

AIR CANADA 

Second Quarter 2016

**MANAGEMENT DISCUSSION
AND ANALYSIS OF RESULTS
OF OPERATIONS AND
FINANCIAL CONDITION**

July 29, 2016



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1. HIGHLIGHTS

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

(Canadian dollars in millions, except where indicated)	Second Quarter			First Six Months		
	2016	2015	\$ Change	2016	2015	\$ Change
Financial Performance Metrics						
Operating revenues	3,458	3,414	44	6,801	6,663	138
Operating income	277	323	(46)	431	523	(92)
Non-operating expense	(91)	(27)	(64)	(144)	(536)	392
Net income (loss)	186	296	(110)	287	(13)	300
Adjusted net income ⁽¹⁾	203	250	(47)	288	372	(84)
Operating margin %	8.0%	9.5%	(1.5) pp	6.3%	7.8%	(1.5) pp
EBITDAR ⁽¹⁾	605	591	14	1,065	1,033	32
EBITDAR margin % ⁽¹⁾	17.5%	17.3%	0.2 pp	15.7%	15.5%	0.2 pp
Unrestricted liquidity ⁽²⁾	3,449	3,283	166	3,449	3,283	166
Net cash flows from operating activities	657	512	145	1,625	1,322	303
Free cash flow ⁽¹⁾	(444)	302	(746)	(592)	687	(1,279)
Adjusted net debt ⁽¹⁾	6,840	4,896	1,944	6,840	4,896	1,944
Return on invested capital ("ROIC") % ⁽¹⁾	16.2%	16.2%	-	16.2%	16.2%	-
Diluted earnings per share	\$ 0.66	\$ 1.00	\$ (0.34)	\$ 1.01	\$ (0.06)	\$ 1.07
Adjusted earnings per share – diluted ⁽¹⁾	\$ 0.72	\$ 0.85	\$ (0.13)	\$ 1.01	\$ 1.26	\$ (0.25)
Operating Statistics ⁽³⁾			% Change			% Change
Revenue passenger miles ("RPM") (millions)	18,418	16,845	9.3	34,510	31,782	8.6
Available seat miles ("ASM") (millions)	22,344	20,132	11.0	42,177	38,467	9.6
Passenger load factor %	82.4%	83.7%	(1.2) pp	81.8%	82.6%	(0.8) pp
Passenger revenue per RPM ("Yield") (cents)	16.7	18.0	(6.8)	17.0	18.1	(5.9)
Passenger revenue per ASM ("PRASM") (cents)	13.8	15.0	(8.2)	13.9	15.0	(6.8)
Operating revenue per ASM (cents)	15.5	17.0	(8.7)	16.1	17.3	(6.9)
Operating expense per ASM ("CASM") (cents)	14.2	15.4	(7.3)	15.1	16.0	(5.4)
Adjusted CASM (cents) ⁽¹⁾	11.2	11.3	(1.1)	11.7	11.6	1.0
Average number of full-time equivalent ("FTE") employees (thousands) ⁽⁴⁾	26.1	24.8	5.1	25.8	24.7	4.4
Aircraft in operating fleet at period-end	380	371	2.4	380	371	2.4
Average fleet utilization (hours per day)	10.1	10.0	0.4	9.9	9.9	0.6
Seats dispatched (thousands)	13,840	12,992	6.5	27,017	25,329	6.7
Aircraft frequencies (thousands)	139	143	(2.0)	273	277	(1.2)
Average stage length (miles) ⁽⁵⁾	1,614	1,550	4.2	1,561	1,519	2.8
Fuel cost per litre (cents)	52.2	66.9	(22.0)	50.2	66.1	(24.0)
Fuel litres (millions)	1,157	1,114	3.9	2,219	2,153	3.1
Revenue passengers carried (thousands) ⁽⁶⁾	10,846	10,229	6.0	20,803	19,716	5.5

- (1) *Adjusted net income (loss), EBITDAR, EBITDAR margin, free cash flow, ROIC and adjusted CASM are each non-GAAP financial measures and adjusted net debt is an additional GAAP measure. Refer to sections 6 and 14 of this MD&A for descriptions of Air Canada's non-GAAP financial measures and additional GAAP measures.*
- (2) *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 June 30, 2016, unrestricted liquidity was comprised of cash and short-term investments of \$3,148 million and undrawn lines of credit of \$301 million. At June 30, 2015, unrestricted liquidity was comprised of cash and short-term investments of \$3,021 million and undrawn lines of credit of \$262 million.*
- (3) *Except for the reference to average number of FTE employees, operating statistics in this table include third party carriers (such as Jazz Aviation LP ("Jazz"), Sky Regional Airlines Inc. ("Sky Regional"), Air Georgian Limited ("Air Georgian") and Exploits Valley Air Services Ltd. ("EVAS")) operating under capacity purchase agreements with Air Canada.*
- (4) *Reflects FTE employees at Air Canada. Excludes FTE employees at third party carriers (such as Jazz, Sky Regional, Air Georgian and EVAS) operating under capacity purchase agreements with Air Canada.*
- (5) *Average stage length is calculated by dividing the total number of available seat miles by the total number of seats dispatched.*
- (6) *Revenue passengers are counted on a flight number basis (rather than by journey/itinerary or by leg) 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 second quarter of 2016. This MD&A should be read in conjunction with Air Canada's interim unaudited condensed consolidated financial statements and notes for the second quarter of 2016, Air Canada's 2015 annual audited consolidated financial statements and notes, and Air Canada's 2015 MD&A dated February 17, 2016 ("Air Canada's 2015 MD&A"). 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 15 "Glossary" of this MD&A. Except as otherwise noted or where the context may otherwise require, this MD&A is current as of July 28, 2016. Certain comparative figures have been reclassified to conform to the financial statement presentation adopted for the current year.

Forward-looking statements are included in this MD&A. See "Caution Regarding Forward-Looking Information" below for a discussion of risks, uncertainties and assumptions relating to these statements. For a description of risks relating to Air Canada, refer to section 17 "Risk Factors" of Air Canada's 2015 MD&A. Air Canada issued a news release dated July 29, 2016 reporting on its results for the second quarter of 2016. 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, our ability to successfully achieve or sustain positive net profitability or to realize our initiatives and objectives, our ability to pay our indebtedness, reduce operating costs and secure financing, currency exchange, industry, market, credit, economic and geopolitical conditions, energy prices, competition, our ability to successfully implement strategic initiatives and our dependence on technology, war, terrorist acts, epidemic diseases, casualty losses, employee and labour relations, pension issues, environmental factors (including weather systems and other natural phenomena and factors arising from man-made sources), limitations due to restrictive

covenants, insurance issues and costs, changes in demand due to the seasonal nature of the business, dependence on suppliers and third parties, including regional carriers, Aeroplan and the Star Alliance, changes in laws, regulatory developments or proceedings, pending and future litigation and actions by third parties and the ability to attract and retain required personnel, as well as the factors identified throughout this MD&A and, in particular, those identified in section 17 "Risk Factors" of Air Canada's 2015 MD&A. The forward-looking statements contained in this MD&A represent Air Canada's expectations as of July 28, 2016 (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 relatively low to modest Canadian GDP growth for 2016. Air Canada also assumes a continuing relationship between the price of jet fuel and the value of the Canadian dollar whereby increases and decreases in the cost of fuel continue to be respectively associated, to some degree, with increases and decreases in the value of the Canadian dollar. Air Canada also expects that the Canadian dollar will trade, on average, at C\$1.30 per U.S. dollar in the third quarter of 2016 and C\$1.31 per U.S. dollar for the full year 2016 and that the price of jet fuel (taking the impact of fuel hedging into account) will average 55 CAD cents per litre in the third quarter and 53 CAD cents per litre for the full year 2016.

INTELLECTUAL PROPERTY

Air Canada owns or has rights to trademarks, service marks or trade names used in connection with the operation of its business. In addition, Air Canada's names, logos and website names and addresses are owned or licensed by Air Canada. Air Canada also owns or has the rights to copyrights that also protect the content of its products and/or services. Solely for convenience, the trademarks, service marks, trade names and copyrights referred to in this MD&A may be listed without the ©, ® and TM symbols, but Air Canada reserves all rights to assert, to the fullest extent under applicable law, its rights or the rights of the applicable licensors to these trademarks, service marks, trade names and copyrights.

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3. STRATEGY AND OVERVIEW

In the second quarter of 2016, Air Canada generated adjusted net income of \$203 million or \$0.72 per diluted share, a decrease of \$47 million or \$0.13 per diluted share from the second quarter of 2015. Record EBITDAR of \$605 million increased \$14 million from the second quarter of 2015. EBITDAR, adjusted net income and adjusted earnings per diluted share are non-GAAP financial measures. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information. On a GAAP basis, Air Canada recorded operating income of \$277 million compared to operating income of \$323 million in the second quarter of 2015, a decrease of \$46 million. Air Canada recorded net income of \$186 million in the second quarter of 2016 versus net income of \$296 million in the second quarter of 2015.

Strategy

Air Canada's principal goal is to be among the best global airlines, to continually improve customer experience and employee engagement, and to create value for its shareholders. Air Canada is pursuing its goal through a focus on four core strategies:

- Identifying and implementing cost reduction and revenue generating initiatives;
- Pursuing profitable international growth opportunities and leveraging competitive advantages to appropriately enhance margins, in large part by increasing connecting traffic through existing and new international gateways and expanding and competing effectively in the leisure market to and from Canada;
- Engaging customers by continuously enhancing their travel experience and providing a consistently high level of customer service, with additional emphasis on premium and business passengers and products;
- Fostering positive culture change through employee engagement programs, including meaningful investments in required training and other tools, that promote an appreciation of how the airline and its employees can work together in a supportive and enriching environment, to successfully realize Air Canada's goals and objectives, including delivering top customer service.

Refer to section 4 of Air Canada's 2015 MD&A for additional information.

Second Quarter 2016 Financial Summary

The following is an overview of Air Canada's results of operations and financial position for the second quarter of 2016 compared to the second quarter of 2015.

