</td>
<td>(295)</td>
<td>(348)</td>
<td>53</td>
</tr>
<tr>
<td>Capitalized operating leases (^{(8)})</td>
<td>2,191</td>
<td>2,226</td>
<td>(35)</td>
</tr>
<tr>
<td>Invested capital</td>
<td>$ 8,295</td>
<td>$ 7,635</td>
<td>$ 660</td>
</tr>
<tr>
<td>Return on invested capital (%)</td>
<td>12.1%</td>
<td>10.5%</td>
<td>1.6 pp</td>
</tr>
</tbody>
</table>

\(^{(1)}\) In 2014, one-time payments totaling $30 million were made to ACPA members under a collective agreement concluded in October 2014.

\(^{(2)}\) In 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.

\(^{(3)}\) In 2014, Air Canada recorded favourable tax-related provision adjustments of $41 million.

\(^{(4)}\) In 2013, Air Canada recorded impairment charges amounting to $30 million.
(5) In 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.
(6) Interest expense excludes the non-recurring interest expense charge on the repayment of the senior secured notes recognized in 2013 as described in (5) above.
(7) 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.
(8) Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totaled $313 million for the twelve months ended December 31, 2014 (for the twelve months ended December 31, 2013 - $318 million).
21. GLOSSARY

ACPA — Refers to the Air Canada Pilots Association.

Adjusted CASM — Refers to operating expense per ASM adjusted to remove the effects of fuel expense, ground packages costs and unusual items. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

Adjusted net income (loss) — Refers to the consolidated net income (loss) of Air Canada 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 fuel and other derivatives and unusual items. Refer to section 20 “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.

Average stage length — Refers to the average mile per departure seat and is calculated by dividing total ASMs by total seats dispatched.

Boeing — Refers to The Boeing Company.

CALDA — Refers to the Canadian Airline Dispatchers Association.

CASM — Refers to operating expense per ASM.

CAW — Refers to the Canadian Auto Workers Union, the predecessor to UNIFOR.

CUPE — Refers to the Canadian Union of Public Employees.

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

EBITDAR — Refers to earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent. EBITDAR is a non-GAAP financial measure. Refer to section 20 “Non-GAAP Financial Measures” of this MD&A for additional information.

EETCs — Refers to Enhanced Equipment Trust Certificates issued in connection with the financing of aircraft.

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

EXIM — Refers to Export-Import Bank of the United States.

GTAA — Refers to the Greater Toronto Airports Authority.

IAMAW — Refers to the International Association of Machinists and Auto Workers.

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 20 “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.

Seats dispatched – Refers to the number of seats on non-stop flights. A non-stop flight refers to a single take-off and landing.

UNIFOR – Refers to UNIFOR the Union, the successor to CAW.

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

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