- Operating revenues of \$3,458 million, an increase of \$44 million or 1% from the second quarter of 2015. Passenger revenues of \$3,143 million increased \$61 million or 2.0% from the second quarter of 2015.
- Operating expenses of \$3,181 million, an increase of \$90 million or 3% from the second quarter of 2015. CASM declined 7.3% from the second quarter of 2015. On an adjusted basis, CASM decreased 1.1% from the second quarter of 2015, better than the 2.0% to 3.0% increase forecast in Air Canada's news release dated April 29, 2016. The better than forecasted adjusted CASM results were due to lower than expected regional airlines expense, aircraft maintenance expense and wages, salaries and benefit expense and other operating expense reductions. Adjusted CASM is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

- Record EBITDAR of \$605 million compared to EBITDAR of \$591 million in the second quarter of 2015, an increase of \$14 million. EBITDAR in the second quarter of 2015 included favourable tax-related provision adjustments which improved EBITDAR by \$23 million. Air Canada has estimated that flight cancellations related to the Fort McMurray forest fires reduced EBITDAR by approximately \$10 million in the second quarter of 2016. EBITDAR is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.
- Operating income of \$277 million compared to operating income of \$323 million in the second quarter of 2015, a decrease of \$46 million.
- Adjusted net debt of \$6,840 million at June 30, 2016, an increase of \$549 million from December 31, 2015. The airline's adjusted net debt to EBITDAR ratio was 2.7 at June 30, 2016 versus a ratio of 2.5 at December 31, 2015. Adjusted net debt is an additional GAAP financial measure. Refer to section 6.2 "Adjusted Net Debt" of this MD&A for additional information.
- Net cash flows from operating activities of \$657 million, an improvement of \$145 million when compared to the same quarter in 2015. Negative free cash flow of \$444 million in the second quarter of 2016 decreased \$746 million from the second quarter of 2015. Refer to section 6.4 "Consolidated Cash Flow Movements" of this MD&A for additional information.
- Return on invested capital ("ROIC") for the 12 months ended June 30, 2016 of 16.2%. ROIC is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

4. RESULTS OF OPERATIONS

The following table and discussion compares results of Air Canada for the periods indicated:

(Canadian dollars in millions, except where indicated)	Second Quarter				First Six Months			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Operating revenues								
Passenger	\$ 3,143	\$ 3,082	\$ 61	2	\$ 6,007	\$ 5,868	139	2
Cargo	111	123	(12)	(10)	227	252	(25)	(10)
Other	204	209	(5)	(2)	567	543	24	4
Total revenues	3,458	3,414	44	1	6,801	6,663	138	2
Operating expenses								
Aircraft fuel	527	648	(121)	(19)	973	1,240	(267)	(22)
Regional airlines expense								
Aircraft fuel	77	97	(20)	(21)	141	183	(42)	(23)
Other	501	497	4	1	1,006	963	43	4
Wages, salaries and benefits	611	568	43	8	1,219	1,136	83	7
Airport and navigation fees	211	201	10	5	409	386	23	6
Aircraft maintenance	239	190	49	26	456	378	78	21
Depreciation, amortization and impairment	202	177	25	14	384	330	54	16
Sales and distribution costs	170	152	18	12	352	306	46	15
Ground package costs	85	84	1	1	316	265	51	19
Aircraft rent	112	84	28	33	224	166	58	35
Food, beverages and supplies	86	80	6	8	163	142	21	15
Communications and IT	59	52	7	13	126	109	17	16
Special items	-	(23)	23	100	-	(23)	23	100
Other	301	284	17	6	601	559	42	8
Total operating expenses	3,181	3,091	90	3	6,370	6,140	230	4
Operating income	277	323	(46)		431	523	(92)	
Non-operating income (expense)								
Foreign exchange gain (loss)	(17)	56	(73)		33	(352)	385	
Interest income	13	12	1		23	21	2	
Interest expense	(99)	(94)	(5)		(201)	(184)	(17)	
Interest capitalized	15	21	(6)		38	30	8	
Net financing expense relating to employee benefits	(17)	(25)	8		(35)	(50)	15	
Gain (loss) on financial instruments recorded at fair value	(1)	5	(6)		(11)	6	(17)	
Gain on sale and leaseback of assets	19	-	19		19	-	19	
Other	(4)	(2)	(2)		(10)	(7)	(3)	
Total non-operating expense	(91)	(27)	(64)		(144)	(536)	392	
Income (loss) before income taxes	186	296	(110)		287	(13)	300	
Income taxes	-	-	-		-	-	-	
Net income (loss)	\$ 186	\$ 296	\$ (110)		\$ 287	\$ (13)	\$ 300	
Diluted earnings (loss) per share	\$ 0.66	\$ 1.00	\$ (0.34)		\$ 1.01	\$ (0.06)	\$ 1.07	
EBITDAR ⁽¹⁾	\$ 605	\$ 591	\$ 14		\$ 1,065	\$ 1,033	\$ 32	
Adjusted net income ⁽¹⁾	\$ 203	\$ 250	\$ (47)		\$ 288	\$ 372	\$ (84)	
Adjusted earnings per share – diluted ⁽¹⁾	\$ 0.72	\$ 0.85	\$ (0.13)		\$ 1.01	\$ 1.26	\$ (0.25)	

(1) EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent), adjusted net income and adjusted earnings per share – diluted are non-GAAP financial measures. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

System passenger revenues

In the second quarter of 2016, system passenger revenues of \$3,143 million increased \$61 million or 2.0% from the second quarter of 2015 on traffic growth of 9.3% partly offset by a yield decline of 6.8%. Business cabin system revenues increased \$4 million or 0.6% on traffic growth of 3.8% largely offset by a yield decline of 3.1%.

The table below provides passenger revenue by geographic region for the second quarter of 2016 versus the second quarter of 2015.

Passenger Revenue (Canadian dollars in millions)	Second Quarter 2016	Second Quarter 2015	\$ Change	% Change
Canada	\$ 1,079	\$ 1,097	\$ (18)	(1.6)
U.S. transborder	674	660	14	2.3
Atlantic	763	726	37	5.0
Pacific	469	431	38	8.8
Other	158	168	(10)	(6.4)
System	\$ 3,143	\$ 3,082	\$ 61	2.0

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the second quarter of 2016 versus the second quarter of 2015.

Second Quarter 2016 versus Second Quarter 2015	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	PRASM % Change
Canada	(1.6)	4.5	4.2	(0.2)	(5.8)	(6.1)
U.S. transborder	2.3	12.3	10.8	(1.1)	(7.9)	(9.1)
Atlantic	5.0	16.6	10.9	(4.0)	(5.4)	(9.9)
Pacific	8.8	12.4	13.7	1.0	(4.2)	(3.1)
Other	(6.4)	6.0	6.5	0.3	(12.4)	(12.1)
System	2.0	11.0	9.3	(1.2)	(6.8)	(8.2)

The table below provides year-over-year percentage changes in system passenger revenues and operating statistics for the second quarter of 2016 and each of the previous four quarters.

System	Year-over-Year by Quarter (% Change)				
	Q2'15	Q3'15	Q4'15	Q1'16	Q2'16
Passenger revenues	3.9	6.9	3.0	2.8	2.0
Capacity (ASMs)	9.3	10.5	8.4	8.2	11.0
Traffic (RPMs)	8.7	10.2	8.6	7.7	9.3
Passenger load factor (pp change)	(0.5)	(0.2)	0.1	(0.3)	(1.2)
Yield	(5.0)	(3.8)	(5.5)	(4.7)	(6.8)
PRASM	(5.5)	(4.0)	(5.3)	(5.1)	(8.2)

An ASM capacity increase of 11.0% in the second quarter of 2016, when compared to the second quarter of 2015, was primarily driven by the continuing introduction of Boeing 787 aircraft into the mainline fleet and the growth of Air Canada Rouge, partly offset by the impact of Boeing 777 aircraft being temporarily removed from operations for conversion into more competitive configurations in support of Air Canada's business strategy.

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

- The 6.8% yield decrease which reflected:
 - o an increase in average stage length of 4.2%, due to long-haul international expansion, which had the effect of reducing system yield by 2.4 percentage points;
 - o the impact of increased industry capacity in the domestic market, increased competition on regional routes and competitive pricing activities affecting certain domestic services;
 - o a continued decline in higher-yielding oil market-related traffic;
 - o increased industry capacity and competitive pricing activities affecting certain European services;
 - o a reduction in carrier surcharges relating to lower fuel prices in certain jurisdictions;
 - o a higher proportion of seats into long-haul leisure markets led by an increase in lower-cost flights operated by Air Canada Rouge; and
 - o a higher proportional growth of lower-yielding international connecting traffic (sixth freedom traffic) in support of the airline's international expansion strategy.

A favourable currency impact of \$58 million was a partly offsetting factor.

- The 9.3% 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 the second quarter of 2016 also reflected incremental connecting traffic to international destinations.

In the first six months of 2016, system passenger revenues of \$6,007 million increased \$139 million or 2.4% from the first six months of 2015 on traffic growth of 8.6% partly offset by a yield decline of 5.9%.

The table below provides passenger revenue by geographic region for the first six months of 2016 versus the first six months of 2015.

Passenger Revenue (Canadian dollars in millions)	First Six Months 2016	First Six Months 2015	Change	% Change
Canada	\$ 2,033	\$ 2,073	\$ (40)	(1.9)
U.S. transborder	1,391	1,359	32	2.4
Atlantic	1,271	1,176	95	8.0
Pacific	867	800	67	8.3
Other	445	460	(15)	(3.3)
System	\$ 6,007	\$ 5,868	\$ 139	2.4

The table below provides year-over-year percentage changes in passenger revenues and operating statistics for the first six months of 2016 versus the first six months of 2015.

First Six Months 2016 versus First Six Months 2015	Passenger Revenue % Change	Capacity (ASMs) % Change	Traffic (RPMs) % Change	Passenger Load Factor pp Change	Yield % Change	PRASM % Change
Canada	(1.9)	5.3	4.2	(0.9)	(6.1)	(7.2)
U.S. transborder	2.4	11.2	8.1	(2.2)	(5.5)	(8.0)
Atlantic	8.0	15.4	12.7	(1.8)	(4.2)	(6.4)
Pacific	8.3	8.0	10.2	1.8	(1.7)	0.4
Other	(3.3)	7.0	7.4	0.4	(10.4)	(9.9)
System	2.4	9.6	8.6	(0.8)	(5.9)	(6.8)

Domestic passenger revenues

In the second quarter of 2016, domestic passenger revenues of \$1,079 million decreased \$18 million or 1.6% from the second quarter of 2015.

The table below provides year-over-year percentage changes in domestic passenger revenues and operating statistics for the second quarter of 2016 and each of the previous four quarters.

Canada	Year-over-Year by Quarter (% Change)				
	Q2'15	Q3'15	Q4'15	Q1'16	Q2'16
Passenger revenues	0.4	0.6	(4.1)	(2.3)	(1.6)
Capacity (ASMs)	2.6	4.8	4.0	6.3	4.5
Traffic (RPMs)	3.1	3.5	2.4	4.1	4.2
Passenger load factor (pp change)	0.3	(1.1)	(1.2)	(1.7)	(0.2)
Yield	(4.1)	(4.8)	(7.3)	(6.5)	(5.8)
PRASM	(3.7)	(6.0)	(8.7)	(8.4)	(6.1)

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

- The 5.8% yield decrease which reflected:

- o a 2.6% longer average stage length which had the effect of reducing domestic yield by 1.5 percentage points in the second quarter of 2016;
- o the impact of increased industry capacity in the domestic market, increased competition on regional routes and competitive pricing activities affecting certain domestic services;
- o a continued decline in higher-yielding oil market-related traffic; and
- o higher proportional growth of lower-yielding international and U.S. transborder passenger flows connecting to Air Canada’s routes in the domestic market in support of the airline’s international expansion strategy.

A favourable currency impact of \$7 million was a partly offsetting factor.

- The 4.2% traffic increase which reflected traffic growth on all domestic services with the exception of routes within Western Canada where capacity was reduced year-over-year. The traffic increase also included incremental connecting traffic to U.S. and international destinations.

In the first six months of 2016, domestic passenger revenues of \$2,033 million decreased \$40 million or 1.9% from the first six months of 2015 on a yield decline of 6.1% partly offset by traffic growth of 4.2%.

U.S. transborder passenger revenues

In the second quarter of 2016, U.S. transborder passenger revenues of \$674 million increased \$14 million or 2.3% from the second quarter of 2015.

The table below provides year-over-year percentage changes in U.S. transborder passenger revenues and operating statistics for the second quarter of 2016 and each of the previous four quarters.

U.S. transborder	Year-over-Year by Quarter (% Change)				
	Q2’15	Q3’15	Q4’15	Q1’16	Q2’16
Passenger revenues	10.9	17.3	10.5	2.5	2.3
Capacity (ASMs)	12.4	15.2	11.9	10.2	12.3
Traffic (RPMs)	12.9	15.6	11.6	5.8	10.8
Passenger load factor (pp change)	0.4	0.3	(0.2)	(3.3)	(1.1)
Yield	(1.9)	1.4	(0.9)	(3.3)	(7.9)
PRASM	(1.5)	1.8	(1.1)	(7.1)	(9.1)

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

- The 10.8% traffic increase which reflected traffic growth on all major U.S. transborder services with the exception of services to Hawaii where capacity was reduced year-over-year.
- The 7.9% yield decline which mainly reflected the impact of increased competition on U.S. short-haul routes as well as increased industry capacity and competitive pricing activities on lower-cost Air Canada Rouge-operated U.S. sun routes to stimulate demand due to a weaker Canadian dollar. A relatively stronger premium cabin performance, an increase in U.S.-originating traffic and a favourable currency impact of \$16 million were partly offsetting factors.

In the first six months of 2016, U.S. transborder passenger revenues of \$1,391 million increased \$32 million or 2.4% from the first six months of 2015 on traffic growth of 8.1% partly offset by a yield decline of 5.5%.

Atlantic passenger revenues

In the second quarter of 2016, Atlantic passenger revenues of \$763 million increased \$37 million or 5.0% from the second quarter of 2015.

The table below provides year-over-year percentage changes in Atlantic passenger revenues and operating statistics for the second quarter of 2016 and each of the previous four quarters.

Atlantic	Year-over-Year by Quarter (% Change)				
	Q2’15	Q3’15	Q4’15	Q1’16	Q2’16
Passenger revenues	6.5	9.1	9.1	12.9	5.0
Capacity (ASMs)	11.2	12.7	15.3	13.6	16.6
Traffic (RPMs)	11.0	12.7	14.2	15.8	10.9
Passenger load factor (pp change)	(0.2)	-	(0.7)	1.5	(4.0)
Yield	(4.0)	(3.2)	(4.5)	(2.5)	(5.4)
PRASM	(4.2)	(3.2)	(5.4)	(0.6)	(9.9)

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

- The 10.9% traffic increase which reflected traffic growth in local markets to and from Europe and the Middle East, including Air Canada and Air Canada Rouge’s new and returning seasonal services. This growth was partly offset by traffic declines on certain services, such as Belgium and Germany. Travel concerns following terrorist attacks in France, Belgium and Turkey, as well as a slowdown in U.K. originating traffic attributable to the June 23, 2016 referendum by British voters to exit the European Union, contributed to close-in traffic declines in both the business and economy cabins.
- The 5.4% yield decline which reflected an increase in average stage length of 2.9%, which had the effect of reducing Atlantic yield by 1.6 percentage points. Increased industry capacity from Canada and the U.S., competitive pricing activities affecting certain European services, as well as a higher proportion of seats offered into long-haul leisure markets were also contributing factors. A favourable currency impact of \$18 million was a partly offsetting factor.

In the first six months of 2016, Atlantic passenger revenues of \$1,271 million increased \$95 million or 8% from the first six months of 2015 on traffic growth of 12.7% partly offset by a yield decline of 4.2%.

Pacific passenger revenues

In the second quarter of 2016, Pacific passenger revenues of \$469 million increased \$38 million or 8.8% from the second quarter of 2015.

The table below provides year-over-year percentage changes in Pacific passenger revenues and operating statistics for the second quarter of 2016 and each of the previous four quarters.

Pacific	Year-over-Year by Quarter (% Change)				
	Q2'15	Q3'15	Q4'15	Q1'16	Q2'16
Passenger revenues	1.4	5.6	4.7	7.7	8.8
Capacity (ASMs)	13.6	11.8	3.4	3.1	12.4
Traffic (RPMs)	10.4	12.1	7.9	6.3	13.7
Passenger load factor (pp change)	(2.5)	0.2	3.6	2.6	1.0
Yield	(8.1)	(5.7)	(2.9)	1.4	(4.2)
PRASM	(10.7)	(5.5)	1.3	4.6	(3.1)

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

- The 13.7% traffic increase which reflected traffic growth on all major Pacific services. The traffic increase versus the same quarter in 2015 was largely driven by the launch, in June 2016, of services to Seoul from Toronto and to Brisbane from Vancouver. In addition, Air Canada operated larger aircraft on its Vancouver-China routes which contributed to the traffic growth year-over-year.
- The 4.2% yield decrease which reflected the impact of increased industry capacity and competitive pricing activities, particularly on routes to China and Australia, and a reduction in carrier surcharges relating to lower fuel prices, especially where carrier surcharges are regulated. A favourable currency impact of \$13 million was a partly offsetting factor.

In the first six months of 2016, Pacific passenger revenues of \$867 million increased \$67 million or 8.3% from the first six months of 2015 on traffic growth of 10.2% partly offset by a yield decline of 1.7%.

Other passenger revenues

In the second quarter of 2016, Other passenger revenues of \$158 million decreased \$10 million or 6.4% from the second quarter of 2015.

The table below provides year-over-year percentage changes in Other passenger revenues and operating statistics for the second quarter of 2016 and each of the previous four quarters.

Other	Year-over-Year by Quarter (% Change)				
	Q2'15	Q3'15	Q4'15	Q1'16	Q2'16
Passenger revenues	(1.3)	8.5	1.1	(1.5)	(6.4)
Capacity (ASMs)	10.3	12.2	9.5	7.5	6.0
Traffic (RPMs)	7.9	11.5	10.5	8.1	6.5
Passenger load factor (pp change)	(1.9)	(0.5)	0.7	0.4	0.3
Yield	(9.0)	(3.1)	(8.6)	(9.2)	(12.4)
PRASM	(11.0)	(3.6)	(7.8)	(8.8)	(12.1)

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

- The 12.4% yield decrease which reflected the impact of competitive pricing activities, driven by weaker economic conditions from point of origin South America, particularly Brazil, an increase in lower-cost Air Canada Rouge capacity on leisure services and new competition on certain services. Partly offsetting this decrease was a favourable currency impact of \$4 million.
- The 6.5% traffic increase which reflected traffic growth on all major services, led by lower-cost Air Canada Rouge flying. International connections to and from South America increased compared to the same quarter in 2015, which is consistent with Air Canada's strategy of growing international-to-international traffic through its Canadian hubs.

In the first six months of 2016, Other passenger revenues of \$445 million decreased \$15 million or 3.3% from the first six months of 2015 on a yield decline of 10.4% partly offset by traffic growth of 7.4%.

Cargo revenues

Cargo revenues of \$111 million in the second quarter of 2016 and \$227 million in the first six months of 2016 decreased \$12 million or 9.9% and \$25 million or 10.0%, respectively, from the same periods in 2015. These decreases reflected an overall reduction in cargo demand, increased industry capacity and competitive pricing activities.

The table below provides cargo revenue by geographic region for the second quarter of 2016 and the first six months of 2016 versus the same periods in 2015.

Cargo Revenue (Canadian dollars in millions)	Second Quarter			First Six Months		
	2016	2015	% Change	2016	2015	% Change
Canada	\$ 15	\$ 17	(11.7)	\$ 29	\$ 34	(16.3)
U.S. transborder	6	6	9.3	13	12	12.3
Atlantic	41	45	(10.6)	88	95	(7.6)
Pacific	41	47	(12.2)	79	93	(15.0)
Other	8	8	(0.9)	18	18	-
System	\$ 111	\$ 123	(9.9)	\$ 227	\$ 252	(10.0)

Other revenues

Other revenues of \$204 million in the second quarter of 2016 decreased \$5 million or 2% from the second quarter in 2015. An increase in ground package revenues at Air Canada Vacations, mainly the result of higher passenger volumes, was more than offset by a reduction in aircraft sublease and other miscellaneous revenues.

Other revenues of \$567 million in the first six months of 2016 increased \$24 million or 4% from the same period in 2015, driven by higher ground package revenues at Air Canada Vacations, particularly in the first quarter of 2016.

CASM and Adjusted CASM

In the second quarter of 2016, CASM and adjusted CASM decreased 7.3% and 1.1%, respectively, when compared to the second quarter of 2015. In the first six months of 2016, CASM decreased 5.4% and adjusted CASM increased 1.0% when compared to the first six months of 2015.

The following table compares Air Canada's CASM and Adjusted CASM for the second quarter of 2016 and the first six months of 2016 to the same periods in 2015.

(cents per ASM)	Second Quarter			First Six Months		
	2016	2015	% Change	2016	2015	% Change
Aircraft fuel	2.36	3.22	(26.7)	2.31	3.22	(28.3)
Regional airlines expense						
Aircraft fuel	0.35	0.48	(27.1)	0.33	0.48	(31.3)
Other	2.24	2.47	(9.3)	2.39	2.50	(4.4)
Wages and salaries	2.13	2.22	(4.1)	2.20	2.25	(2.2)
Benefits	0.61	0.60	1.7	0.69	0.71	(2.8)
Airport and navigation fees	0.94	1.00	(6.0)	0.97	1.00	(3.0)
Aircraft maintenance	1.07	0.95	12.6	1.08	0.98	10.2
Depreciation, amortization and impairment	0.91	0.88	3.4	0.91	0.86	5.8
Sales and distribution costs	0.76	0.75	1.3	0.83	0.80	3.7
Ground package costs	0.38	0.42	(9.5)	0.75	0.69	8.7
Aircraft rent	0.50	0.42	19.0	0.53	0.43	23.3
Food, beverages and supplies	0.39	0.39	-	0.39	0.37	5.4
Communications and IT	0.26	0.26	-	0.30	0.28	7.1
Special items	-	(0.11)	100.0	-	(0.06)	100.0
Other	1.34	1.40	(4.3)	1.42	1.45	(2.1)
CASM	14.24	15.35	(7.3)	15.10	15.96	(5.4)
Remove:						
Aircraft fuel expense ⁽¹⁾ and ground package costs at Air Canada Vacations, and special items	(3.08)	(4.07)	24.3	(3.39)	(4.36)	22.2
Adjusted CASM ⁽²⁾	11.16	11.28	(1.1)	11.71	11.60	1.0

(1) Includes aircraft fuel expense related to regional airline operations.

(2) Adjusted CASM is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

Operating expenses

In the second quarter of 2016, operating expenses of \$3,181 million, increased \$90 million or 3% from the second quarter of 2015. The more notable components of the year-over-year change in operating expenses included:

- The impact of the 11.0% capacity growth.
- The unfavourable impact of a weaker Canadian dollar on foreign currency denominated operating expenses which increased operating expenses by \$73 million in the second quarter of 2016 (comprised of \$22 million relating to aircraft fuel expense and an aggregate of \$51 million relating to non-fuel operating expenses).
- An increase in aircraft maintenance expense of \$49 million or 26% from the second quarter of 2015 as further described below.

Largely offsetting these increases was:

- The impact of lower base jet fuel prices (before the impact of foreign exchange but taking into account fuel expense related to regional airline operations) which decreased operating expenses by \$192 million in the second quarter of 2016.

In the first six months of 2016, on capacity growth of 9.6%, operating expenses of \$6,370 million increased \$230 million or 4% from the first six months of 2015. This increase was mainly driven by the capacity growth and the impact of a weaker Canadian dollar on foreign currency denominated operating expenses which increased operating expenses by \$225 million in the first six months of 2016 (comprised of \$68 million relating to aircraft fuel expense and an aggregate of \$157 million relating to non-fuel operating expenses). These increases were partly offset by the impact of lower jet fuel prices (before the impact of foreign exchange but taking into account fuel expense related to regional airline operations).

Aircraft fuel expense

In the second quarter of 2016, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to \$604 million, a decrease of \$141 million or 19% from the second quarter of 2015. This decrease reflected:

- lower base jet fuel prices (before the impact of foreign exchange) year-over-year, which accounted for a reduction of \$193 million.

Partly offsetting this increase were:

- a higher volume of fuel litres consumed, which accounted for an increase of \$30 million; and
- the unfavourable impact of a weaker Canadian dollar versus the U.S. dollar when compared to the second quarter of 2015, which accounted for an increase of \$22 million.

In the second quarter of 2016, hedging gains on the settlement of fuel derivatives offset the associated premium costs.

In the first six months of 2016, aircraft fuel expense (including fuel expense related to regional airline operations) amounted to \$1,114 million, a decrease of \$309 million or 22% from the first six months of 2015. This decrease reflected significantly lower base jet fuel prices (before the impact of foreign exchange) year-over-year, which accounted for a reduction of \$431 million, partly offset by the unfavourable impact of a weaker Canadian dollar versus the U.S. dollar when compared to the first six months 2015, which accounted for an increase of \$68 million, as well as a higher volume of fuel litres consumed, which accounted for an increase of \$44 million. Net fuel hedge losses of \$10 million were recorded in fuel expense in the first six months of 2016.

The table below provides Air Canada's fuel cost per litre and economic fuel cost per litre (including aircraft fuel expense related to regional airline operations) for the periods indicated.

(Canadian dollars in millions, except where indicated)	Second Quarter			First Six Months		
	2016	2015	% Change	2016	2015	% Change
Aircraft fuel expense	\$ 527	\$ 648	(19)	\$ 973	\$ 1,240	(22)
Aircraft fuel expense related to Regional airline operations	77	97	(21)	141	183	(23)
Total Aircraft fuel expense – GAAP	\$ 604	\$ 745	(19)	\$ 1,114	\$ 1,423	(22)
Add:						
Net cash payments on fuel derivatives ⁽¹⁾	-	11	(100)	-	22	(100)
Economic cost of fuel – Non-GAAP ⁽²⁾	\$ 604	\$ 756	(20)	\$ 1,114	\$ 1,445	(23)
Fuel consumption (thousands of litres)	1,157,371	1,113,576	3.9	2,219,031	2,152,997	3.1
Fuel cost per litre (cents) – GAAP	52.2	66.9	(22.0)	50.2	66.1	(24.0)
Economic fuel cost per litre (cents) – Non-GAAP ⁽²⁾	52.2	67.9	(23.1)	50.2	67.1	(25.2)

(1) Includes net cash settlements on maturing fuel derivatives and premium costs associated with those derivatives. With adoption of hedge accounting for fuel derivatives effective April 1, 2015, any premium costs associated with fuel derivatives are deferred as cost of the hedge and reclassified to aircraft fuel expense when the hedged jet fuel is used, as are any net cash settlements on maturing fuel 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.

Regional airlines expense

Regional airlines expense of \$578 million in the second quarter of 2016 decreased \$16 million or 3% from the second quarter of 2015, mainly due to lower fuel expense and lower rates associated with Air Canada's amended capacity purchase agreement with Jazz, including a year-to-date favourable adjustment. These decreases were partly offset by an unfavourable currency impact and the impact of fleet expansion initiatives in the Air Canada Express fleet at Sky Regional and Air Georgian.

Regional airlines expense of \$1,147 million in the first six months of 2016 increased \$1 million from the same period in 2015. In the first six months of 2016, the impact of fleet expansion initiatives in the Air Canada Express fleet at Sky Regional and Air Georgian and an unfavourable currency impact were offset by lower fuel expense and the impact of lower rates associated with the Jazz CPA.

The following table provides a breakdown of Regional airlines expense for the periods indicated:

(Canadian dollars in millions)	Second Quarter			First Six Months		
	2016	2015	% Change	2016	2015	% Change
Capacity purchase fees	\$ 289	\$ 302	(4)	\$ 582	\$ 576	1
Aircraft fuel	77	97	(21)	141	183	(23)
Airport and navigation	71	70	1	139	135	3
Sales and distribution costs	35	33	6	70	66	6
Aircraft rent	8	3	167	15	6	150
Depreciation, amortization and impairment	6	4	50	11	8	38
Other operating expenses	92	85	8	189	172	10
Total regional airlines expense	\$ 578	\$ 594	(3)	\$ 1,147	\$ 1,146	-

Wages, salaries and benefits expense

Wages, salaries and benefits expense of \$611 million in the second quarter of 2016 and \$1,219 million in the first six months increased \$43 million or 8% and \$83 million or 7%, respectively, from the same periods in 2015.

Wages and salaries expense of \$475 million in the second quarter of 2016 and \$926 million in the first six months of 2016 increased \$28 million or 6% and \$62 million or 7%, respectively, from the same periods in 2015. These increases were due to higher average salaries, which were primarily driven by the impact of collective agreements concluded in 2014 and 2015, an increase in crew training related to Air Canada's new Boeing 787 aircraft, and a higher number of full-time equivalent (FTE) employees. As a result of the capacity growth, in the second quarter and the first six months of 2016, the average number of FTE employees increased 5.1% and 4.4%, respectively, when compared to the same periods in 2015.

Employee benefits expense of \$136 million in the second quarter of 2016 and \$293 million in the first six months of 2016 increased \$15 million or 12% and \$21 million or 8%, respectively, from the same periods in 2015. In the second quarter of 2016, Air Canada benefitted from the impact of a gain on post-employment liabilities which reduced employee benefits expense by \$10 million. In the second quarter of 2015, Air Canada benefitted from the impact of benefit plan amendments relating to U.S. post-retirement health plans which lowered employee benefits expense by \$19 million.

Airport and navigation fees

Airport and navigation fees of \$211 million in the second quarter of 2016 and \$409 million in the first six months of 2016 increased \$10 million or 5% and \$23 million or 6%, respectively, from the same periods in 2015, largely due to growth in wide-body and international flying and an unfavourable currency impact.

Aircraft maintenance expense

Aircraft maintenance expense of \$239 million in the second quarter of 2016 and \$456 million in the first six months of 2016 increased \$49 million or 26% and \$78 million or 21%, respectively, from the same periods in 2015, mainly due to an increase in end of lease maintenance provisions which was largely driven by Air Canada having extended fewer aircraft leases versus the same periods in 2015. An unfavourable currency impact was also a contributing factor to the increase in aircraft maintenance expense year-over-year. Partly offsetting these increases was the impact of a lower volume of maintenance activity year-over-year.

Depreciation, amortization and impairment expense

Depreciation, amortization and impairment expense of \$202 million in the second quarter of 2016 and \$384 million in the first six months of 2016 increased \$25 million or 14% and \$54 million or 16%, respectively, from the same periods in 2015, largely due to the addition of Boeing 787 aircraft to Air Canada's mainline fleet and an increase in expenses related to the airline's aircraft refurbishment programs. In 2015, Air Canada recorded impairment charges of \$14 million related to the planned disposal of two Airbus A340-300 aircraft (neither of which was operated by Air Canada). No such charges were recorded in the first six months of 2016.

Sales and distribution costs

Sales and distribution costs of \$170 million in the second quarter of 2016 and \$352 million in the first six months of 2016 increased \$18 million or 12% and \$46 million or 15%, respectively, from the same periods in 2015, reflecting a higher volume of ticket sales generated through all sales channels, including Global Distribution System providers, an increase in credit card expenses (in line with sales and revenue growth) and an unfavourable currency impact.

Ground package costs

Ground package costs of \$85 million in the second quarter of 2016 and \$316 million in the first six months of 2016 increased \$1 million or 1% and \$51 million or 19%, respectively, from the same periods in 2015, mainly due an unfavourable currency impact and higher passenger volumes, particularly in the first quarter of 2016.

Aircraft rent

Aircraft rent of \$112 million in the second quarter of 2016 and \$224 million in the first six months of 2016 increased \$28 million or 33% and \$58 million or 35%, respectively, from the same periods in 2015, mainly due to a greater number of leased aircraft, primarily Airbus A321 and Boeing 767 aircraft, an unfavourable currency impact, and the reclassification of certain finance leases to operating leases.

Special items

In the second quarter of 2015, Air Canada recorded favourable tax-related provision adjustments of \$23 million (\$23 million in the first six months of 2015). No special items were recorded in the first six months of 2016.

Other expenses

Other expenses of \$301 million in the second quarter of 2016 and \$601 million in the first six months of 2016 increased \$17 million or 6% and \$42 million or 8%, respectively, from the same periods in 2015, mainly due to the capacity growth, Air Canada's international expansion strategy and an unfavourable currency impact.

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

(Canadian dollars in millions)	Second Quarter			First Six Months		
	2016	2015	% Change	2016	2015	% Change
Terminal handling	\$ 59	\$ 59	-	\$ 118	\$ 109	8
Building rent and maintenance	41	36	14	81	71	14
Crew cycle	37	36	3	76	72	6
Miscellaneous fees and services	34	35	(3)	67	66	2
Remaining other expenses	130	118	10	259	241	7
Total other expenses	\$ 301	\$ 284	6	\$ 601	\$ 559	8

Non-operating expense

Non-operating expense of \$91 million in the second quarter of 2016 increased \$64 million from the second quarter of 2015. In the first six months of 2016, non-operating expense of \$144 million improved \$392 million from the same period in 2015.

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

(Canadian dollars in millions)	Second Quarter			First Six Months		
	2016	2015	\$ Change	2016	2015	\$ Change
Foreign exchange gain (loss)	\$ (17)	\$ 56	\$ (73)	\$ 33	\$ (352)	\$ 385
Interest expense, net	(71)	(61)	(10)	(140)	(133)	(7)
Net financing expense relating to employee benefits	(17)	(25)	8	(35)	(50)	15
Gain (loss) on financial instruments recorded at fair value	(1)	5	(6)	(11)	6	(17)
Gain on sale and leaseback of assets	19	-	19	19	-	19
Other	(4)	(2)	(2)	(10)	(7)	(3)
Total non-operating expense	\$ (91)	\$ (27)	\$ (64)	\$ (144)	\$ (536)	\$ 392

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

- Losses on foreign exchange which amounted to \$17 million in the second quarter of 2016 compared to gains on foreign exchange of \$56 million in the second quarter of 2015. In the second quarter of 2016, losses on foreign currency derivatives were largely offset by foreign gains on U.S. denominated long-term debt. The foreign exchange gains on U.S. denominated long-term debt were attributable to a stronger Canadian dollar at June 30, 2016 when compared to March 31, 2016. The June 30, 2016 closing exchange rate was US\$1 = C\$1.2917 while the March 31, 2016 closing exchange rate was US\$1 = C\$1.2987. In the first six months of 2016, gains on foreign exchange amounted to \$33 million compared to losses on foreign exchange of \$352 million in the first six months of 2015. Foreign exchange gains on U.S. denominated long-term debt of \$357 million and foreign exchange gains on net maintenance provisions of \$62 million were largely offset by losses on foreign currency derivatives of \$303

million and \$54 million on cash and short-term investment balances. The foreign exchange gains were attributable to the stronger Canadian dollar at June 30, 2016 when compared to December 31, 2015. The December 31, 2015 closing exchange rate was US\$1 = C\$1.3840.

- Increases in net interest expense (comprised of interest income, interest expense and interest capitalized) of \$10 million in the second quarter of 2016 and \$7 million in the first six months of 2016 which largely reflected the impact of new aircraft financing transactions and the unfavourable impact of foreign exchange on interest expense. In addition, in the first six months of 2016, Air Canada recorded special charges amounting to \$7 million related to the prepayment of debt associated with the disposal of Embraer 190 aircraft.
- Decreases in net financing expense relating to employee benefits of \$8 million in the second quarter of 2016 and \$15 million in the first six months of 2016 which were mainly due to the impact of the lower net defined pension benefit obligation.
- In the second quarter of 2016, Air Canada recorded a gain of \$19 million on the sale and operating leaseback of two Boeing 787-9 aircraft.

5. FLEET

The following table provides the number of aircraft in Air Canada's operating fleet as at December 31, 2015 and June 30, 2016, 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, 2016 and December 31, 2017.

	Actual			Planned			
	December 31, 2015	First Six Months 2016 Fleet Changes	June 30, 2016	Remainder of 2016 Fleet Changes	December 31, 2016	2017 Fleet Changes	December 31, 2017
Mainline							
<u>Wide-body aircraft</u>							
Boeing 787-8	8	-	8	-	8	-	8
Boeing 787-9	4	9	13	-	13	9	22
Boeing 777-300ER	17	2	19	-	19	-	19
Boeing 777-200LR	6	-	6	-	6	-	6
Boeing 767-300ER	17	(2)	15	-	15	(5)	10
Airbus A330-300	8	-	8	-	8	-	8
<u>Narrow-body aircraft</u>							
Boeing 737 MAX	-	-	-	-	-	2	2
Airbus A321	14	1	15	-	15	-	15
Airbus A320	42	-	42	-	42	-	42
Airbus A319	18	-	18	-	18	-	18
Embraer 190	37	(12)	25	-	25	-	25
Total Mainline	171	(2)	169	-	169	6	175
Air Canada Rouge							
<u>Wide-body aircraft</u>							
Boeing 767-300ER	15	4	19	-	19	5	24
<u>Narrow-body aircraft</u>							
Airbus A321	4	1	5	-	5	-	5
Airbus A319	20	-	20	-	20	-	20
Total Air Canada Rouge	39	5	44	-	44	5	49
Total wide-body aircraft	75	13	88	-	88	9	97
Total narrow-body aircraft	135	(10)	125	-	125	2	127
Total Mainline and Air Canada Rouge	210	3	213	-	213	11	224

Air Canada expects to introduce five Boeing 787-9 aircraft into its operating fleet in 2018 (for a total of 35 Boeing 787 aircraft of the 37 on order). Air Canada has firm orders for 61 Boeing 737 MAX aircraft, of which 16 aircraft are expected to be delivered in 2018, to replace existing aircraft in its mainline fleet. As part of this narrow-body replacement program, Air Canada is currently reviewing which aircraft will be retired.

In June 2016, Air Canada and Bombardier Inc. (“Bombardier”) finalized a purchase agreement which includes a firm order for 45 Bombardier C Series CS300 aircraft and options for an additional 30 Bombardier C Series CS300 aircraft. Deliveries are scheduled to begin in late 2019 and extend to 2022. The first 25 aircraft on delivery will replace Air Canada’s existing mainline fleet of Embraer E190 aircraft, with incremental aircraft supporting Air Canada’s hub and network growth.

Air Canada Express

The following table provides, as at June 30, 2016, the number of aircraft operated, on behalf of Air Canada, by Jazz, Sky Regional and other airlines operating flights under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada.

	As at June 30, 2016			
	Jazz	Sky Regional	Other	Total
Embraer 175	-	20	-	20
Bombardier CRJ-100/200	13	-	14	27
Bombardier CRJ-705	16	-	-	16
Bombardier Dash 8-100	19	-	-	19
Bombardier Dash 8-300	26	-	-	26
Bombardier Dash 8-Q400	37	5	-	42
Beech 1900	-	-	17	17
Total Air Canada Express	111	25	31	167

The following table provides the number of aircraft planned, as at December 31, 2016, to be operated, on behalf of Air Canada, by Jazz, Sky Regional and other airlines operating flights under the Air Canada Express banner pursuant to capacity purchase agreements with Air Canada.

	As at December 31, 2016			
	Jazz	Sky Regional	Other	Total
Embraer 175	-	20	-	20
Bombardier CRJ-100/200	13	-	14	27
Bombardier CRJ-705	16	-	-	16
Bombardier Dash 8-100	19	-	-	19
Bombardier Dash 8-300	26	-	-	26
Bombardier Dash 8-Q400	39	5	-	44
Beech 1900	-	-	17	17
Total Air Canada Express	113	25	31	169

6. FINANCIAL AND CAPITAL MANAGEMENT

6.1. Financial Position

The following table provides a condensed consolidated statement of financial position of Air Canada as at June 30, 2016 and as at December 31, 2015.

(Canadian dollars in millions)	June 30, 2016	December 31, 2015	\$ Change
Assets			
Cash, cash equivalents and short-term investments	\$ 3,148	\$ 2,672	\$ 476
Other current assets	1,306	1,453	(147)
Current assets	4,454	4,125	329
Property and equipment	8,611	7,030	1,581
Pension	402	851	(449)
Intangible assets	311	314	(3)
Goodwill	311	311	-
Deposits and other assets	450	496	(46)
Total assets	\$ 14,539	\$ 13,127	\$ 1,412
Liabilities			
Current liabilities	\$ 4,950	\$ 3,829	\$ 1,121
Long-term debt and finance leases	6,401	5,870	531
Pension and other benefit liabilities	2,795	2,245	550
Maintenance provisions	845	892	(47)
Other long-term liabilities	221	251	(30)
Total liabilities	15,212	13,087	2,125
Total equity	(673)	40	(713)
Total liabilities and equity	\$ 14,539	\$ 13,127	\$ 1,412

Movements in current assets and current liabilities are described in section 6.3 "Working Capital" of this MD&A. Long-term debt and finance leases are discussed in sections 6.2 "Adjusted Net Debt" and 6.4 "Consolidated Cash Flow Movements" of this MD&A.

At June 30, 2016, property and equipment amounted to \$8,611 million, an increase of \$1,581 million from December 31, 2015. The increase in property and equipment was mainly due to additions to property and equipment of \$2,554 million, partly offset by the disposal of two Boeing 787 aircraft under a sale and operating leaseback transaction, the disposal of 12 Embraer 190 aircraft and the impact of depreciation expense of \$371 million. The additions to property and equipment in the first six months of 2016 included seven Boeing 787-9 aircraft (excluding the two Boeing 787 aircraft under operating lease) and two Boeing 777-300ER, progress payments on future aircraft deliveries and capitalized maintenance costs.

The net pension and other benefit liabilities of \$2,393 million (comprised of pension and other benefit liabilities of \$2,795 million net of pension assets of \$402 million) increased \$999 million from December 31, 2015, mainly due to a 60 basis point decrease in the discount rate used to value the liabilities, which contributed to a loss on Remeasurements on employee benefit liabilities of \$927 million recorded in Other comprehensive income.

6.2. Adjusted Net Debt

The following table reflects Air Canada's adjusted net debt balances as at June 30, 2016 and as at December 31, 2015.

(Canadian dollars in millions, except where indicated)	June 30, 2016	December 31, 2015	\$ Change
Total long-term debt and finance leases	\$ 6,401	\$ 5,870	\$ 531
Current portion of long-term debt and finance leases	549	524	25
Total long-term debt and finance leases, including current portion	6,950	6,394	556
Less cash, cash equivalents and short-term investments	(3,148)	(2,672)	(476)
Net debt	\$ 3,802	\$ 3,722	\$ 80
Capitalized operating leases ⁽¹⁾	3,038	2,569	469
Adjusted net debt	\$ 6,840	\$ 6,291	\$ 549
EBITDAR (trailing 12 months)	\$ 2,566	\$ 2,534	\$ 32
Adjusted net debt to EBITDAR ratio	2.7	2.5	0.2

(1) Adjusted net debt is an additional 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 (including aircraft rent expense related to regional airline operations) was \$434 million for the 12 months ended June 30, 2016 and \$367 million for the 12 months ended December 31, 2015.

At June 30, 2016, total long-term debt and finance leases (including current portion) of \$6,950 million increased \$556 million from December 31, 2015. In the first six months of 2016, new borrowings of \$1,308 million, which were all related to aircraft financings, were partly offset by debt repayments of \$381 million and the favourable impact of a stronger Canadian dollar of \$357 million, as at June 30, 2016 compared to December 31, 2015, on Air Canada's foreign currency denominated debt (mainly U.S. dollars).

Adjusted net debt amounted to \$6,840 million at June 30, 2016, an increase of \$549 million from December 31, 2015. This increase in adjusted net debt reflected higher long-term debt and financial lease balances as discussed above. The impact of higher capitalized operating lease balances, largely driven by additional aircraft leases in the first six months of 2016 and an unfavourable currency impact on aircraft rent expense, was mostly offset by higher cash and short-term investment balances. At June 30, 2016, the adjusted net debt to EBITDAR ratio was 2.7 versus a ratio of 2.5 at December 31, 2015.

At June 30, 2016, Air Canada's weighted average cost of capital ("WACC"), on a pre-tax basis, was approximately 9.4% (compared to 10.8% at June 30, 2015). WACC is based on an estimate by management and consists of an estimated cost of equity of 27.5% and an average cost of debt and finance leases of 5.1% (compared to an estimated cost of equity of 22.4% and an average cost of debt and finance leases of 5.5% at June 30, 2015).

6.3. Working Capital

The following table provides information on Air Canada's working capital balances as at June 30, 2016 and as at December 31, 2015.

(Canadian dollars in millions)	June 30, 2016	December 31, 2015	\$ Change
Cash, cash equivalents and short-term investments	\$ 3,148	\$ 2,672	\$ 476
Accounts receivable	815	654	161
Other current assets	491	799	(308)
Total current assets	\$ 4,454	\$ 4,125	\$ 329
Accounts payable and accrued liabilities	1,705	1,487	218
Advance ticket sales	2,696	1,818	878
Current portion of long-term debt and finance leases	549	524	25
Total current liabilities	\$ 4,950	\$ 3,829	\$ 1,121
Net working capital	\$ (496)	\$ 296	\$ (792)

The negative net working capital of \$496 million at June 30, 2016 represented a net use of working capital of \$792 million from December 31, 2015, mainly in support of capital expenditures of \$2,568 million (or \$1,260 million net of the financing drawn upon the delivery of seven Boeing 787 and two Boeing 777 aircraft), partly offset by the cash flow benefit of positive operating results in the first six months of 2016. Debt repayments of \$381 million were largely offset by the proceeds of \$351 million from the sale and leaseback of two Boeing 787 aircraft. Advance ticket sales and accounts receivable balances usually increase in the first six months of the year as a result of the seasonal build-up of sales and activity levels heading into the third quarter.

6.4. Consolidated Cash Flow Movements

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

(Canadian dollars in millions)	Second Quarter			First Six Months		
	2016	2015	\$ Change	2016	2015	\$ Change
Net cash flows from operating activities	\$ 657	\$ 512	\$ 145	\$ 1,625	\$ 1,322	\$ 303
Proceeds from borrowings	692	7	685	1,308	289	1,019
Reduction of long-term debt and finance lease obligations	(157)	(147)	(10)	(381)	(262)	(119)
Shares purchased for cancellation	(24)	(1)	(23)	(58)	(1)	(57)
Distributions related to aircraft special purpose leasing entities	-	-	-	(32)	(9)	(23)
Issue of common shares	-	2	(2)	-	3	(3)
Financing fees	(1)	(7)	6	(2)	(22)	20
Net cash flows from (used in) financing activities	\$ 510	\$ (146)	\$ 656	\$ 835	\$ (2)	\$ 837
Short-term investments	(229)	(139)	(90)	(193)	(290)	97
Additions to property, equipment and intangible assets	(1,452)	(210)	(1,242)	(2,568)	(635)	(1,933)
Proceeds from sale of assets	150	9	141	294	10	284
Proceeds from sale-leaseback transactions	351	-	351	351	-	351
Other	(8)	19	(27)	(8)	16	(24)
Net cash flows used in investing activities	\$ (1,188)	\$ (321)	\$ (867)	\$ (2,124)	\$ (899)	\$ (1,225)
Effect of exchange rate changes on cash and cash equivalents	\$ (5)	\$ (3)	\$ (2)	\$ (26)	\$ (5)	\$ (21)
Increase (decrease) in cash and cash equivalents	\$ (26)	\$ 42	\$ (68)	\$ 310	\$ 416	\$ (106)

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

(Canadian dollars in millions)	Second Quarter			First Six Months		
	2016	2015	\$ Change	2016	2015	\$ Change
Net cash flows from operating activities	\$ 657	\$ 512	\$ 145	\$ 1,625	\$ 1,322	\$ 303
Additions to property, equipment and intangible assets, net of proceeds from sale-leaseback transactions	(1,101)	(210)	(891)	(2,217)	(635)	(1,582)
Free cash flow ⁽¹⁾	\$ (444)	\$ 302	\$ (746)	\$ (592)	\$ 687	\$ (1,279)

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

Net cash flows from operating activities and free cash flow

In the second quarter of 2016, net cash flows from operating activities of \$657 million reflected strong operating results which improved \$145 million when compared to the same quarter in 2015. This increase in net cash flows from operating activities was mainly due to the impact of higher cash inflows from working capital and the impact of lower pension funding payments. The higher cash inflows from working capital were mainly due to the impact of the growth in advance tickets sales. Negative free cash flow of \$444 million in the second quarter of 2016 represented a decrease of \$746 million from the free cash flow of \$302 million in the second quarter of 2015. This decrease was due to a higher level of capital expenditures year-over-year, partly offset by proceeds of \$351 million from the sale and leaseback of two Boeing 787 aircraft and by the impact of higher cash flows from operating activities.

In the first six months of 2016, net cash flows from operating activities of \$1,625 million improved \$303 million from the first six months of 2015, mainly due to the improvement in operating income and the impact of higher cash inflows from working capital. The higher cash inflows from working capital were mainly due to growth in advance ticket sales. Negative free cash flow of \$592 million deteriorated by \$1,279 million due to a higher level of capital expenditures year-over-year, partly offset by the proceeds from the sale and leaseback transaction discussed above and by the impact of higher cash flow from operating activities.

Net cash flows from financing activities

Proceeds from borrowings amounted to \$692 million in the second quarter of 2016 and \$1,308 million in the first six months of 2016. Reduction of long-term debt and finance lease obligations amounted to \$157 million in the second quarter of 2016 and \$381 million in the first six months of 2016. Refer to sections 6.1 "Financial Position" and 6.2 "Adjusted Net Debt" of this MD&A for additional information.

6.5. Capital Expenditures and Related Financing ArrangementsBoeing

As at June 30, 2016, Air Canada had outstanding purchase commitments with Boeing for 16 Boeing 787 aircraft and firm orders for 33 Boeing 737 MAX 8 and 28 737 MAX 9 aircraft with substitution rights between them as well as for the 737 MAX 7 aircraft. Additional information on Air Canada's purchase commitments and related financial arrangements is described in section 9.6 of Air Canada's 2015 MD&A.

Bombardier

In June 2016, Air Canada and Bombardier finalized a purchase agreement which includes a firm order for 45 Bombardier C Series CS300 aircraft and options for an additional 30 Bombardier CS300 aircraft. Deliveries are scheduled to begin in late 2019 and extend to 2022.

Capital Commitments

As outlined in the table below, the estimated aggregate cost of the future firm Boeing 787, Boeing 737 MAX and Bombardier CS300 aircraft deliveries and other capital purchase commitments as at June 30, 2016 approximates \$8,182 million.

(Canadian dollars in millions)	Remainder of 2016	2017	2018	2019	2020	Thereafter	Total
Projected committed expenditures	\$ 275	\$ 1,923	\$ 1,675	\$ 1,324	\$ 1,381	\$ 1,604	\$ 8,182
Projected planned but uncommitted expenditures	77	307	366	370	335	Not available	Not available
Projected planned but uncommitted capitalized maintenance ⁽¹⁾	85	149	117	110	113	Not available	Not available
Total projected expenditures ⁽²⁾	\$ 437	\$ 2,379	\$ 2,158	\$ 1,804	\$ 1,829	Not available	Not available

(1) Future capitalized maintenance amounts for 2020 and beyond are not yet determinable however an estimate of \$113 million has been made for 2020.

(2) U.S. dollar amounts are converted using the June 30, 2016 closing exchange rate of US\$1 = C\$1.2917. 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 June 30, 2016.

6.6. Pension Funding Obligations

As at January 1, 2016, the aggregate solvency surplus in Air Canada's domestic registered pension plans was \$1.3 billion. Based on the results of the actuarial valuations, as at January 1, 2016, all Canadian domestic registered pension plans are in a surplus position on both a solvency and going-concern basis. No contributions are required or permitted to any plan for past service. For current service, depending on the level of surplus on a going concern basis, a contribution in respect of each plan (but a small one) is either not permitted or is optional, depending on applicable pension rules. Air Canada does not intend to make current service cost payments for 2016 for all plans for which it is allowed to not do so. Taking this into account, on a cash basis, total pension funding contributions for 2016 are forecasted to be \$94 million versus total pension funding contributions of \$312 million in 2015.

As at June 30, 2016, taking into account the effect of financial instrument risk management tools, approximately 75% of Air Canada's pension liabilities were matched to fixed income products to mitigate a significant portion of the interest rate (discount rate) risk. Air Canada may continue to increase the percentage of fixed income products matched to pension liabilities, subject to favourable market conditions.

For additional information on Air Canada's pension funding obligations, refer to section 9.7 "Pension Funding Obligations" of Air Canada's 2015 MD&A.

6.7. Contractual Obligations

The table below provides Air Canada's contractual obligations as at June 30, 2016, 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.

(Canadian dollars in millions)	2016	2017	2018	2019	2020	Thereafter	Total
<i>Principal</i>							
Long-term debt obligations	\$ 212	\$ 646	\$ 629	\$ 1,674	\$ 882	\$ 2,726	\$ 6,769
Finance lease obligations	18	40	48	45	48	87	286
Total principal obligations	\$ 230	\$ 686	\$ 677	\$ 1,719	\$ 930	\$ 2,813	\$ 7,055
<i>Interest</i>							
Long-term debt obligations	\$ 162	\$ 319	\$ 274	\$ 242	\$ 134	\$ 322	\$ 1,453
Finance lease obligations	13	23	19	14	10	24	103
Total interest obligations	\$ 175	\$ 342	\$ 293	\$ 256	\$ 144	\$ 346	\$ 1,556
Total long-term debt and finance lease obligations	\$ 405	\$ 1,028	\$ 970	\$ 1,975	\$ 1,074	\$ 3,159	\$ 8,611
Operating lease obligations	\$ 277	\$ 510	\$ 459	\$ 381	\$ 278	\$ 673	\$ 2,578
Committed capital expenditures	\$ 275	\$ 1,923	\$ 1,675	\$ 1,324	\$ 1,381	\$ 1,604	\$ 8,182
Total contractual obligations ⁽¹⁾	\$ 957	\$ 3,461	\$ 3,104	\$ 3,680	\$ 2,733	\$ 5,436	\$ 19,371

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

6.8. Share Information

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

	June 30, 2016	December 31, 2015
Issued and outstanding shares		
Variable voting shares	92,688,271	98,059,765
Voting shares	183,474,598	184,722,413
Total issued and outstanding shares	276,162,869	282,782,178
Class A variable voting and Class B voting shares potentially issuable		
Stock options	9,954,887	8,735,634
Total shares potentially issuable	9,954,887	8,735,634
Total outstanding and potentially issuable shares	286,117,756	291,517,812

Issuer Bid

In May 2016, Air Canada approved a new normal course issuer bid for its Class A variable voting shares and Class B voting shares (collectively the "Shares"), authorizing, between May 30, 2016 and May 29, 2017, the purchase of up to 22,785,511 Shares, representing 10% of the public float of 227,855,112 Shares as at May 16, 2016. This renewal followed the conclusion of the 2015 normal course issuer bid which expired May 28, 2016 and under which Air Canada purchased and cancelled a total of 11,300,000 Shares, since May 29, 2015, for aggregate consideration of \$110 million.

In the second quarter of 2016, Air Canada purchased, for cancellation, 2,498,000 Shares at an average cost of \$9.51 per Share for aggregate consideration of \$24 million (6,914,065 Shares at an average cost of \$8.41 per Share for aggregate consideration of \$58 million for the six months ended June 30, 2016). At June 30, 2016, a total of 22,187,511 Shares remained available for repurchase under the existing issuer bid.

7. QUARTERLY FINANCIAL DATA

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

(Canadian dollars in millions, except where indicated)	2014		2015				2016	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Passenger	\$ 3,476	\$ 2,755	\$ 2,786	\$ 3,082	\$ 3,716	\$ 2,836	\$ 2,864	\$ 3,143
Cargo	128	133	129	123	119	135	116	111
Other	194	216	334	209	188	211	363	204
Operating revenues	3,798	3,104	3,249	3,414	4,023	3,182	3,343	3,458
Aircraft fuel	939	680	592	648	697	527	446	527
Regional airlines expense								
Aircraft fuel	137	111	86	97	95	81	64	77
Other	471	460	466	497	489	468	505	501
Wages, salaries & benefits	549	560	568	568	598	590	608	611
Airport and navigation fees	208	178	185	201	223	193	198	211
Aircraft maintenance	158	187	188	190	192	203	217	239
Depreciation, amortization and impairment ⁽²⁾	142	130	153	177	165	160	182	202
Sales and distribution costs	146	123	154	152	157	145	182	170
Ground package costs	56	74	181	84	63	87	231	85
Aircraft rent	74	76	82	84	89	98	112	112
Food, beverages and supplies	84	70	62	80	91	81	77	86
Communications and IT	49	51	57	52	52	50	67	59
Special items	-	30	-	(23)	-	31	-	-
Other	259	268	275	284	297	310	300	301
Operating expenses	3,272	2,998	3,049	3,091	3,208	3,024	3,189	3,181
Operating income	526	106	200	323	815	158	154	277
Foreign exchange gain (loss)	(71)	(115)	(408)	56	(251)	(159)	50	(17)
Interest income	11	10	9	12	12	13	10	13
Interest expense	(81)	(83)	(90)	(94)	(106)	(112)	(102)	(99)
Interest capitalized	6	9	9	21	20	20	23	15
Net financing expense relating to employee benefits	(34)	(32)	(25)	(25)	(28)	(27)	(18)	(17)
Gain (loss) on financial instruments recorded at fair value	(31)	9	1	5	(20)	(3)	(10)	(1)
Gain on sale and leaseback of assets	-	-	-	-	-	-	-	19
Other	(3)	(4)	(5)	(2)	(5)	(6)	(6)	(4)
Total non-operating expense	(203)	(206)	(509)	(27)	(378)	(274)	(53)	(91)
Income (loss) before income taxes	\$ 323	(100)	\$ (309)	\$ 296	\$ 437	\$ (116)	\$ 101	\$ 186
Income taxes	-	-	-	-	-	-	-	-
Net income (loss)	\$ 323	(100)	\$ (309)	\$ 296	\$ 437	\$ (116)	\$ 101	\$ 186
Diluted earnings (loss) per share	\$ 1.10	\$ (0.35)	\$ (1.08)	\$ 1.00	\$ 1.48	\$ (0.41)	\$ 0.35	\$ 0.66
EBITDAR ⁽¹⁾	\$ 749	\$ 319	\$ 442	\$ 591	\$ 1,076	\$ 425	\$ 460	\$ 605
Adjusted net income ⁽²⁾	\$ 457	\$ 67	\$ 122	\$ 250	\$ 734	\$ 116	\$ 85	\$ 203
Adjusted earnings per share - diluted ⁽²⁾	\$ 1.55	\$ 0.23	\$ 0.41	\$ 0.85	\$ 2.50	\$ 0.40	\$ 0.30	\$ 0.72

(1) EBITDAR (earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent) is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

(2) Adjusted net income (loss) and adjusted earnings (loss) per share – diluted are non-GAAP financial measures. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

The following tables provide major quarterly operating statistics for Air Canada for the last eight quarters.

System	2014		2015				2016	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Passenger PRASM (cents)	16.1	15.6	14.9	15.0	15.5	14.7	14.1	13.8
CASM (cents)	15.4	17.2	16.6	15.4	13.6	16.0	16.1	14.2
Adjusted CASM (cents) ⁽¹⁾	10.1	12.1	11.9	11.3	10.0	12.2	12.3	11.2
Economic fuel price per litre (cents) ⁽²⁾	90.0	80.7	66.3	66.9	61.4	58.6	48.1	52.2

(1) Adjusted CASM is a non-GAAP financial measure. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

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

The following table provide revenue passenger miles (RPMs), available seat miles (ASMs) and passenger load factors, on a system-basis and by market, for Air Canada for the last eight quarters.

System	2014		2015				2016	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
RPMs (millions)	18,565	14,090	14,937	16,845	20,462	15,301	16,092	18,418
ASMs (millions)	21,299	17,403	18,335	20,132	23,535	18,869	19,833	22,344
Passenger load factor (%)	87.2%	81.0%	81.5%	83.7%	86.9%	81.1%	81.1%	82.4%

Domestic

RPMs (millions)	5,417	4,191	3,805	4,525	5,606	4,291	3,960	4,717
ASMs (millions)	6,344	5,023	4,657	5,433	6,649	5,222	4,952	5,678
Passenger load factor (%)	85.4%	83.4%	81.7%	83.3%	84.3%	82.2%	80.0%	83.1%

U.S. transborder

RPMs (millions)	2,588	2,479	3,191	2,804	2,992	2,768	3,376	3,107
ASMs (millions)	3,074	3,122	3,883	3,384	3,539	3,493	4,278	3,799
Passenger load factor (%)	84.2%	79.4%	82.2%	82.9%	84.5%	79.2%	78.9%	81.8%

Atlantic

RPMs (millions)	6,028	3,256	2,938	4,864	6,792	3,719	3,401	5,394
ASMs (millions)	6,781	4,124	3,860	5,839	7,640	4,755	4,383	6,805
Passenger load factor (%)	88.9%	79.0%	76.1%	83.3%	88.9%	78.2%	77.6%	79.3%

Pacific

RPMs (millions)	3,460	2,967	3,026	3,432	3,877	3,202	3,218	3,902
ASMs (millions)	3,861	3,649	3,621	4,000	4,318	3,773	3,732	4,496
Passenger load factor (%)	89.6%	81.3%	83.6%	85.8%	89.8%	84.9%	86.2%	86.8%

Other

RPMs (millions)	1,072	1,197	1,977	1,220	1,195	1,322	2,137	1,298
ASMs (millions)	1,239	1,485	2,314	1,476	1,389	1,626	2,488	1,566
Passenger load factor (%)	86.5%	80.6%	85.4%	82.6%	86.0%	81.3%	85.8%	82.9%

8. FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Air Canada's financial instruments and risk management practices are summarized in section 12 of Air Canada's 2015 MD&A. There have been no material changes to Air Canada's financial instruments and risk management practices from those disclosed at that time. Additional information on Air Canada's risk management practices and financial instruments is discussed in Note 8 of Air Canada's second quarter 2016 interim unaudited condensed consolidated financial statements.

9. ACCOUNTING POLICIES AND CRITICAL ACCOUNTING ESTIMATES

Air Canada's accounting policies and critical accounting estimates are as disclosed in Air Canada's 2015 MD&A. There have been no material changes to Air Canada's accounting policies and critical accounting estimates from those disclosed at that time.

10. OFF-BALANCE SHEET ARRANGEMENTS

Information on Air Canada's off-balance sheet arrangements is disclosed in section 15 "Off-Balance Sheet Arrangements" of Air Canada's 2015 MD&A. There have been no material changes to Air Canada's off-balance sheet arrangements from those disclosed at that time.

11. RELATED PARTY TRANSACTIONS

At June 30, 2016, 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.

12. RISK FACTORS

For a detailed description of risk factors associated with Air Canada and its business, refer to section 17 "Risk Factors" of Air Canada's 2015 MD&A. Air Canada is not aware of any significant changes to its risk factors from those disclosed at that time.

13. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

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

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

In the Corporation's 2015 filings, the Corporation's CEO and CFO certified, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design and effectiveness of the Corporation's disclosure controls and procedures and the design and effectiveness of internal controls over financial reporting.

In the Corporation's second quarter 2016 filings, the Corporation's CEO and CFO certified, as required by National Instrument 52-109, the appropriateness of the financial disclosure, the design of the Corporation's disclosure controls and procedures and the design of internal controls over financial reporting.

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

Changes in Internal Controls over Financial Reporting

There have been no changes to the Corporation's internal controls over financial reporting during the quarter ended June 30, 2016 that have materially affected, or are reasonably likely to materially affect, its internal controls over financial reporting.

14. NON-GAAP FINANCIAL MEASURES

EBITDAR

EBITDAR (earnings before interest, taxes, depreciation, amortization and impairment, and aircraft rent) is a non-GAAP financial measure commonly used in the airline industry to view operating results before depreciation, amortization and impairment, and aircraft rent as these costs can vary significantly among airlines due to differences in the way airlines finance their aircraft and other assets. EBITDAR is not a recognized measure for financial statement presentation under GAAP, does not have a standardized meaning, and may not be comparable to similar measures presented by other public companies.

EBITDAR is reconciled to operating income as follows:

(Canadian dollars in millions)	Second Quarter			First Six Months		
	2016	2015	\$ Change	2016	2015	\$ Change
Operating income – GAAP	\$ 277	\$ 323	\$ (46)	\$ 431	\$ 523	\$ (92)
Add back (as reflected on Air Canada's consolidated statement of operations):						
Depreciation, amortization and impairment	202	177	25	384	330	54
Aircraft rent	112	84	28	224	166	58
Add back (included in Regional airlines expense):						
Depreciation, amortization and impairment	6	4	2	11	8	3
Aircraft rent	8	3	5	15	6	9
EBITDAR	\$ 605	\$ 591	\$ 14	\$ 1,065	\$ 1,033	\$ 32

Adjusted CASM

Air Canada uses adjusted CASM to assess the operating and cost performance of its ongoing airline business without the effects of aircraft fuel expense, the cost of ground packages at Air Canada Vacations and special 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.

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

Adjusted CASM is reconciled to GAAP operating expense as follows:

(Canadian dollars in millions, except where indicated)	Second Quarter			First Six Months		
	2016	2015	\$ Change	2016	2015	\$ Change
Operating expense – GAAP	\$ 3,181	\$ 3,091	\$ 90	\$ 6,370	\$ 6,140	\$ 230
Adjusted for:						
Aircraft fuel expense (as reflected on Air Canada's consolidated statement of operations)	(527)	(648)	121	(973)	(1,240)	267
Aircraft fuel expense (included in Regional airlines expense)	(77)	(97)	20	(141)	(183)	42
Special items	-	23	(23)	-	23	(23)
Impairment charges	-	(14)	14	-	(14)	14
Ground package costs at Air Canada Vacations	(85)	(84)	(1)	(316)	(265)	(51)
Operating expense, adjusted for the above-noted items	\$ 2,492	\$ 2,271	\$ 221	\$ 4,940	\$ 4,461	\$ 479
ASMs (millions)	22,344	20,132	11.0%	42,177	38,467	9.6%
Adjusted CASM (cents)	¢ 11.16	¢ 11.28	(1.1)%	¢ 11.71	¢ 11.60	1.0%

Adjusted Net Income and Adjusted Earnings per Share – Diluted

Air Canada uses adjusted net income and adjusted earnings per share – diluted to assess the overall financial performance of its business without the effects of foreign exchange, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value and special items as these items may distort the analysis of certain business trends and render comparative analysis to other airlines less meaningful. Air Canada also uses adjusted net income as a measure to determine its return on invested capital which is described below. These measures are not recognized measures for financial statement presentation under GAAP, do not have a standardized meaning and may not be comparable to similar measures presented by other public companies.

(Canadian dollars in millions, except per share values)	Second Quarter			First Six Months		
	2016	2015	\$ Change	2016	2015	\$ Change
Net income (loss) attributable to shareholders of Air Canada	\$ 186	\$ 295	\$ (109)	\$ 287	\$ (15)	\$ 302
Adjusted for:						
Special items	-	(23)	23	-	(23)	23
Impairment charges	-	14	(14)	-	14	(14)
Foreign exchange (gain) loss	17	(56)	73	(33)	352	(385)
Special interest charge related to the prepayment of debt associated with the disposal of Embraer 190 aircraft	1	-	1	7	-	7
Gain on sale and leaseback of assets	(19)	-	(19)	(19)	-	(19)
Net financing expense relating to employee benefits	17	25	(8)	35	50	(15)
Loss (gain) on financial instruments recorded at fair value	1	(5)	6	11	(6)	17
Adjusted net income	\$ 203	\$ 250	\$ (47)	\$ 288	\$ 372	\$ (84)
Weighted average number of outstanding shares used in computing diluted income per share (in millions)	283	295	(12)	284	295	(11)
Adjusted earnings per share – diluted	\$ 0.72	\$ 0.85	\$ (0.13)	\$ 1.01	\$ 1.26	\$ (0.25)

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

(in millions)	Second Quarter		First Six Months	
	2016	2015	2016	2015
Weighted average number of shares outstanding – basic	278	287	279	287
Effect of dilution	5	8	5	8
add back anti-dilutive impact	-	-	-	-
Weighted average number of shares outstanding – diluted	283	295	284	295

Return on Invested Capital

Air Canada uses return on invested capital ("ROIC") to assess the efficiency with which it allocates its capital to generate returns. Return is based on adjusted net income (loss), excluding interest expense and implicit interest on operating leases. Invested capital includes (i) average year-over-year total assets (excluding pension 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.

(Canadian dollars in millions, except where indicated)	12 Months Ended		
	June 30, 2016	June 30, 2015	\$ Change
Net income for the period attributable to shareholders of Air Canada	\$ 605	\$ 205	\$ 400
Remove:			
Special items ⁽¹⁾	31	7	24
Impairment charges ⁽²⁾	-	14	(14)
Foreign exchange loss	377	538	(161)
Special interest charge related to the prepayment of debt associated with the disposal of Embraer 190 aircraft	20	-	20
Gain on sale and leaseback of assets ⁽³⁾	(19)	-	(19)
Net financing expense relating to employee benefits	90	116	(26)
Loss (gain) on financial instruments recorded at fair value	34	16	18
Adjusted net income	\$ 1,138	\$ 896	\$ 242
Adjusted for:			
Interest expense ⁽⁴⁾	399	348	51
Implicit interest on operating leases ⁽⁵⁾	213	161	52
Adjusted income before interest	\$ 1,750	\$ 1,405	\$ 345
Invested capital:			
Working capital, excluding current portion of long-term debt and finance leases	264	329	(65)
Long-term assets, excluding pension assets	8,571	7,081	1,490
Maintenance provisions	(838)	(760)	(78)
Other operating long-term liabilities	(202)	(263)	61
Capitalized operating leases ⁽⁶⁾	3,038	2,296	742
Invested capital	\$ 10,833	\$ 8,683	\$ 2,150
Return on invested capital (%)	16.2%	16.2%	-

(1) Special items for the 12 months ended June 30, 2016 included one-time payments totaling \$62 million related to Air Canada's contract on collective agreement terms with CUPE and the IAMAW and a \$30 million recovery related to cargo investigations for a fine that was previously paid. Special items for the 12 months ended June 30, 2015 included one-time payments totaling \$30 million related to Air Canada's contract on collective agreement terms with ACPA and favourable tax-related provision adjustments of \$23 million.

(2) In the 12 months ended June 30, 2015, Air Canada recorded impairment charges of \$14 million related to the planned disposal of two Airbus A340-300 aircraft in the second half of 2015 (neither of which was operated by Air Canada).

(3) In the 12 months ended June 30, 2016, Air Canada recorded a gain of \$19 million on the sale and leaseback of two Boeing 787 aircraft.

(4) Interest expense excludes the special interest expense charge related to the disposal of Embraer 190 aircraft.

- (5) *Interest implicit on operating leases is equal to 7.0% of 7 times the trailing 12 months of aircraft rent. 7.0% is a proxy and does not necessarily represent the actual implicit interest on operating leases for any given period.*
- (6) *Capitalized operating leases are calculated by multiplying the trailing 12 months of aircraft rent by 7. Aircraft rent totaled \$434 million for the 12 months ended June 30, 2016 and \$328 million for the 12 months ended June 30, 2015 (includes aircraft rent related to regional operations).*

15. GLOSSARY

Adjusted CASM – Refers to operating expense per ASM adjusted to remove the effects of aircraft fuel expense, ground packages costs at Air Canada Vacations and special items. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

Adjusted net income (loss) – Refers to the consolidated net income (loss) of Air Canada attributable to the shareholders of Air Canada adjusted to remove the effects of (to the extent included in consolidated net income (loss)) foreign exchange gains or losses, net financing income (expense) relating to employee benefits, mark-to-market adjustments on derivatives and other financial instruments recorded at fair value and special items. Refer to section 14 "Non-GAAP Financial Measures" of this MD&A for additional information.

Air Georgian – Refers to Air Georgian Limited.

Atlantic passenger and cargo revenues – Refer to revenues from flights that cross the Atlantic Ocean with origins and destinations principally in Europe. Also refers to revenues from flights to and from India and the United Arab Emirates.

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.

Bombardier – Refers to Bombardier Inc.

CASM – Refers to operating expense per ASM.

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

EBITDAR – Refers to earnings before interest, taxes, depreciation, amortization, impairment and aircraft rent. EBITDAR is a non-GAAP financial measure. Refer to section 14 "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.

EVAS – Refers to Exploits Valley Air Services Ltd.

Jazz – Refers to Jazz Aviation LP.

Jazz CPA – Refers to the capacity purchase agreement between Air Canada and Jazz dated January 1, 2015 which became effective on January 1, 2015.

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 14 "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 number 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.

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

Sky Regional – Refers to Sky Regional Airlines Inc.

Special items – Refer to those items that, in management's view, are to be separately disclosed by virtue of their size or incidence to enable a fuller understanding of the Corporation's financial performance.

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).